

THE URBAN INSTITUTE  
AND  
BROOKINGS INSTITUTION  
TAX POLICY CENTER

CONFERENCE TRANSCRIPT

TAXING CAPITAL INCOME:  
DO WE? SHOULD WE? CAN WE? CAN WE NOT?

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

1  
2  
3 MR. BURMAN: I would like to welcome you to this conference on Taxing Capital  
4 Income. I am going to start with a few logistical matters. One, if you would like to speak, come  
5 up to a microphone. People at the table push your speak button before you start and then turn it  
6 off when you are done because there are only three microphones that can be on at once.

7 If you make comments, please identify yourself by your name and affiliation. There is  
8 going to be a transcript and we would like to not have anonymous contributions. Regarding  
9 lunchtime, there are a lot of people and we want to move people through quickly. There are  
10 going to be four lines for the buffet lunch. It will be easier than getting out of Houston. It is going  
11 to be in the same room where you had the coffee and bagels this morning.

12 I am going to ruthlessly enforce time limits because we have a lot to do and we want to  
13 have a lot of time for discussion. I have this really annoying kitchen timer and basically you want  
14 to beat the beeper if you can because it is not pretty.

15 Several people can't be here today. George Zodrow who wrote a paper for the  
16 conference is evacuating his family from Houston, as is John Diamond, and we are praying that  
17 that turns out not to have been necessary.

18 Gene Steuerle, who is one of the conference co-organizers and an editor of the volume,  
19 double-booked his daughter's wedding with the conference and somehow chose the wedding.  
20 He wrote, "My apologies for not attending the conference itself, a bit of an embarrassment as  
21 editor. Henry suggested I tell my daughter to move her wedding reception from the Charleston  
22 Aquarium to the Brookings Auditorium since live things tend to swim in circles in both venues."  
23 Gene always likes to start his presentations with a joke. I feel really honored that this is much,  
24 much better than most of his jokes.

1 (Laughter.)

2 MR. BURMAN: I would like to thank all the people who made this conference  
3 possible including Kathleen Elliott Yinug of Brookings, who is standing back there in the corner,  
4 and Anya Arax Manjarrez and Olga Popovic of the Urban Institute who organized all the  
5 logistics of the conference, which turns out to be very complicated. Troy Kravitz of IBP who  
6 manages the TPC web page is also helping out today and Janine Hoke of the American Tax  
7 Policy Institute.

8 I would also like to thank our co-sponsors, the American Tax Policy Institute and Tax  
9 Analysts. Rudy Penner is the president of ATPI and he would like to just make a brief comment  
10 before we start.

11 MR. PENNER: Well, thanks a lot, Len. We are very pleased to be able to co-sponsor  
12 this conference. I should give gratitude to our own funders who are the tax section of the ABA,  
13 the College of Tax Councils and a large number of life members. If any of you would like to  
14 become life members, we would welcome you with open arms. Thank you.

15 MR. BURMAN: And finally I would like to thank our presenters and commentators. I  
16 realize we don't have a little binder with all of their short one-paragraph bios. All of these  
17 people are so well known to this group, you probably remember what was in their bio the last  
18 time you saw them. Given the time constraints, I am not going to start with effusive introductions  
19 even though they would be warranted in every single case.

20 Joel Slemrod from the University of Michigan is going to start off.

21 MR. SLEMROD: Well, given Len's warning about the time, let me start by saying as an  
22 economist, assume that I have jokes about taxing capital income.

23 (Laughter.)

24 MR. SLEMROD: Jokes that are both hilarious and thought provoking.



1           The question I was asked to think about is: Does the United States tax capital income?  
2   Okay. That didn't move. Let me start by talking about why does it matter briefly. It matters first  
3   because of the schemas of capital ownership. The taxation of capital has stark distributional  
4   consequences. The second reason it matters is that the marginal effective rate of tax on capital  
5   affects saving and investment, which is key to long-term growth.

6           Well, it turns out that the correct measures for distributional and incentive purposes are  
7   not exactly the same and in today's talk I am going to focus on the latter. So I am going to be  
8   talking about does the United States tax capital income in a way that impedes incentives for  
9   savings and investment.

10          Frankly, the organizers of the conference have charged me to answer a yes or no  
11   question, which they have with all the presenters today. So let me give you a peek at my  
12   conclusions. Yes, the United States does tax capital income, but at a fairly low rate and at a  
13   much lower rate than one might think from reading references to double taxation of corporate  
14   source income.

15          How do I know that the answer is yes? Well, in the paper, I calculated three ways.  
16   Before I talk about the three ways to calculate this, let's—let me say a few things about what  
17   would be the characteristics of an informative calculation. Well, first of all, it should identify  
18   those features of the tax system that affect incentives to save and invest and ignore the others. In  
19   particular, it should appropriately deal with pure profits and risk premia, which can, in any given  
20   year, raise revenue but don't necessarily affect the marginal incentive to save or invest.

21          An ideal measure should be forward looking. It should be about the incentives to save  
22   and invest now and in the future and not be affected by what the tax system was in the past,  
23   especially if it was different. And an ideal method should account for tax system details and the  
24   kind of arbitrage opportunities that several of the other authors of papers here today will talk

1 about.

2 So I am going to consider three different methods this morning: a tax collections-based  
3 method, a hypothetical project-based method and the GKS method, and I will explain what that  
4 stands for later.

5 Method number one, tax collections-based measure. Here is how it works. Well, you  
6 sort of look tax by tax on the U.S. tax system and decide which ones are taxes on capital and  
7 which ones aren't. Now a more subtle version might put fractions on some of these taxes. You  
8 then add up the revenue each raises and then you divide by a measure of capital income. The  
9 advantages of this method is that it is relatively easy to calculate and by relatively, I mean  
10 relative to the next two methods I will talk about.

11 It is also relatively transparent. You can check over somebody's calculations, make  
12 sure they pulled off the right numbers from NIPA (And one could argue about how that was  
13 done). What are the disadvantages of this method? First of all, in principle, the identification of  
14 which taxes are on capital and which taxes are not on capital is arbitrary. Related, the tax rate  
15 that this method generates is not the answer to any well-posed question. It is not the answer to  
16 what is the marginal disincentive to save and invest nor would the people who calculate this  
17 method argue it is.

18 For example, it doesn't attempt to identify or measure to what extent the taxes that are  
19 identified to be on capital affect the marginal incentive to invest and save. It might take into  
20 account taxes on pure profits or disguised or shifted labor income that shows up in the  
21 corporate tax base. Taxing these things might raise revenue, but doesn't affect the marginal  
22 incentive to save and invest. It is backward looking—that is, it is affected by laws previously in  
23 place.

24 In the paper, I talk about a calculation of this method based on a paper by two OECD

1 economists. Because this method is relatively easy to calculate, it has been done for many  
2 countries and compared across these countries. They say that the federal tax rate on capital is  
3 about 24 percent. About one-quarter comes from the corporation income tax and the majority  
4 comes from personal taxes.

5 Now one caveat to the calculation of the method, as opposed to the method itself, is  
6 that the majority of taxes on capital, they say, come from individual personal income taxes. How  
7 do they get that? They take total individual tax revenues. They calculate the share of capital  
8 income and household income and multiply that ratio by total revenues. This ignores all special  
9 preferences to saving Roths, traditional IRAs, and is a very gross approximation.

10 Method number two, what I call the hypothetical project method. This begins with a  
11 well-understood model of how business level taxes affect the marginal incentive to invest in a  
12 single asset. And going back to Hall and Jorgensen in the 1960s, it is a model of how a profit-  
13 maximizing firm would invest up until the margin and looks at what taxes affect that margin.

14 Because this is about one asset, it then computes a weighted average based on asset  
15 usage and then makes further assumptions about corporate financial equilibrium so as to allow  
16 for the effective personal taxes on corporate income, based on estimates of personal tax rates,  
17 debt equity ratios, et cetera.

18 Advantages. It builds on a widely accepted theoretical framework for business taxes  
19 and admittedly, a more controversial theoretical framework for personal taxes. It does identify  
20 the marginal affect on savings investment. It is forward looking and so appropriately disregards  
21 the current tax implications of past policies.

22 Disadvantages. Its accuracy rests on the accuracy assumptions about many variables. I  
23 list some here. You need to know true economic depreciation, asset by asset. You need to  
24 know the expected rate of inflation. You need to estimate personal-effective personal tax rates

1 on types of income.

2 And second, it doesn't account for much of the detail of tax provisions and their  
3 enforcement. It doesn't make much use of actual tax collections to provide a reality check on  
4 the parameter assumptions. For example, if all the arbitrage opportunities that the papers follow  
5 exist, they have to be accounted for in an ad hoc way and they don't take advantage of the  
6 actual revenue collected by certain taxes.

7 Calculation of this method. I talk about calculations done by Jane Gravelle, who we will  
8 hear from in a minute. Her calculation of this for 2003 in the United States was that the tax rate  
9 on capital was 23 percent in 2003—a weighted average of a higher number for corporate  
10 capital and a much lower number on residential capital.

11 One caveat to this particular calculation of the method is that it assumes that tax  
12 preferred savings accounts do not operate at the margin of new savings. So IRAs and private  
13 pension accounts are—it is assumed that most people when they are making their marginal  
14 saving decision are already past the limits. And so there is no subtraction in the calculation for  
15 these. Based on Jane's paper, I estimate that if one changed that assumption, say they do  
16 operate at the margin, the 23 percent figure would fall to about 14 percent.

17 Where is the timekeeper? How are we doing?

18 MR. BURMAN: Good.

19 MR. SLEMROD: Reality check. How can the right answer be so low for an income tax  
20 that double taxes corporate income? Well, just keep a few things in mind. There is accelerated  
21 depreciation, or there could be, depending on the year. So the business tax base is less than true  
22 income. On average, interest paid by corporations is deducted at a lower rate than interest  
23 receipts are taxed. That is a kind of tax arbitrage and there are many. Owner-occupied housing  
24 is hardly taxed. So that is a basic reality check about why this number might be lower than you

1 would think.

2 Third method, which I call GKS. The G is Roger Gordon and the K is Laura  
3 Kalambokidis, who have been my coauthors on a few papers using this approach. Here is how  
4 it works. For a given year, start with actual total tax collections. Then subtract from that what an  
5 estimate of what tax collections would be under an R-base tax. An R-base tax is very similar to  
6 a Hall or Bush–Rabushka flat tax. We know the R-base tax is non-distortionary to savings  
7 investment.

8 Under an R-base tax, investment is expensed, not expressed, interest payments are not  
9 deductible and interest dividends and capital gains are not taxable. So you start with actual  
10 taxes, subtract what we get under an R-base tax with the same rates, divide by real capital  
11 income and that is the GKS method.

12 Advantages. Under certain assumptions, the GKS measure is exactly equal to the  
13 correct measure of the disincentive, the marginal affect on savings and investment. It equals the  
14 Hall–Jorgensen measure under some assumptions. It automatically accounts for things that might  
15 raise revenue, but don't affect the marginal incentives such as taxation of pure profits and risk  
16 premia.

17 The idea is that an R-base tax would treat those things exactly the same as the current  
18 tax system. We subtract the two. So those things that don't affect the margin just come out of  
19 our numerator. It doesn't require calculating things like economic depreciation rates, effective  
20 personal tax rates, etc. It automatically allows for tax system details that are not easily  
21 parameterized. So, for example, if there were extensive arbitrage that influences the effective tax  
22 rate on savings and investment, we would pick that up because we would see tax revenues  
23 eroded.

24 Disadvantages. It is backward looking and so will be affected by past tax laws and

1 cannot account for known future changes in tax laws. It is based on revenues in a given year and  
2 its accuracy depends on how close the economy is to a steady state in the year measured.

3         Given the data we have available, calculating it is tricky and requires a savvy  
4 investigator. That is also true for the hypothetical project-based method. For that method, we  
5 are lucky to have a savvy investigator here, Jane Gravelle, do it. In our case, I am lucky to have  
6 two savvy investigators do it, Roger Gordon and Laura Kalambokidis. We do this calculation  
7 that I refer here to as GKRS. For this particular paper, we had Jeff Rohaly, of the Urban  
8 Institute as a coauthor who ran the R-base through the Tax Policy Center calculator.

9         Well, according to this calculation, the actual current tax system raised about \$60 billion  
10 more than an R-base tax would have raised. So compared to a nondistortionary tax,  
11 consumption tax, we raised \$64 billion more. That translates to an effective tax rate of about 14  
12 percent. Without bonus depreciation, which is no longer in effect but may be back soon, it  
13 increases to about 20 percent.

14         We note in that paper that if there were expanded tax preferred savings accounts and  
15 bonus depreciation, as was proposed by the Bush administration, this calculation could turn  
16 negative so that on the margin we not only don't tax capital income, we subsidize it.

17         Well, luckily I am to the conclusions so I don't have to hear that horrible sound Len  
18 referred to. You can take it off in anticipation of me being done on time.

19         (Laughter.)

20         MR. SLEMROD: Here are my conclusions. The simple collection-based method is not  
21 reliable. It doesn't measure the answer to any interesting question. Two theory based methods,  
22 which under some assumptions, should give exactly the same answer, but which have different  
23 measurement advantages and disadvantages, provide similar answers to the question at hand.

24         You may be thinking, well, what was that question? Does the United States tax capital

1 income? Yes, but only at a rate of between 14 percent and 20 percent. Why does it matter?  
2 Well, if we are right, the existing system provides a modest disincentive, but certainly a  
3 disincentive, to saving and investment. Note, though, that the current system not only causes a  
4 modest disincentive to the volume of saving investment, but also causes a misallocation of a  
5 given amount of capital across uses. In this paper I don't try to measure that.

6 MR. BURMAN: Good job. Thank you, Joel. I am glad not to hear that buzzer.

7 Our first discussant is Reed Shuldiner from the University of Pennsylvania Law School.

8 MR. SHULDINER: Well, thank you for inviting me first of all. I was asked—  
9 discussants in general were asked—to not necessarily focus specifically on the paper, but to  
10 think about the question more broadly. So starting on some of the ideas in the paper, I want to  
11 step back for a minute and look a little more broadly at what we are doing.

12 As we think about tax reform, there are essentially three types of broad-based taxes we  
13 are considering. We are considering an income tax, we are considering a consumption tax, like  
14 a VAT, a Hall–Rabushka flat tax, a cash flow tax, retail sales tax and another tax on the table is  
15 a payroll or wage tax.

16 And it is generally known that the difference between these types of taxes is the way  
17 they treat capital. They all tax labor and the usual understanding is that the consumption tax and  
18 the wage tax don't tax capital. The problem, as Joel clearly recognizes, is that is a gross  
19 oversimplification and the problem is, again, as Joel has alluded to, the returns to capital come in  
20 different flavors.

21 One is pure return to waiting, the risk-free rate. You know, you can think of investing in  
22 a government bond and you are just getting a risk-free return. Another is the return to risk  
23 bearing. Think here of investing in the stock market. We expect that we will, on average, have a  
24 payoff and that payoff will include a risk premium. So that is another piece of this return to

1 capital.

2 And the third are unique returns often called, in the literature, infra-marginal returns.  
3 What are those? Well, those may be things like monopoly rents. They may also be returns to  
4 entrepreneurial effort, but I think they are really labor income disguised as capital income.

5 And it is important to keep these ideas straight because these different taxes tax them  
6 each differently. Let's look at the one slide I have.

7 So if we consider, for example, the normal risk-free return—the income tax, of course,  
8 taxes the normal risk-free return; the consumption tax does not—nor does the wage tax. And  
9 usually if you just look at that—that is why people say, “Well, those taxes don't tax capital.”

10 What about the risk premium. Well, the income tax and the consumption tax treat the  
11 risk premium in precisely the same manner. Now do they tax it? Well, I put share here rather  
12 than tax because what they are doing is they are taking a piece of the risk premium, but they are  
13 also sharing the risk.

14 And so I don't think it is right to really view that as a tax and it is because they treat  
15 them the same that Joel is able to just ignore them in his measure. His measure does not include  
16 that tax and his net measure subtracts that out. The wage tax does not tax the risk premium,  
17 obviously it is just taxing pure labor income. And finally, these monopoly returns or hidden labor  
18 are taxed under both the income and the consumption tax.

19 So what does that tell us? First of all, it tells us we should be very careful if we are going  
20 to move to a consumption tax, not to think that a payroll tax is a good way to implement a  
21 consumption tax. The failure to tax these monopoly returns and hidden wage income seems to  
22 me to be a serious problem with that. It seems to me those are exactly the kinds of returns that  
23 we want to tax.

24 From a distributional point of view, these tend to be returns of high-income individuals.



1 So this can be a serious distributional effect if we don't tax them. And from an efficiency point  
2 of view, as Joel pointed out, we are not bothered by taxing them. If these are monopoly rents,  
3 then generally we are not causing any inefficiencies by taxing them. If they are hidden returns to  
4 labor and we are taxing all the rest of labor, we should be taxing them too.

5 The wage tax also doesn't share in the risk premium, but that is a tougher question—  
6 whether that is a problem or not depending on how you think markets work. But just on the  
7 question of monopoly returns, it seems to me clearly that a wage tax is an inferior way to go  
8 about it.

9 What about the difference in an income tax and a consumption tax? Well, the first  
10 observation is that there is not nearly as much difference as people often think because we have  
11 two of these categories and it is identical with respect to two of these categories. They both tax  
12 the monopoly returns and the hidden labor returns and that is, I think, quite good. They share in  
13 the risk premium. Probably good on net, but unclear.

14 So the only question is the taxation of the risk-free return, which leads to the question of  
15 how important is that, which leads to the question of how big is this risk-free return. There has  
16 been a strand in the literature that has said what we want is to look at the short-term rate. So  
17 basically the T-bill rate.

18 Of course we need the real T-bill rate and not the nominal T-bill rate. And they have  
19 looked at it and they have said, "Well, we are talking about half a percent by looking at a  
20 particular historical period." And they have said well, maybe up to 1 percent, but it is small, it is  
21 inconsequential, and therefore the difference between the taxes is very small. So even smaller  
22 than you would get just by looking at this chart.

23 I think that is wrong. I think it is wrong for several reasons. One, even sticking with the  
24 short-term rate, I think they simply mis-measured the short-term rate because of the historical

1 period they looked at. They looked at a period that included a lot of unexpected inflation, so  
2 depressed the real rate. If you look at more reasonable periods, you get estimates of 1.5 up to  
3 2.9 percent, depending on the period. Given time, I won't go into details here.

4 The second question—but already we are talking about a substantially higher rate. Also,  
5 I think to use a 30-day rate is a mistake. I think we are talking about investments with longer  
6 time horizons. So if you, for example, used a long-term government bond rate rather than the T-  
7 bill rate, you would end up with estimates more in the order of 3.3 to 3.5 percent. So already  
8 we are talking about 6 or 7 times the estimates some people have used.

9 One other way to look at that would be to look at TIPS, Treasury Inflation Protected  
10 Securities. There is a very direct measure of people's estimates of what the real rate should be.  
11 Those have ranged from, at issuance, from 1.6 to 4.25 percent and have averaged about 3  
12 percent.

13 Finally, should we be thinking in terms of annual terms or should we be thinking about a  
14 longer horizon? It seems to me we are concerned with investment over much longer horizons.  
15 So if we are looking, for example, at a 20-year horizon, a 35 percent tax rate would reduce a  
16 3.5 percent annual return from an overall return of approximately a hundred percent over that  
17 horizon, a cumulative return, to about 57 percent.

18 That is a substantial difference. Even if you use Joel's lower end of 14 percent, you are  
19 reducing it from 100 percent to 80 percent. So I think there is something substantial going on  
20 here. Hall refers to it as almost confiscatory. I think that is an exaggeration, but it is clearly  
21 substantial.

22 So in conclusion, in terms of this part of it, I think the difference is less than people often  
23 think because they confuse the risk premium in the monopoly return, but it is more than some  
24 have argued because I think there is a substantial difference between—I think the risk-free rate

1 is substantial and so there is a substantial difference.

2           Going back more directly to Joel's paper, I just want to emphasize one point that he  
3 made at the end of his presentation. We are really looking here at average numbers and that  
4 causes a real problem. I mean, it is obvious if you look at, in Jane Gravelle's work, where she  
5 estimates for housing a 2 percent rate and for corporate capital, she estimates a 32 percent rate.

6           I mean, that is a huge divergence and it means that the disincentive to invest in the  
7 corporate sector is really quite large. There is a huge incentive to shift capital into housing. So  
8 the efficiency cost is much greater than you would get just by looking at the raw 14 percent rate  
9 and that is a problem that you would find in her work and in Joel's work. So while I think that  
10 work is tremendously valuable, I think you have to be careful to understand, as Joel points out,  
11 that there is a lot more at stake and that there is a higher cost going on there.

