THE BROOKINGS INSTITUTION

TIME TO '86 THE TAX CODE?
PROSPECTS FOR TAX REFORM AFTER 25 YEARS

Washington, D.C.
Wednesday, October 19, 2011

PARTICIPANTS:

Welcome and Introduction:

WILLIAM GALE
Senior Fellow and Co-Director, Urban-Brookings
Tax Policy Center
The Brookings Institution

PANEL I: WHAT HAVE WE LEARNED? LESSONS FROM THE TAX REFORM ACT OF 1986

Moderator:

DONALD MARRON
Co-Director, Urban-Brookings Tax Policy Center
The Urban Institute

Panelists:

BRUCE BARTLETT
Author, *The Benefit and the Burden*
Columnist, *The Fiscal Times*

JANE GRAVELLE
Senior Specialist, Economic Policy
Congressional Research Service

ADAM LOONEY
Senior Fellow and Policy Director
The Hamilton Project
The Brookings Institution

GENE STEUERLE
Institute Fellow and Richard B. Fisher Chair
The Urban Institute

PANEL II: WHAT ARE THE OPTIONS? PROSPECTS FOR TAX REFORM AND DEFICIT REDUCTION

Moderator:

ISABEL SAWHILL
Senior Fellow and Director, Budgeting for National Priorities
The Brookings Institution

Panelists:

WILLIAM GALE
Senior Fellow and Co-Director, Urban-Brookings
Tax Policy Center
The Brookings Institution

KEVIN HASSETT
Senior Fellow and Director of Economic Policy Studies
American Enterprise Institute

ADELE MORRIS
Fellow and Policy Director, Climate and Energy Economics
The Brookings Institution

ERIC TODER
Institute Fellow and Co-Director, Urban-Brookings Tax Policy Center
The Urban Institute

* * * * *

P R O C E E D I N G S

MR. GALE: I want to thank you all for coming out on a rainy afternoon to talk about a topic, tax reform, that we've been talking about for years. When economists say tax reform they don't mean tax cuts, they mean something quite different from tax cuts. Tax reform typically involves making sense of the tax system, making the various parts of the code fit together, making them, in essence, a real system, something integrated, something systematic.

One of the principles of tax reform is that, other things equaled, the best way to proceed is with a broad base and low rates. That's the structure that works best for equity, efficiency, simplicity, and revenue. A second feature of tax reform is the notion that activities or people that create burdens on society that are not captured in the marketplace should be taxed more heavily. In economic terms, we should tax externalities.

Everybody knows all of this and yet we never get a tax system like that. So, the question is, why talk about tax reform now? And I was going to say there are three reasons but I'm going to add a fourth. The fourth reason, which I'll give you first, is before the event started the speakers were sitting in one of the rooms talking about whether objects could travel at speeds faster than the speed of light, and certainly if physicists can figure out how to make things travel faster than the speed of light, we economists need to get our act together and figure out how to get the tax system reformed.

But there are three other reasons. First, this Saturday, October 22nd, marks the 25th anniversary of the Tax Reform Act of 1986, the last major reform that the U.S. implemented. The second reason is the Joint Select Committee on Deficit Reduction presents a unique opportunity for tax reform or other fiscal reform given the access to an up or down vote with no intervening points of order or amendments. And third, as you all know, we really, really, really need a better tax system.

So, today's event is dedicated to those ideas. We'll start, on the first panel, looking back at TRA '86 and what we've learned over the last 25 years. And then the second panel will look forward to what the Joint Select Committee can do or what Congress can do after the committee is done.

Before we start, though, let me just -- I realize that when I prepared the outline for the afternoon, I didn't ask anyone to actually say what happened in the Tax Reform Act of '86, so I'm going to take about 30 seconds and just remind you, given how long ago it was, what happened.

Basically, TRA was the quintessential broadening of the base, lowering the rates. The top individual rate came down from 50 to 28 percent, although there was a bubble at 33 percent. The top corporate rate came down from 46 to 34. There were a whole variety of deductions, allowances, et cetera, that were limited or eliminated. This was all done in a way that was roughly revenue-neutral and distributionally-neutral. Capital gains were taxed as ordinary income for the first time and the last time in a long time, but it was also greatly simplified tax rules.

About five million people were removed from the tax rolls through higher personal exemptions and other items, and I want to emphasize these were real people, because it's worth emphasizing that seven million imaginary people were also removed from the tax rolls by the requirement that people report the Social Security Number of people that they were claiming as a dependent.

So, this was kind of the biggest anti-dog, anti-cat tax bill in U.S. history.

There's a very nice symposium in this week's issue of *Tax Notes*, a lot of leading authors writing about it, and so I refer you to that for more information.

And then one last piece of housekeeping before we start, you have bios of the speakers and a number of papers are available outside. The moderators are not going to give big introductions for each speaker. Let me just say we have a very august group of speakers and I thank each of them for participating.

So, turning back to the current day, now the questions are: can lawmakers do tax reform again? Should they do it again? Can they go farther than '86 and build a system that's more structurally sound that pays for government spending, so on? So, those are the questions and after 25 years of waiting you will know the answer in about 2 hours. So, it's a good investment of your time.

So, what I was going to say was, without further ado, let me turn the mic over to the moderator of the first panel, but the moderator of the first panel turns out to be me because Bel Sawhill was going to do it, but she's feeling ill today and had to stay home, so let me move over here and then ask our speakers each to speak for five to seven minutes each on what we've learned in the last 25 minutes (sic). Gene, why don't you start?

MR. STEUERLE: Start, okay, sure.

Well, tax reform has an interesting history and I'm reminded of every time one does a postmortem on history there's this notion, you know, we can look back on history; we can go from cause to effect to secondary cause to secondary effect. We say, well, that's why it happened, and we form this linear view of why things happen, and I guess if there's any lesson from 1986 tax reform is in point in fact, it didn't have to happen, that there were a lot of things that happened and it wasn't just all luck.

And part of what I want to do is not attack what I believe to be a straw man. Sometimes the discussion of something, when you do these postmortems on what happened historically, people sometimes want to know, well, in this linear line A led to B, so is the question now we can repeat A and therefore we'll repeat B? And then you get several sources of criticism, which some of the authors here at the table have actually expressed before. One of them is, A, is it repeatable, and that's right, the second one is, well, B wasn't really all that great -- that's sort of the contrarian view, and that's probably right to some extent too, we can always exaggerate it.

And C is, B, is it the right target today? And all of that is right, but part of that comes from thinking that the belief in the straw man, that we're trying to learn how to repeat A so we can cause B, when, in fact, what I think the lessons are from tax reform have to do with how you can take certain things that happen then and some of the things that certain people did then and how you can use them for future reform, and that's where I want to concentration my comments.

I do have one of the articles in the *Tax Notes* magazine that Bill referred to and I actually refer you to this because there's a lot of interesting pieces in there from people like Bill Bradley or Bob McIntyre and some of my coauthors -- my co-panelists here as well.

So, in this article -- and I'm not going to go to the first part of my article -- I basically talk about trying to understand our current problems and I talk about government being in some what an adolescence in terms of trying to merge tax and transfer programs. I talk about how we've gone to this two Santas at the same time policy where both sides of the aisle basically want to give away the future, and I think that's part of our problem.

Some things that are more relevant that applied in the past as well as today is the misleading budget accounting of tax expenditures. An interesting thing a lot of people don't think about, which is the jurisdictional problem, in tax reform, for instance, we were stuck with doing tax reform. And that meant if we wanted to go after, say, a tax expenditure, like an education subsidy in the tax code, we had two choices: keep it, modify it in the -- or three -- keep it, modify it in the tax code, or get rid of it. We didn't have any choice of saying, merge it with Pell Grants, which is interesting compared to today because if you think about something like the Joint Committee on Deficit Reduction, whatever it's going to end up doing, it actually can cut across taxes and spending in ways that we couldn't do it.

So, what are my quick -- very quick lessons from '86 reform? And I'd say one also wants to look a little bit at '69 and '54 reform too, is one is, you can seize these opportunities, that there's something about -- I distinguish between luck and serendipity, perhaps inaccurately from Webster's point of view, but I think of serendipity as putting yourself in the right place so that you have increased the probability that good things happen. You don't make them happen, but you can increase those odds. And so what was the opportunity in '86? Well, one of the opportunities that actually almost no article here talks about is that there was this vast growth in tax shelters. I mean, it was permeating the tax system. The IRS was becoming to the point it could administer it, and it actually had, in my view, some very pernicious economic effects that were growing, and that it was related -- not unrelated, to the actual stagnation part of stagflation in the sense we had huge amounts of money going into tax shelters that weren't very productive investments.

So, that was an opportunity that was there at the time and something had to be done about it, so, something has to be done to channel those forces. I'd say today you have sort of the same thing, something has to be done about the budget, and so we want to think about channeling those forces in ways that we can maximize the option for serendipity.

A second lesson I have from '86 is that principles really do matter. You can have a reform that just sort of picks items off some laundry list, which is what we often do in budget and tax reform, or you can set up principles, and among the ones that I think always stand out and that really do drive the public, is equal justice. I think equal justice is a principle that very seldom conflicts with other principles. Sometimes progressivity conflicts with the notion of individual equity, we're entitled to get rewards from our own work. Equal justice, it seems to me, continues to apply forever, and it has a force in promoting reform.

A third lesson is to be comprehensive. If you're comprehensive, you've got a chance of putting good things out -- and that was part of our theory, Eric worked -- Eric's going to be on the next panel -- works with the Treasury. We sort of had this hopper theory list, put out enough good things, even if there's no reform -- we had no idea tax reform was going to get through, we put out enough good things into the hopper, good things might cost the same thing.

And also the political cost is the same. The headlines -- I said this to the Simpson-Bowles Committee when I testified, the headlines are going to be the same. The lobbyists are going to be out there no matter what you do. As soon as you're in a world of identifying losers, which, by the way, is a world we haven't been in in some time, that is, tax increases or spending cuts, or even making trade offs as you do in something like tax reform -- once you identify losers, the lobbyists are going to be just out there and the headlines are going to be just as big, so why not be comprehensive and solve something?

The other advantage about being comprehensive, and it's not just being comprehensive is, if you put forward a very good alternative plan, you can shift the burden of proof, as opposed to you having to bear the burden of proof of why you want to reform this and take something away from somebody, you set up an alternative that for most people, at least for a lot of people, appears better, and you shift the burden of proof to the people saying, no, I don't want that new law. I still deserve my tax break.

Fifth lesson is you can form liberal and conservative coalitions. Then it had to do with things like taxing the poor and taxing the family, which is a liberal-conservative compromise. Getting rid of tax shelter and lowering rates was a liberal-conservative compromise. Those are really important -- Bill Bradley mentions that as well in his *Tax Notes* article.

Sixth, presentation makes a huge difference. We worked a lot at Treasury for months on presentation. One example, at the time if you invested in tax shelters and you made $500,000 and you had $495,000 of partnership losses, you showed up with an AGI, Adjusted Gross Income of $5,000. In our distributional tables you looked like you were poor and if we increased taxes on you it would look like we increased taxes on the poor. That may sound minor to you, but I can tell you if we hadn't adjusted those distributional tables, there would have been no tax reform. And there are similar issues I could say today with respect to tax and budget reform as well.

So, presentation makes a huge amount of difference.

A seventh issue -- lesson, is we really did engage nonpartisan staffs, we really did have the Treasury staff and then later the Joint Committee on Taxation really doing a lot of work to make this happen. You know, I view that a lot of reform efforts these days often have the problem that we get these commissions or we get these -- whether they're members of Congress or even on the side, and they come up with this sort of whole list of items, but they sort of exclude the -- if you don't want to call us the architects or the engineers, call us the plumbers, at least make sure the building's going to stand. The decision makers should decide what kind of building they want, whether they want it to be mainly glass or mainly brick, or whatever, but they should allow the people who know how these systems work to pull it together.

Leadership. Leadership was very important, and that's not just the leadership of the staffs that we have, but also Reagan, Rostenkowski, who made an agreement not to criticize each other, Bill Bradley's early leadership, Baker and DeArmond later on. Leadership is really important.

Accountability, which is closely related to leadership, one of the things that happened in tax reform was that at every stage along the way, somebody was held accountable and there was a point at which -- there were three times that people said -- four times people said tax reform is going to fail and it started making people look bad. So, Ways and Means wasn't going to come up with something, Rostenkowski started getting bad headlines. All of the sudden he felt he had to do something because not putting forward a proposal looked worse than the fire he was going to get for putting forward one and of all the people to actually back tax reform, Senator Packwood, I mean, Senator Packwood was the advocate of tax deform for years and decades, but he started looking bad when he couldn't get it out of the commission.

And the last one which I think is very important is, if you want to achieve reform you, at some point -- at different stages, have to empower somebody to run with the ball. That's what I give Jim Baker credit for. There's a number of things that he and DeArmand did that I don't agree with when they went from Treasury 1 to Treasury 2, but they started forming coalitions, they started dividing the business community where they were going to get oppositions, they started making bargains -- whatever your plan is, it might not be the plan I'm going to come forward with, you've got to have somebody in charge of trying to make sure that that objective is reached, and when you have these sort of crazy commissions where no one is accountable, no one is in charge, no one really has to come up with a plan for moving something forward, you often don't succeed.

So, those are my ten lessons from Tax Reform '86.

MR. GALE: Thank you. Bruce?

MR. BARTLETT: First of all, I would associate myself with the remarks of the gentleman to my left and I just want to make two points. One is we shouldn't oversell the potential of tax reform to improve the economy. I think there's a widespread belief, especially on the Republican side, but also on the Democratic side, that we can really jumpstart growth and really get the economy out of its doldrums through the right kind of tax reform and I think that's very unlikely. First, I think the nature of our economy's problems are not really amenable to tax solutions right at this particular moment in time and I think the best that a good tax reform can do is increase the long-term trend rate of growth, which is not -- which is worth doing but is not going to get you a lot of headlines.

And, thirdly, the analyses that I have read of the Tax Reform Act of '86 show that it had a very modest impact on the macro economy and I relied very heavily on an article that appeared in the *Journal of Economic Literature* in, I believe, 1997 by Joel Slemrod and Alan Auerbach who went very carefully through all the literature and they found, well, maybe there's a little bit of an increase in labor supply by secondary workers. That was about it in terms of the supply side of the economy. Now, there were lots of behavioral, accounting, and financial effects. People moved up capital gains realizations and things of that sort and there's been, apparently, a permanent change in the nature of business organizations. The number of C Corporations peaked, I think, in '86 or '87 and has been declining pretty steadily ever since and you've had a huge increase in pass-through entities.

Now, that sort of thing is very important for the IRS and it may have some impact on, for example, the measured rate of inequality, but those are not real economic effects, they don't reduce the unemployment rate, they don't increase median family income, things of that sort, at least not in real terms. So, I think we need to be very modest or at least the professionals who deal with this stuff -- we can't control what the politicians do -- but I think we need to be, you know, circumspect in what we can anticipate.

And the second point I want to make is that I think the -- simply because almost everybody is in favor of tax reforms is an insufficient reason to think it's actually going to happen. I think the political preconditions for tax reform today are actually quite dismal despite the widespread view to the contrary. I think the '86 act, it's important to remember, was building upon at least 20 years of really serious talk about tax reform that culminated in tax reform acts in '69 and '76. There was a lot of activity in Congress -- the Bradley-Gephardt Bill, the Kemp-Kasten Bill, and the similarity between those two measures, I think, was very important in telling people that there was an opportunity here to, as Gene said, build sort of a left to right kind of alliance around certain things, and I don't see that at all today. And we didn't have the tax pledge back then, which I think is a very, very severe barrier to tax reform because, you know, unless Grover, you know, goes like this, you know, he decides what we're allowed to do and what we're not allowed to do, and the view back in the '80s was that it was, per se, a good idea to get rid of loopholes and tax shelters from the tax code, even if they weren't offset. Now you're not allowed to do that. That's an impermissible tax increase.

Also, the -- I think the one area where there's probably almost a consensus among economists is we ought to move towards a consumption-based tax system, but we're not allowed to do that because the only sensible way to do that is with some kind of value-added tax, which is impermissible because Grover Norquist won't allow it.

So, I think that the political situation -- oh, and one other thing too, is the grease that really made the '86 act work is that we closed tax preferences on the corporate side and used the revenue to cut taxes, rates for individuals. That was very, very popular. Today, given the nature of the tax and economic problems we're facing, we'd have to do the reverse. We'd have to close individual shelters in order to be able to reduce the corporate rate. Now, I don't see any political universe in which that's really doable politically, but if you ask anybody, you know, what is the number one tax reform we need to do, they usually say we need to cut the corporate rate. I don't know that that's necessarily correct, but that's what everybody says. But if you only close corporate tax preferences, you're not going to get enough money to do anything, so you have to take some money on the individual side.

And, finally, one other thing about the '86 act is you've got to be really careful about the interactions among different provisions of the code and some mistakes got made. One, in particular, is that we thought we were going to do something to increase saving by getting rid of the deduction for consumer interest. Well, everybody forgot about the mortgage interest loophole and so everybody just got home equity loans and it just shifted the money over and there was absolutely no change. Again, it gets back to the idea that the principle effects of the '86 act were behavioral and not macro economic.

I'll stop.

MR. GALE: Thank you. Jane?

MS. GRAVELLE: Well, I actually am in agreement with both of the gentlemen that have gone before me in a lot of ways particularly, I think, with Bruce not to overstate the potential gains from tax reform. I just did an estimate using my international model of what would happen to the U.S. economy if we cut the corporate tax rate by 10 percentage points doing nothing else to look at the international capital flows and I got that U.S. output would increase on a one-time basis by 0.2 of GDP and that U.S. income -- because most of that money belongs to foreigners already belongs to us -- would only increase by 0.02 of a percent. Shouldn't be surprising since the corporate tax is only 2 percent of GDP, but I think there's a lot of exaggeration of what we might gain from some of these tax reform things.

But to go back -- that wasn't in my original thoughts, you just stimulated them -- to go back to the Tax Reform Act of 1986, I think there's a real difference between what happened with the corporate tax -- or business taxes and what happened with individual taxes. I mean, the corporate tax reform in 1986 was a clear and lasting success, it dramatically changed a lot of differential taxations of different kinds of investments and different kinds of assets, and that has stuck until today. It's been a little eroded by the fact that we've got lower inflation and we didn't index, and a little bit by a higher depreciable life for structures enacted in 1993, but that's pretty much there.

The upshot of that is there's not a lot of room left to fix the corporate tax. I mean, there's not very far we need to go and I found that if you repealed every corporate tax expenditure, every one, including things like the Low Income Housing Credit and tax exempt bond interest, you could only get the corporate rate down to a little below 30 percent, so there's just not very much room for a deep cut in the corporate rate without losing revenue.

So, the news for the corporate tax in 1986 was good, but it makes kind of bad news for doing anything now and, I think, we need to think about what we can really do in that arena.

The individual tax changes, I think, were much less successful. There were many major provisions that were hardly touched, you know, that included fringe benefits, a mortgage interest deduction, state and local taxes outside of sales taxes, chartable contributions, and as Bruce just said, even though we disallowed consumer interest deductions, we allowed home equity loans. How much progress we could make with those now, I'm just not sure.

There are also many base broadeners that were rolled back eventually: the capital gains differential, the IRAs were restored for most individuals, there's a sales tax option went much more limited, and there are new provisions, you know, like the Tuition Tax Credit, that have appeared in the meantime, so it's hard to see the individual success -- individuals being a great success. I agree with Gene, I think, the tax shelters were a big sea change in that act. There are obviously important things that happened, getting people in poverty off the tax rolls and things like that, and of course, for unincorporated business income there were the same kind of changes as for the corporate tax.

So, maybe you just can't do that kind of individual reform because it just steps on too many toes. You should have -- I mean, you probably observed the screaming and gnashing of teeth that happened when we proposed putting a 28 percent limit on itemized deductions, you know, that charities would fall apart and the housing industry would fall apart and whatever.

I think the second thing is that process is important. I mean, TRA started with a long sustained action by experts in the Treasury Department then followed on by the Joint Tax Committee. There was a lot of spade work that happened before that and up to now we've just kind of talked generally about tax expenditures without a lot of close specifics, in many cases, and I think you're going to need a lot of time and a lot of input from technicians and staff to do a good job with tax reform, so I don't think you're talking about having a successful TRA reform -- kind of tax reform by December. (Laughter.)

So, the other thing is, I think, one of the lessons of '86 was don't just look at tax expenditures. I mean, a lot of the discussion right now is about tax expenditures. Many provisions in the Tax Reform Act of 1986 were not tax expenditures. Among them were inventory capitalization rules, tax shelter provisions, minimum tax, moving expenses, entertainment expenditures, the foreign tax credit provisions, none of those were in tax expenditures at that time.

The other thing is the considered provisions were proposed in Treasury 1 but not enacted. I mean, I don't know whether they weren't enacted because they're hopeless or whether they're still, you know, sort of medium hanging fruit, but they're certainly fringe -- they propose to cut back on health fringe benefits and eliminate cafeteria plans, disallow state and local income and property tax deductions, put a floor on charitable contributions, limit charitable contributions or appreciated property. For corporations and business there's a lot of inflation indexing including indexing of debt that was proposed. There was also a per country foreign tax credit limit which has actually been proposed in the Wyden-Gregg and the Wyden-Coats bill. And the final -- wait, is that my final? -- I've got one more point.

Also to consider provisions that were rolled back like capital gains, the dividend relief, a lot of people saying maybe we should increase those taxes and use the revenue to cut the corporate rate or use the revenue to reduce the deficit, there's always that possibility out there, to restrict IRAs, again, to low income people and to people not covered by employer pension plans, get rid of the optional sales tax deduction, which is an extender.

Finally, as a warning, if you look back at TRA it raised 120 billion from the corporate sector and lost 120 billion from individuals over five years. I estimated, in an article I did not long after that, that over half of that corporate revenue was transitory, you know, it was going to disappear after a few years from things like inventories and just short-term provisions, and another 43 billion of the individual was transitory. We face the same kind of risk particularly with the corporate tax right now. If we use depreciation revenues in the first 10 years to do a revenue neutral corporate rate exchange, we will lose money in the long-run, so I think we really need to pay attention to those things that have timing effects that are going to fade out after time.

MR. GALE: Great, thank you. Adam?

MR. LOONEY: Well, I think I'm -- after listening to my fellow panelists I feel like I'm in the most danger of being the disagreeable one and the reason is that what I wanted to start off talking about in terms of what we've learned since the Tax Reform Act of 1986 that has important implications for how we think about our tax system and how we think about tax reform, is actually the performance of our economy since then.