12           MR. BURMAN: Thank you, Reed. I have two presentations under budget already.

13           Jane?

14           MS. GRAVELLE: What a challenge.

15           MR. BURMAN: Jane Gravelle, Congressional Research Service.

16           MS. GRAVELLE: You can just run it for me. I can see it from here.

17           MR. BURMAN: That is great.

18           MS. GRAVELLE: So I am commenting on Joel's paper but trying to answer the same  
19 question that he is. So if you go to the next slide, the question is capital income tax. Does the  
20 United States tax capital income and really how much? It depends on how it is measured.

21           Joel mentioned three different rates. What I would call the marginal effective tax rate,  
22 the hypothetical investment rate. Its biggest problem, clearly, is measurement, particularly of  
23 economic depreciation. For the average tax rate, the biggest problem is that it fluctuates  
24 because of timing issues. It really doesn't capture timing. And it also can't be used to show

1 differentials across assets.

2 The GKS measure, I just don't think is conceptually suited to measure a tax rate. It  
3 basically subtracts the consumption tax measure from an average tax rate and it should be used  
4 in the wage tax, which in case you would get back to the average tax rate.

5 Okay. The next slide. Now I put all these formulas in because they tell me not to and  
6 also to try to persuade you that I know what I am talking about, but I won't talk about them  
7 right now. What I want to talk about is, to start with, a base point for these three measures.

8 What I have done here is a hypothetical investment. I am thinking about the corporate-  
9 level investment, I am thinking about the firm level, not with individual taxes or deductions of  
10 interest or anything, over the 35 percent marginal tax rate. And you can start with a benchmark,  
11 which says if you got economic depreciation and the growth rate is equal to the discount rate,  
12 then you do, indeed, find the marginal effective tax rate conceptually, theoretically and the  
13 average tax rate are the same, 35 percent.

14 I actually find that the GKS measure under these circumstances is 23 percent. I think  
15 this is right. Joel and I have been talking about this and we just weren't able to get this  
16 difference resolved before the meeting, but we will.

17 MR. BURMAN: You will let the rest of us in on it.

18 MS. GRAVELLE: We will. I will.

19 But I think that is really not the important issue. I think a much more important issue is  
20 how these measures change when you don't make the assumptions that the growth rate is equal  
21 to the discount rate. I assume the growth rate would be around 2 1/2 percent, whereas the  
22 discount rate is about 5 1/2 percent. That makes a lot of difference.

23 So, in the next table I am going to vary it by using this lower growth rate assumption. I  
24 am also going to look at economic changes from economic depreciation. So what I have had to

1 do is—again, this is conceptual—to look at a representative investment and I have done five  
2 schemes: expensing, fast depreciation where the depreciation rate is twice the economic rate,  
3 economic depreciation, slow depreciation, which is half, and no depreciation.

4 And so you can see the pattern. You see that if you are close to economic depreciation,  
5 then the marginal effective tax rate and the sort of average tax rate from collections are the  
6 same. The GKS rate is really much, much lower. That is because of this growth rate effect,  
7 choosing a different growth rate.

8 But you can also look at what happens when you change the schemes. Now if you are  
9 actually doing expensing, the marginal effective tax rate and the GKS tax rate are the same  
10 because they are zero and the average tax rate (this isn't a steady state) overstates the tax  
11 burden a lot. But as you go closer towards economic depreciation, you find that actually this  
12 average tax rate collection, in theory, is not a bad measure of the tax rate.

13 The next slide really does the same sort of thing. For real estate, for building and again, I  
14 think you have a very similar pattern. If you are close to economic depreciation, the average tax  
15 rate and the marginal effective tax rate are the same and actually very good estimates. That is  
16 because depreciation is not so important for these long-lived assets. But again, the GKS tax rate  
17 is really sort of too low.

18 The other thing I did was try to look at some important issues Joel raised in his paper  
19 about how badly these tax rates are affected by looking at risky investment and excess profits  
20 and I tried to do these calculations with risk. I basically said for this—for the marginal effective  
21 tax rate discount everything at the riskless rate, but for the other tax rates, I only discounted the  
22 sure depreciation stream at the riskless rate. And everything else I discounted at a risky rate so  
23 you could capture the effect of risk in these measures.

24 So if you will go to the next slide, you still, again, find a very similar pattern. I mean, you

1 do find that the differences between the average effective tax rate and the marginal effective tax  
2 rate increased, but not by a great deal. As you go close to economic depreciation, there is still a  
3 pretty good measure and the GKS measure is still understated.

4 The next slide does the same risk with real estate. The same sort of general result. So  
5 then the question is—I mean, these are all theoretical conceptual measures. They all assume you  
6 are measuring everything right.

7 So the next thing I wanted to do was to go and try to compare the measures. Using the  
8 data Joel presented in his paper, I just took the average—the collections measure and divided it  
9 by the measure of capital stock. I took the GKS differential, divided it again by capital income,  
10 adjusted to add back the bonus depreciation correction, changed the timing to the same year. In  
11 other words, to try to get everything into the same measure, which is for the same year and the  
12 same tax system, which is basically the tax system we have without extending the tax cuts. So it  
13 is without dividend relief or capital gains relief. And so the question is, how do these numbers  
14 look empirically?

15 My prediction, because I think we are pretty close to economic depreciation, is that the  
16 collections measure and the marginal effective tax rates measures will look very similar. The  
17 GKS measure will be too low and perhaps even lower than suggested here because it leaves  
18 out some of the personal taxes. And that is what I came up with.

19 If you will go to the next slide, there are two marginal effective tax rates that I  
20 calculated. And again, this is for no relief for dividends or capital gains. This is like 2001 law  
21 basically. And I find that if you don't include the effects of pensions and IRAs as marginal  
22 effects, you will get a 30 percent tax rate. If you do then include, you get a 22 percent tax rate.

23 The average tax rate presented in the paper (and basically I took out employment taxes  
24 and added back bonus depreciation) is 24 percent and the GKS measure is only 3 percent. So

1 I just think that measure doesn't work.

2 If you went to the capital gains and dividends rules, you know, where you have those  
3 exclusions, in other words, doing the law, assuming those will be continued, I get a tax rate of  
4 26 percent with a marginal—no marginal effects of pensions and IRAs and 20 percent with  
5 marginal effects. So my conclusion is yes, we tax capital income and we tax it about as we  
6 intend to tax it, somewhere probably around 25 percent.

7 If you will go to the last slide—I am doing okay, right?

8 MR. BURMAN: Yes.

9 MS. GRAVELLE: So here is my conclusion. Capital income in the aggregate is taxed  
10 probably at around 25 percent. There is a good bit of evidence to support that view. There are  
11 still big variations. Again, not if you don't have the tax provisions prominent, the prominent tax  
12 capital gains and dividends relief, and you are not counting IRAs and pensions as marginal, you  
13 have about a 40 percent tax rate in the corporate sector and you have a 0 percent, maybe even  
14 a negative rate, for owner-occupied housing, again, depending on how you deal with pensions  
15 and IRAs.

16 I don't think these measures are really affected that much by risk and by excess profits  
17 because I think we are very close to the statutory rate. I do think the GKS measure tells us that  
18 we wouldn't lose very much, at least at the corporate level, if we switch to a consumption tax.

19 And now just to depart for a moment, my task was to talk about do we tax capital, but  
20 I just want to say two things about reform. First, my view is that we may talk about  
21 consumption taxes until we are blue in the face, but we will never do it because I think the  
22 transition problems are overwhelming. I believe we will never have a consumption tax.

23 So that means if you are going to cut the capital income taxes, you are going to have to  
24 raise the taxes on wages. You are going to have to amend the direction of a wage tax. I would

1 expect that at least some of the President's tax commission tax proposals might look like that  
2 and that, I think, trades off efficiency issues for, I think, some very important distributional issues  
3 and I think that is the real story in tax reform. Thank you.

4 MR. BURMAN: Thank you very much. I think Joe Thorndike is not here. There was a  
5 medical issue that came up last night and he said he wasn't sure he would be able to come. So  
6 his comments will be in the published volume. We are also going to post the comment and when  
7 Jane and Joel agree their comments are going to—Jane's comments and revisers of the papers  
8 will be posted on the ATPI web site and Tax Policy Center as well.

9 I guess Hank would like to make a comment. Anybody at the table who would like to  
10 make a comment, you should put your card up sideways. We are also going to take questions  
11 or comments from the floor.

12 Hank.

13 MR. AARON: My question is for Joel and I guess Reed. Well, maybe Jane as well.  
14 Each of you has placed great emphasis on the superiority of forward-looking measures of tax  
15 burden and the reason, I take it, is that that is the way you measure the impacts on behavior,  
16 investment or savings behavior.

17 Economists, traditionally, are very interested in efficiency. Most everybody else is  
18 interested in distribution. If one is interested in distribution, why isn't what counts what actually  
19 happened, which is the mélange of past tax changes that impact on current investment returns at  
20 least along with the kinds of analyses that you described.

21 And one might argue they are even a guide to what people should expect in the future. I  
22 would suggest that anybody who expects the tax law to remain unchanged, even as it affects  
23 investments already in place, is ignoring the lessons of history, to put it mildly. So my question is,  
24 why shouldn't one be interested at least as much in a measure of tax collections based on the



1 historical record for distributional reasons?

2 The second question is really more to Jane and it is just for clarification. Do her  
3 estimates allow for tax arbitrage and the distribution of deductions and income based on tax  
4 clients? If not, wouldn't that affect the results?

5 MR. SLEMROD: I agree with Henry that considering forward-looking measures is  
6 certainly the right thing to do if you are interested in the incentive effect of the system we have or  
7 a new system. And as I said in, I think in the first slide, if you are trying to understand the  
8 distributional effects of the tax system.

9 It is not necessarily the full right answer. For example, if there are pure profits (and their  
10 distribution of pure profits is skewed), then you would want a measure that would take that into  
11 account. I am not as convinced that that means you want to look at an average tax rate measure  
12 or a tax collection-based measure.

13 I could see how, in some circumstances what happened in the past might be a  
14 reasonable predictor of what we can expect in the future. I understand that idea, but I can think  
15 of plenty of examples when a tax system is in transition to another tax system, a tax collection  
16 based measure of a year in transition will give you—well, it will not give you the right answer to  
17 any question, distributional or efficiency.

18 MR. SHULDINER: Yes. I mean, I have a few responses. One, I think as between  
19 average rates and marginal rates, it seems to me that for distributional concerns, we definitely  
20 are interested in the marginal—in the income average where, for efficiency, we are interested in  
21 the marginal, but I am not sure why you would want to look at the past average rate rather than  
22 some prediction of the future average rate.

23 Now in making that prediction, you know, learning from the past is clearly relevant and  
24 trying to decide what a tax system will actually look like, which I take to be part of your point,

1 we need to anticipate that Congress will make many different changes to it and we have some  
2 sense of what sort of changes those might be.

3 And finally, you could say, as a sense of fairness, we want to see how people have been  
4 treated in the past and that goes into a sense of how they should be treated in the future, but I  
5 think that is very difficult to do in this context.

6 MR. SLEMROD: A good example of Henry's point, I think, is the capped tax  
7 preferences for saving. If Jane is right that they are not effective at the margin, then we wouldn't  
8 want to consider them in calculating the effect on the incentive to save and invest, but we  
9 wouldn't want to ignore them either in understanding the distributional consequences of the  
10 current tax system.

11 MS. GRAVELLE: Well, Henry, I agree with you. I think it is important to look at what  
12 is the cash flow. That is something we should take into account. I do think there are problems  
13 when you change things because—in fact, Alan Auerbach just gave a very interesting  
14 presentation last week at the NBER meeting, which talked about the importance of thinking  
15 about tax capitalization when you make a change. So I think that is important.

16 In answer to your arbitrage question, basically what I do in these calculations, courtesy  
17 of Dan Feenberg, is to use his tax rates. So if he says interest income is taxed at some rate, then  
18 I use that rate, and if he says that capital gains—well, we know what capital gains is. For  
19 example, if the dividends are taxed at a different rate, I use that.

20 So in a sense, I guess there is some arbitrage in that different people are investing in  
21 different assets. But it is not really very complicated; calculating tax rates is more of a  
22 mechanical thing.

23 MR. BURMAN: Thanks.

24 David?

1 MR. WEISBACH: A question for Jane. There is something about your slides which I  
2 don't understand. You said that the one piece of Slemrod's you agree with is that it wouldn't  
3 cost very much to switch to a consumption tax.

4 MS. GRAVELLE: Well, at the firm level.

5 MR. WEISBACH: At the firm level? Okay. You pick up a very high marginal effective  
6 tax rate. So I guess the question is what else is that picking up? Is that primarily picking up the  
7 risk premium and profit, which Joel is explicitly leaving out, as an incentive issue?

8 MS. GRAVELLE: No. I think if you just think about the firm level and you think about  
9 an economy where 25 percent of income is capital income and 75 percent is labor income and  
10 you have maybe a 5 percent savings rate. Basically that means that the consumption tax base is  
11 20 percent, the income tax base is 25 percent. So the consumption base is like—if I do my  
12 math right, 80 percent of the income tax base.

13 So when you have a very low savings rate, those tax bases are the same. I mean, it is  
14 very different in the sense that a consumption tax has this huge lump sum tax, you know, on  
15 existing capital, which allows you—it is really what that cash flow tax, that 20 percent of income  
16 is collecting. So it is because you can impose a lump sum tax on old people that you can move  
17 to a consumption tax without losing a lot of revenue.

18 MR. BURMAN: Julie, a quick comment.

19 MS. ROIN: I was just trying to figure out why the GKS measure comes up with such a  
20 low tax rate and I was wondering if in that GKS measure, you were dividing the tax that  
21 remained by the total cost—the total amount of capital.

22 Because if that is what you were doing, you are saying, well, that is how much we are  
23 taxing the time value of money returns on that capital. There can also be this tax on risk premia  
24 and monopoly returns that we are collecting under the total tax that we are collecting and that

1 might account for the discrepancy between the two tax rates, that you are essentially reporting  
2 part of the tax.

3 MR. SLEMROD: Well, remember that the way GKS understands GKS, the tax rate  
4 we get is actually quite comparable to the hypothetical project-based method. It isn't what you  
5 described. The GKS method gives you exactly the marginal effective tax rate under some  
6 assumptions. The denominator is something close, but not exactly the real risk-free rate of return  
7 times the capital stuff. And so for it to be a conceptually meaningful measure, that has to be the  
8 denominator.

9 MR. BURMAN: Dan?

10 MR. HALPERIN: I suppose this is obvious, but I think the discussion indicates that you  
11 are really thinking about two separate questions here. One, is a high tax and we are talking  
12 about distribution, then the question would be if we switched our tax system, should we maintain  
13 this distribution and are we going to be able to maintain this distribution?

14 If the focus is on incentives, then the question would be what is the impact of these  
15 incentives on actual savings and investment and can we possibly hope to change that  
16 dramatically by some new system? And, in particular, if you are talking about differences in  
17 rates across various sectors, then the real question becomes will a consumption tax actually be  
18 more perfect than an income tax in dealing with various sectors. So I think all those questions  
19 are there and of course if the tax rate turns out to be very low, maybe none of this matters.

20 MR. BURMAN: Are there any questions from the floor? Please go to the microphone.

21 MR. ROSENTHAL: This may be a basic question. I just want to clarify something. I  
22 am Steven Rosenthal of the lawyers at Miller and Chevalier. The context of the question do we  
23 tax capital more greatly in the past, any trends and more specifically how about taxing capital  
24 relative to labor. Is this the same order of magnitude in terms of the tax fees imposed on capital

1 versus the taxes on labor?

2 MR. BURMAN: This is why I wish Joe Thorndike were here. He was going to talk  
3 about the history of the debate about taxing capital income. Any comments?

4 MS. GRAVELLE: Yes. I actually published a paper in the June 2004 issue of the  
5 *National Tax Journal*, which I did these tax rates historically. I also have a CRS paper. So  
6 basically we are taxing capital at a much lower rate now than we did historically.

7 Back in the '50s, the corporate tax rate was 52 percent I think, depreciation was much,  
8 much slower. So we had very high tax rates back then and they have fallen dramatically and will  
9 fall further if we keep the capital gains and dividends. I can't remember what those numbers  
10 were, but it is probably followed by two-thirds or so.

11 MR. BURMAN: I realized I was remiss when I thanked people in the beginning. I  
12 should have pointed out that this conference is a real collaborative effort between the Tax Policy  
13 Center, the American Tax Policy Institute, and Tax Analysts and in particular, we had a  
14 committee that included Dan Halperin, Ron Pearlman, Bill Wilkins, and Clarissa Potter of ATPI  
15 that made very substantive contributions in putting this conference together and we are very  
16 grateful for that.

17 We are going to take a 15-minute break. There will be coffee in the room off to the  
18 side, and we are going to start very promptly at 10 after 10:00.

19 (A brief recess was taken.)

20 MR. AARON: As Len mentioned, George Zodrow didn't get his priorities straight and  
21 decided to stay with his family in Houston rather than—well, or outside Houston rather than  
22 come to a Brookings conference. Unfortunately, he is not here.

23 Fortunately, one of his discussants is Alan Auerbach from Berkeley who consented to  
24 present the paper for George. Then he is going to change hats and discuss it or maybe they will

1 be blended and you won't be able to tell them apart. In any event, let's have Alan start.

2 MR. AUERBACH: Thank you very much. In answer to Hank's query, I am going to  
3 use the device of color and font to indicate when it is me and when it is George talking.

4 (Laughter.)

5 MR. AARON: Will he be blue?

6 MR. AUERBACH: Right. Now, of course, his blue is not really George talking. It is  
7 George talking through me. He is not here to defend himself. I am not sure what we will do in  
8 the question time when I am trying to answer questions on George's behalf, but we will see.

9 George's paper has three sections: a framework for analysis in which he goes over what  
10 the issues are in thinking about whether we should tax consumption, an overview of the literature  
11 on the effects of moving to such a tax, and conclusions about what we should do.

12 Just to point out the significance of his title: he doesn't say "should we have a  
13 consumption tax?", he says, "Should capital income be taxed under a consumption tax?" The  
14 significance of that title is, as was pointed out in Reed's comments, we tax capital income, to a  
15 certain extent, under a consumption tax.

16 My first comment, is that this is true of a consumption tax, but again, as Reed and Jane  
17 pointed out, it is not true under all taxes that eliminate the tax wedge facing new savings. It is  
18 particularly not true under a tax on labor income.

19 So to move to the first part of George's paper, a framework for analysis, he deals with  
20 three issues. First, is a pure consumption tax more likely than a pure income tax in terms of what  
21 we will actually experience?

22 Then he goes into a more detailed discussion of how capital income is taxed under a  
23 consumption-based tax as opposed to an income-based tax; then he gets a little bit into  
24 international issues, which are very complicated.

1           As to the first question, whether we can purify the tax system by moving to a  
2 consumption tax, he starts with the self-evident proposition that the income tax is a mess. Given  
3 our failure to make it better and our success at making it worse over, say, the last couple of  
4 decades, could we do better under a consumption tax? That is, given that we have tried and  
5 failed to make the income tax clean, can we do better if we move to a consumption tax? Many  
6 people worry that it would be just as messy.

7           His first argument is that a consumption tax might be purer is that since consumption is  
8 easier to measure than income, we don't start out behind the eight ball. That is, some of the  
9 complexity of the income tax is self-inflicted, but some of it isn't. Some of it is just the results of  
10 our trying to do the right thing and failing. So he argues that since measuring consumption is  
11 easier than measuring capital income, in particular, we can avoid that element of complexity.

12           Just a point of advertising here: we could tax income without trying to measure it, as  
13 David Bradford and I pointed out in an article published last year, using what we called  
14 generalized cash flow taxation. That is, it is technically possible to impose a tax like a  
15 consumption tax just on cash flows that doesn't seek to measure capital income, that  
16 nevertheless has the effect of taxing income. Whether you would want to do that is a more  
17 complicated issue.

18           Continuing on this issue about reasons why a consumption tax might result in a cleaner  
19 tax system, George makes the argument that a uniform marginal tax rate of zero on all  
20 investment seems like a logical place to stop so that the political process would come to rest  
21 there.

22           (Laughter.)

23           MR. AUERBACH: I didn't feel that his heart was in that argument, but he did put it in  
24 the paper and so it is fair game. And he also makes the interesting point that because people are

1 concerned about the lack of progressivity associated with a consumption tax, this concern might  
2 lead to pressure to eliminate certain tax expenditures that benefit the well to do. That is, we live  
3 with them under our current tax system, but if we move to a consumption tax, we would be  
4 searching for ways to broaden the base at the top and that search might eliminate those tax  
5 expenditures.