Since at least the mid 1980s and probably earlier, the U.S. economy has simply not delivered for a large segment of the American workforce. There's been a slowdown on productivity growth that started a decade before that translated into poor wage growth and it contributed to a contraction in job opportunities for many American workers over the same period and since 1986 we've discovered that there has been widening income inequality and so that the gains in income that we have experienced have accumulated to a relatively narrow segment of the society.

And so the consequent of stagnant wages, contracting job opportunities, rising inequality, means that there's actually been a decline in living standards for a non-trivial segment of society. And just to give you one example of that, if you look at the combination of stagnant wages for male workers and the fact that one in five men no longer work, the earnings of the median prime aged male have declined by 28 percent in real terms over the last 40 years. And so I think that that's a key policy question in general that we need to confront, and I'm not suggesting that tax reform is a silver bullet.

In fact, I don't think there is any silver bullet and I think that it will require changes on many fronts, but I do think that the lessons that we've learned over the last 25 years do have implications for how we should think about the tax system and so I wanted to give three examples where economic history has lessons for how we think about both the Tax Reform Act of '86 and also tax reform going forward.

And the first thing to say is just that over the last 30 years we've experienced a tremendous rise in income inequality and at the same time many features of the tax system have become less progressive, and so what that means is that instead of being a countervailing force to differences between the very wealthy and everybody else, the tax system has, in fact, piled on and exacerbated the differences in take-home pay. And so I think what that means is that distributional considerations, which are always important in tax reform, are going to be particularly important going forward.

My second point is just beyond distributional issues, improving compensation and living standards for workers in the aggregate requires increasing labor productivity and labor productivity is, in part, a function of investments in things like factories, machines, software and equipment. And, again, I don't think this is a silver bullet, but I do think that changes in the tax system, particularly in the corporate tax system, that encouraged business investment, can help increase living standards over a period of time and I think that that's -- that should be an important consideration when we're doing tax reform. And so when I look out at current discussions of corporate tax reform, they seem highly focused on the fact that we have the world's highest or second highest corporate rate. And I like to point out that this year, at least, we probably have the lowest rate or among the lowest rate in the world on new investment, and that's because we have the expense in the investment. If a company builds a new factory, invests in equipment or machines, it's able to take a deduction against its taxable income, which is kind of like your 401(k) where you take a tax deduction today and that offsets your future tax liability down the road.

And then, of course, on top of this corporations can deduct the interest on their debt use to finance that, so they actually have a net subsidy. And I actually think that that kind of a low tax rate on new investment is exactly what we should want if our goal is to promote investment, and I think in maintaining that low rate on new investment or maintaining a low rate on new investment, should be a priority over and above our efforts to lower the top line corporate rate.

And so, finally, addressing these long-term economic trends is, again, not just going to be about our corporate tax system, but also requires a variety of other programs -- public investments in human capital or continued financing for important safety net programs -- and that means that we're going to need tax revenues and if you look at our tax system, our current tax system doesn't raise enough revenue to pay for Social Security, Medicare, Medicaid, Defense, and net interest, let alone everything else that the government finances.

And so I think that, you know, that's another motivation for why we need a tax reform is to ensure that we have the revenues we need to finance our government and address our deficit problems over the long-run. I'll stop there.

MS. GRAVELLE: Bill, could I just say something that I forgot to say. That my views are not the views of the Congressional Research Service.

MR. GALE: Excellent. Thank you.

MS. GRAVELLE: They're my views, but not the Congressional Research Service.

MR. BARTLETT: My views are not Jane's views all the time, but a lot of the time they are.

MS. GRAVELL: Sometimes Jane's views, sometimes Bruce's views.

MR. GALE: All right. Very good. So, I appreciate everyone's conciseness given how much there is to say about tax reform generally. I want to ask two questions to sort of start our conversation and then we'll open it up to questions from the floor.

The first question has to do with the jurisdictional issue that Gene mentioned, but it's for everyone. In '86 we basically, as I understand it -- I was in grad school in California, I just know what I read in the history books -- but basically tax reform was discussed independent of either entitlement reform or spending reform. Now, with the Joint Select Committee, with the budget outlook hanging over our heads, most of the talk about tax reform is in the context of a grand bargain that involves something like Social Security and Medicare on one side, taxes on the other.

There's an argument that that -- there's an obvious argument that that makes it harder to bring about tax reform because then you've got to deal with Social Security and Medicare too, but on the other hand, as you were saying, Gene, the more comprehensive the proposal, the more, you know, in some sense it's easier to get it through because, yes, everyone's going to have a beef, but there are so many moving parts and so much overall to be gained that you can sort of squash targeted opposition.

But my sense is -- my question is, do you -- given that difference in the political atmosphere now versus '86, does that make tax reform harder or easier? Or does it somehow constrain the form that tax reform might take now in 2011, 2012? Any of you.

SPEAKER: Well, as a general point, I think it's one of the great disappointments of the whole tax expenditures effort that started in the '60s, was the original idea was if we knew -- that you could trade off, you know, you could make a rational decision as to whether to do something on the tax side or the spending side. And it turned out, that never, ever happened because of the jurisdictional problem. And I think the main barrier to -- that has been created by this rigid differentiation between the tax side and the spending side is in terms of distribution. I don't remember, maybe it was Gene who said you can't do something, like for example, get rid of the child credit and replace it with some sort of grant from the Department of HHS to families with children. You can't do that because it would look like you were increasing taxes on the poor and you would never see the increased spending that would go to the same identical people.

So, you're very limited in what you're allowed to do, and I think it mainly impacts on the distributional tables because, like it or not, we're always constrained by the necessity of not changing too much the current distribution of taxation. So, if you cut taxes for the rich, you've got to find some way to cut taxes for people that don't pay any taxes, which means you have to have refundable credits and I think that's still a very, very serious barrier to tax reform.

I don't know if that answers your question.

MS. GRAVELLE: I don't think this circumstance of doing a grand plan makes it any easier, actually. I think it makes it harder and I think it's exactly because until we can get to the point where we can see tuition benefits done though the spending system as a true substitute for tuition tax credits, and I just don't see that view being taken. All of the talk is, how big are taxes, how big are the entitlement programs, and I think to really look at them together you'd have to cross that divide, and I just -- I don't see that changing.

MR. STEUERLE: Bill, I think you're right in the way you framed the question. The way I would put it is, is that I think that we're going through a major restructuring period of time. Now, we're actually not doing the restructuring, but I think we're in to a very different fiscal era than we were from -- I basically say from about '97 to 2010, 2011, when most major enactments were on the -- I'm going to call it the give away side of the budget, tax cuts and spending increases. We had a similar period, by the way, from '46 to '81, which I won't go through, and then we had this '82 to '97 period where most of the major enactments were deficit reduction agreements or tax cuts or broad wholesale reform, Social Security, welfare, the tax system.

I think we're into a new fiscal era and I think it's going to take us years to get through there, so I don't view going through that era as just going to be one piece at a time. But I think to get through it we're going to have to cope with this type of jurisdictional issue.

Another way I have of putting it, thinking of the long history of taxation, in the broad history of taxation in this country, even beyond, most of the time taxation was there to collect revenues mainly to provide public goods -- defense and highways and justice -- and it really wasn't involved in transfers, but it wasn't because so much the tax system wasn't making transfers, it's because government wasn't making transfers. The whole idea of transferring money to redistribute income, redistribute healthcare, all these types of things, is relatively new in this history of the world. And so you have these structures, these ways and means committees that we inherit from, say, a parliamentary system, we sort of adopt and it's supposed to raise the revenues to provide these public goods. Now, all of the sudden it's raising revenues to provide transfers and all of the sudden people discover, well, you know, we could do the transfers in the tax system. You know, to us economists transfer is a negative tax and a tax is a negative transfer.

But the other one that a lot of people forget about that I worry almost just as much about but isn't even on the radar screen for a lot of people are what I call expenditure taxes, which are all these phase outs of expenditure programs, which creates these huge tax rates. So, we don't really have right now a structure that allows us to think insistently about how we combine these together and think about them together. And, in fact, we don't even present distribution.

You know, I actually suggested this on the side to some staff people involved with the new commission, the new Congressional committee, I said, you know, you ought to be thinking about what type of distributional table you want to present because if you're doing spending and taxes, you shouldn't be reporting the distributional tables separately, you should be reporting them together. Like, how do you want to distribute the net burden increase that you're going to impose on spending and taxes? Maybe you should suggest, as a compromise, have it be the same percentage AGI for everyone.

But the way we do tax tables doesn't work, the way we do spending -- we don't even measure distribution, by the way, progressivity, the same on spending taxes. So, we've got all these issues, I think, we really have to sort through. And in some ways, at least for the people in this audience, many of whom are people who struggle with this issue, I think in some ways it's an exciting time for us is to think structurally about how we can actually work through this.

MR. GALE: Excellent.

MR. LOONEY: I would say that there are some examples where it has come together and maybe welfare reform is not a perfect example, but that was an era where there were bargains struck between taxes, like the EITC, and transfer programs, like welfare, where they were maybe not paired exactly temporally, but they were offsetting benefits. And I would say also that things like the Greenspan Commission on Social Security -- you know, Social Security, obviously, is a whole program in the sense that the payroll tax and the benefits are closely tied. And so that came as a package and I guess it can be evaluated as such.

And so, in general, I imagine that this raises barriers, but I am hopeful that there some opportunities to make some of these bargains.

MR. GALE: Great. Thank you. Then the other question I have has to do with sort of the tone and tenor of the '86 debate relative to now. We have this kind of gauzy image of like Reagan putting out his ideas but he and Rostenkowski and Packwood kind of sitting down and Kemp and Bradley working out their differences. And I wonder if that has kind of a "history is written by the winners" kind of feel to it. And, you know, now we have the real hardball tactics and the ugly statements and the -- you know, you all know about the current tenor and debate, but I really wonder, like, for those of you who were involved in this, was the tenor of the debate then any less strident or oppositional or nasty than it is now? Or is it simply that it was the same nasty debate, but they kind of understood that they needed to compromise and we're not sure whether our current political leaders understand whether they need to compromise?

MR. BARTLETT: It's never been worse than now.

MR. STEUERLE: I think I would say it was very nasty then. I mean, we had a huge -- talk about getting Treasury part out of Treasury -- we had huge internal fights. Bruce may remember this because some -- although I would not put him in this camp, but some of the more extreme supply siders who came in were very strong on how we had to keep these negative tax rates on capital, which, by the way, I would refer to what you're dealing with Adam, too, in terms -- speaking between you and Jane talking about arbitrage opportunities and you wanted to favor investment. When you can borrow with expensing or you borrow with investment tax credit, you create these huge negative tax rates, and we really worried about that, but at the time there were some people in

Treasury who really wanted to fight this, other people said, you can't contradict what Reagan said in 1981. Actually, a great thing about Ronald Reagan, quite honestly, was he was willing to contradict himself. You may think that's bad but relative to these presidents who think they have to keep every campaign promise they make in a campaign, it's actually a good thing.

MR. BARTLETT: Wasn't it Keynes that said, "When the facts change, I change my mind. What do you do?"