6 My comment here is I think that purity is more likely to happen under a tax system  
7 where we have a clean break from the present one. That is, if we move to a retail sales tax, you  
8 could be pretty confident that a lot of tax expenditures would disappear; it would be hard to  
9 implement them under a retail sales tax. Perhaps under a value-added tax as well, less so under  
10 something like a flat tax that looks a lot like the current tax system.

11 To move on to the second point in his framework, how much do these tax bases really  
12 differ. I can go through this quickly because this was analyzed in Reed's slide. I have several  
13 slides to make the same point.

14 There are three components of capital income: the safe return, rents, and the  
15 compensation for risk-taking. Two of these three components are hit by both consumption taxes  
16 and income taxes. So it is really just the safe return we should be thinking about.

17 Now of course, this return might be taxed pretty heavily because with our messed-up  
18 income tax; for example, with the lack of indexing for inflation—historic cost depreciation—the  
19 tax on that small safe rate of return can be quite high when expressed as a rate. So you can still  
20 have a pretty big distortion even though the rate is small and, as George points out, that is  
21 compounded, because there are other distortions such as imperfect competition. When you add  
22 another distortion to an already distorted market, the effect of that incremental distortion is  
23 magnified.

24 I would add further that the presence of tax rate asymmetries ends up raising the tax



1 burden under a capital income tax and so we again have a bigger distortion.

2 Now, consider some of the implications that George draws from this point about only  
3 the safe rate of return being taxed: first the distributional consequences may not be as important  
4 as has been suggested. I associate this point also with a paper in the literature by Gentry and  
5 Hubbard.

6 Yes, this point is true. But if you want to do this calculation correctly, you should leave  
7 the return to risk taking out of the calculation because there is no burden attributable to that  
8 component of tax payments, at least in an efficient capital market.

9 Under neither income tax nor consumption tax does that represent a burden to the  
10 taxpayer and, therefore, we should leave it out and just compare the tax on rent to the tax on  
11 the safe return in thinking about the difference between an income tax and a consumption tax.

12 George also argues that simulation models, of the kind he reviews later in the paper,  
13 may overstate the effects of moving a consumption tax because these typically assume a higher  
14 rate of return than is appropriate if you only want to look at the safe rate of return and the  
15 change in the tax on that return.

16 But this point isn't obvious to me because the efficiency gains in moving to a  
17 consumption tax come from two places. One is the elimination of the tax and the safe rate of  
18 return and the other is the capital levy on existing assets.

19 The capital levy on existing assets doesn't go away when the safe rate of return is lower  
20 and so it could well be that the bulk of the efficiency gains found in these models would continue  
21 to exist even if the assumed rate of return were lower.

22 As to international issues, George doesn't make a serious attempt to deal with all of the  
23 issues that come up. He simply points out that with a source-based capital income tax, capital  
24 flows make distortions of taxing capital bigger, although he also points out that if you have got a

1 big country like the U.S., that doesn't immediately lead you to say that capital income taxes  
2 should be zero.

3 The paper also points out that the results are different under a residence-based tax. I  
4 would just point out a piece of the literature here. The last time I came to a conference at  
5 Brookings on tax reform, I presented a paper then that showed if you have an open economy,  
6 even under a residence-based tax, there are bigger benefits of reducing taxes on capital income  
7 because with worldwide opportunities to invest. You don't get declining rates of return as  
8 quickly in an open economy and that tends to make the benefits of more saving greater.

9 On the other hand, once you move to an open economy, one thing you need to take  
10 into account is the fact that rent itself is mobile. As Reed said, taxing rent is a good thing if it  
11 doesn't move. It may or may not move in the domestic context. Once you move to an  
12 international context, even if the rent is fixed worldwide, it isn't necessarily fixed in the United  
13 States. When you have an opportunity to choose the location of your operations and the rent  
14 moves with them, that could lead to a distortion of taxing even that component of capital  
15 income.

16 The second part of George's paper is his literature review in which he goes through the  
17 different kinds of simulation models that have been used to analyze the effects of capital income  
18 taxes starting with the very simplest infinite horizon models in which taxing capital income is  
19 effectively taxing future consumption more and more as you get into the distant future; this  
20 analysis leads, inevitably, to the conclusion that you shouldn't tax capital income in the long run.

21 Of course, that doesn't preclude taxing capital income in the short run, but then if you  
22 keep saying you are only going to tax capital income in the short run, that leads to the problem  
23 of dynamic inconsistency where the government makes promises that aren't credible—the  
24 taxpayers know the government will have an incentive to change policy once the future arrives.

1           Now the same issues might seem to arise with the capital levy that occurs under a  
2 consumption tax. When we move to a consumption tax, we take away basis or do other things  
3 to old capital and say we are never going to do this again. Might the taxpayer worry that this is  
4 just the first of many capital levies?

5           I think that is less of a problem because a capital levy under the consumption tax only  
6 occurs when we shift from an income to a consumption tax; we can't shift from an income to a  
7 consumption tax again once we have implemented a consumption tax unless we subsidize  
8 income and then have a higher consumption tax.

9           He also points out the curious fact that the logic supporting zero long-run taxes on  
10 capital income also applies to human capital, particularly if you have nondeductible expenses. If  
11 you have deductible expenses, then human capital investment already gets consumption tax  
12 treatment, but it wouldn't if you had nondeductible expenses. But one might respond what is left  
13 to tax if we tax neither capital income nor labor income? The answer, in those models, is that  
14 you tax labor income and capital income at zero in the long run and tax them both in the short  
15 run, which makes the dynamic inconsistency problem even more severe.

16           Now we move to finite horizon models. Suppose we don't live forever. I guess you  
17 could call that an economist simplifying assumption.

18           In this case, there is no theorem about the optimal level of the capital income tax. We  
19 can't say it should be exactly zero. Of course, as George suggests, if we find out it should be  
20 really very small, then, for reasons of simplicity, maybe it is just better to get rid of it. The  
21 literature, starting with a paper by Larry Summers in 1981, has used life cycle models of many  
22 periods to try to sort this out.

23           Larry found very big welfare gains from moving to a consumption tax in the long run, but  
24 it was a very specialized model that had a very responsive saving behavior and fixed labor

1 supply.

2 In several papers that Larry Kotlikoff and I wrote, and in our book, we introduced  
3 variable labor supply, and, made the saving responses smaller; but we still found that the switch  
4 to a consumption tax delivered notable gains in welfare. I updated that for a conference here 10  
5 years ago to consider more realistic versions of the consumption tax. I still found sizeable,  
6 potential gains, but also that if you try to maintain the current degree of progressivity and  
7 provide transition relief, most of the potential welfare gains disappear.

8 A question that comes up often when thinking about distributional issues is whether a  
9 consumption tax can be as progressive as an income tax. Many people view this as a show  
10 stopper. If you start with a retail sales tax, which is proportional, obviously you can make the  
11 system more progressive than that; but people worry that you can't make a consumption tax as  
12 progressive as the income tax.

13 In the paper that David Altig and I and three other colleagues published four years ago,  
14 we extended my model with Larry Kotlikoff to consider population heterogeneity within  
15 cohorts, as well as different generations. We looked at 12 lifetime income categories where we  
16 took deciles of the population and then broke the bottom decile into the bottom 2 percent and  
17 then the next 8 and then the top decile into the top 2 percent and then the next 8.

18 We found that the X-tax, David Bradford's modification of the flat tax, with a top rate  
19 of 30 percent, the long-run percentage welfare gains for the different categories were quite  
20 similar. The ranking was reversed so that the lowest group was slightly better off than the highest  
21 group, but the percentage changes weren't that big. And the highest group was the top 2  
22 percent of the population.

23 This suggested that at least if you define the highest income individuals as the top 2  
24 percent, a consumption tax can do it. This, in turn, suggests that the real problem, in terms of

1 distribution, at least in the long run and leaving transition issues aside, is the very top, not the top  
2 2 percent, but maybe the top half percent or the top one-tenth of a percent. People might react  
3 that this concern is trivial, but for those of us who have looked at tax data we know that there is  
4 a lot of income there and a lot of tax payments there.

5 So this is not a trivial consideration and it really does make a difference whether you are  
6 talking about the top 1 percent or 2 percent or a half percent or a tenth of a percent in particular  
7 because that is where the biggest gains have occurred in income in recent years.

8 Another issue that George considers when critiquing the literature is that the literature  
9 tends to consider fairly standard life cycle models of saving. What if that model is inaccurate?

10 There has been a lot of emphasis in the very recent literature on so-called behavioral  
11 models of saving, where people save for reasons that aren't, in economic terms, rational. This  
12 literature has pointed out the importance of employer-sponsored saving and employer-provided  
13 education and other coercive mechanisms in encouraging people to save.

14 Now if it is this kind of coordination that causes people to save, a consumption tax  
15 might actually reduce saving because it would eliminate any prominence that employer-  
16 sponsored programs would have. If every form of saving had the same tax benefit, these  
17 programs might wither away. If they did, that might eliminate or weaken the coordination  
18 mechanism or the coercive mechanism that people currently have.

19 Now a point that George doesn't make that I would make is that once you move away  
20 from the economist rational to people, who, when they are young, don't think about the need to  
21 have resources when they get old. Then, when they are old, they wish they had thought about it  
22 when they were young. It is not clear how we should measure welfare changes because we  
23 usually measure welfare changes by asking how a person's lifetime well-being is affected by a  
24 change in policy.

1           In some of these models where people don't save enough unless coerced to do so, they  
2 don't care about their consumption when retired. And so if we evaluate a policy that forces  
3 them to save when they are young in terms of their well-being when young, they are going to be  
4 very unhappy about that policy. On the other hand, their elderly selves will be extremely happy  
5 that we forced their younger selves to save. It is hard to know exactly how to measure welfare  
6 changes in a model like that.

7           Now the transitional issues, which is the last major point George talks about. The  
8 consumption tax gets a big share of its efficiency gains from taxing old capital. This also  
9 contributes to progressivity in the transitions since asset ownership has an age component, but it  
10 also has a very significant income component.

11           So George raises the question of whether transition relief can be limited, which he sees  
12 as a positive thing because—as I have noted and as he notes in the paper—you lose a lot of the  
13 efficiency gains or most of the efficiency gains if you have very generous transition relief.

14           He argues that maybe you can limit transition relief because, as has been pointed out in  
15 the literature, there is an offset. Yes, people lose tax benefits in transition, but there is also an  
16 increased demand for assets because consumption taxes encourage people to save. That tends  
17 to push asset values up and that ought to offset the decline in value of old capital from transition  
18 losses.

19           So he says maybe it is not such a bad deal for capital owners after all to which my  
20 response is people won't associate the gains with tax reforms only the losses because the loss of  
21 tax benefits is direct. I see my basis disappear. I think my asset values change for other reasons  
22 as well.

23           Economists may say it is because of the change in tax policy, but that doesn't happen at  
24 one point in time, it happens over time, and it is much harder to attribute.

1           Again, as with other tax expenditures, transition relief might be easier to avoid with a  
2 clean break in the system. It is hard to imagine keeping basis under a move to a retail sales tax,  
3 much easier under a flat tax, which, after all, was designed to look like the current system and  
4 that has both political benefits and costs.

5           Note, there is a legal literature especially, although an economics literature as well, in  
6 which George has contributed, on retroactivity of taxation, whether we should provide  
7 compensation. The literature tends to suggest that when things happen incidentally, if we move  
8 from an income base to a consumption base and the capital levy just sort of happens, as might  
9 happen if we had a change in tax year or something like that—there might be inadvertent double  
10 taxation and we should provide transition relief.

11           I think the central question here—whether we should provide transition relief or not—is  
12 whether the capital levy is incidental. It happens, that is for sure, if you move from an income tax  
13 to a consumption tax; but it is not obvious to me that it is incidental, that is, that it isn't an  
14 organic part of the change in the tax system.

15           So to conclusions. If we move to a consumption tax—and this is George talking—it is  
16 important to limit transition relief because this limitation may make sense, given the other gains to  
17 asset values that may occur, and it certainly makes sense if we are looking for long run welfare  
18 gains.

19           Second, the gains may be larger than models suggest since they don't fully account for  
20 the differential treatment of assets under our current tax system. That is, we have widely differing  
21 treatment of different kinds of investments and if we could get rid of that, that would give us an  
22 additional benefit, more than we would get simply from lowering taxes on capital income.

23           But of course some of these gains could be achieved under an income tax and some  
24 would be forgone under a consumption tax because, after all, we will probably keep some

1 incentives to invest in housing, relative to other assets, and we may mess up things in other  
2 ways. Again, this gets back to the point of whether we can keep the tax base pure.

3 A simple view he expresses in the paper is that simplicity promotes compliance. That is,  
4 if we make the tax system simpler, if measurement issues aren't as complicated, then we ought  
5 to be in a position where the tax system is easier to comply with and it is easier to administer.

6 I think here that compliance depends very much on the form of the consumption tax. As  
7 discussions of the USA tax in the 1990s brought out clearly, you can make a consumption tax  
8 that is pretty complicated and hard to enforce too. And so with that, I am done.

9 MR. AARON: Five seconds away from hearing that horrible noise. Thank you very  
10 much, George Allen.

11 (Laughter.)

12 MR. AARON: We are going to move directly to Eric Toder and Kim Rueben.

13 MR. TODER: The title of this paper is "Should We Eliminate Taxation of Capital  
14 Income?" As an introduction, I just want to say that we are both very pleased to have an  
15 opportunity to present this paper at the conference and want to thank the organizers for  
16 including us.

17 I came to Treasury originally in 1976 and one of the first conferences I came to at  
18 Brookings in 1977 was on the subject of should we have an income tax or a consumption tax.  
19 So I feel like we are still talking about the same things, hopefully with a little more wisdom  
20 today.

21 I also want to acknowledge the help of Jeff Rohaly and Adeel Saleem of the Urban  
22 Institute who did the simulations that went into this paper.

23 Okay. Main issues. Does eliminating the tax on capital income get you a consumption  
24 tax? What is the case for a pure consumption tax? I won't spend a whole lot of time on that.



1 Can a consumption tax be progressive? I will spend a little more time on that. And will  
2 eliminating capital income taxes promote growth and economic efficiency?

3 Just as an aside, I think it is very interesting that this session is titled “Should We Tax  
4 Capital Income” instead of “Should We Replace an Income Tax with a Consumption Tax.” And  
5 as the previous discussion has indicated, those are not exactly the same questions. And so that  
6 is going to be part of the theme of my remarks.

7 What is a consumption tax? This is just a general review. All the tax experts know what  
8 this is. It is an income tax that exempts net saving from the tax base. It can be collected a lot of  
9 ways: from final sellers, as in a retail sales tax; from all businesses, as in a VAT at each stage of  
10 production; from businesses and wage earners, as in the flat tax, which is a VAT with a wage  
11 deduction; or from individual taxpayers, as in the consumed income tax, which is in the Blueprint  
12 study or the Nunn and Domenici proposal of some years ago.

13 What is common about all these taxes is that they allow immediate deduction of capital  
14 purchases. I just want to make one more comment related to this. It is a common misconception  
15 to think of a consumption tax as a tax on consumption—consumers, i.e., buyers and an income  
16 tax is a tax on earners, i.e., sellers. All taxes on transactions make the tax paid by buyers higher  
17 than the price received by sellers. So all taxes are really both consumption taxes and income  
18 taxes.

19 A consumption tax can be designed to look like an income tax if it exempts savings, but  
20 an income tax can also be designed to look like a consumption tax. For example, you could  
21 have a VAT with capitalization as well as expensing. So it is really not about how you collect the  
22 tax.

23 The difference between consumption taxes and yield exempt income taxes, I don’t think  
24 I can say this better than Reed said it. So I am not going to spend much time on this slide, other

1 than to note that reported capital income includes much more than normal returns to new saving.

2         And I have an example in the paper of an entrepreneur who gets a good idea,  
3 establishes a company with a value that is many multiples of his investment. The increase in his  
4 value is really a return, as it were, to his labor services, to his good idea. But the income will  
5 come out as business profits, dividends, and capital gains when it is paid out and the initial  
6 increase in value goes untaxed under our current tax system until the company or the investment  
7 is sold and even then it may never end up paying any tax.

8         There is research, which I cite in the paper, that says that entrepreneurial returns  
9 account for a large share of the buildup of wealth and also that inheritances and gifts represent a  
10 large share of wealth. So exempting capital income taxing is partly exempting tax on the  
11 hardworking person who saves and has foresight, but it is a lot of other stuff as well.

12         Okay. People have remarked on the potential regressivity of a consumption tax if capital  
13 income taxation is distributed to higher income groups. I do want to make the point, however,  
14 that in some sense, when we talked about capital income taxation, our current law is really three  
15 tax systems that treats different kinds of taxpayers very differently.

16         Low-income people are mostly out of the tax system and in fact are getting refundable  
17 credits in many cases, but the base for determining eligibility of those credits, as my colleague  
18 Gene Steuerle pointed out in an interesting paper in Tax Notes last year, the base includes  
19 capital income. I don't know that we would ever think of having a system where we determined  
20 whether you can get an earned income credit and whether you are poor by exempting your  
21 returns from capital.

22         Middle-income people pay little or no capital income taxation. Most of their savings is in  
23 the form of homes or tax-deferred accounts. There is some burden of the corporate income tax,  
24 although the question of how much is disputed.

1           And finally, high-income people pay most capital income taxes. Taxpayers with income  
2 over 200,000, as this chart shows, receive about 70 percent of total capital income and  
3 taxpayers with individual taxable capital income and taxpayers with income over a million  
4 receive almost 50 percent of that income.

5           I am going to go through the pure income versus consumption taxes issue very quickly  
6 because it was really very well discussed in George Zodrow's paper. The fairness arguments, all  
7 income is taxed the same, that is one view everybody thinks. Or the other argument, which is  
8 more of a longer-term perspective is, tax liability should be independent of the timing of  
9 consumption or earnings. And it has been shown that in a lifetime perspective, a consumption  
10 tax may better reflect ability to pay than an income tax.

11           There are all sorts of questions about that, whether that holds up when tax policy isn't  
12 stable over time, whether it is really applicable when people's family circumstances are  
13 changing, 50 percent of marriages end in divorce and so forth. So I don't know how relevant  
14 the lifetime perspective really is, but certainly in a stable model where everyone can borrow and  
15 lend at the risk-free interest rates, there is an argument that makes for a fairer tax base.

16           There is also a question about whether it would be politically acceptable to impose a  
17 high tax on a low-income person on the grounds that they are going to be rich later or were rich  
18 in the past. So that is another issue.

19           On efficiency grounds, the consumption tax is neutral between present and future  
20 consumption. Under some assumptions, it can be shown, I guess the assumption is that utility is  
21 separable in goods and leisure, which means the choice of how much you want to work is  
22 independent of the choice of how much you want to save.

23           If that assumption holds, a consumption tax is unambiguously more efficient than an  
24 income tax that raises the same revenue; however, those conditions may not hold and in a more

1 complicated model, we may still think a consumption tax is more efficient, a pure consumption  
2 tax, but we can't prove it.

3 Now I want to talk a little bit about designing a progressive consumption tax. Can we  
4 do that? It seems people are focusing on the X-tax and the way that works, to sum up, that is  
5 an individual tax on wages; individual interest, dividends, and capital gains are excluded. There  
6 is no interest deduction for individuals and graduated rates can be applied to wages and  
7 deductions and credits, other than those applying to investment income, can be retained.

8 That is combined with a business tax on net receipts, from which wages and capital  
9 expenditures are deductible and there are no interest deductions. That can be shown to be  
10 equivalent to a subtraction method value-added tax with a wage deduction.

11 People have mentioned transition rules earlier. The designers of the flat tax designed it  
12 with no transition rules; that is, basis of existing business assets went to zero the day the tax was  
13 enacted. The issue, of course, is: Should basis be returned for old wealth accrued from after tax  
14 dollars?

15 The estimated amount of that is about \$15 trillion. That is the estimated amount of basis  
16 from calculations that Kim made. And I would say that is interesting because we refer to this  
17 problem as transition, which is a funny name for something where, in fact, the amount of old  
18 capital is going to be a whole lot greater than the amount of accrued new savings for a long time.  
19 So it is not just something you have to worry about for a couple of years.

20 There would be pressures for transition relief, both for older people who are spending  
21 down their wealth that was accrued from after-tax dollars and for businesses with recent capital  
22 purchases who didn't get the benefit of expensing and have to compete with businesses that do;  
23 however, the consequences of transition relief are large windfalls for existing wealth holders and  
24 as Alan pointed out, a loss of much of the efficiency gained from moving to a consumption tax.