MR. STEUERLE: So, I'll quickly summarize here. I think the one thing we did have in '86 -- in the mid '80s that not only guided '86 tax reform but '82 and '84 budget agreements, is we did have certain leadership and it was often on the Republican side, Dominicci, Dole, Baker in the Senate, who led a reform effort there, were able to combine with people like Rostenkowski, so we did have certain groups of leaders including this Rosti-Reagan deal to not criticize each other. We did have certain leaders who at certain points said, let's come together and make it happen. That's what, so far, we haven't seen today.

MS. GRAVELLE: Well, I do recall that there was not this certainty that we were going to succeed with this. I mean, there were points all along the way with tax reform. First of all, you know, a lot of Treasury 1 was gutted with Treasury 2 or with the White House version of it, and then it was affected again as it went through Congress.

Remember the collapse in the Ways and Means Committee when, you know, everybody thought it was all over with? So, I think at the time, you know, there was a great deal of uncertainty as to whether, you know, we would actually, you know, come out with or if this all kind of fall of its own weight. I don't know if you remember it like that, Gene, but that's how kind of I remember it.

I agree that --

MR. STEUERLE: There were books out called *Tax Reform: The Impossible Dream.*

MS. GRAVELLE: Yeah, yeah. I just don't think -- I think looking back we did it, but I think at the time nobody was really sure. And I think it was quite a shock when Packwood sort of rescued things from the dying embers, but I do think that -- I guess I have to agree a little bit with Bruce that, you know, there's a lot of confrontation -- more confrontation, I guess, I see now than was true in 1986.

MR. BARTLETT: If I could just follow up on one point. When I talked about the paucity of real economic effects, I meant on the negative side as well, and Gene is right, there were people like Norman Torrey who thought the world was coming to an end when tax reform was enacted, and even guys like Larry Summers were very pessimistic about the -- they thought it was going to devastate investment, it didn't really have much of an effect.

Now, one possibility is that everybody was right and all the effects just simply canceled out, the positive effects and the negative effects, so it just looked like nothing was happening, but actually a lot was happening. That's one possibility.

MS. GRAVELLE: Well, the real estate people were sure we'd never construct another building. I remember that.

MR. GALE: They turned out to be right.

All right, let's turn to questions and please let us know who you are and please be sure you have a question.

MS. HIRSCH: My name is Michelle Hirsch. I'm a reporter for *The Fiscal Times.* I just -- you know, I was talking to some folks in the lobbying community and, you know, some of them have said that part of the argument is that back in 1986 the rates slowly came back up after the tax code was flattened, so, you know, how -- you know, a future congress can't be bound. So, then, in this day and age, you know, what argument can there be for tax reform when those concerns still exist? You know, is that a barrier?

MR. STEUERLE: (inaudible) and can partly answer your question is, to me, you've got these hundreds, or if you want to, thousands of pros on the tax code, you've got thousands of pros on the expenditure code. A lot of them are broken, and sort of like to prove you have a fix that makes them work perfectly and then all of the sudden you can prove GDP grew by 2 percent more a year is a total fiction.

So, you can fix up a lot of programs, not just in the tax system -- the welfare system, Social Security, everything else -- and you're not going to be able to prove that it has this huge impact on GPD and you're not going to be able to retain -- it's like Congress isn't going to sit there and say, you know, no member of Congress says, boy, you know, those guys last time, they really got it right. I can go home now. We don't have to change -- I mean, a half of government or more is in the tax code. Count the revenue side and a third of the spending side, or a fourth -- so, of course it's not going to stay stagnant.

So, what you try to do is keep enforcing -- I view sort of reform as trying to set the right boundaries around the actions that people can do, and then you allow the electorate and the officials to start it within those boundaries, within those guidelines, within those, if you want to, barriers, to then move forward according to what they think is good for the country, where there's conflict, or what the public wants to vote for.

And, so, I mean, the tax reform, I mean, the reason I disagree partly with this economic assessment as well is, so, Tom Nubick did this analysis, I think it was with David Joelfane, and basically concluded we reduced about $200 billion of tax expenditures. A lot of that was through the rate reduction.

Well, suppose we got $200 billion of tax expenditures to go from 0 -- so, now we had a 0 percent rate of return on that money and now it gets a 5 percent return. Well, that's $40 billion. That was about 1 percent of GDP. Then you couldn't prove that tax reform increased GDP or didn't increase GDP by 1 percent, and certainly the biggest effects are always on the portfolio side, I agree with that because those are the things people can change immediately.

MR. GALE: Michelle's question has to do with the permanence of any tax deal and people being reluctant to sign up because they think that the thing that they get is going to be temporary and the thing they give up they're going to give up permanently.

MR. STEUERLE: So, there's these battles between tax reform and deform, and I'm just going to say, it keeps going and you've got to keep fighting the battle.

MR. GALE: Bruce?

MR. BARTLETT: Yeah, I don't know, the analogy I always use is, just because weeds grow back is not a reason to not weed your garden, you know? (Laughter) But, yeah, that's a very serious problem. It's the Lucy and the football problem, you know, a lot of people -- I mean, one of the things that's most disappointing about the subsequent tax legislation is that as early as 1990 the key deal was, you lower the top rate and you get rid of special treatment of capital gains, and as early as 1990 that deal was broken; they raised the top rate and they kept capital gains at 28. If they had raised capital gains to 31, you would have at least had half the deal, but basically the liberals and the conservatives both lost and they both feel like if we give up something that's really important to us, there's no guaranty that it'll keep, and I don't know what you do about that.

Didn't Cain have some idea that he would have, in his 9-9-9 plan, a part of the law was that the future congresses couldn't change it? They can always do that, you know? (Laughter)

MS. GRAVELLE: That didn't work with repatriation holidays.

SPEAKER: No, I see, there are good arguments and bad arguments in the tax reform. I think that one is actually a bait and switch because I don't think the lobbyists would be in favor of giving up their particular cherished deduction even if they knew the lower rate was going to stay, I think they're just using -- for lobbyists to be using that argument, you know, for one of the big sectors, whether it's health or housing or medical, you know, whatever, they're just marshalling any argument they can find. Ask them back, well, if you knew the rate would stay lower, would you be willing to give up their deduction? And I bet the answer is no.

MR. BARTLETT: Oh, yeah.

MS. GRAVELLE: I'd also like to point out that we haven't lost all of the ground that we gained. I mean, the corporate tax rate is not 48 percent now, it's 35 percent. The top -- we had tax rates up to 50 percent and they're now --

SPEAKER: Fifty-one.

MS. GRAVELLE: Fifty-one? Okay. I'll accept it. But we had, you know, now the tax rates are 39.6 percent, and I think that's probably a smaller slice of the population. My guess is that the average marginal tax rates that most people -- statutory rates that people place, you know, are down and we did lose some of the base broadening, that's true. But remember when we started off with this we really had a 31 percent rate, you know, kind of hidden in the bubble. So, we've gone from 31, at the moment we're at 35. I mean, you know, that's a big difference from 50, so -- but I guess I kind of agree with Bruce, to some extent. I mean, what should you do, just totally give up trying to improve things because you think somebody will be bad in the future? You know, I don’t think you can make policy that way.

MR. BARTLETT: One other thing is, I think in the ‘80s, people were more concerned about the administrability of the tax code and they were actually concerned about the IRS’s ability to collect revenue and to appropriately deal with different taxpayers, and now I don’t think people really care. They don’t seem to -- they certainly don’t act as if they care. I mean, they’re always cutting the IRS’s budget. They’re the bad guy for everything. Nobody really seems to be willing to say, yeah, we really ought to have a tax code that people can comprehend and that the IRS can administer. I don’t know if that affects your point.

MR. GALE: Yes.

DR. POPLIN: Hi. I’m Dr. Caroline Poplin. My late husband, Marty Slate, was a tax lawyer. He was with the IRS in 1986. My question is a follow up on what the last gentleman said. Economists always talk about distributional effect and I think you’ve all said that the tax code doesn’t have that much of a fiscal effect, but it seems to me in this situation where we are now, where in fact real household income is reduced after wives went to work and people borrowed on their houses, that if on top of that you imposed further taxes on the other 99 percent, the people in the streets and/or a VAT that would -- we have a problem with aggregate demand and we don’t know that it’s just going to go away by itself, and if you broaden the base to include poor people or you imposed a VAT, that would make the situation worse.

MR. GALE: Thank you.

MS. GRAVELLE: Well, there’s a short-run problem and a long-run problem and I think almost everybody would agree that we have to be very cautious in the short-run about raising -- at least I agree with the chairman of the Fed, you know, we have to be very careful about raising -- doing things that reduce aggregate demand in the short-run. But, nevertheless, we have these long-run stresses on the budget and to me, at least, it's very hard to see how you're going to deal with those long-run costs in Social Security and Medicare without every side of the budget pitching in, which would mean, I think, some kind of higher taxes, some kind of cuts, and, I mean, I just don't see another way to do that. We don't have enough room in discretionary spending to take care of that by far.

So, I think it's very hard to envision fixing our future deficit problems in the long-run. So, it's long-run versus short-run to me.

MR. GALE: Thank you. Let's take another question. There's one.

MR. LAWSON: Mike Lawson, ICMA, International City/County Management Association. My question concerns the role of state tax reform, both before and after '86. There was a lot of activity in state tax reform during that period. What impact, if any, do you think those reform efforts may have had on the '86 reform or effects of the '86 reform on state tax reform efforts after that time?

MR. BARTLETT: Well, federal tax reform affected the states enormously. I don't know that there was much effect in the other direction, but most states follow the federal tax base. So, if you broaden the federal tax base, you're going to probably broaden the state tax bases as well, which gave them, many states, a bonus of revenue that they could then use to make some adjustments in their own tax systems, but certainly the impact -- especially if we do something like the state and local -- the deduction for state and local taxes, obviously would have enormous effect on the states, but I'm not aware of any tax reform efforts at the state level that people are talking about imitating at the federal level.

MS. GRAVELLE: I think the research on the sales tax showed that there wasn't much of an effect on the state and local sources of revenue from disallowing the sales tax deduction, as I recall. I think that's what the research is.

The states were enthusiastically indulging in private activity bonds, which certainly led to a lot of the concern about cutting back and constraining those because if we'd just let those go, you know, the whole world would have been private activity bond financed by now. So, there are some interactions, I think, like that.

MR. STEUERLE: I think Jane's comment also goes into one other thing that I think about where a lot of times you've got things really falling apart and sometimes reform is basically just stopping those things from falling apart, whether it's private activity bonds or individual tax shelters, a lot of other things. So, maybe it doesn't change the world so much for the better, but it stops it from getting a lot worse.

MR. GALE: All right. Great. Please join me in thanking our panelists for this session and let's make a quick segue to the -- we'll make essentially an immediate segue to the second panel. You guys can come up.

MR. STEUERLE: I will be the moderator. And before I allocate time to our panelists I'm just going to ask them what they think of the last panelists and how well they did. No, no, not actually.

(Laughter)

MR. STEUERLE: So we're going to take a slightly different order.

SPEAKER: You were the best, Gene.

MR. STEUERLE: We're going to take a slightly different order. Eric, I'm going to let you actually start because we're going to go from individual tax to consumption tax to energy tax to that -- at least covering that. Right?

MR. TODER: Right.

MR. STEUERLE: And consumption taxes. So Eric, I'm going to let you start. Their biographies are in your portfolio so I'm just going to invite you to look at them for outstanding scholars. We'll go from Eric to Kevin to Adele to Bill. So Eric, do you want to start?

MR. TODER: Okay. It's a little hard to say much that wasn't said in the last panel but I'll try.

Just a couple of comments. Today's situation is much different than '86. There was a deficit problem then as well but today it's much more serious and much more immediate. And the large gap between long-term spending and revenue suggests we need more revenue, but despite that, there's no political consensus on whether revenue should be raised or not. But I'm just teeing that up to say that I think based -- revenue-neutral tax reform, as was done in 1986, is probably a lot of pain for not solving our most important problem. So we really need to think about raising more revenue and that's harder.

That being said, of course, there's also a lot of belief that our current tax system is not up to the task, which leads us to think about having a different way of raising revenue than we have in the past. Another thing different in 1986, people then understood tax reform to mean broadening the base to pay for lower rates. Today people don't agree on what constitutes tax reform. Some people think it means simplifying the income tax; some people think it means removing capital income from the tax base. We've seen proposals of that sort. And maybe replacing the income tax with a tax on consumption. Some people think it means making the rich pay their fair share, whatever that is, or enhancing tax subsidies for low income families. That's what tax reform is doing more aggressively, dealing with the distributional problems with the tax system. Others think it means eliminating tax expenditures to pay for lower rates. That's the more traditional kind of view. And some may think it means making the tax law more environmentally friendly by having a carbon tax or a gas tax. So there are a lot of different things that people might think are tax reform. So all I can do is give you my take on what I think needs to be done, so I'll go there.

I don't have a 14-point plan, so I'm just going to talk about various directions. First of all, obviously, we need to raise more revenue over time. We need to reduce the growth of entitlement spending, too, but it's hard to imagine any politically acceptable solution that won't involve both more revenue and less spending.

Three main problems with the current tax problem I see. One is needless complexity, two is tax expenditures, and three is the way we tax saving and investment. I'll go through each of those three very briefly.

First is complexity. First to state, I don't think we can have a simple tax system. We have a complex world. We can't have a system on a postcard or anything like that even if we wanted to. But our system is much more complicated than it needs to be, and I think we ought to eliminate what I consider gratuitous complexity. For example, we don't need an alternative minimum tax. We don't need people to calculate their taxes two different ways. We don't need multiple and overlapping incentives for higher education or for retirement saving or multiple ways of calculating your capital gains tax. There are a lot of groups out there that have identified simplifications -- the President's Advisory Board, Bush's Tax Reform Panel, the IRS Taxpayer Advocate. I don't need to go through that list all to say that this is something that should be done if nothing else is done. It can be done by Congress. It should be the leadership of the tax writing committees, and it can be done in such a way that doesn't really change the basic tax structure.

The second issue is tax expenditures. That's been referred to in the previous panel, an enormous amount of backdoor spending in the tax system. Many of these programs promote worthy social and economic goals. It's wrong to say sweep them all away, but certainly the bar is lowered of things done through the tax system than through direct spending. And there's a lot that gets in there that shouldn't be done or could be done very differently or could be done better.

So this is not spending policies but, you know, I can think of mortgage interest deduction is one. I can think of many, many ways in which there are things done through the tax code that should be done differently and should be done in ways that cost less money, whether you want to view those as tax reform or just spending cuts in another form, that's fine, but it is in the domain of tax policy.

I would just make one comment. The tax reform recent budget panels that Simpson-Bowles referred to these as earmarks or loopholes, I think that's a very misleading terminology. The big tax expenditures are not earmarks, they're loopholes. They include benefits that affect millions of taxpayers and that doesn't mean they should escape scrutiny in an era of budgetary restraint but people should understand it's not simple to get rid of these things and it's just not a matter of a small handful of lobbyists protecting them.

The third thing is taxation of saving and investment. And I would just make the general comment I think the current tax system is not well designed today for a world in which capital moves easily across international borders. I think the source of where investment is located is a very fungible item and people who do international tax understand this -- that we should base our taxes more on where individuals live rather than where income is earned or where corporations invest. And that means to me a combination of directions. Again, without being specific, but two things we probably need to have somewhat lower taxes on saving and investment and we also somehow need to make our taxes more based on destination residence than origin of production.

And that suggests the following directions: lower corporate and individual income tax rates, elimination of reduction of tax breaks for U.S. shareholders. I'm specifically thinking of the very large preferences for capital gains and dividends, and introduction of some new broad-based tax on goods and services combined with rebates for low income taxpayers. So anyway, actually, the program I've laid out is not all that different than some of the ideas in Simpson-Bowles and the Bipartisan Policy Center. Again, I'm very agnostic about the specifics but I think that's the direction we need to go.

MR. STEUERLE: Thanks, Eric. Kevin.

MR. HASSETT: Thanks, Gene.

And I was actually taking Alan Auerbach's Public Finance seminar in graduate school just as they were passing the '86 Act, which shows how old we're all getting up here because that was a long time ago now.

I also have had a few questions. I'm going to be drawing in my presentation on a recent paper that Aparna Mathur and I wrote on the recent history of world tax policy, and Aparna just had her baby last week, baby Samar sends regards and is apparently already calculating the generational account shortfall that he's inheriting from us.

I think there was an earlier tax policy center presentation a couple years back now of Larry Summers where I think that Larry talked about some work that he had been doing with Jim Hines about how this shot of flattening world was changing the tax policy problem in ways that we tax policy scholars need to take serious. And I think that he made a pretty convincing case at referring one of the earlier panel members' comments that because there was increasing competition with an increasingly mobile world where factors can vote with their feet a little bit better. There's increasing competition, especially for low-skilled workers in the U.S. with low-skilled workers abroad which increases the necessity for redistribution or the demand for redistribution at the same time that the mobility undermines the ability to redistribute. And thinking about exactly how you work that problem out in this complex, highly mobile new world is something that's a very high order problem.

And one way that I've been trying to think about how it works out is through -- in another glimpse of this paper Glenn Hubbard and I had a paper that we presented at AEI a couple weeks ago on how maybe we could use the Tiebout model to think about this competition that's going on between nations. And one way that I've been thinking about it is to think about how these mobility factors have been changing policies in countries that are more on the frontlines of mobility. I think maybe like in the E.U. and clearly I don't think the demand for social justice in the E.U. -- typically E.U. countries are going to be a lot lower than here in the U.S. And so how have the forces of sort of mobility mutated the policy there.

And so what Aparna and I did was gathered a lot of tax data from a lot of countries and then looked to see how the U.S., which I think has been until recently perhaps more insulated against the sort of negative effects of this mobility in part because we're the biggest and most attractive market, the safe haven and all that. But how is the U.S. different from the common practice of the rest of the world right now? And the summary of what we found is actually something that you've heard Mike Gratz say many times and maybe even on this stage, that the U.S. is still kind of -- despite what people say, it's still a small government country but we're not necessarily a low tax country. And the big headline reason why is because we don't have a value-added tax.

And so if you look at the evolution of tax policy and maybe the nations that have been facing this kind of factor mobility and the problems associated with it for longer than we have, so how are we different? Well, one, we don't have a value-added tax. Our corporate tax, statutory tax at least, is a lot higher. And the next thing is that our payroll tax is capped. It's very often not capped in other countries. And there's one other factor that we found in the data that was really surprising to us that I had never thought of before but you could imagine, again, as we're trying to think about the whole political dynamics of tax reform and how do you get to the thing that you want to have and stuff like that, well, it's typical in most of the OECD nations that the employer side of the payroll tax is a lot higher than the employee side. I think the economists in the room would say, well, it doesn't really matter which side you put it on, and it's probably borne by workers and so on, but it's interesting as sort of an observation of political economy that the employer side -- so not only is it not capped but the employers tend to pay a higher payroll.

Now, I can remember thinking back to that '86 Tax Act a lot of times when we were thinking about the different proposals that were coming through than Alan Auerbach, who was very young back then and still very young, but Alan used to make us always sort of write everything down. How does it affect the budget constrains? And if you move it over here, if you move it over there, which taxes are equivalent to what? And I kind of sometimes watch Washington and think that it'd be great if people were forced to go through that exercise again because how many times have you heard someone say, well, I love the Hall-Rabushka flat tax but I hate the value-added tax? Well, I mean, they are kind of mathematically equivalent. And so if you like one and hate the other then you've got some explaining to do at the very least. Right?

But I think that if you look at the way the Europeans are different and the typical OAC nation is different from the U.S., then really it's that they're leaning a lot more on the taxes that we think are efficient, the consumption taxes, and they're doing it both because of the value-added tax, but also because of the higher payroll taxes because payroll taxes are a big component of the VAT. There's a little bit of a difference. You need the tax on old capital somewhere in there, too, but it's basically kind of like having more consumption taxation.

And so the question then becomes how in the U.S. can we move from where we are to a system that's probably proven both to be politically sustainable and repeated in the sense that very often you'll see countries around the world adopt a tax reform where they do something like increase the value-added tax a little and cut their corporate rate and then a couple of years later they take another stab at it because maybe they liked what they saw.

And for that I think that we have a big political hurdle in the U.S. that Mike Gratz talks about, that it seems like the value-added tax -- and there are lots of jokes about why it's a non-starter for both parties at times. And so I think that's one reason why that we in the U.S. are kind of stuck because as, you know, we observe, when people introduce a value-added tax, then to the extent that there are efficiency benefits for tax and consumption, then when you increase your value-added tax and cut some other distorting taxes and you notice that things are better and then you want to do it again, because we haven't been able to introduce even a little one, then we've never started to play in that game. We've never really decided, you know, we've never had a chance to say, well, let's try this little tax swap and see what happens and see if we like it and then talk again next year.

And so I think that that's why in the U.S. we're kind of stuck with we've got the strange -- if you remember the SS model, Herbert Scarf, where we're sort of -- we have a really, really big adjustment cost and so we're really, really far from the optimal and we feel like we have to jump all the way to something like a big X tax or something which Alan Viard and Bob Carroll are about to publish a book at AEI on, which is a very sweeping fundamental tax reform way to get to a consumption tax.

And I would urge us as we think about how to move forward, to recognize that this sort of -- this increase in competition between nations for mobile factors to the extent that you're out of the competition, then it could well be harmful, that it might be that shooting low and trying to get to a system where we have the mechanisms in place where we can increase the good taxes and reduce the bad taxes over time is an objective that maybe the left and the right ought to try to embrace. And if that means having a small national value-added tax or a small national retail sales tax because that's the only thing that you can do then that should be a cost that we should be willing to play to start to let these sort of international forces drive us towards optimal policy.

So thank you very much.

MR. STEUERLE: Just as an anecdote to show you how complex this world can get, I testified once with Robert Hall of Hall-Rabushka fame and he said he really didn't favor a single rate of tax. He would recommend multiple rates, several rates. So he spoke out against the flat tax.

Adele.

MS. MORRIS: Thanks, Gene. And thanks, Bill, for inviting me to talk about energy and environmental taxes.

There's a whole range of energy and environmental fiscal issues but I'm going to focus on my comments on the potential for a carbon tax to be part of a broader tax reform package. And I'm going to make two points.

The first point is that it makes every economic sense to -- if you're going to have some kind of major tax policy revision, to put a price on carbon as part of that. And likewise, if you're going to do serious climate policy, it makes a lot of sense to make a revenue component to that part of it and using that revenue to reduce the deficit or offset other distortionary taxes. And I'll describe why.