1           So I guess the question about the X-tax is, is it really a consumption tax or is it a yield-  
2 exempt income tax? And that is a very important distinction. It looks like a yield-exempt income  
3 tax because it exempts the capital income at the individual level, but that is not really true  
4 because if you think it is true, business expensing is really equivalent to exempting the net saving  
5 of individuals.

6           When individuals purchase shares in a business, the price of the shares are discounted  
7 because businesses get expensing and when they sell shares or sell assets, the return from those  
8 assets gets discounted because all business returns are taxed.

9           So it really is, when you think about it, equivalent to a cash flow method of looking at  
10 capital income of individuals, but nonetheless, some consumption may escape tax. Returns from  
11 old capital would escape tax. Foreign-source income, under the proposal, would escape tax  
12 and there are many avoidance problems that result from the yield exempt treatment of financial  
13 assets. They, as well as potential transfer pricing, will be discussed this afternoon. The estimates  
14 I will present next assume no transition rules and no avoidance problems. So I am just going to  
15 assume this can work.

16           So the simulation of an X-tax is basically we take off the tax on interest dividends and  
17 capital gains. We eliminate interest deductions, we retain the rate structure and all other tax  
18 preferences because we are not looking at simulating a broad-based tax reform; we are just  
19 looking at the piece that moves from an income tax to a consumption tax. And for business  
20 taxes, we replace expensing instead of depreciation and we use some estimates that the GKS  
21 paper referred to earlier did to estimate how that affects the business tax base.

22           We adjust for revenue losses by changing marginal tax rates. And here is a summary of  
23 the results of the simulation. As you can see, there is not much change in after-tax income  
24 except there is some dip in the 75 to 200,000 income group. They pay higher taxes because

1 they would lose the mortgage interest deduction and there are some higher taxes—I mean big  
2 rate gains in after-tax income at the very top of the distribution: about 100 percent of the  
3 benefits go to the top 1 percent of returns. And then we did a simulation where we adjusted for  
4 this by raising marginal tax rates to keep tax payments the same in each tax bracket.

5 That isn't purely distributionally neutral at the very top. The very highest income  
6 taxpayers still get a tax cut and you need really high rates to fix that; but you end up with a  
7 system with a top rate of about 44 percent which is necessary to keep the distribution roughly  
8 the same.

9 We argue in the paper that economic benefits of eliminating capital taxation are  
10 inconclusive as far as growth. There could be some more efficient allocation of capital, but there  
11 are issues there too. I wanted to go to this slide, "No substitutions, please." It reminded me of  
12 Jack Nicholson ordering a chicken salad sandwich to get his toast.

13 If you retain interest deductions, you have big arbitrage possibilities and that cancels any  
14 positive effects on savings. If you retain other preferences, you can have lower rates. If you  
15 have transition rules, you have heard about that. Tax some transactions on a yield-exempt basis.

16 All of these things are the likely political result of trying to move to this system. It can be  
17 described in our paper as dessert without the broccoli. And an example is the five easy pieces  
18 proposal, which would reduce marginal rates, eliminate taxes on capital gains and dividends,  
19 eliminate the estate tax, move toward expensing, and allow tax-free savings accounts and do  
20 this without—no base broadening, no pay force, retaining interest deductions, and cutting  
21 marginal rates instead of raising them.

22 I conclude there is no real clear case for eliminating capital income taxation. I just  
23 wanted to raise a few questions that I would be interested in seeing people look at in the future.

24 One, how much of capital income represents a return to past savings instead of returns

1 to inheritance or assets accrued from pre-tax dollars? That has been done some, but I think we  
2 could learn more. How do after-tax yields particularly affect the saving of the very highest  
3 income individuals because those are the people whose tax regime will be changed by this. And  
4 what would be the efficiency gain from an imperfect consumption base? Thank you.

5 MR. AARON: Another example of misplaced priorities is one of our two other  
6 discussants, since Alan has already spoken. I am told that George Thorndike's wife went into  
7 labor and he chose to be with her rather than here. I think that the lesson here is that we should  
8 choose older discussants.

9 Now satisfying that role is David Weisbach.

10 MR. WEISBACH: Given the constraints, I will start with my conclusion slide, go right  
11 to the end. And everybody has been quite academic and careful about their thoughts.  
12 Everybody who knows me knows that is not what I am going to do. So I will stick my neck out  
13 with the first bullet point and say that the case for a consumption tax, I think, is overwhelming.  
14 The central economic arguments, I think, support consumption taxation. There are a lot of  
15 nuances that I will talk about in a few minutes, but I think that the core arguments point towards  
16 a taxing of capital income of roughly zero. It could be a little negative, it could be a little positive,  
17 but roughly zero. I think there will be administrative and compliance cost savings.

18 I think the real burden is figuring out how to do this, how to think about what kind of  
19 system you are going to have that will be distributionally neutral that will deal with transition or  
20 not. We have some good ideas, but we are not all the way there.

21 So what are the economic arguments? I think the Zodrow and Toder papers do a good  
22 job of capturing them. I won't review them too much. We continue to work on these things. The  
23 model is already really complex. They still don't capture everything. We don't know exactly  
24 how people behave and why they save and why they don't, so there is still more work to be

1 done. But I think the central tendency in the economic arguments is towards no taxation of  
2 capital income and I think that is true whether you look at the infinite horizon models, the OIG  
3 models that Alan discussed.

4 One that hasn't come up much today are the Atkinson and Stiglitz models, 1976, which  
5 I will talk about in the next slide. They point towards no taxation of capital income. And in all  
6 these things, I think the question is the size of the gains, not directions. So even in the OIG  
7 models, if you look at the Auerbach–Kotlikoff stuff, they add transition relief to make it  
8 progressive, you still end up with gains. The only question is the size, not the direction of the  
9 gains.

10 And the last bullet point is really important. The best of these models include  
11 redistribution. That is, you are seeing gains from moving to a consumption tax, holding  
12 distribution neutral or you could hold efficiency neutral if you wanted and you would see more  
13 redistribution, right? That is, you are seeing improvements in the overall taxes. Then you can  
14 allocate those how you want, redistribute it later efficiently, but these things are not pure  
15 efficiency arguments. You are talking about including redistribution in the models.

16 Now what is the key economic idea? I am not an economist. So this is a lawyer's  
17 attempt at translation. The argument people make for an income tax, I think, is the second slide.  
18 The second bullet point there is that the rich have more savings. Income tax imposes a tax on  
19 savings so that brings the rich more. And that is a good thing if you care a lot about  
20 redistribution. And why is that wrong? The reason it is wrong is the same reason why a luxury  
21 tax is not a good idea, right? The rich have more yachts than other people too and by the same  
22 argument, for taxing savings, we should tax yachts more as well. We know that is not a good  
23 idea. Why? It is better off to tax the rich more directly and not distort their choices between  
24 yachts and other things they might purchase. The same thing with savings. It is better off to tax



1 them more directly and not distort the choices between savings and not savings.

2 Here is another way to say it. There is a tradeoff that people often make in support of  
3 an income tax or maybe against the efficiency arguments in a consumption tax, which is an  
4 income tax trades off lower taxes on labor for more taxing on savings and you want to look at  
5 the relative elasticities. If it turns out that savings are not very elastic, maybe you want to tax  
6 them.

7 That is wrong. That is flat out wrong. And the reason why is that taxes on savings are  
8 also taxes on today's labor income, because if you are working today knowing you want to  
9 allocate some of your money towards today's spending and some towards the future, you are  
10 going to get less future consumption to cause the tax on savings. Therefore, it is going to affect  
11 today's labor leisure distortion. So the tradeoff theory is wrong. It is not the case that an  
12 income tax sacrifices some tax—some inefficiency in savings in order to benefit on a labor  
13 leisure distortion. No, in fact, it has the same effect as a consumption tax on the labor decision.

14 Now of course there is infinite sell fees in the economics arguments. You can come up  
15 with models that show that, in fact, you want to have some small capital tax, maybe some small  
16 capital subsidy. We don't really know which way these things go. They have to do with things  
17 like relative complementarity of savings to leisure.

18 None of these kinds of arguments end up with a tax on capital income that is anywhere  
19 near the tax on the wages. You don't end up with something that looks like a pure capital  
20 income tax.

21 And if you follow these arguments all the way to their conclusion, in fact, savings  
22 wouldn't be where you would focus. You would look at relative compliments to leisure other  
23 than savings or you might look at these kinds of indicator goods, as referred to briefly in the  
24 Zodrow paper, other than savings. You might want to tax education, you might want to

1 subsidize smokers or things like that.

2 Well Saez's paper talks about subsidizing smokers. That is what he would do on this  
3 argument. I don't think they lead you towards anything near an income tax.

4 What about compliance administration here? I think we have a lot of work to do. Look,  
5 Bankman and Schler are going to present a paper today saying the X-tax doesn't work. Roin is  
6 going to present a paper today saying the income tax doesn't work. Now you tell me which one  
7 is going to be better or worse? I think it is hard to imagine that tax and consumption is going to  
8 be harder to implement, it is going to be worse than an income tax on these grounds. That is,  
9 consumption is just inherently easier to measure. It may not be very much better, we don't really  
10 know. We would have to work out the details, but I think you can't argue it is not going to be  
11 better.

12 I say well, why is the belief in the income tax so persistent and why do honest, good  
13 faith people who want to do the best thing for the country believe in an income tax? What are  
14 the arguments you want to grapple with? I tried to write them down.

15 I think the first one is the most important, which is the real fear about distributive effects  
16 of switching. So we see papers like the one Alan talked about where we show, in fact, the gains  
17 in the top one-half of 1 percent are going to be large in switching to a consumption tax. We  
18 don't believe that we can actually get those guys.

19 Two reasons why. We might not trust the people in power now to do it. That is this  
20 correlation between people who like consumption taxes and people who don't like  
21 redistribution for whatever reason, I don't know, it may be just a design issue; but I think that if  
22 you think that consumption tax theoretically can be awful, then the challenge is to come up with  
23 a design that can do this, not to give up and say it can't be done.

24 Then there is the correlation between money and power. People say, well, you have got

1 to tax wealth because they are going to have political power otherwise. I think if you cared  
2 about political influence of wealth, you wouldn't turn to an income tax. You would, in fact, think  
3 about campaign finance reform.

4 The administrative gains are uncertain. The analysis tends to be of pure systems. Who  
5 knows what holes would be in a consumption tax. It would be like jumping off a cliff. You  
6 know, sometimes you have got to work on these things and try hard.

7 Income tax is a place in the heart to a lot of people. It is the major progressive reform of  
8 the 20th century and it is hard to give up. Jane mentioned one that is not on my slide, but I will  
9 add it; and that is, transition. Jane thinks transition can't be done. I think it depends on whether  
10 you think you are giving transition relief or not as to what you think about that.

11 I will point out that the Atkinson and Stiglitz argument, the luxury tax argument in favor  
12 of a consumption tax, does not depend on lack of transition relief to show their consumption tax  
13 is more efficient than an income tax. So you could do this giving transition relief. I think it can be  
14 done.

15 It is true that an old tax is a good tax. But in that case, we should go back to tariffs  
16 because after all, that is the oldest of taxes and, you know, it is a big experiment. The world's  
17 largest economy could be the world's largest tax experiment. No one else in the world has a  
18 pure consumption tax. I think I heard once that the country of Sri Lanka did this or something  
19 like that. But it takes a lot of study to be careful. I think that if we think the gains are big enough,  
20 we should do it.

21 I would say the burden on consumption tax advocates is to show that you have a  
22 workable system that maintains redistribution and doesn't assume some kind of unrealistic  
23 transition. If we think that there is going to be transition relief one way or another, then we need  
24 to think about how to model that and we need to show that it is simpler than the current income

1 tax.

2 I think we are pretty close to being able to do this as I think the X-tax is getting there. It  
3 is not all the way there, but I think it is getting there and I also think that every time that we  
4 come up with a pretty good consumption tax argument or a good consumption tax system, like  
5 the X-tax is starting to be, I don't think you can raise the barrier anymore to an income tax  
6 advocate saying well, there is some subtlety in the economics argument.

7 It might be that you have some relative complementarity that isn't taken account of or  
8 something like that. I think that you have to go with what we think are the core and central  
9 arguments and in that case, I think they indisputably support a consumption tax.

10 MR. AARON: Thank you very much, David. I hope before this conference is out, you  
11 will tell us what you really think.

12 If there are any comments from around the U-shaped table, we will take those.  
13 Otherwise, we will go to the floor. Rudy.

14 MR. PENNER: I think there is a kind of transition problem that bears more discussion  
15 because it will bring enormous political opposition to radical reform of business taxes and that  
16 stems from what I would call a prepayment of income taxes.

17 Many businesses have an enormous amount of unused operating losses; they have  
18 unused credits of various kinds, AMT, foreign tax credits, and so on, and they will want to be  
19 compensated if you radically change the regime and they will fight tooth and nail to get  
20 compensation, but you can't. There are hundreds of billions of dollars of these things and it  
21 would just be too expensive.

22 MR. AARON: In the same vein, I would like to take off on the paper to which Alan  
23 Auerbach referred in which he presented an estimate that if one gave transition relief for unused  
24 depreciation deductions, one lost substantially all of the efficiency gains, if I am stating things

1 correctly, from moving to a consumption tax; that is, if one accepts the model framework that he  
2 uses.

3 And I would like to pose the question, under what practical circumstances would one  
4 be able to institute a consumption tax with the greatest likelihood that one wouldn't give  
5 transition relief and I would like to suggest an answer. And the answer is with an add-on value-  
6 added tax.

7 I cannot imagine that there would still be pressure in that kind of a situation to provide  
8 relief to the elderly, perhaps by adjusting Social Security benefits. That might be resistible in light  
9 of the long-term financing problems that Social Security currently faces, but that would not, I  
10 think, pose any direct pressure to deal with other aspects of transition.

11 Presumably, one would start at a relatively low rate. It could rise over time, and  
12 eventually I could even imagine some substitution of value added tax for income tax à la Gratz  
13 or somebody else, by the Gratz plan or somebody else's. But short of that, the idea that we  
14 would move directly to a consumed income or an X-tax without providing relief, both at the  
15 business level and at the household level for mortgage interest deductions, just strikes me as  
16 utterly implausible.

17 Are there other comments around the table? We have got Jane and Joel. Alphabetical  
18 order. Jane before Joel.

19 MS. GRAVELLE: One thing I just want to say, and it is certainly more about David's  
20 comments, I think, than anybody else's. But to some extent, it pertains to the other papers, as  
21 well. Just because you get a simulation result from a model doesn't mean it is true. These  
22 models have not been necessarily empirically tested and in fact, they produce results that are  
23 kind of difficult to believe.

24 If you don't think that the country is composed of a bunch of identical individuals who

1 have interdependent utility functions and a dynastic, unbroken model and who reproduce  
2 asexually, if you don't think that is true, then you need to think hard about the Ramsey model or  
3 the infinite horizon model.

4 But even in a life cycle model, that requires people to think in a way that probably the  
5 people in this room can't even think. What makes you decide on your saving over time and  
6 more importantly, how do you respond to interest rates and do I get up in the morning and say,  
7 "Well, look, the interest rate went up. I need to work more today, extra hours today and less  
8 tomorrow. I need this intertemporal substitution."

9 So until these models have been empirically tested in a better way than they have been,  
10 and I don't know if they ever could be, I think you need to remember there is a difference  
11 between a model simulation result and empirical evidence and I think the empirical evidence  
12 says that people don't tend to change their savings rate very much.

13 And I also think that I would advise you to read the missing voice here, Doug  
14 Burnheim's, who in his very good article on saving and the public and in the handbook of public  
15 economics, talks about the problems of people making complex decisions where they don't  
16 have information or have a chance to practice. He also talks about the rules of thumb that  
17 people use, which are very, very different from the assumptions made in these models.

18 MR. AARON: We are going to take one more comment from the table and let authors  
19 and discussants come in at the end and then I am going to go to the floor.

20 MR. SLEMROD: If we are going to have a serious debate about income versus  
21 consumption tax, I think it is very important to get our language right, to use words precisely.  
22 Often, the differences posed are differences in the timing of taxes and in most of the models we  
23 use to think about this, the timing isn't critical. For example, I think Eric said you can't get a  
24 consumption tax without immediate deduction for capital purchases. The present value has to be

1 equal to the value of the capital purchase. It doesn't have to be immediate. The timing of  
2 payments can look very different, especially the timing of payments from an individual. The  
3 check writing timing can be very different.

4 And so that just leads you in the wrong direction. I think the right way to think about  
5 what a consumption tax does is the analogy to an individual's choice in a given period over  
6 many consumption goods. Think about one period. If you have a uniform consumption tax on  
7 food and clothing, etc., it doesn't affect the relative price of those goods. It does affect the  
8 relative price of working or leisure versus those goods, but it doesn't affect the relative price of  
9 those goods. So the budget set in goods changes in parallel. Go back to Ec 1.

10 What a consumption tax does is that instead of thinking about goods like food and  
11 clothing, you think about consumption today, consumption in a year or consumption in 10 years.  
12 A consumption tax doesn't affect the relative price of consumption at different time periods. But  
13 there is a difference. And the difference is that in the one period model, we can be pretty sure,  
14 with a uniform tax, that that budget changes in parallel. It doesn't affect the relative prices.

15 For us to say that about a consumption tax is a great leap of faith that we know that the  
16 consumption tax rate will be the same this year, next year, in 5 years, and in 10 years. We can't  
17 guarantee that with a consumption tax.

18 Now to a question. I guess for all the people on this panel, if we can't guarantee that the  
19 consumption tax rate stays the same, and best evidence suggests it won't, then we need to  
20 consider how much damage does it do to the efficiency arguments for a consumption tax?

21 MR. AARON: Comments from the floor. I see Bill Gale.

22 MR. GALE: I am Bill Gale at the Tax Policy Center in the Brookings Institution.

23 One comment—maybe a couple of comments, a couple of questions. One, on the  
24 transition and the mortgage interest deduction, I think there is a lot of Chicken Littling going on.

1 We could get rid of the mortgage interest deduction. After all, England did. I mean they have  
2 basically phased out 80, 90 percent of their mortgage interest deduction. It is not impossible to  
3 do. Transition relief. Again, there are timing issues and perception issues, but I am convinced we  
4 could do it if we wanted to.

5 I want to come back to the way David opened his comments because I think it leads  
6 into an interesting discussion. He said the case for a consumption tax was overwhelming. Well,  
7 as I understand it, a pure consumption tax and a pure income tax are not very different. If you  
8 took the flat tax and you changed expense into depreciation, you would have an income tax  
9 more or less.

10 So it is a tiny difference. It is odd to me to say that there is an overwhelming case that  
11 you should expense rather than depreciate once you have changed everything else and I kind of  
12 have the sense we are talking about a 300-pound person in debating whether they should come  
13 down to 160 or 170. And somebody is arguing, oh, it has got to be 160 and someone else says  
14 no, it has got to be 170. The real question is, how do we get from 300 to 170 or 160.

15 In the income tax example, the issue is how do we get from the current system, which is  
16 a nowhere near an income tax in any logical or realistic sense to either a realistic income tax or a  
17 realistic consumption tax? And that leads me to the question where David said that the big fear  
18 of a consumption tax was distributional.

19 I don't really think that is true or at least it is not true in my case. In my case the  
20 question is, are we going to end up with a 300-pound consumption tax instead of the sleek 160-  
21 pound version? Or to put it differently, when I look at states sales taxes or European VATs, I  
22 see ugly taxes. I don't see clean, elegant, simple, you know, growth-enhancing taxes. So why  
23 do we think that if we say consumption tax, we are going to get a consumption tax in the real  
24 world that looks any more like the income tax we have looks like an income tax, you know, that



1 we could design on paper.

2 MR. AARON: Are there any other comments?

3 MR. KLEIN: I am Bob Klein from Ernst and Young. Transition. The word “transition”  
4 has come up quite frequently. There is an experiment going on at the state level that is directly  
5 related to this issue, consumption versus income taxation. Ohio has eliminated phasing out their  
6 corporate profits tax altogether luring property taxes on business property and paying for it  
7 partly through a gross receipts tax, not a value-added tax, but a gross receipts tax with some  
8 significant amount of subtractions in calculating the base.

9 I think it looks somewhat like a shift from income taxation to consumption taxation and  
10 one of the key issues at the last step in the whole political process was what to do about the  
11 unused net operating losses of significant corporate taxpayers in the state. And the political  
12 decision was to finally allow them to carry forward into the new gross receipts tax system,  
13 unused net operating losses because of the potential negative impact on their asset values on  
14 their balance sheets.

15 The question is, for members of the panel, and Eric and others—Rudy had mentioned  
16 the transition issue—if you had been asked to testify in front of the tax committees in Ohio, what  
17 would you have said about this proposal to allow unused NOLs to be carried forward into the  
18 new consumption tax system?