The second big point I'm going to make is that a lot of the political impediments to a carbon tax don't just come from anti-tax republicans who don't believe the science of climate change. A lot of the impediments actually come from democrats in the environmental community who are uncomfortable with the substitutability of a carbon tax for some of the other policies that they favor. And I'm going to explain why I think that is.

So first on the economics. I am very sensitive to the concern that tax reform is hard enough. Larding it up with a grab bag of other policy priorities is dangerous. We heard about the difficulty of getting through the '86 package. You know, you don't what to threaten that. But on the other hand I think that the potential fiscal and environmental synergies of a carbon tax as part of that are worth the risks associated with getting the package through. And I'm going to give you a bunch of reasons why I think that is.

But first let me stipulate that the reason to do a carbon tax is because you're worried about the risks to the earth's climate and the disruptions that come from that. You don't need to pursue that kind of excise tax unless you believe that scientific evidence. And if you don't believe that evidence, then nothing else I'm going to say is going to be very compelling anyway. But if we just stipulate the risks to the earth's climate then, you know, a policy that prices those damages as best we can estimate them into the price of fossil fuels is an economic no-brainer. I mean, it's just self-evidently true to economists at least that you need to discourage those bad things and a price is a good way to do that.

So why should we embed this carbon tax as part of tax reform? To give you an idea of the kind of tax I'm envisioning, and this is kind of a canonical economist's proposal in this realm, is a tax that would be an excise tax on the carbon content of fossil fuels. It would start relatively modestly. You know, maybe $15-$20 per ton of CO_2 embedded in fossil fuels broadly across the U.S. economy that would ramp up at some modest real rate over inflation, something like four percent a year. These are the typical kinds of proposals that you would see. Usually you would see a credit against any carbon that is not actually released to the atmosphere. If you have a carbon capture and storage system that pumps it underground and doesn't release it, maybe you can get a tax credit for that. If you use your fossil fuels to, you know, create petrochemicals or plastics and it's not actually released, well, maybe you can get a credit for that. But that's the basic idea.

So why would you want to put this as part of a tax package? Perhaps the number one reason is that it could raise a lot of revenue. And depending on how high this tax is you'll raise more rather than less. And estimates vary but something like $33 per ton of CO_2 in 2020 could raise about $180 billion per year. So the revenue estimate trajectories, you know, start out at around $100 billion when the tax is imposed at the kind of rates I was talking about. As the tax ramps up, the revenue doesn't necessarily increase all that fast because people are responding precisely in the way you want them to by emitting less and using less of those fuels. So the revenue kind of goes up a ways and eventually it tapers off. As the rate goes up and the emissions fall, the emissions fall faster than the rate goes up. And eventually, you know, this tax, somewhere out in the latter part of the century would end up in not very much revenue at all.

So this would be an intermediate, medium- to long-run revenue instrument, but eventually in the very long run it would not be a revenue instrument at all. And that's what you need if you're going to stabilize concentrations. You need those emissions to taper off.

So aside from the revenue you want the carbon tax embedded in a bigger tax package because it's regressive. And if you don't embed it in a broader tax reform, you either fix the regressivity as part of the carbon tax proposal or you don't fix it at all. And so if you try to fix the regressivity within the carbon program, what you end up doing is something like maybe rebating some of the tax to households to blunt their energy bills. Well, what's that going to do? It's going to blunt the incentive to conserve energy. And there you have to have a higher carbon tax to reach the same environmental objective. And that obviously makes it more costly.

Third, if you use carbon tax revenue for deficit reduction, you might obviate some of the rent seeking that plagued the discussion of cap and trade. I mean, in the cap and trade debates relatively little of the squabble was over the cap. It was who got the allowances. All that activity meant that anybody who thought they were about to lose their share of the piece of pie had the incentive to block the whole measure so they could get another bite at the pie. So if all that revenue goes to deficit reduction or embedded tax reform, then there's nothing to squabble over and maybe you can actually get something done.

Finally, I think that if you don't use the revenue for tax reduction you're going to get a lot more costly climate program. This is a robust result on a lot of the climate policy literature. If you have a climate program that just takes the allowances and gives them away or takes the revenue and gives it away, you're not offsetting those other distortionary taxes and you're not getting the economic benefit. And that raises the overall cost to the climate program considerably.

And finally, I think if the carbon tax is embedded in an overall fiscal package, it's a lot harder to unwind. I mean, as we see that tax going up there's going to be a concentrated constituency to get rid of it, but if there's a concentrated constituency that got the benefit from that tax revenue in the form of lower other taxes, then maybe we can obviate the politics around trying to get rid of that tax. And that's exactly what they did in British Columbia. They very carefully tied the carbon tax in British Columbia to reductions in income and corporate taxes. I don't know if we could do that as part of this but I think it's worth looking carefully at that model.

My final point is that the politics are hard and like I said, it's not just anti-tax republicans that are unnerved by a carbon tax. You know, at an event yesterday Kevin pointed out, you know, economists haven't done a very good job convincing republicans that Pigovian taxes are okay. That if you tax something you want less of, that can be a good thing. Well, I think economists also haven't done a very good job convincing democrats in the environmental community that Pigovian taxes are good environmental policy and even better than some other environmental policies they might be quite attached to.

We did see the environmental community embrace cap and trade. It took some time. Eventually they came onboard but you almost never -- I mean, there are a few very vocal NGOs that support a carbon tax but most of the environmental groups much more supported cap and trade over a carbon tax because they like that environmental certainty and I think there's just sort of an intrinsic distrust of downward sloping demand to do the job. And I think economists need to do a better job making the case that once you impose a carbon tax that obviates the need for a lot of other more costly environmental policies, some of which the environmental community is very attached to. And we saw even in the cap and trade bill, one title was cap and trade and the rest were a bunch of ancillary policies, many of which would have no environmental benefits over and above the cap. And I'm thinking in particular fuel economy standards, appliance standards, renewable energy subsidies and mandates. Once you've got an emission cap, all those other things do is move around where the emissions reductions take place but they don't actually necessarily increase the emissions reductions that were induced by the cap itself. So I think we've got to work on that.

Now, just to be clear, I don't think that the only attachment to those ancillary policies derives from sort of a concern over the efficacy of the price signal. I think some of it is that there are very important constituencies that are recipients of those renewable subsidies or what have you. And we even saw that in the debate around the debt ceiling. We were on the precipice of default on U.S. debt and the democrats could not agree to spending cuts on clean energy-related or clean manufacturing-related subsidies. So we see that that's an important political component to their position.

So where do I think we go? I think we need to have a serious proposal that explains what the democrats might be willing to give up to get a carbon tax and what other policies we could unravel accordingly.

MR. STEUERLE: Thank you. Bill.

MR. GALE: All right. Thanks. I want to talk about the value-added tax a little bit as part of the solution. And I mean that both as part of the tax reform solution and the fiscal solution. So I'm adding revenue concerns to the typical list of equity efficiency and simplicity that we talk about when we talk about tax reform concerns.

I want to make the case that the VAT is a good part of the solution, good as opposed to perfect. Too often in tax reform issues I think we let the perfect be the enemy of the good and I just want to emphasize there are, of course, problems with the tax with the VAT. There are problems with any tax. But when you look around at the alternatives the VAT is an attractive way to raise revenues. Some of that revenue can be used for deficit reduction; some of it can be used to finance tax reform.

Very briefly, Kevin alluded to the VAT in Europe. The VAT is used in about 150 countries around the world. It's not a hypothetical, utopian tax. It's a tax that's actually out there doing the job every day. In most countries it either raises the most amount of revenue or is second only to personal income tax.

There are two ways to structure a VAT. I won't go into the details unless you really want to, but one is called the credit invoice and it's sort of a transaction by transaction method. The other is what's called a subtraction method and it looks more like the income tax. You sort of add things up at the end of the year and take tax deductions. Herman Cain's business plan, for example, looks an awful lot like a subtraction method VAT. It's not exactly a VAT, but no VAT in the world is exactly a VAT. There are always design mechanisms. But basically I think the Tax Policy Center has come to the conclusion that it's essentially a VAT with one or two exceptions.

The VAT gets a bad name in a number of circles as there's this famous line about Larry Summers having said that liberals don't like it because it's regressive and conservatives don't like it because it's the money machine, and we will get a VAT when liberals realize it's a money machine and conservatives realize it's regressive.

(Laughter)

MR. GALE: It doesn't have to be regressive though, and it doesn't have to be a money machine. As Bruce Bartlett has pointed out in his writings, in fact, it hasn't really been a money machine. It hasn't the last 25 years. VATS were introduced in the '50s and '60s, and then the '70s, of course, were a very inflationary time period and there was a lot of adjustment of VAT rates in the '70s but he shows in some recent work that over the last 25 years, oddly enough since the Tax Reform Act of '86, VAT has not been fueling growth of government. VAT rates have not been rising inextricably. They basically leveled out. So it doesn't have to be a money machine, although obviously one of the goals is to help raise revenue. It doesn't have to fuel eternal growth of government.

Some of the arguments are that the VAT is a hidden rate. It's a mysterious tax that people never see. It's easily resolvable. All you've got to do is print the VAT payment on the receipt just like you print a sales tax payment on the receipt. It's not tricky. It doesn't make it an agent of big government. You just print the receipt.

At the same time the VAT can raise substantial revenue. And if you're talking about wanting to raise, you know, two to five percent of GDP in revenue, which is a lot of money, you can't get that from income tax reform without jacking up the rates so high or doing extreme acts to the tax expenditures in there. So if you're talking about significantly realigning revenue in the U.S., or if you're talking about generating enough revenue that you can use some for debits of reform and some to finance tax reform, a VAT is sort of, in the Willie Sutton parlance, a VAT is where the money is.

And the other criticism that a VAT would be regressive, the VAT itself would be regressive but that regressivity can be offset by other policies, either credits in the income tax or Kevin mentioned that European countries use value-added tax. Typically, they offset it with more generous social spending. So there are ways to offset the regressivity of the VAT. What you care about, of course, is the regressivity or the redistribution in the whole tax system, the whole tax and spending system, not in particular taxes. And getting hung up on the distributional effects of particular taxes when you can make adjustments for that in the rest of the system doesn't seem like a constraint that needs to be imposed.

Lastly, there was a question earlier about the states and how their tax reform interacted with federal reform. There is a lot of opposition in the states to the notion of the federal government imposing a VAT, the ideas that consumption taxes are the domain of the states. They have these sales taxes, for example, but sitting from my humble vantage point in Washington, D.C., it looks to me like a federal VAT would be one of the best things that could happen to the states. The state sales taxes are extremely poorly designed. They leave out services. They leave out all sorts of goods; you know, food, etcetera. They're very kind of Swiss cheesy type of taxes, and if they're not well enforced businesses end up paying sales taxes on purchases that they shouldn't. Individuals end up not paying sales taxes on consumption goods that arguably they should.

So if there were a federal VAT, the states could piggyback their own VATs on top of the federal VAT just like they do with the income tax. And I think if -- I don' see why that's not an improvement for the fiscal status of the states. It would help them tax, you know, interstate mail order things. It would help them tax Internet sales, so on. Sort of hard to tax items. So I think that the issue with the states could actually be resolved, too.

Lastly, I encourage you -- you'll hear a lot of horror stories about the VAT. I encourage you to look at the evidence in Canada which imposed the VAT about 20 years ago and is essentially subject to none of the problems, none of the concerns that have been raised by the more strident opponents of the tax.

So I think the value-added tax, for all the reasons I've discussed, for the reasons other people have discussed, can be part of a fiscal package that, of course, would involve stuff on the spending side and other stuff on the tax side, too. But I think it's time that we in the United States seriously consider a VAT.

MR. STEUERLE: Thank you. So I have one quick question before I'm going to go to the audience. Let's suppose the four of you had been appointed to be the new Simpson-Bowles Commission and now you've got to make some choices. So you've offered us a menu of options. We can go after tax expenditures. We can undertake some international tax reform. We can adopt a carbon tax. We can add on a

VAT. And, of course, the experience of these various commissions is that they had trouble making all of these choices.

In Tax Reform '86, for instance, there's a great third volume that a lot of people don't look at that Charlie McLure mainly wrote. Charlie is one of the best experts in the world on a VAT, and talks a lot about a VAT which we didn't adopt as an option. The Rivlin-Domenici Commission, bipartisan commission, at one point thought about both a carbon tax and a VAT and decided they couldn't go for both. I think as much for political reasons as any other reason.

And, of course, there's the economics of it, not just the politics of it. So, for instance, we've got two former commissioners of the IRS here in our audience. Maybe did I miss a third one? I don't know. At least two. And they might say, gee, you might think about how much administration you're imposing on the system if you're going to add on all these systems without at least cutting back on the income tax. So now the question for you is thinking first of the economics and then the politics, what's the right type of compromise under all these things assuming -- I'm going to assume for the moment you are going to do some deficit reduction. Do we go hugely after tax expenditures and let it go there? Eric expressed a bit of being agnostic a bit. Do we have to pick one target because politically that's about as far as we can get? I just offer this to each of you.

Easy question.

MR. GALE: You want four new Bowles-Simpson plans?

MR. STEUERLE: I just want a quick question on how you address the issue of whether you want to go after tax expenditures, adopt a VAT, adopt a carbon tax at the same time and how you might --

MR. GALE: Robbing the base of the income tax, lower the rates. Same with the corporate. Impose a value-added tax. Use it to finance. Earmark it to Medicare which provides an automatic cost adjustment balancing thing there. Everything else is details.

MR. STEUERLE: But you left off the carbon tax.

MR. GALE: I think the carbon tax would be a good idea.

MR. STEUERLE: So you'd do them all.

MS. MORRIS: Yeah, you know, I understand the commission's reluctance to add two new revenue instruments. And if you do have to choose between a VAT and a carbon tax and you're primarily worried about the revenue side, I can understand why they chose the VAT over the carbon tax.

I think as long as we're in the business of heavy lifts, you know, the marginal lift is maybe left important. And because we need to do climate policy anyway it seems to me a major lost opportunity not to put a carbon tax as part of this overall package. I'd go for it but then maybe that's why economists don't necessarily get elected to these positions as much.

MR. GALE: It is worth nothing that if we don't really solve the climate change situation we really don't have to worry about the fiscal situation.

(Laughter)

MR. STEUERLE: So does it reduce social security cost?

MR. GALE: Yeah, sure.

MR. STEUERLE: Do you either of you want to take a crack at it?

MR. TODER: Oh, I mean, I think I told you what my preferred directions were. I think I'd do a little bit of everything. Maybe not the trust fund Medicare link. I'm not that big on linking things specifically but other than that --

MR. HASSETT: Yeah. And I agree with Bill. I would not want to use the

VAT revenue to fund Medicare. I'd want to leave that reform for the next committee. We're doing taxes and I'd want to introduce a VAT and recognize that by having it and dedicating the revenue to lowering marginal rates and the income tax that you can create a coalition that supports the overall reform.

MR. STEUERLE: Okay. So we're going to go out to the audience. And again, I remind you please ask a question, identify yourself, and wait for the microphone.

So we've got one over here. All the way in the back.

MR. BAXLEY: Thank you. Steve Baxley with Bessemer Trust.

Everyone hates making predictions, I know, but I wonder if you wouldn't mind telling us your level of enthusiasm that the Joint Select Committee might actually reach a consensus that involves a meaningful tax reform.

MR. STEUERLE: That's an easy one.

MR. HASSETT: I would say that there's one observation that gives me hope that they'll be quite successful, and that's that I have no observations. And what I mean is it's very hard to get any information about what's going on, you know, how it is going. I mean, everybody's tightlipped; at least the people that talk to me and often aren't tightlipped. And so that suggests that people are taking the job seriously and that they've agreed to not leak things and so on, and that suggests there might be something serious going on. But that's the only observation I have is the absence of observations.

MR. GALE: That's interesting you say that. I actually made exactly that observation to a reporter yesterday -- the fact that --

MR. HASSETT: It must be correct then because Bill and I never agree.

MR. GALE: Yeah, it must be correct. Exactly.

I guess what I'd say is it's the best opportunity right now.

MS. MORRIS: I would also say that one thing that improves my view of the odds of success is that we have a credible threat if they're not successful. You know, we have the default cuts and I think nobody likes those. You know, big cuts in the military and so on. So I think they have every incentive to get the job done. That said: it's a very hard job.

MR. TODER: I'm extremely pessimistic. The only thing that makes me not totally pessimistic is that I haven't heard anything from them. So I'll go with Kevin on that.

And the other thing that you should know is I was also extremely pessimistic about the 1986 Tax Reform Act happening.

MR. HASSETT: But it might be reminiscent of the old cease fire between Reagan and Rostenkowski to sort of not criticize each other. Because normally at this point in the process we would have heard, oh, you won't believe what this guy did and we haven't heard any of that stuff.

MR. STEUERLE: You have a question here?

SPEAKER: Everybody seems to assume that a new tax -- brand new, never used in the United States -- will be self-enforcing. Just as an experience, I went shortly after the Brits enacted a VAT to see how it worked and actually talked with the administrators and talked with business people and so forth. And everything that is settled in the tax law now is brand new. Is it subject to the VAT or is it not? Because, believe me, our Congress is not going to enact a VAT with no exceptions.

(Laughter)

SPEAKER: I mean, that's one bet I'm willing to make on long odds.

So, and the tax not being self-enforcing, obviously you're going to run into the problem, for example, we're having at the moment, which is the Congress, both Houses, both the Senate and the House, have cut the IRS appropriation. Now, what does that do? The House cut it by $550 or $560 billion. The Senate cut it by a different number. You can figure somewhere between seven and 10 times in the first year. It'll be a little more than that later on. Now, if they won't appropriate money to make money, how are you going to make a new tax work?

MR. STEUERLE: So hear the question is both what are some of the administrative costs with a VAT and are they worth it?

MR. GALE: Right. So I would start from the premise that if there were going to be a VAT you would need to administer it and that an intelligent set of policymakers would administer the funds needed to administer the tax. So I mean, I don't see that administration as some impossible hurdle given that the VAT exists in the 150 countries in the world. I agree there's an issue with IRS funding but that, you know, just tack that onto the list of issues.

In terms of whether a VAT is a better idea than some other tax or some other spending cut, you know, all the issues of equity efficiency whatever come into play. So my assessment having looked around is that the VAT is the superior way to boost revenues. I'd be happy to put it up. I'm not ruling out a carbon tax here. As Adele mentioned, you know, you can get more money out of a VAT than you can out of a carbon tax. Now, they're not opposing ideas at all but, yeah, so yes, if we have a VAT we should allocate funds so that we can administer a VAT.

SPEAKER: Realizing the VAT is inflationary.

MR. GALE: It's not inflationary. It's a one time -- it should -- if it's accommodated by the Fed it should lead to a one-time price level adjustment but that's different from igniting an inflationary spiral.

MR. STEUERLE: All right. We have another question here.

MS. HIRSCH: My name is Michelle Hirsch. I asked a question before, too. Do both sides have anything to gain by working together on tax reform this time around, you know, compared to what they had to gain or didn't have to gain back in 1986? And how does that impact the state of affairs?

MR. HASSETT: I'll go first. I think that we all have a huge amount to gain. And the way to think about it is that if we accept the Reinhart-Rogoff and Reinhart-Reinhart result, that you're looking at a slow decade of growth after a financial crisis-related recession. Then we're looking at, if we have the median experience of the typical country and their dataset, then in 2018 we have an unemployment rate in the U.S. of about 8.5 percent. And I think that when you're looking at a long, slow growth period, and they have a lot of good reasons why the slow growth happens. I think we understand that that's not just sort of, you know, looking at the past and saying it will repeat itself, that there are theoretical reasons why we would expect slow growth, then it makes it really hard even if you're a Keynesian optimist to design a policy because when you introduce a Keynesian stimulus you get a year of good growth and then a year where there's the hangover or the Keynesian stimulus is removed and then the growth goes down because of government spending declining. And so what happens in a long period of slow growth is that you're looking at a hangover arriving when you're in a period of slow growth and it might kick you into recession.

And so it's like really the only thing we can do I think to really kick start the economy is look for things that don't have hangovers, things that permanently improve the growth trajectory of the economy and tax reform is one of the few things that can do that. And so I think that what we all have to gain is that we've got a very serious problem if we don't address it. It's going to -- the technical term Bill and I use for this -- it's going to really suck for a long time if we don' do this.

(Laughter)

MR. HASSETT: And I think that one of the reasons why you're going to see more protests, and it's not just like the Tea Party people and the Wall Street people, it's just that the economy is terrible. And as the economy gets terrible, then there's an urgent need to do something. And given the sort of medium frequency of the challenge, I think tax reform is the right medicine at this time. And my guess is that -- I mean, so maybe there's some guy who thinks, oh, if we have a lousy economy then it helps me get elected or something like that, but I would think that that's not going to last very long because the economy isn't going to be getting that much better that fast.

MS. HIRSCH: But do you think individual politicians can internalize that enough to, you know, look past their own personal --

MR. GALE: I totally agree with the premise of the question which is that they're constantly thinking about whether it pays off to cooperate or fight. It's not just how much they have to gain. It's also how much they have to lose. And I would argue that this is where White House leadership (cover) really matters. If the president would go out there and say, you know, really make the case for tax reform, then people could be falling in line. Whereas, right now to be in favor of tax reform you have to sort of step out. And so you have a lot more to lose in that situation.

So I think the politics of this are essential and I guess somehow your question led me to think that the absence of White House leadership made it much harder for the political process in terms of (inaudible).

MR. HASSETT: I'd just like to add, like for the people who are more in the middle of the '86 Act, this is actually a speculation now. It's not something I've thought of before but your question made me think of it. I kind of wonder if -- so we watch the response the 9-9-9 Plan is getting, and I don't think people are really excited about it because they love Godfather's Pizza. Right? I've tried Godfather's Pizza. Trust me. It's not -- but I think that if you look back at sort of the kind of things Jack Kemp was doing back in the day, that that also was creating, you know, at least in pockets of the United States a lot of buzz. And I wonder if in some sense the sort of extreme tax positions didn't sort of help create the demand for the '86 Act because it's sort of like, well, there is demand for tax reform out there. Let's do a tax reform that we like better and then the moderates got together and did it. And maybe we're not also headed for a similar moment where people could look at the 9-9-9 Plan and the response to it and say, oh, well there is -- clearly they've hit some kind of nerve. And so now it's time for the moderates to get together again and grab something.

MR. STEUERLE: Well, I would actually say that the reaction to tax shelters, especially the individual side even more so than corporate, although corporate was big, too. Bob McIntyre pushed the -- you know, and Don Regan pushed, you know, the GEs of the world paying zero. And it was a very visible type of thing. And whether the analysis was exactly correct is different from the fact that people really felt that we had to do something about it. So I do think that there were those alternative pressures.