19 MR. YECIES: My name is Mark Yecies. I am a former partner at Ernst and Young  
20 and a former trustee of the ATPI. This question is directed to David Weisbach. I would like to  
21 focus, David, on one element of your presentation and that is the taxation of capital gains.

22 If one were to assume that the taxation of capital gains is inappropriate, then I would  
23 have to ask what is the problem with tax shelters in general? Most of the ones that I have seen  
24 have to do with the creation of capital losses that eliminate capital gains and so I would be

1 curious as to your view of that.

2 MR. AARON: Are there additional comments from the floor? Yes, sir.

3 MR. POTERBA: Jim Poterba from MIT.

4 MR. AARON: Also on the President's Tax Advisory Board.

5 MR. POTERBA: I had a question for Kim and for Eric on the very striking picture  
6 about the distributional consequence of something like an X-tax, and it links up with Alan's  
7 earlier comments about the transitional issues and the concentration of the assets.

8 The picture that we saw for the top, I guess the over a million dollar income group  
9 getting a lion's share of the benefits when you do this, my guess is that that basically doesn't do  
10 anything about transitions and doesn't try to figure out where the transitional losses would be if  
11 you went without any transitional relief to a new steady state type of structure.

12 So I was just hoping you could say a bit and I am wondering if you have done any kind  
13 of sensitivity analyses; for example, what would happen to this kind of picture if, in fact, we did  
14 a no transitional relief world where the assets, which are held by those people today,  
15 presumably decline in value, as they do some in simulations that Alan and others have done, or if  
16 you played around at all with the questions about the allocation of a capital income tax burden  
17 between the tax-deferred assets and non-tax-deferred assets?

18 Again, I suspect, and we have seen this earlier in the presentation today, that the  
19 middle- and upper-middle-income and low-high-income tax groups are the ones where most  
20 the tax-deferred assets live and the taxable assets primarily reside with the people who are up in  
21 that very top group. So we have seen a picture that is very stark and the question is, how  
22 sensitive is some of these transitional issues that we have heard about other times?

23 MR. MAZUR: Mark Mazur, the Internal Revenue Service. One question I have, and  
24 this is mostly directed to Eric, is that if we look at the income tax system we have, mostly high

1 rates at the top and mostly low rates or negative rates at the low end, in a sense that provides  
2 some kind of insurance for people who have uncertain income.

3 And I think if you look at the very top of the income distribution, it is really hard to tell  
4 yourself that all those people have great ideas and there is no luck. And so if you think about a  
5 shift from an income tax to a consumption tax, how do you work out the fact that there is this  
6 gap.

7 MR. BRAZELL: David Brazell, Treasury Department. I just have a couple of questions  
8 that are directed to anyone. Dealing with tax-based symmetries, it is often known as that is a  
9 problem with the current system. And there are remarks about the losses being carried over—  
10 not being able to take losses is the problem with the income tax, is one of the problems.

11 Under a consumption tax in the form of a either a VAT or an X-tax, would it not be  
12 easier to correct that asymmetry. In other words, under the income tax, we seem to be very  
13 concerned about whoever is paying income tax, whoever is writing the check is measuring that  
14 person's income appropriately and therefore we don't like the selling and buying of tax benefits  
15 from taxpayer to taxpayer.

16 Under an X-tax where we have a single rate among all businesses, we seem to be less  
17 concerned about who is paying the tax because the taxpayer is really no longer really a  
18 consumption of that business unit, it is that we can much more easily correct the asymmetry  
19 problem under a, let's say, an X-tax.

20 And my second question has to do with basis recovery and transition. Eric referred to  
21 base recovery as a windfall. I am not sure that people who would be subject to that would view  
22 that as a windfall when they made their investments irrespective of depreciation deductions.  
23 They would not view that as a windfall. It is taken away.

24 Which goes to my last question about what we mean by transition. And it is not always

1 clear. Today we have been talking mainly about seeing the basis recovery of depreciable assets  
2 and other assets. There is also sort of negative basis you think out there in the form of pension  
3 plans that under a consumption tax, you would think you would not be taxing withdrawals in  
4 pensions and IRAs and so forth, if you did the same sort of model as we seem to be modeling  
5 here, but just forgetting about what happened under the income tax.

6 In other words, in such a negative, we still want to recover that sort of that built-in tax  
7 that measures savings and whether—I guess this is directed more to Alan Auerbach—is when  
8 you did your model run was transition just getting back—giving basis back or I often also hear  
9 about transition referring to trying to restore the value of old assets. And those are two different  
10 things as far as I can see and what sort of analysis.

11 MR. AARON: Thank you. Dan Halperin up here. If there are more from the audience,  
12 please stand up and come to the mike.

13 MR. HALPERIN: We have heard discussion that the return to risk taking while there is  
14 a nominal check written, there is no burden on the investor, either under an income tax or a  
15 consumption tax. I am skeptical that that is as true under income tax as it is under a consumption  
16 tax because there is an assumption for more borrowing going on under an income tax and I  
17 wonder how realistic that is in all circumstances.

18 But my real question is if we talk about keeping progression where it is today, what  
19 would you do about the checks that are now being written on the return to risk? Is that going to  
20 count as the tax burden on the investors that has to be replicated under a new system that is  
21 equally as progressive or do we say nobody has ever paid that so we don't have to duplicate?

22 MR. AARON: If there are no more questions, there will be an opportunity, I am sure,  
23 provoked by the responses. Let's start with Eric and/or Kim, then let Alan speak either for  
24 George or himself and then David.

1 MR. TODER: I will try to take these in reverse order, try to remember what the  
2 questions were. I guess David and David Brazell and Jim Poterba both had questions regarding  
3 transition and the only way I can describe the way I look at it is this. Imagine you have a million  
4 dollars of wealth and it is earning 10 percent. So you get 100,000 on that wealth and it is being  
5 taxed under an income tax and assume you already have also a million dollars of basis.

6 So under current law, you can consume that million dollars of wealth, tax free. You have  
7 already paid tax on it. But if you invest it and get an annuity of say a 25 percent tax rate of a  
8 hundred thousand a year, you can only consume \$75,000 a year from the annuity.

9 If we went to a consumption tax or to perfect with no transition rules, the immediate  
10 effect would be to reduce the value of that wealth to \$750,000. So if you wanted to consume  
11 today, you would be taking a big hit. If you wanted to, however, consume an annuity, that that  
12 was your future pattern, you could still get \$75,000 a year because you would no longer be  
13 paying any tax on the rate of return.

14 So essentially, it is not exactly true to say that the transition from an income tax to a  
15 consumption tax is hurting wealth owners. It is hurting wealth owners who plan to spend out of  
16 their wealth. It is leaving wealth owners in the same position if they plan to spend the annuity or  
17 the earnings from that wealth and it is making them better off if they plan to spend less of the  
18 earnings in that wealth.

19 MS. ROIN: I think that point is not correct because under an income tax, they would  
20 get a deduction for the basis of the annuity and of the \$75,000, they wouldn't have to pay tax  
21 on it.

22 MR. TODER: Oh, I am sorry. Let me not use the word "annuity." I made some  
23 confusion. They are investing in a perpetual bond and they are getting it. I am not talking about  
24 return of capital. I am talking about interest income. So I used poor terminology. I am sorry.

1 PARTICIPANT: Let's talk about people living forever.

2 MR. TODER: Well, it depends on what your time horizon is and whether you planned  
3 to save or consume. If you were young, you probably would be building up assets over time  
4 and you would benefit from the change with no transition rule.

5 MR. BURMAN: But the neutrality result only strictly holds if you are going to live  
6 forever and only consume the interest, right?

7 MR. TODER: Or you are going to pass the wealth on. You know, however you want  
8 to look at the time horizon, if you are not going to spend down that wealth, you are being held  
9 neutral. Now I would argue that if you have transition rules and if you give basis to old capital so  
10 that they get basically treated as if the basis is a million under the consumption tax, then basically  
11 it is allowing them to consume a million dollars tax free and also to invest that and get a hundred  
12 thousand a year in perpetuity.

13 So, as long as they are not consuming everything immediately, they are made better off  
14 by switching to a consumption tax with a transition relief. So it is kind of unambiguously  
15 providing a benefit and I guess I used the phrase "windfall." Maybe that is an unfair way to  
16 describe it, but it is really saying people who have existing wealth are made better off by that  
17 kind of transition. They are not held harmless.

18 MR. AARON: Are you assuming the same discount rate unaffected by the switch?

19 MR. TODER: Yes, I am assuming the same discount rate.

20 MR. AARON: Is that valid?

21 MR. TODER: I think so if you are looking at a world capital market, but that is a good  
22 question. There is no question that the value of their wealth drops without the transition and I am  
23 really merely raising the question as to whether you should view the capital loss as how better  
24 off they are in terms of the capital loss or in terms of the future income stream. Usually when we

1 are talking about capital losses, we are talking about results from raising the tax on an asset,  
2 which adversely affects both the future income stream and the capital value. And this is quite a  
3 different thing.

4 So to get to Jim's question, the way we treated transition was essentially looking at  
5 what is the change in the income flow from the substitution of a consumption tax for an income  
6 tax and the way that was treated is since the business income tax was allocated to owners of  
7 assets and the income flow was treated as basically what happens if you immediately substitute  
8 expensing for economic depreciation.

9 To get to a few other questions, Mark Mazur made a comment about income tax  
10 system providing uncertainty because of the luck component in determining people's wealth. I  
11 guess I would assume that a consumption tax properly implemented would also have that  
12 property. If you had a variability in your returns, it would tax both the luck component of wealth  
13 of returns as well.

14 Let's see. The other comments. I guess I had a couple of comments on David  
15 Weisbach's remarks that the consumption tax is uniformly better than an income tax. I was  
16 struck by his example of yachts and since I guess in the case of optimal tax theory, we want to  
17 tax goods that are complimentary to leisure, my guess is we probably would want to tax yachts.

18 MR. BURMAN: They are very expensive, right? You have to work really hard to get a  
19 yacht.

20 MR. TODER: But you have to have the time to—yes.

21 MR. BURMAN: You need the time and the money. So I don't think that is right.

22 MR. TODER: I guess it depends.

23 MR. AARON: This is not a conference on the taxation of yachts.

24 MR. TODER: All right. So let's move on to that. I guess we don't agree on that either.

1           And I guess the other Mark, I think, would echo what Jane is saying that we are placing  
2 an awful large weight on their conclusions of fairly stylized models. For example, if you do look  
3 at the Atkinson–Stiglitz model, as David said, there is no transition gain; but there is actually no  
4 old wealth in that model either. There is no economic grants and the issue of whether you can or  
5 can't tax those economic grants under one form of tax is not dealt with.

6           I am really not making the argument that a pure and perfectly implemented consumption  
7 tax is necessarily a bad model; but I think the issue really depends on some of the discussion  
8 that will be going on this afternoon, as to whether you can really implement that kind of tax or  
9 not.

10           And I guess finally, in response to Joel's comment about whether a consumption tax  
11 potentially taxes capital income if rates are changing and wouldn't that affect the efficiency? He  
12 asked how much and I don't know how much. But I think it certainly does affect that argument  
13 just as it also affects the fairness argument, which depends on the fact that rates are assumed to  
14 be stable over time.

15           MR. AARON: Kim, do you want to add anything?

16           MS. RUEBEN: No.

17           MR. AARON: Okay. Then Alan, speaking either for George or yourself?

18           MR. AUERBACH: I think it will be easier if I just speak for myself. A few points.

19 Picking up on Eric's last point with consumption taxes changing in the future, I think there are a  
20 couple of responses. The first response is yes, it does affect the efficiency of a consumption tax  
21 and it is certainly unavoidable under a consumption tax.

22           And it is worse under a consumption tax than under an income tax because there is  
23 more of a misalignment of deductions and positive taxes than there is under an income tax. And  
24 that leads to one possible solution under a consumption tax: instead of allowing immediate



1 expensing, as you would under a flat tax or an X-tax, you would have a basis carry forward  
2 with interest so that you would get the same present value deduction, but you try to time the  
3 deductions to occur when the positive returns are earned.

4         One of the forgotten benefits of an income tax—this goes back to a paper by  
5 Samuelson in the '60s—is, if you have a proper alignment of economic depreciation and taxes,  
6 then you lose a lot of the announcement—the damaging announcement affects of tax rate  
7 changes because income is being accrued properly in each period and being taxed and so there  
8 is no attempt to take advantage of timing differentials, which there certainly would be under the  
9 current tax system and most definitely under something like a flat tax or an X-tax. Of course,  
10 that makes the tax system more complicated because you then need to have a basis to carry  
11 forward and take deductions and you have to figure out when to take the deductions. And that  
12 is, of course, the problem we have under the income tax. So it is not a solution.

13         An alternative approach, which I know I had conversations with David Bradford about,  
14 and he believed that an alternative was to allow people to have the so-called prepaid accounts,  
15 at least for new assets—no tax deduction on the way in and no tax on the way out, and to let  
16 people choose. And so essentially insure themselves so that if they think the tax rates are going  
17 to go up in the future and they put their money in a Roth IRA instead of a deductible IRA.

18         So we have that option now under the current income tax and it obviously would be a  
19 broader option if all savings could be done that way. Of course, that would punish the  
20 government for engaging in opportunistic tax changing behavior because it would find its tax  
21 base had disappeared if people thought the tax rate was going to go up.

22         As to what we did in our simulations in analyzing transition relief, we did it not trying to  
23 preserve wealth, but rather just saying what we thought a realistic transition relief would look  
24 like and we thought it would be preservation of basis and continuation of old rules under the

1 new tax system.

2 That turned out, in some simulations, to be too much relief. That is, because demand for  
3 assets goes up, you could actually, with that kind of transition relief, have asset values going up  
4 and elderly asset holders benefited by the tax change, which is one of the reasons why you lose  
5 potentially all the efficiency loss in providing transition relief. You may be providing too much,  
6 which, to echo Eric's point about the Atkinson and Stiglitz analysis, that doesn't really come up  
7 in their analysis because it automatically is giving exactly the right amount of transition relief  
8 because there is no assets to be given.

9 I have one final point on the transition issue, and also in terms of what Eric was saying.  
10 It is true that if you are an asset holder, your time horizon is important in considering whether  
11 you lose or gain under a shift to a consumption tax because your assets go down in value, but  
12 they are also going to earn a higher rate of return. And so if you have a very long horizon, that is  
13 better for you; and if you have a very short horizon, if you are planning to cash out tomorrow, it  
14 is very bad for you.

15 But, you know, you can answer this empirically, or that is what we did in our simulation  
16 analysis. We looked at the effects on different generations of shifting to a consumption tax and a  
17 consumption tax without transition relief hurts asset holders above a certain age as intuition  
18 suggests.

19 And the final point I wanted to make on the issue of net operating losses and whether to  
20 have them, I won't say whether you should have them under a consumption tax, but it is worth  
21 pointing out that the severity of the problem depends on the kind of consumption tax you have.

22 If you had a value-added tax where you included all labor income in the tax base at the  
23 business level, I don't think we would worry as much about net operating losses. If you have net  
24 operating losses there, you have really got losses. It is a much more severe problem under a

1 cash flow tax for companies that are doing a lot of investment and don't have a lot of tax basis.

2 MR. AARON: Our final comment is going to be from David Weisbach who has just  
3 told me that he has recanted completely and wants to announce that he is now in favor of the  
4 income tax.

5 MR. WEISBACH: I give up, right. Let me start with Jane and Eric's comments about  
6 what we think about the models. It is kind of funny to have an economist telling a lawyer not to  
7 trust the models.

8 The theoretical models point towards a consumption tax. The simulations, such as they  
9 are (and they are done by good-looking and smart people like Alan Auerbach), point to at least  
10 some gains for a consumption tax. I don't know what hurdle you want to set for this, but  
11 everything—I could change that first slide to the case, as we now know it, is overwhelming.  
12 And I think you couldn't refute that. And then tell us what the hurdle is and then don't change it  
13 after that and say what do we have to show. I think we can show it.

14 And secondly, where is the presumption? If the models now that we point towards a  
15 consumption tax, then why is the presumption well, the models aren't good enough. Therefore,  
16 we can still believe in an income tax. I don't see why that would be the way we should go about  
17 this. We should say, well, what is the best that we have now? Can we improve on it? What is  
18 wrong with that? I don't know.

19 I was going to talk about Joel's question, which raised a lot more interesting questions,  
20 but I think it has been discussed. I would accept all of Bill Gale's amendments to my comments.  
21 The question that was posed was the income consumption tax question, not where are the most  
22 important gains to be had in tax reform, which I would be with Bill on that. Perhaps the most  
23 important gains are to be had in just neutrality across capital income taxation generally. Don't  
24 Gentry and Hubbard have a paper that basically says this in the NBER series?

1           Dan Halperin. No one has addressed your question on return to risk. If we allow  
2 immediate expensing, the tax payments still look the same on receipts as if we had basis. The  
3 only question is whether you are recovering that basis or not. So if you are going to count that  
4 the receipts due to risky returns in an income tax for distributional purposes, you would count  
5 that as well under a consumption tax or not or not. All you are doing is changing the timing of  
6 basis recovery, not the payment on receipts. So I don't think it should matter very much.

7           Rudy's question on old credits. I guess I would assume they are in the simulation  
8 models that are doing something with those things, but they also are in our current tax base and  
9 our current tax rate. And so when we change to a new system, I would think you would do  
10 something with them as well.

11           MR. AARON: Jane? For some reason she wanted to say something.

12           MS. GRAVELLE: The point that I was trying to make is these models are not based on  
13 empirical evidence from what people actually do. And if people don't actually do what the  
14 models say they are supposed to do if they were optimizing, then the models don't mean  
15 anything.

16           My feeling is that the empirical evidence on the intertemporal labor substitution elasticity  
17 indicates there is virtually none, that the evidence on responses to savings rates to rather  
18 dramatic changes that have happened in tax policies, say in 1981, introducing investment  
19 credits, are not there. I mean, you just cannot see these kinds of changes in the interest rates.

20           When the stock market went up and people purportedly should have gotten a higher  
21 rate of return from investing in that market, what happened? The real savings rate went down.  
22 So I just don't think the empirical evidence is there and I don't think people are able—I can't  
23 do it myself. I mean, I can't optimize over my lifetime and decide exactly how I am going to  
24 respond to the rate of return. Do you? And my mom certainly doesn't. So I think you have got

1 to have empirical evidence that people behave this way. Simulation models are good for  
2 organizing your thoughts, but they are not empirical evidence.

3 MR. AARON: Dan, did you have a comment on this? I just saw you shaking your  
4 head. We can have a debate on methodology. That is how low we have sunk. Could you use  
5 the microphone? Dan Feenberg, NBER.

6 MR. FEENBERG: Dan Feenberg, NBER. The most important thing is the call from  
7 transition relief, which largely comes from people who benefit from the consumption taxation.  
8 That is, people who would have lots of assets who are looking forward to a lower tax rate on  
9 those assets and it is obvious they are. On the other side, there is a plea for justice for people  
10 who are ill-treated.

11 MR. AARON: This may be getting technical in a scenario that I am sure I don't  
12 sufficiently understand, but I wonder if that is correct. You would, by reducing the tax rate on  
13 new capital, end up with a situation in which eventually the required rate of return would be  
14 lower. You would end up with a before-tax rate of return which would be lower. Is that going  
15 to raise the value of old capital since the supply will increase and presumably the before tax  
16 return will decline?

17 MR. FEENBERG: Wouldn't you want to compare the consumption possibilities  
18 through time rather than levels of wealth if you are going to make some kind of a social welfare  
19 comparison of someone worse off or better off? You wouldn't look at their wealth, you would  
20 look at their consumption possibilities. And I don't think those actually go down.

21 MR. GALPER: Harvey Galper at BearingPoint. The question has come up that a lot of  
22 capital comes from carrying wealth. And so there has been no discussion whatsoever of any  
23 relationship between an inheritance or estate taxes and consumption taxes. And 20 years ago,  
24 we talked about the possibility of consumption taxes and of course along with that, was the fact

1 that we would have an inheritance tax that would be part of that system. So I am wondering if  
2 those who would pay for the softer tax, maybe there is only one, but if that is as important as an  
3 element of this transition that should be given consideration.

4 MR. AARON: Alan has volunteered.

5 MR. AUERBACH: I wanted to bring that point together with David Weisbach's point,  
6 about the 10 reasons why people want to preserve an income tax, because it is related. I think  
7 one of the problems people would see shifting to a consumption tax with an estate tax would be  
8 the fear that the estate tax would be eliminated. I mean, I don't know where I would think of  
9 something like that, but the estate tax would be eliminated and the consumption tax would be  
10 kept because for most people with wealth today, the estate tax is far in the future.

11 And that, I think, relates to a point about why people might be nervous about a  
12 consumption tax. It also relates to Joel's point about changing tax rates. Under a consumption  
13 tax, the date of taxation, the date of earning income can be very different, especially different if  
14 their consumption occurs by a future generation.

15 And if we think that the tax system will change again, either by lowering the  
16 consumption tax rate or by shifting to a tax on labor income, for example, we might worry that a  
17 consumption tax deferred with interest for a hundred years might not be collected, whether or  
18 not people are rational and think ahead that far. It is hard to express that in terms of how serious  
19 it is as a policy consideration.

20 But given the lack—this relates back to the point we were talking about before about  
21 the timing—I think when you have a tax system where the timing of consumption is so different  
22 from the timing of earning income, it certainly gives one pause in thinking about a reform.

23 MR. AARON: We are on a tight schedule and I think are going to have to end it here.  
24 It is 10 minutes to noon by my watch. Doug Holtz-Eakin is going to be coming and talking to us

1 at lunch time. He is on an even tighter schedule than we are.

2 So what I would ask you to do is go get your food and try to eat it while sitting in these  
3 chairs so that we can be back in the room to hear Doug who we expect to arrive in a very few  
4 minutes and to leave very promptly around 1:00. Go and get it, please.

5 (A brief recess was taken.)

6 MR. AARON: The best part of the day—with all due respect to our authors, the best  
7 part of the day is to get to hear from Douglas Holtz-Eakin, whom, as you all know, is director  
8 of the Congressional Budget Office. I first knew Doug some years ago when he was an  
9 academic economist and then when he was an editor at the *National Tax Journal* and viewed  
10 as an altogether salutary sign when he joined the Bush administration because it was clear there  
11 was going to be somebody there certainly who was a solid economist and quite hardheaded.

12 He has to leave sharply at about 1:30 to catch a train. He was just saying that CBO was  
13 about to issue revised estimates of the cost of Hurricane Katrina and he said they decided that  
14 they should delay the reissue for a day or two because things might change.

15 I am personally looking forward to hearing what he has to say. Without keeping you  
16 from Doug any further, here is Doug.

17 Incidentally, you are going to have to watch everybody eat lunch.

18 MR. HOLTZ-EAKIN: Well, thank you for the gracious introduction, including the fact  
19 that you knew me when I still had hair and, you know, I really appreciate the chance to come  
20 and talk to this group. It is a great pleasure for me.

21 I have a section here in my notes, which I wrote, which is called “Caveats, Disclaimers,  
22 Dodges, and Weaves.” So let me go through those. First, I have revealed that I can no longer  
23 compete with this crowd in serious research caliber and output and so I am just going to ruin  
24 your lunch. It is my only way to compete now.

1           And secondly, CBO does not have views, officially, nor does it take positions, actually  
2     statutorial. So anything I say in the next couple of minutes is entirely my personal observation on  
3     the really interesting topic of this conference on whether we should, in fact, tax capital income.

4           And I thought that it might be easiest to simply assume, as do all good academics, which  
5     I remember being, just assume the answer is no. And given that assumption—from whatever  
6     reason. It could be that you are one of those people who simply believes that ethically, it is more  
7     appropriate to tax people on what they take out of the society in the form of their consumption  
8     than what they contribute to the society in the form of their supply of labor or their supply of  
9     capital.

10           Or you could be one of those folks who has done all the arithmetic in a very careful  
11     fashion and decided that the intertemporal distortions outweigh the atemporal distortions and on  
12     the whole, we would be better off moving away from that kind of a tax system.

13           Or you could be one of those people who I hear on the Hill who say, “Look, you  
14     know, only the rich pay taxes anyway. We might as well pick a tax system that suits the people  
15     who are actually paying this and take advantage of their particular realities in designing a tax  
16     system and build it for better growth and those kinds of things.”

17           Or you could be a slave to practicality and make the point that we can’t measure capital  
18     income. We don’t know where in the globe it occurs. We can’t figure out how to adjust it  
19     appropriately for depreciation and inflation and so if you can’t measure something, perhaps you  
20     should give up trying to tax it.

21           Or you could just be one of those folks who is doing a process of elimination and says,  
22     “Look. You know, in 1986, we came about as close as we could to taxing all of income and  
23     then going after a Haige–Simons income tax. We have tried that. Why don’t we try the other  
24     idea Congress has had, which is to leave some out. We only have two ideas. We tried one, we



1 could try the other and completely exploit economists' lack of imagination.”

2 But if we do that, I think the first thing we have to do is recognize that by stopping  
3 taxing capital income, we have to do a better job of it than we are doing of taxing capital income  
4 because at the moment, the effective tax rates at the margin are on capital income. If one looks  
5 at the King–Fullerton-style marginal effective tax rates, they suggest a tremendous potential for  
6 distortion from our attempts to tax capital income.

7 Recent calculations that we have done at CBO indicate the overall effective marginal tax  
8 rate is about 14 percent, 13.8 percent for capital in the economy, and it varies tremendously  
9 across sectors. Corporate business, about 26 percent at the margin; noncorporate business, 20  
10 percent at the margin; tenant-occupied housing, 18 percent; owner-occupied housing, negative  
11 5 percent, in effect a subsidy to owner-occupied housing.

12 It varies tremendously across assets. If you look within C corporations, the low in our  
13 marginal effective tax rate estimates is 9.2 percent on petroleum and natural gas structures, we  
14 will get an update on that on Wednesday, to a high of 37 percent on peripherals and—  
15 computers and peripheral equipment.

16 The median tax rate in the corporate sector on assets is about 30 percent, half above,  
17 half below. There is an enormous variation across sources of finance with corporate debt  
18 finance with an effective tax rate of minus 6 percent and corporate equity finance investment  
19 with a marginal effective tax rate of 36 percent.

20 One could go through the list, but if we are going to decide to stop taxing capital  
21 income, I would hope that we would set the aspirational bar higher than how we have set it in  
22 trying to tax capital income. And then having set the aspirational bar, I think we ought to  
23 recognize some of the political legislative policy and education/public relations hurdles that have  
24 to be surmounted. An important question is just how exactly one would do this. How does one

1 go about eliminating the tax on capital income?

2 One possibility would be for me to simply call on Jim Poterba and ask him. I won't do  
3 that. Another possibility would be to have a big reform and do it all at once, move the marginal  
4 effective tax rate to zero. And another strategy that you hear a lot about is let's do it in a  
5 sequence of steps. But the difficulty with the sequence of steps is that there is always the chance  
6 you might stop and as a result, have a very different outcome than the one you set out to  
7 achieve.

8 If you went through and first eliminated all the supply-side taxes, so you took the tax  
9 wages out of the supply of capital and eliminated all the individual-level taxes, you would lower  
10 that overall marginal effective tax rate from 13.8 to 5.5 percent in our calculations. That is step  
11 one.

12 Step two would be to eliminate the demand side of taxes by allowing full expensing of  
13 capital investment. If you ended up stopping there, you would have moved the marginal effective  
14 tax rate from 13.8 percent to negative 15.1 percent.

15 And then the final step would be to eliminate interest deductibility and thereby set the  
16 marginal effective tax rate to zero. You could switch the order, of course, but the lesson is that  
17 we have the potential for enormous inefficiency from where we are and to the extent that we  
18 don't get all the way to the punitive goal, we leave on the table the potential for great  
19 inefficiencies or even worse. So we have to recognize that. And I want to stipulate those  
20 calculations ignore any distortions that involve intangible capital or human capital as well. Those  
21 are just physical capital investments.

22 I think the second important thing to recognize is that not taxing capital income is not the  
23 same thing as a consumption tax. They are often discussed that way in the political environment,  
24 but those are two very different elements and the nasty truth about a real comprehensive tax

1 reform is that it is about raising some taxes and that by bringing into the base those pieces of  
2 consumption, which are also part of income, there would have to be higher taxes on the  
3 consumption of health insurance, housing, education, and a whole variety of tax-preferred  
4 activities under the current code.

5           And it is also important to recognize that taxing consumption is probably just about as  
6 hard or harder than taxing capital income, getting the tax rate on those pieces of consumption  
7 provided by not-for-profit organizations, by some government agencies, by the financial services  
8 sector raises up particularly difficult questions and there is always the perennial dividing line  
9 between what constitutes a consumption item and what constitutes an investment item. Anyone  
10 who has sat in a college classroom and watched the activity known as human capital investment  
11 in practice always wonders exactly where to draw that line.

12           (Laughter.)

13           MR. HOLTZ-EAKIN: So there will be some very real difficulties, from a policy point  
14 of view, in moving toward a broad consumption tax because it involves raising some taxes and  
15 that is always hard. And then one will have to pick among the many great flavors of  
16 consumption tax. The debates are full of discussions of national sales taxes, which are  
17 administratively difficult to imagine and involve lots of issues of federalism that make them hard  
18 to easily imagine implementing.

19           Then there is the notion of moving instead to the economically conceptual, but politically  
20 very different, notion of having a value-added tax, which has never shown any great political  
21 legs in the United States. And then probably the most recent and important innovation, based on  
22 the work of David Bradford, the notion of an X-tax, a tax that is explicitly progressive in its  
23 structure and it attempts to use consumption as the base, but builds on the existing two-part  
24 collection system with a corporate- or entity-level tax and individual-level filing to allow one to

1 actually tax consumption and do so in a progressive fashion.

2 I think that, of course, is a particularly intriguing notion from an economics point of view,  
3 but it does raise the question about whether economists could ever explain to the public exactly  
4 what this animal is doing. And I think the education and public relations aspect of this has been  
5 underappreciated and one that I would argue we have not done a particularly good job at.

6 So the central question, of course, will be the distributional implications of these  
7 alternative tax systems and to frame up the kinds of issues I think will arise, you could imagine  
8 starting with an income tax and collecting that income tax, essentially, in a stylish hold-all at the  
9 entity level where a business would be allowed to subtract off only its depreciation for capital  
10 investment and not fully expense it. Then you could move the wage piece and the compensation  
11 piece to the individual level and allow them to subtract that as well. You could use that as a  
12 starting point and have a national income tax base.

13 Will the public accept the notion that that the tax system is collecting a tax on capital  
14 income even though the holders of capital are not writing any checks to the Treasury? I think the  
15 answer today would be no and that even though economists are quite comfortable with the  
16 equivalence of collecting at the entity level and attributing the incidents to the capital owners, the  
17 public is not there. The writing of the checks matters a great deal and education is crucial.

18 Now imagine starting from that tax system and replacing depreciation with full  
19 expensing. Well, all you have done in that exercise is take something that has a present value of  
20 less than one dollar for every dollar of investment and replaced it with something that has a  
21 dollar of deductions per dollar of investment and effectively ask the Treasury to borrow that  
22 difference. You have given up that little bit of difference in revenue and as a result, you have  
23 given up something that is going to grow at the Treasury borrowing rate, which is the risk-free  
24 rate of return. Otherwise, the economic incidents is exactly identical and would you be able to

1 convince the vast majority of the public that that system is also taxing all but the risk-free rate of  
2 return on the wealthy owners of capital. Could you make a convincing case that you are  
3 collecting a tax on the windfall rents and the monopoly profits and all the other sources of  
4 supernormal returns in the economy without the rich actually writing checks to the U.S.  
5 Treasury?

6           If that is true, if you can convince the public that the distributional cases are the same  
7 and that effectively, by collecting the tax systems at the source before this capital income can  
8 move out, start going through the financial system where all the finest young minds in America  
9 engineer lower taxes by changing one kind of paper into another, if you can make that case,  
10 then, in fact, it may be the case that we will have a fighting chance of having some kind of a  
11 broad-based tax, whether it be an income or a consumption tax, but I think that piece of  
12 education is the one that we simply have been unsuccessful in doing.

13           If we are forced to rely, instead, on the taxes at the individual level, then we are back to  
14 a world that I think we know pretty well and we know how hard it is to effectively tax capital  
15 income using the tax system in that two-part fashion.

16           So I think that there is a very big education piece that should be a part of the discussion  
17 about deciding not to tax capital income, if that is the way we go, and move to a broad  
18 consumption base. And I guess the last point I want to make, because it is my sworn duty as  
19 CBO director to remind people of this, is that if we don't control federal spending, it is just not  
20 going to matter.

21           The fine virtues of better collecting 18 to 20 percent of GDP will pale in comparison of  
22 trying to collect 30 percent of GDP, which is the kind of federal government we are on track to  
23 having in the absence of changes in the fundamental side of the spending system.

24           So I think it is an important discussion to talk about what is the preferred tax base. I

1 think it is nice to talk about not taxing capital income as a way to go to a consumption tax, but I  
2 am more concerned about just how much we are going to have to pay in taxes to pay the bills,  
3 given the outlay side, then exactly how we are going to collect that.

4 So I want to thank you for the chance to come and talk today. I am now reduced to  
5 shell observations on the difficulties of moving from conceptual systems to new tax systems in a  
6 political world. I think that we have two big hurdles that one might want to contemplate. And  
7 the first is, should and can we tax consumption, because that involves taxing pieces of income  
8 that we have previously not been willing to tax and implementing an effective collection system,  
9 and secondly, can economists convey to the public the distributional implications of these kinds  
10 of choices in a convincing fashion? And I would argue that both are important hurdles and  
11 without crossing both of them, we are unlikely to see a big change from the tax system that we  
12 have today. So I will stop there and I will answer all easy questions.

13 MR. SLEMROD: I have got a real easy one. I completely agree with you that educating  
14 the public about the implications of something like a flat tax or an X-tax would be critical and as  
15 we have failed in conveying consensus views among economists on so many other issues, there  
16 is no reason to think we are suddenly going to succeed on this. Perhaps the analogy to  
17 withholding works better than you seem to fear.

18 I remember, I don't know, it is 20 maybe more years ago there was a proposal to have  
19 withholding out of interest and I don't remember the opposition being on distributional grounds.  
20 People seemed to understand that if the banks or corporations on dividend payments withhold,  
21 then that wouldn't be a tremendous change in the distributional educations.

22 After all, people seem to understand about employer withholding and they think that is a  
23 tax they tend to bear. In the UK, which has sort of an income tax, for most people there is exact  
24 withholding so that individuals don't have to file returns at all. The employee gives enough

1 information to the employer to make that work and there is withholding of interest dividends and  
2 even on the mortgage interest.

3 I don't know if it is still true today, but for a while in the UK, instead of an individual  
4 getting a mortgage interest deduction, the lender got a subsidy and as we know, it works either  
5 way. And I don't think the distributional differences in these systems loom so large in the UK  
6 So I guess I am slightly more optimistic. I started by saying we can't convince people of  
7 anything, but I am slightly more optimistic than you are on that.

8 MR. HOLTZ-EAKIN: Well, that is role reversal because I am usually the optimist in all  
9 of these things. I really think that given all the pressing policy issues that we talk about, that in  
10 the end, we can come to terms with them. So, you know, I think we could probably do this, but  
11 I don't think we have been very successful so far in conveying subtle issues in tax incidence and  
12 I think there is a lot of work left to do.

13 And in my experience I would say there is still a lot of education left on who pays the  
14 employer's share of the payroll tax, and that is a pretty straightforward one that we have been  
15 through, and this isn't going to be more complicated because lots of people want proof by  
16 construction.

17 So they want to take Joel Slemrod's savings account and track it through all the  
18 financial entities in the economy, to all the real entities and even abroad, find out where it was  
19 earned and see exactly what you are paying on those. And proof by existence, which is to say  
20 here is the capital income and here is the collection, we withheld it, isn't going to convince them  
21 that you paid your taxes.

22 And that is what I am worried about because the proof by construction is just  
23 impossibly hard to do and that is one of the problems in trying to collect this stuff at the  
24 individual level. You have to trace it through too much. So it will be an empirical issue in the

1 end, no question, but maybe I have enough scars at the moment that I am worried about that.

2 MR. AUERBACH: Doug, you presented the case for fiscal responsibility as somehow  
3 an alternative or a necessary condition for a tax reform that somehow if we don't get our house  
4 in order, then we are rearranging deck chairs on the Titanic I guess.

5 MR. HOLTZ-EAKIN: Alan said that.

6 MR. AUERBACH: Which ship would you choose?

7 (Laughter.)

8 MR. AUERBACH: It seems to me that for those of us who take a realistic view of the  
9 future path of government spending and government tax receipts, the argument for tax reform is  
10 even stronger, and that would be a consumption tax, but whatever we determine is a better tax  
11 system than the one we have now, which typically would involve the lower marginal tax rates, it  
12 seems to me the case is simply strengthened considerably by the recognition that many of us  
13 have that taxes will go up.

14 And so while it is painful to contemplate a world without entitlement reforms, it is even  
15 more painful to contemplate it without some sort of tax reform in place.

16 MR. HOLTZ-EAKIN: I guess it is the chicken and the egg problem at some level. We  
17 know these two sides have to come into balance. There is a budget identity that will hold. I just  
18 think that if you want to think of the efficiency virtues of collecting 20 percent of GDP more  
19 efficiently one way versus the other way, those are dwarfed by the efficiency consequences of  
20 moving from 20 to 30 percent of GDP as the scale of tax collection. And that is it.

21 MR. AUERBACH: But the difference between the efficiency cost of not having tax  
22 reform is much higher when the level of revenue is 30 percent than when it is 20. And that is the  
23 only point I was trying to make.

24 MR. HOLTZ-EAKIN: And I agree with that. If you take it as a given that you want to



1 collect 30 percent of GDP, tax reform is much more important because the efficiency  
2 consequences are so big, I agree. But I have just noted that in some parts of my experience in  
3 the past five years in Washington, both sides of the budget identity are not brought into play in  
4 the same conversation. I didn't want to commit the same error.

5 (Laughter.)

6 MR. AARON: Questions from the floor? Please go to a mike.

7 MR. BRAZELL: This sort of falls on Joel's comments.

8 MR. AARON: Please identify yourself.

9 MR. BRAZELL: Oh, David Brazell, Treasury. If instead of going to an X-tax where we  
10 find the owners of capital not writing checks but wage earners are writing checks, instead we  
11 collected all taxes on wages, including payroll taxes if you wish at the entity level, would your  
12 views on the need for education change in that respect change? Now if I can't see through the  
13 corporate veil to see that somebody is paying those taxes, then if I am not writing the check, do  
14 I really care as a wage earner?

15 MR. HOLTZ-EAKIN: I guess no. My views on the need for education don't change  
16 because I would like for people to understand the consequences of that tax system as well and  
17 if they perceive the government to be a free good, that would be an interesting world in which to  
18 live compared to the one where it is perceived as not being free that we have at the moment,  
19 right?

20 MR. BRAZELL: But the need for education is to get political support.

21 MR. HOLTZ-EAKIN: Oh well, the difficulty there is it is a question of a political  
22 support for—let's run the race fairly, apples to apples, you know. If you want to collect the  
23 same revenue—if they perceive something as just being getting rid of taxes, I think raising the  
24 political support is much simpler. If they are deceived into thinking it is just a lower tax burden,

1 that is fine.

2 If it is a choice between a tax burden that they perceive to be distributed in one way  
3 versus the same tax burden perceived to be distributed more heavily toward the low end, that is  
4 the issue I think, right, taking the same perceived tax burden and getting the understanding of the  
5 distribution rate.

6 If it is just a misperception about how much is out there, then you can gain political  
7 support by suggesting that people aren't going to pay taxes all the time. I don't think that is quite  
8 fair and that wasn't the point. I mean, there has to be a recognition that these taxes are being  
9 collected. It is a little bit different.

10 MR. AARON: I wanted to take your offhand remark about if taxes aren't collected,  
11 people regard the government as a free good, which we know mathematically to be false. This  
12 is a classic case of pay me now or you pay me later.

13 So if it is a fact that there is a tendency to regard government services as somehow  
14 costing less than we know in present discounted value terms they eventually will, the question I  
15 have for advocates of consumption taxation is how on earth can one use the analytical  
16 framework, which assumes perfect perception of long-term costs and discounting to infinity?

17 It seems to me that the correct comment that you just made, Doug, that there is a  
18 perceptual effect, in terms of viewing public spending when we don't pay for it currently, if one  
19 accepts that, it simply undermines the framework that is conventionally used for analyzing  
20 consumption taxation.

21 MR. HOLTZ-EAKIN: Was there a question?

22 MR. AARON: What is wrong with the line of reasoning that I just said?

23 (Laughter.)

24 MR. HOLTZ-EAKIN: You know, the question is where you put the underpinnings of

1 the advocacy for consumption taxation. So I can't speak for those who advocate consumption  
2 taxes. I can just speak for myself. But essentially what you are saying is, well, if the only reason  
3 to favor a consumption tax is that you get all these properties over infinite horizon models that  
4 people understand now and feel better about, then you are not on board.