I always view it as when you have to make difficult decisions it's sort of like going to the dentist. It's the pain of not going to the dentist has to become greater than the pain of going to the dentist. For the politician, when that happens, that's when you get action. So similar to their --

MR. TODER: But I just want to make one historical point about 1986 and I think it's an accurate reading of the polls. At no time was there overwhelming public support for what was done in the 1986 Tax Reform Act. At best you could say there wasn't a strong organized enough public opposition to stop it. But this was basically an inside the beltway job that was done by experts who were thinking that this was a better way to run the tax system. It was not a populous movement.

MR. STEUERLE: Questions here.

MR. NADEL: Hi. I'm Mark Nadel, the Government Affairs Institute at Georgetown.

I have a question. I guess it's sort of a comment/question. In terms of the value-added tax, Bill Gale sort of made a passing comment about Internet sales and I would suggest and I'm interested in seeing your reaction, that actually that's a much bigger deal because, you know, I'm always amazed at the stuff you can get on Amazon. I mean, there is nothing anyone in this room buys that you can't get tax free on Amazon. And so I'm wondering politically whether there is some -- could be some real momentum as the folks who have bricks and mortar stores could get behind it because you are then removing a competitive advantage that Amazon has just on the tax side of whatever a state sales tax is.

Another aspect is on the tax avoidance. A relative of mine who shall go nameless always pointed out the benefit of a cash business. You know, some for the government, some for me. On a value-added tax, at least the government gets some of that if perhaps not at the last point of contract. So I just think in terms of the tax avoidance side alone, not only is it good policy but politically there are possibilities for some coalition. Or am I being -- is the whole, you know, Internet stuff too small for that to matter? I just don't know the economics. I think I know the politics; I just don't know the economics of it.

MR. GALE: I think it's a push in the right way but, you know, there's a lot of factors that go into it. It's probably not the decisive one but it's interesting.

MR. HASSETT: The Amazon fact, for those who aren't just addicted to this, the metric of how wide it's spread is there's a friend of our family who is listing a personal trying to find a match for herself and she listed in the personal must be Amazon prime.

(Laughter)

MR. HASSETT: But the Amazon advantage is -- the cost of it is so huge that last winter I bought a 50-pound box of salt for the driveway from Amazon and it was delivered to my porch for free and it was like vastly cheaper than going to the store. But I just think you've raised a very important question that a value-added tax would presumably sort of resolve this conflict.

MR. STEUERLE: I saw about three other questions. If you had your hand already raised what I'm going to ask the people with the microphone to do is let all of you ask your question, please quickly, and then I'm going to let the panelists have one last swipe at answering your questions or anything else they want to raise. So I think I saw about three hands. One here, one here, and one here. So start in the back.

MR. GREEN: I'm Kyle Green. I'm a graduate student at George Mason University, so maybe in 25 years I'll be up there talking about the reform that someday was implemented.

(Laughter)

MR. GREEN: One of the things that we're studying right now in one of my classes is the Japanese Lost Decade, and I find it eerily similar to where we find ourselves today in American minus the deflationary tendencies. And so one of the things that they did in '97 was raise consumption tax two percent and sent what was a struggling but growing economy into a deeper recession than it had in the first place.

My question, and perhaps it's going to get me booted out of this auditorium though is tax reform the proper discussion to be having now given that it greatly deflates consumer confidence which is the basis for growing an economy in the long run?

MR. STEUERLE: All right. And we have on here. This gentleman, next, right in the middle here. About three more rows up.

MR. TROTSA: Time does change

MR. STEUERLE: Identify yourself.

MR. TROTSA: Can you hear me?

MR. STEUERLE: Identify yourself.

MR. TROTSA: Oh, I'm sorry. I'm Charles Trotsa. I'm a consultant.

Time does do things to your memory but my recollection, as Dr. Tota said there was very little leadership in 1986. I can remember following it -- or strong leadership to take the package through. I can remember following it and thinking there were a lot of nice things in it, good things in it, and they were interrelated. And the report was that the package was delivered to Congress but it was in the word processor, at which I threw down the newspaper, said a few deleted expletives, and said it's going to be cherry picked and the Christmas tree will light up. I think that happened.

This suggests something. What we've been talking about is a number of interrelated things. And to send a package up that is subjected to individual change suggests to me something like the military's Base Realignment and Closure Commission where the expert panel puts together something and it's either rejected or accepted and not picked apart so that it becomes an unrelated set of interests of statements rather than an integrated tax policy.

MR. STEUERLE: Okay. And then we had a lady here as well.

MS. FRIEDMAN: Richelle Friedman with the Coalition on Human Needs.

Bill, I wanted to ask you specifically because you mentioned that one of the ways to deal with the regressivity of the VAT is for increased social spending and currently the political climate, both in terms of social spending as I understand it to be both in the discretionary and mandatory side is in a downward trajectory or at least it's very much at risk. So I guess I would be concerned a little bit about the regressivity of a VAT. If you could comment a little more.

MR. STEUERLE: Did I miss somebody over here? I think I missed somebody here.

MS. PENA: Gloria Pena.

My question is related to both the lady who just spoke and the gentleman over there. To what extent, I mean, acknowledging that tax reform is a very complex issue in any country but mostly in the United States at this moment since the economy is so bad and we have so many difficulties, my question is related to equity that has been measured by some of you. To what extent it is correct or incorrect that the current tax structure favors the wealthy at the expense of the less wealthy? And to what extent this has an impact in the way in which during the last 10 or 15 years the economy grew for a while and in the last four or five years we are having sort of very serious economic problems?

MR. GALE: So we have four questions here. One is about potential for a lost decade and whether by consumer confidence if we have tax reform. The second one is how do we -- even if we have a good tax reform package or any other budget reform package, how do we actually control the change and make sure that it continues to be channeled in the right direction? The last two were somewhat related. One is how can we ensure that social spending could offset regressivity, and the other one is a bit of a progressivity question as well as the basic progressivity of the tax system itself, whether that needs to be addressed.

So I invite -- you don't have to answer every question but maybe I'll start on that end and come across. If there's anything else you want to raise, please do so.

MR. HASSETT: For the lost decade, I think that first there are things that you can do as you move towards the more rational consumption-based tax that could both stimulate long-run growth and provide a near=term stimulus which is pretty sorely needed presumably now, too.

So, for example, if the corporate tax rate is declining over time, then it's kind of like an investment tax credit because you get to deduct your expense this year and then get your profit next year at a lower rate and it has a stimulative effect on the user cost of capital. On the other side of it, if you have a consumption tax that's increasing over time you create the kind of sales tax holiday impetus to buy the stuff today before the consumption tax arrives. I think that some clever designs in that regard might increase the desirability of the reform given the weak level of output right now. But I could say that if we adopted let's say the value-added tax just as a sort of tax increase and didn't face up to the fact that we've got this massive deficit in part because of the entitlements that we haven't been able to address, then I'd lean more towards thinking that we would have a lost decade like in Japan.

I'll let you guys go after the other questions.

MR. TODER: All right. I'll start with income distribution because that I know the answer to. Our tax system is moderately progressively higher and people do pay a higher percentage of their income in tax. That's certainly not true for all higher income people and there are many who pay less than the average for their level and even for everybody else. So there are issues with individual equity or particular kinds of people that broadly our system is progressive.

With regard to a VAT, because this has been discussed in several contexts, I just want to make the general comment that addresses some of these questions. A VAT is not going to happen in the short run. Congress and the public are overwhelmingly against this. There's zero chance of this coming out of the current commission. And I think when I think of how you get to long-run fiscal balance and what you have to do and what the other options are, I find it hard to see how you can get there without some kind of additional tax source. So my scenario for a VAT is it sort of comes in after everything else has been tried and failed but not before.

In terms of talking about tax reform and that having a bad effect on the economy, I don't really think anything we say in this room has any effect on the economy and my guess is this is not going to have a big effect on the economy even if it's enacted, just like the '86 Act, as Bruce said, didn't have that huge an effect on the economy. It certainly -- the best I could say for it is that given that we're going to have to raise taxes at some point, we want to raise taxes in a way that's less burdensome. And so we really need to do something different about the way we raise our taxes than the way we're doing them now. Just simply ramping up what we currently do would have a bad effect.

And one other point, just to clarify, I did not say that there was no leadership in 1986. There was a lot of leadership in 1986. I did say that it didn't seem to make much impression on public opinion.

MR. STEUERLE: Adele.

MS. MORRIS: You know, I don't have any special insights with regard to the VAT but I will share Eric's view that perhaps we'll do a carbon tax when we've tried everything else and it's failed. And you know, we can mess around with renewable mandates and subsidies and appliance standards and all that stuff and eventually we'll realize that our emissions continue to go up and we're not meeting our environmental goals. And at that point I think we'll reach sort of the economic equivalent of finally concluding that the earth does revolve around the sun and we have to put a price on carbon. And the downward sloping demand will actually work.

MR. GALE: All right. Thanks. In reference to the graduate student, I fervently hope that 25 years from now when you're on this stage you're not still talking about the Tax Reform Act of '86.

(Laughter)

MR. GALE: I hope there's something that comes along before then.

In terms of the lost decade issue, which I'm going to interpret more broadly as just sort of economic structure in the U.S., Adam Looney talked about this in his comments. You know, the waters run deep here. The problems with the education system, with infrastructure, with the delivery of health care are, you know, are pervasive and systematic and they've been catching up with us and maybe we were able to avoid it because we had housing price increases that fueled the economy for a number of years. But we're in for a big structural realignment that either, well, either we do -- we make a big structural realignment along those lines or we don't and we just putter along at this low level. Tax reform can help or hurt that process but I don't think it's the central decisive factor in that.

And then on the issue about regressivity and of the VAT and another issue about politics, I think the right way to say it is right now there is no feasible solution. There's no politically feasible solution out there. That doesn't mean we won't eventually reach a solution; it just means whatever we eventually do, it's something that's currently considered to be impossible. Okay? Which makes it hard to predict what it's going to be. But, you know, if you look back at the history of the country -- I don't know, civil rights, women's suffrage issues, the Civil War -- I mean, there are just these things that have torn the country apart and eventually we've dealt with them. And this to me, the fiscal situation, has a feel that it's going to be one of those things, especially against the economic backdrop of what I was talking about with education and infrastructure and so on.

So Eric said he thought eventually we would come around to a VAT. There's a Winston Churchill quote that I'm going to mangle but it's something to the effect that you can always count on the Americans to do the right thing after they've considered everything else. Right? And I think that's how we're going to get a solution, and I think that's how we're going to get a VAT as part of that solution. They're going to try everything else. They're going to try to cut Medicare, they're going to try to cut Social Security, they're going to try to tax rich people, they're going to try to do all these solutions that either are not real solutions or that don't get enacted. And then they're going to find that they're going to need to raise revenues and the VAT and carbon tax are going to look like attractive options.

So that's my operational definition of being cautiously optimistic I guess.

MR. STEUERLE: That's a good conclusion.

I'd invite you all to put on your calendar 2036. There will be another tax policy discussion of the results of the super committee. Among the topics are did it really affect economic growth? Did they adequately deal with the demographic issues? So be sure to put it on your calendar.

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

Carleton J. Anderson, III

(Signature and Seal on File)

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2012