5 Well, I think that is fine. But I have heard lots of other reasons, some of which I tried to  
6 sketch at the beginning, why some people would like to move away from taxing capital income  
7 as part of moving to a consumption tax base and they have, in many cases, very little to do with  
8 that perceptual issue. In some cases, you know, the old argument going way back about simply  
9 the ethical basis for taxation. It is not a statement about asymptotic properties, it is a statement  
10 about what is just in taxing. So, you know, it is not the only argument.

11 MR. AARON: So I take it what you are saying is the line of reasoning is correct, but it  
12 isn't sufficient.

13 MR. HOLTZ-EAKIN: It is one piece, yes.

14 MR. BURMAN: You touched on, I think, a problem in getting the tax reform, which is  
15 that for at least the last four years, the political message has been nobody ever pays—nobody  
16 ever gives up anything. We get lower taxes and more spending and there are no hard choices to  
17 be made.

18 Given that tax reform of any sort would involve, as you mentioned, a bunch of people  
19 paying higher taxes, I mean, do you have any insights into how we get there? I mean, you work  
20 with 550 or so people who will be making decisions. How do we convince the members of  
21 Congress that they should for some kinds of long-run gains, should do things that are going to  
22 upset a lot of their constituents?

23 MR. HOLTZ-EAKIN: That is the hardest question I get asked. I get asked that all the  
24 time. You know, the question is, what mechanisms exist to transfer to the present the benefits of

1 hard choices so that you can get benefits in cost at the same point in time weighed against one  
2 another? And the only way to answer it is to not answer it by going through the list and letting  
3 you pick how it is going to happen.

4 One way to do it is to have financial markets do it. Financial markets are really good at  
5 moving things through time and a standard line of reasoning is well, at some point, the financial  
6 markets are going to convey, through equity prices and interest rates and valuations in the  
7 currency markets. The future consequences of both good and bad things in the present and  
8 everyone, then, will get it and they will translate that to their politicians. And there has been a lot  
9 of talk about that.

10 It was something that is widely cited as a key to thinking about fiscal policy in the '80s  
11 and early '90s and then the question is, what is going on today? That is number one—that is one  
12 way to translate it.

13 The second way to do it is through political mechanisms either in the form of parties as  
14 intertemporal institutions. You know, parties have reputations, parties have a stake in not just  
15 the present, but in the future. And as a result, there is another mechanism out there to convey  
16 the benefits in the future from hard choices today and that is the political system itself carrying  
17 these benefits and costs across time.

18 And the third is leadership. That is a different political mechanism. It is one that says,  
19 you know, I am sure, you may not be, but we need to do this and the active leadership in  
20 economic terms is dragging people across a benefit-cost decision that they don't necessarily  
21 agree with.

22 And those are the three that you have got and I don't know which comes first. I don't  
23 know which is most effective and as usual, the right answer is probably neither zero nor one; it is  
24 somewhere in between. All three will have to come into play, but, you know, the arithmetic is

1 real simple in the United States. I mean, the fiscal policy, as it is currently configured, is  
2 unsustainable. It just won't last. So something is going to change and the question is when and  
3 what mechanisms like that will come into play.

4 MR. SLEMROD: I think this is a follow-up. It seems like you have talked about two  
5 different aspects of taxation, whether it is efficient and whether it is hidden. You brought up the  
6 hidden aspect of it, which leads to the tension. If we all decided that pure business base taxes  
7 that don't require individual returns are most efficient, but hide the tax burden, how do we  
8 choose between the two?

9 As you know, there are people who advocate eliminating withholding to get people to  
10 feel the pain more even if any tax administrator would tell you that it is going to make the cost of  
11 collection go way up. Here is my question. Baker and Mulligan actually have a paper arguing for  
12 inefficient taxes as a way to restrain government. The question is, what do you say to people  
13 who think that we don't want to make the tax system as efficient as possible as a way to restrain  
14 government?

15 MR. HOLTZ-EAKIN: What I would say to you is you have your policy objectives in  
16 many ways, and perhaps one is the size of the government. Is a really inefficient tax code that  
17 has detrimental consequences for the well-being of people who live in this economy the best  
18 way to control the size of the government? My answer would be no. That is my judgment and  
19 that would be what I would tell them.

20 This whole business of do people get the economic or the statutory incidence of a  
21 particular tax system I think is an important one because I think it is possible to educate people  
22 to understand the economic incidence. You know in the UK with familiarity what your argument  
23 is, is essentially people get it now, it is no big deal.

24 I just don't think we have done that here and it is not that it can't be done. I just think

1 that has to come first. That is part of the process. And that is a better way to deal with the  
2 problem than saying well, it just can't be done and we are stuck, as a result, with less efficient  
3 taxes because we are unwilling to do the education. I don't buy that.

4 MR. AARON: Let me ask one other question. What is going to happen when the  
5 President's commission dumps its report in Congress's lap in your view?

6 MR. HOLTZ-EAKIN: It is a good question, but first of all, the timing has not yet been  
7 determined. I think timing is important here.

8 MR. AARON: Jim Poterba is here.

9 MR. HOLTZ-EAKIN: Yes.

10 Here is a rule that I have come up with. I don't know if it is a great rule by which to  
11 conduct yourself, but if someone puts you on the spot, don't turn around and point to someone  
12 else, however tempting it may be. But I think timing matters. I don't know exactly when the  
13 report will come out, but the timing will matter.

14 Broadly, the panel has two mandates and one is to come up with large reforms to  
15 provide us with a better system of taxation over our current income tax and the other is do stuff  
16 with the current income tax to make it easier to administer, less complex with which to comply,  
17 make it a better tax system by some economic measures. You know, that kind of a mandate.

18 I think that the first mandate, the big reform mandate, is a really important one and I  
19 think that this panel's report is going to have a lasting political legacy. It will be a report to  
20 Treasury and it will be right there on the web site and it will be in bound volumes forever. It will  
21 have the same kind of legs that the '84 Treasury reports had and the White House report  
22 thereafter.

23 I think it is a really important document that Congress won't get that dumped on its lap  
24 in the same sense as lots of things, but it will be there and it won't go away. I think it is very

1 important in that way particularly if it addresses, in the same way that those reports did on a  
2 Haige–Simons income tax, other approaches like a consumption tax base.

3 The second part of the mandate, to make this particular tax system better, is, I think, of  
4 more immediate consequence because it will constitute a ready-made list of things that are a  
5 good idea from the view of experts who have been put on a panel by the President of the  
6 United States for our current tax system. And that, obviously, will have great political weight  
7 and it will be a very attractive set of recommendations, whatever they may be, for immediate  
8 drafting into legislation of whatever type.

9 And what opportunities that will present, I am not sure; but I can promise you that I  
10 have been astonished at the ability of Congress to draft into one piece of legislation a priority  
11 that came from somewhere else and the list of things that have Katrina in it is stunningly long. So  
12 I don't know, but I think that is the way that plays out in my view.

13 MS. GRAVELLE: We have been spending a lot of time in this meeting talking about the  
14 possibility of moving to a consumption tax. Now I have actually more history here in my mind  
15 than I probably need, but Blueprints was issued in 1978.

16 MR. HOLTZ-EAKIN: Yes.

17 MS. GRAVELLE: When the Republicans came to power in the mid-nineties, both the  
18 chairman of the Ways and Means Committee and the Majority Leader had very strong views  
19 about consumption tax, although I am not sure the Majority Leader knew he was talking about  
20 a consumption tax. But he was certainly talking about a Hall–Rabushka tax. They talked about  
21 ripping the income tax out by the roots.

22 Now we are into 2005. Now my lesson from this history is that this is something we  
23 love to talk about, but the barriers to doing it are so enormous that even if the Commission  
24 reports a consumption tax, that is what we will continue to do. What is your take on that?

1 MR. HOLTZ-EAKIN: I think if you dialed the clock back, you know, to the mid-  
2 seventies, we would have said the same thing about a Haige–Simons income tax and, you  
3 know, we love to talk about it and we teach it and the '86 reform was not a Haige–Simons  
4 income tax.

5 It was a real aggressive push towards a comprehensive income tax base and I think the  
6 same here—we are just going to talk about this, but the “we are not ever really going to try it”  
7 sentiment would have prevailed as you just characterized about the consumption tax. What then  
8 switched things? Well, I don't know exactly.

9 MS. GRAVELLE: Ronald Reagan.

10 MR. HOLTZ-EAKIN: So I guess I can't rule out the same kind of attempt by using the  
11 consumption tax base, you know, and I think an important question is why the '86 reform so  
12 quickly came undone and that is a question I don't have a good answer to, but one that I think  
13 about all the time because if we were, in fact, to go to any sort of big reform that cleaned up the  
14 tax code, its durability is as important as its initial incarnation.

15 So what will get us there and how we keep it remains to be seen. But I can't say that I  
16 rule it out as just talk that we will never get to because the same consideration applied to the  
17 income tax.

18 MR. BURMAN: Is CBO planning to analyze the panel's recommendations?

19 MR. HOLTZ-EAKIN: As you know, Len, CBO works for the Congress and if our  
20 congressional leaders are interested in an analysis of any tax plan, we will do it, but that is the  
21 extent of my planning.

22 MR. AARON: As you mentioned, Doug, everything these days on the Hill has been on  
23 Katrina and we were actually thinking of renaming this conference the Post-Katrina Capital  
24 Income Taxation Conference. But that segues nicely into a question to you.



1           There are a lot of tax provisions associated with relief to the area. Has CBO begun to  
2 do any work in evaluating those or is there anything you would be willing to say about them?

3           MR. HOLTZ-EAKIN: No.

4           MR. AARON: That is clear.

5           MR. HOLTZ-EAKIN: Yep.

6           MR. AARON: That is how he survives in the world of—if there are no more questions,  
7 Doug, thank you very much.

8           MR. HOLTZ-EAKIN: Thanks.

9           (Applause.)

10          MR. AARON: We are actually in the extraordinary position for a conference of this  
11 kind of actually being ahead of schedule. I suggest that we are going to probably need the time  
12 this afternoon. It is 12:45. Let's gather again at 1:00 and at that point the lawyers take over and  
13 the economists can sit back.

14          MS. GRAVELLE: See how many people stay, right?

15          MR. AARON: We better. There are some very interesting papers.

16          (A brief recess was taken.)

17

18

#### A F T E R N O O N S E S S I O N

19          MR. HALPERIN: As you can see, the subject for this afternoon is Can We Tax Capital  
20 Income. Basically, can we solve the problems of the income tax or would we have some of the  
21 same problems under consumption tax and we start off with Ed Kleinbard of Cleary, Gottlieb.

22          MR. KLEINBARD: Thank you, Dan. I found this morning very interesting. You heard  
23 from people who, in my view, are serious tax visionaries. They stood here on what I like to  
24 think of as the shores of tax Todayland. They looked out across the gulf and asked how do we

1 get to tax Tomorrowland? Should we rehabilitate this bridge across the gulf or should we build a  
2 new tunnel? Build a bridge or a tunnel? Then I come this afternoon as the fellow who says, “I  
3 hear that you guys have some bridge contract that you are bidding out.”

4 So my approach is a very different one. I am a practical person. I can’t help it. That is  
5 my training, that is my personality. And so I took on the assignment of trying to figure out not  
6 which is better (a consumption tax or an income tax), but rather, how can we work within the  
7 current income tax system to do a better job of it?

8 To me, when it comes to taxing capital in the current income system, there are two basic  
9 approaches one can take, as a practical matter. The first way to attack the problem of taxing  
10 capital is by fixing the rules for the depreciation of real assets, and by getting capitalization rules  
11 correct so that I am not expensing what I should be capitalizing. Finally, I would have to  
12 address the realization problems associated with real assets.

13 But that is not the direction in which I wanted to go. And so I tried to approach the  
14 taxation of capital from the point of view of the taxation of financial capital instruments: stocks,  
15 bonds, options, swaps, the whole universe of derivatives and said to myself, Let’s see if we can  
16 get those rules right rather than concentrating on the taxation of real assets.

17 I think that one of the points of complete consensus in the academic community, which  
18 we heard several times this morning, is that modern financial theory actually tells even practical  
19 people like me a few important points about how to go about redesigning the bridge to make a  
20 better income tax system on financial capital. What we have learned is that there are three  
21 components of financial returns: time value of money returns; risky returns, which I like to think  
22 of as the payoffs from bets; and finally supersized returns, which the economists refer to as rent.

23 I think we also learned a few more details than that. We learned that for time-value of  
24 money returns, it is really, really important to get those right if you care about an income tax

1 because that is the difference between an income tax and a consumption tax. That is what Reed  
2 told us this morning. The difference between income tax and the consumption tax is that income  
3 tax reaches time value of money returns. So the first lesson is, if we are going to try to do an  
4 income tax, can't we at least get this one thing right?

5 For risky returns, what did we learn? Well, we learned that we should not break out  
6 into a sweat over risky returns because we can always just scale up our bets to accommodate  
7 whatever tax rate Congress chooses to impose—so long as we can deduct losses. And I take  
8 from that the lesson that it would be really great if we could get to a tax system that not only  
9 actually reaches time value of money returns consistently, but also a system that permits  
10 economic losses to be deducted on some basis.

11 And finally, we learned that we really shouldn't worry too much about supersized  
12 returns, because they are going to be taxed under both systems. My answer to that is from your  
13 lips to God's ears, if only we did. I think the number one problem in doing so is the problem of  
14 the taxation of intangibles. Those are problems of transfer pricing, and I address that in the  
15 course of the paper, and it is a little bit of a side point in this talk, but I urge you all not to forget  
16 the taxation of intangibles.

17 So, how well do we do today at taxing financial capital instruments? What is the state  
18 that our bridge to the future is in today? And the answer is that we are in terrible shape—and  
19 thank God for it. That is how I make a living. But if you actually care about getting it right, we  
20 need to do a much better job.

21 I don't have time to go through the parade of horrors, but the first fundamental point is  
22 that I don't think it is right to begin with realization as the key problem. I think it is much easier  
23 to begin with what I refer to as the original tax sin, which is the debt–equity distinction in this  
24 area.

1           Once you have a distinction between debt and equity, you cannot help but have an  
2 unstable system for the taxation of financial capital. It is just not possible to reconcile one world,  
3 in which we kind of recognize the time-value of money, which in turn we then undue by having a  
4 universe populated entirely by tax exempts on the investor's side, with a second world that, in  
5 effect, repudiates time-value principles, doesn't give the user of capital a deduction, doesn't  
6 require an inclusion to the investor, and taxes, returns at preferential rates.

7           Everything follows from that. I have a nice example of that that I could go through with  
8 you, but I am not allowed to have the time. But if you look at the paper, you will see a few  
9 examples that try to illustrate that point.

10           So my first lesson is that the current system, in fact, is in chaos. The second lesson I  
11 would like you all to take away from these oral remarks—actually, I have a few points and an  
12 agenda. The agenda is to get someone somewhere to read my paper.

13           (Laughter.)

14           MR. KLEINBARD: And so far I have two readers, I have my mother and my son. I  
15 worked it out that that means that the average age of my readership is 47 but I would like to get  
16 a few more data points clustering around that number if I could.

17           PARTICIPANT: I read it so it is 42.

18           (Laughter.)

19           MR. KLEINBARD: At this point I need to identify the criteria by which I solve the  
20 problems. I conclude in the paper that the first thing I have to do is come up with some uniform  
21 rules for all kinds of financial capital, that the debt–equity distinction, the root of all of our tax  
22 evils in this area, is predicated on a false premise that we can distinguish owners of a business  
23 enterprise, on the one hand, from guys who are just renting out money by the day on the other  
24 hand. But, of course, we can't. All these different claimants on the earnings of a business

1 enterprise are, in totality, the owners, but they are also the lenders. We cannot make these nice  
2 distinctions between these two kinds of groups.

3 The second point I conclude is that we have to have uniform rules for all kinds of  
4 business enterprises. It is impossible, for those of you who aren't in practice, to fully appreciate  
5 the level of work we impose on the Internal Revenue Service and on practitioners by virtue of  
6 the multiplicity of different forms of business enterprise, some of which are pure pass-throughs,  
7 some of which are entities, some of which are entities some of the time and pass-throughs other  
8 times. It makes for, again, a very unstable result.

9 The third thing we need to do, of course, is to have some kind of a workable  
10 coordination role between the taxation of claim holders and the enterprise, because otherwise  
11 we don't have a neutral system. This coordination usually goes by the name of integration, but I  
12 just think of it as one of the goals of a neutral system. You tax all income once, that is the time  
13 value principle. But you tax it only once. That is the neutrality principle.

14 All of which leads me to think that what you need to end up with is what I call a  
15 "featureless tax topography." That is, we cannot have these little rivers and valleys and  
16 mountains of this kind of entity and this kind of financial instrument. We need to make the tax  
17 topography as flat and boring as possible.

18 The next thing I conclude is that if you focus on the business enterprise and try to get the  
19 measure of income right, at that level, we are just never going to succeed. There are too many  
20 problems in getting the measure of income from real assets right, getting depreciation rules right,  
21 getting capitalization, which I think is a bigger issue, frankly, the tendency to expense what we  
22 should be capitalizing in the first place, right.

23 And real assets, which is a term I dislike since I spent 30 years working in the capital  
24 markets and I like to think what I do is real, don't turn over as quickly as financial assets do. So

1 I have more realization problems when I focus on the enterprise as opposed to the investor.

2 So the fourth point is to say that I have got to minimize the distortions that realization  
3 creates. I have got to figure out some way to do something about realization. And I can do that  
4 in one of two ways. I can go with mark to market, which economists confusingly call accruals  
5 taxation, or I can try to have lots more realization events.

6 And the irony here, of course, is that the only thing at which I can genuinely hold myself  
7 out as an expert is in the field mark to market taxation. I do more work in that area than any  
8 other practitioner in private practice, but I reject it utterly as the basis for solving the problem  
9 and I, therefore, come down on the side of lots more realization events. And again, I wish we  
10 had time to go through why.

11 And then I conclude that the best—and this, I think, is the most important point I would  
12 like to leave you with in terms of how I try to go about rehabilitating the bridge to tomorrow—is  
13 that, if you want to get time value of money income inclusions right for all the reasons I have just  
14 said, concentrating on the business enterprise, trying to get the right number to the business  
15 enterprise and then allocating it up in some fashion to holders, either by saying I have got the  
16 right number at the enterprise and now distributions to holders are exempt, which is, you know,  
17 the Treasury CBIT approach of 1992, or alternatively, through a pass-through system is just  
18 doomed to failure.

19 It is doomed to failure because we are never going to get it right at the entity level. The  
20 consequence is in a CBIT-type structure, you have to create shadow accounts that are really  
21 the enterprise's secret true income so we can figure out when our distributions really should be  
22 treated in the hands of holders as after-tax income as opposed to pre-tax income.

23 There are terrible international problems too with an enterprise-level approach because  
24 it doesn't work well in coordinating with foreign investors.

1           Moreover, doing a true pass-through type solution is a nightmare because you have  
2 realization events at both levels. You have claims holders selling their interests, you have the  
3 entity selling its real assets from time to time and it is impossible to coordinate the two. We have  
4 very, very elaborate rules in the Tax Code today that try to do that for partnerships. When a  
5 partner sells his partnership interest at a gain, these rules keep track of what that means for the  
6 partnership's basis in its assets and vice versa. I have never understood those rules in 30 years  
7 and even those who claim they do would acknowledge that those rules are not going to work in  
8 the context of public companies.

9           Mark to market by reference to public trading prices of an entity's stock, or stock and  
10 debt, of course, suffers from the problem that it would create a giant rift in the tax structure, just  
11 as does the debt-equity distinction today. If we follow mark-to-market taxation as the solution,  
12 we are going to have public/nonpublic rifts and completely arbitrary and nonneutral results.

13           And so in conclusion, I believe that the best place to capture time-value of money  
14 returns is at the investor level first and not at the entity level. It can be done. We can introduce  
15 more kinds of realization events. I have a plan that does just that, but to find out about the plan,  
16 you will have to read the paper.

17           I will say this, that my plan is complex only in the sense that it requires a fair amount of  
18 administrative hassles of keeping track of data. It is not complex in the sense that its results are  
19 unpredictable. Its results are easily predicted. I think that is much more important in the business  
20 context than are administrative hassles.

21           The capital markets do not do a good job of absorbing tax risk. They act in a  
22 completely binary fashion by either ignoring a tax contingency or by valuing it at a 100 percent.  
23 So I think that having an answer that is easily predicted, even if a nuisance to keep track of, is  
24 the right way to go.

1           And finally, I would say that the plan, as proposed, is a plan that adopts enthusiastically  
2 a principle rejected by everyone this morning, which is the principle of rough justice—or good  
3 enough for government work. This is why they made the phrase. The point of the proposal is  
4 not to get it right. The point of my proposal is to get it close enough to right that we are a lot  
5 better than we are today.

6           I will close with the famous aphorism of Voltaire, who first observed that the perfect can  
7 be the enemy of the good. This debate is a debate that has gone on in its modern incarnation for  
8 40 years. To a large extent, it has been a debate about the perfect. It is time to move, in my  
9 view, past that and ask instead what pretty good results can we possibly, actually implement.

10           MR. HALPERIN: Next we will hear from Julie Roin from the University of Chicago.

11           MS. ROIN: Well, like Ed, I am a lawyer much more than I am anything else and so,  
12 like him, I will not use PowerPoint and I will approach the topic that I have been given, which is  
13 to answer the question of Can Income from Capital Be Taxed: An International Perspective.

14           I will analyze this problem from a practical perspective, looking at the question of who  
15 appears to pay capital taxes in an open economy. I should add, however, that there is an  
16 economic perspective. One can draw models based on assumptions of investor behavior and  
17 try and determine where the actual economic burden of an income tax actually falls in an open  
18 economy or in a globalized economy sort of world.

19           I am not an economist. So I am not going to do that, but I do feel it necessary to give  
20 you fair warning that some economists might claim that the way I go about viewing the question  
21 is well, basically, silly. It is silly because looking only at who appears to pay taxes is often quite  
22 misleading because the person who pays the tax often isn't the party bearing the economic  
23 burden of the tax.

24           And I must admit, that is often true. After all, we all know that much of the tax benefit or



1 the benefit of the tax exemption provided for municipal bonds flows not to the investors in those  
2 bonds, but instead to the issuing municipalities who get to pay lower interest rates on the bonds  
3 that they issue.

4 Nonetheless, in this case, I am going to ignore this economic perspective and one of the  
5 reasons I am going to ignore it is because the underlying economics on tax incidence are actually  
6 quite disputed. The substance of the dispute was laid out in George Zodrow's paper from this  
7 morning and I won't repeat it.

8 So if you are interested in that dispute, check out the international section and you will  
9 see why that is the case.

10 The other reason for ignoring the economic perspective and focusing on who appears to  
11 pay taxes is because this is Washington, D.C., and from a political standpoint, appearances do  
12 matter and so who appears to pay the tax might have some independent significance.

13 So what I am going to do is try to answer the question of whether it is possible for  
14 taxpayers to appear to tax capital income in a global economy. That is, can we collect a tax  
15 from people that is based on the income that they earn from investments in foreign stocks and  
16 bonds and can we levy a tax on corporations that at least, ostensibly, includes the income that  
17 they derive from transnational transactions because if we can't, if we can't even do that, there is  
18 not going to be a tax on capital income.

19 There won't be a tax on capital income because what people will invest transnationally  
20 instead of domestically and they will, thereby, avoid paying tax on capital income because they  
21 would have to be sort of silly to pay tax on domestic capital income when they can get away  
22 with avoiding all tax by investing transnationally.

23 Now as it happens, I think that we can collect that sort of tax, but it is not going to be  
24 easy and it will almost definitely require some coordination with other nations that are also

1 interested in imposing a capital income tax on their investors and, of course, it will also require  
2 substantial changes in our legal regime. That sort of goes without saying.

3 Well, what sort of changes are required and why do we need coordination. It depends  
4 on the type of transnational income you are talking about. And the reason it depends on the type  
5 of transnational income you are talking about is because we actually have two different taxing  
6 regimes out there for two different types of income and both of the taxing regimes have flaws,  
7 but they are different flaws and, therefore, they require different solutions.

8 There are two taxing regimes: one applies to passive investments income and the other  
9 taxing regime applies to active business income, more or less. It is a little more complicated than  
10 that, but you can sort of take those categories for purposes of this talk. And the first thing to  
11 realize is that virtually no country, and that includes the U.S., applies its regular tax rules to the  
12 passive investment income earned by foreigners. Instead, if foreigners are subject to tax at all on  
13 their passive investment income, they are subject to a tax that is equal to 30 percent of the gross  
14 amount derived from the investment.

15 So, when a French individual buys shares of stock in a U.S. company and that company  
16 distributes dividends to that French individual, that French individual does not fill out a Form  
17 1040 and go through the various schedules and calculate taxes from a rate table or anything  
18 even close to that. Instead, the French individual may be subject to a tax of 30 percent on the  
19 gross amount of the dividends paid to him.

20 If the dividend is \$100, the French individual receives \$70. The other \$30 is remitted by  
21 the dividend paying corporation directly to the U.S. Treasury.

22 Well, when you think about it, this 30 percent withholding tax on gross income is a  
23 pretty awful tax or taxing regime, however you want to say it. I mean, just think about what  
24 would happen if the individual, say, borrowed money in order to invest in U.S. stock. That

1 individual would not get a deduction for the interest cost of the loan incurred in order to buy the  
2 stock even if there was dividend income that was of a greater amount than that interest payment.

3 The amount of the tax could, in fact, easily exceed the taxpayer's net profit from making  
4 that sort of investment, which means that, of course, that no well-advised taxpayer would ever  
5 borrow money in order to make a transnational investment in stock. But, and this is why  
6 countries have this terrible tax regime, it is incredibly easy for the source country, the U.S. in this  
7 case, to enforce.

8 I mean, they have leverage over the dividend paying corporation and they can audit that  
9 company's books and they don't have to deal with this individual taxpayer who may never set  
10 foot in the United States and whose books and records may never be in the United States. They  
11 don't have to deal with that individual at all.

12 But of course, it is an awful enough taxing regime that it can't be applied to some  
13 categories of income of passive investment income that is earned by foreign taxpayers and as a  
14 result, some categories of passive investment income are entirely exempt even by statute from  
15 tax in the country of source.

16 Even that income which is taxable in the country of source by statute may have the rate  
17 of withholding tax either eliminated or reduced by virtue of a bilateral tax treaty negotiated  
18 between the U.S. and another country on a reciprocal basis. Basically, France can say, "Okay.  
19 We won't tax the dividends that U.S. taxpayers receive from French companies as long as the  
20 United States doesn't tax the dividends that French people get from U.S. companies."

21 The problem is that when this income isn't taxed at source, it very often isn't taxed at  
22 all. Why not? Because the foreign taxpayer's country of residence, which is the country that has  
23 jurisdiction to tax this passive income, doesn't have an easy way to learn about the existence of  
24 the income and French taxpayers are not about to help France out by voluntarily reporting the

1 income in these circumstances.

2 Now non-reporting of hard-to-discover income is not a problem limited to French  
3 taxpayers or foreign taxpayers, generally, that are investing in the United States, nor is the  
4 problem limited to U.S. taxpayers willing to invest abroad or, indeed, and this is an increasingly  
5 serious problem, U.S. taxpayers investing in the U.S. while pretending to be foreign taxpayers  
6 investing in the United States. This country saw huge increases in “voluntary” tax compliance  
7 when we instituted computer matching of information returns of dividend and interest income.  
8 We also eliminated millions of dependents when we started requiring taxpayers to identify their  
9 dependents with Social Security numbers. Apparently lots of people were either making up  
10 dependents or claiming their dogs and cats as dependents. The general rule is that people cheat  
11 on their taxes when it is easy to cheat and when the chances of getting caught are low. And that  
12 exactly describes the situation with passive investment income earned particularly by individuals  
13 in foreign countries.

14 So what to do? Well, what we ought to do is exactly what we did with domestic  
15 interest, which is come up with a reporting scheme for foreign investors that works or at least  
16 works reasonably well. This means instituting an automatic comprehensive system for reporting  
17 earnings to a resident’s country in usable form, a form which includes the home country’s tax  
18 identification numbers as well as our own.

19 Technically, this might be rather difficult. After all, the IRS can’t seem to get its own  
20 computer system to work so it is hard to see how we are going to come up with a system that is  
21 going to integrate well with those of other countries, but, in fact, the larger problem is political.

22 The EU spent 10 years negotiating an automatic information return scheme. It started  
23 being implemented this July. The United States refused to sign on to it to become a participating  
24 member with the EU fearing, among other things, that if it did so, it would reduce the investment

1 attractiveness of the United States because EU investors would actually have to pay tax on their  
2 investment income.

3         Whoever made this decision failed to appreciate that, if we provided the European  
4 Union countries with this information, European Union countries were going to have to provide  
5 similar information about our taxpayers who would not only, then, have to pay tax on the  
6 investment income that they earned in the EU, but also might be deterred from investing in the  
7 EU because they couldn't earn those returns tax free any more. So that is problem number one  
8 with the passive investment income. We really need much better multilateral enforcement.

9         The problem with business income is different. There, the problem is that we have these  
10 crazy complex rules for determining the source of income and then we have basically all tax  
11 treatment hanging on those source determinations. The problem isn't so much that the source  
12 rules are complex and crazy, though, as that taxpayers have learned to manipulate those source  
13 rules in order to get the result that they want.

14         And the result that they want is to have enormous amounts of income allocated to tax  
15 haven countries, to countries which have very low tax rates. And there is, I should say, no way  
16 to fix these source rules. They have been fixed innumerable times and all that has happened is  
17 that the statutory sections have gotten longer and tax lawyers have come up with new schemes  
18 to get around them.

19         So the answer, I think, is a new approach for sourcing income, which isn't such a new  
20 approach at all. It is one that resembles the method used by the states, the United States, for  
21 allocating the income of multi-state entities. That is the so-called formulary method. You figure  
22 out worldwide income and then you allocate it across jurisdictions using a formula based on real  
23 economic factors.

24         Now not all our experience with the formulary method for allocating interstate income is

1 good, but we have had enough experience that we ought to be able to come up with a pretty  
2 decent formulary method that would work for international rules. After all, we aren't required to  
3 do exactly what the states are doing. We can improve on that model.

4 And what we come up with certainly won't be foolproof. It won't be perfectly accurate,  
5 whatever that means, but it should be better and less manipulative than what taxpayers currently  
6 do with the source rules. And again, it will help if we try and effect this reform with other  
7 countries. If nothing else, it would help taxpayers who don't really want to do separate tax-  
8 based calculations and perhaps even formulary calculations for every country in which they do  
9 business.

10 We might, I should make clear, have some aid in doing that or I should say we might  
11 have. There have been a string of tax decisions by the European Court of Justice, which have  
12 had the effect of setting up tax arbitrage opportunities in the EU, which has the EU tax  
13 authorities seriously thinking about whether the EU, too, ought to switch to tax-base  
14 harmonization and formulary apportionment. And so they could very well be anxious to work  
15 with us on this project. So, my recommendation is that if we want an income tax, this is what we  
16 have got to do in order to make it a viable tax and it can be done.

17 MR. HALPERIN: Thank you, Julie. We have three commentators and first we have  
18 Michael Keen of the International Monetary Fund.

19 MR. KEEN: Thank you very much. My apologies for being late. I am afraid this is the  
20 time of the IMF annual meetings, but you all didn't help by starting early, I have to say, in my  
21 own defense.

22 And so with apologies again. So I will speak unencumbered by having heard the  
23 presentations or the facts, which again is IMF tradition. So I am quite at home.

24 (Laughter.)

1 MR. KEEN: But I just have a few remarks on both of the papers that I read and  
2 enjoyed starting with BEIT, COCA and all that.

3 MR. KLEINBARD: The BEIT(like “BITE”).

4 MR. KEEN: The BEIT. We say the BEIT?

5 MR. KLEINBARD: Yes.

6 MR. KEEN: Oh, okay. The BEIT.

7 MR. KLEINBARD: Referring to tax, the BEIT.

8 MR. KEEN: BEIT. Oh, okay. You need another “O” for COCA, at least the English  
9 spelling, but I am sure we can figure—it is a very homey, comforting kind of sound to it.

10 Very brief commentator. My main impression was I think it is a really neat idea. I come  
11 to it knowing a little bit about the ACE, the advanced—or whatever it is called, the allowance  
12 for corporate equity scheme that has been inflated in the UK, and I think, as Edward notes, that  
13 there are some similarities to the ACE, which in a way I think of it as a logical extension.

14 It very neatly finesses the distinction between debt and equity, which I think the paper  
15 makes a very strong case and I think it is clearly true, but this is an increasingly artificial  
16 distinction. So it is a very, I think, neat extension of the ACE idea or at least that is how I find it  
17 easiest to think about it, which I guess goes back to Boadway and Bruce, the theorists would  
18 say, but it is a really neat idea.

19 There is also, in one of the notes it is mentioned, I don’t know if you had a chance to  
20 mention in the presentation, but there is some experience now with—

21 MR. KLEINBARD: I left Croatia out of my presentation.

22 MR. KEEN: Excellent. Because I wanted to say a bit about that because I think you  
23 make a strong—I would say there is now really quite substantial experience within ACE, and  
24 that it is actually good, which I think goes in the direction of supporting your scheme.

1           There is not only Croatia, which I will bore you with a little bit in a moment, but Brazil  
2 has had an ACE since 1996, very popular in Brazil. They basically got rid of extension inflation  
3 accounting and the quid pro quo is they brought in an ACE.

4           Italy and Austria, Italy had a variance of the ACE. I won't go into the sense in which it  
5 was a variant, but it was pretty much an ACE-based idea. They got rid of that. Austria had a  
6 similar thing. I am not quite sure if they still do. So there is quite a lot of experience and one that  
7 we have looked at, as you know, fairly closely at the fund was actually Croatia, which had one  
8 from '94 to 2001, which is very much a part of a very wider consumption tax system.

9           I mean, Croatia, in that period, pretty much had a consumption tax. I mean, it was one  
10 of the few countries that you would look at and say this is clearly a well-designed, consistent  
11 consumption tax, which included an ACE, but then interest was exempt. So the personal level  
12 was taken out because they were trying to get a consumption tax.

13           And I think the question there would be well, if it was so great in Croatia, why did they  
14 get rid of it. And really the point is that they didn't get rid of it for any very technical reason.  
15 There was no great technical problem. There were issues about—there was some concern  
16 about whether it would be credible in the U.S., but that seemed to work out okay.

17           They did the interest adjustment monthly, which turned out to be burdensome, but really  
18 they had a new government and the new government wanted to introduce some incentives. They  
19 wanted to do something new and in a way, the ACE—I wanted to point out, one of the  
20 beauties is it is hard to hard to introduce incentives in the formerly accelerated depreciation  
21 because it all washes out, which is kind of, in a way, is quite a nice defense against incentives,  
22 but essentially they were unhappy with it on that ground.

23           So I think—and again, as I said, Brazil, the experience has been very happy. Italy,  
24 again, it was, I think, essentially, a political reason, a change of government. So I think very



1 much I think supporting, although as you point out, there are important differences, but I think it  
2 does suggest these things can work and they can work actually quite well.

3       Clearly there are some issues. I mean, one is going to be the choice of the imputation  
4 rate and whatever—the Croatians used to call it protective interest and I think you are right.  
5 Theoretically it should be the risk—some kind of more or less risk-free rate, but I think that can  
6 be a hard argument to sell.

7       That was certainly an argument we found it quite tough to sell to the Croatians that that  
8 was the right rate because companies will come along and say oh, well, you know, we can't  
9 borrow at it now. We have all these risks. But I think so long as the tax treatment is certain,  
10 which you have with your carry forward provisions, it is theoretically the right rate, but it is a  
11 hard sell. The theory papers in this are pretty tough. So I think it is a hard sale.

12       I was also left a bit unclear about what we do about the self-employed, where the self-  
13 employed are in this scheme. And again, there are some related experiences in the Nordic  
14 countries not with a system like this, but with a system that had essentially an imputed return to  
15 capital, a little bit like you have, and really the treatment of the self-employed became or still is  
16 quite a big issue.

17       Of course, the other thing about the Croatian experience is that when they introduced it,  
18 the IMF advised against it. We then advised them to keep it, they got rid of it.

19       This is the job satisfaction we get down the road. Perhaps maybe a few little thoughts  
20 on the second paper. I think very much picking up—it seemed to me one of the lessons is that in  
21 some form, you need some cooperation to get this thing going and between countries that have  
22 really very different interests.

23       I think for an economist, it is very natural to think about what are the incentives here and  
24 how we can get the incentives for people to participate in this scheme right. You can try a stick,

1 which, to some extent, I think, was at least the perception of the OECD initiative. But this was a  
2 defensive measure. You can try a stick, or you can try to actually create some positive  
3 incentives for countries to go along, which I think has been much less thought about.

4         And I think one way to think about that is actually in the context of the EU savings  
5 director, which you mentioned. One of the interesting and innovative things about that was that  
6 countries that impose the withholding tax actually don't get to keep all the money. They get to  
7 pass the bulk of it to the resident's country, which is quite interesting. You say well, why do they  
8 do that.

9         In pure economic terms, you don't need that. If you believe what we are trying to do is  
10 implement the residence principle, the efficiency argument there says nothing about who gets the  
11 money, but it is all about what the tax rates are. It is nothing to do with who gets the money.

12         So why did they do it. Well, probably it was some kind of political thing. But we should  
13 also think through what are the incentive effects of that kind of arrangement when you try to be  
14 a little bit innovative about revenue sharing on international tax issues. And you could say that it  
15 was a rather good idea to return some of the money to the resident's country because that  
16 actually has quite good strategic incentive effects in terms of the rates of tax the countries set  
17 because it means that the resident's country that is losing capital can now happily set a higher  
18 tax rate because it doesn't need to worry so much about money going abroad because it is  
19 going to get some of the money back anyway.

20         So the resident's country could be more comfortable setting a higher tax rate. That is  
21 beneficial, too, to the kind of tax saver, or whatever we are going to call the other country,  
22 because then they can also either take in more cross border savings or they can raise their own  
23 tax rate as well.

24         So strategic effects of that are quite nice, which also makes you think about well,

1 shouldn't we think of—maybe we should be a little bit more creative over information exchange  
2 arrangements. And I think you are very right to be somewhat skeptical about the practicality of  
3 these things.

4           You know, who should get the money. If you have an information exchange agreement  
5 and that leads to some additional revenue being collected, who should get the money. Well,  
6 again, there is a little bit of theoretical literature and you think through the incentives and again,  
7 the argument is that for efficiency reasons, it should be the resident's country, which comes as at  
8 present because again, this provides it with a security against money going abroad and lets it go  
9 for the higher tax rate, which can be advantageous.

10           But if you really want countries to go along with these schemes, it may be worth taking  
11 some inefficiency, but actually thinking about sharing some revenue. I mean, if these countries  
12 are being expected to provide information, which is going to give you some more revenue, you  
13 can make a case certainly on incentive grounds that there should be some sharing of the  
14 revenues because that gives them an incentive to go along with the scheme.

15           Well, Len has given me two minutes, but I am actually finished. So if anyone wants to  
16 buy two minutes of time—but again, apologies, but I thought they were both extremely  
17 enlightening and helpful papers. Thank you.

18           MR. HALPERIN: The next commentator is Paul Oosterhuis of Skadden Arps.

19           MR. OOSTERHUIS: Actually, Michael, if I could ask you a question that may use up  
20 some of your time. One of the things that is unclear to me about Ed's paper is the impact on  
21 cross border investments. Ed proposes a notional inclusion for U.S. portfolio investors in foreign  
22 companies even though the foreign companies, obviously, do not get any kind of COCA  
23 deduction. The result is a double tax on that income in a system that is not intended to double  
24 tax corporate income because of the mismatch between the U.S. and other country tax systems.

1           In the opposite circumstance with foreign portfolio investors in United States  
2 corporations, Ed proposes withholding on notional income through a deferred catch-up  
3 mechanism because, obviously, you can't withhold out of nothing and we are talking about  
4 notional income here.

5           Ed's proposal is to accrue the withholding amount and then when there is a dividend or  
6 sale amount out of which to withhold, the company or a broker withholds the accrued amount,  
7 which means there has to be some system to withhold on all the gains and losses on the sale of  
8 shares.

9           My reaction is that such a withholding requirement is probably not going to work as a  
10 practical matter, and that in the end foreign investors in the U.S. are going to end up letting  
11 companies be exempt from the COCA tax so that unless every major country adopts COCA,  
12 U.S. investors will be double taxed on their foreign corporate investments and foreign investors  
13 will pay no tax on their U.S. corporate investments. Such a result seems to be somewhat  
14 unstable. How do countries like Brazil and Croatia, where foreign investment is obviously  
15 important, deal with that?

16           MR. KEEN: The short answer is I don't know. I would have to figure it out. I don't  
17 know offhand.

18           MR. OOSTERHUIS: Okay. But it seems to me that this is a very big issue. The whole  
19 income tax integration system in Europe, the UK ACT system, and the German imputation  
20 credit floundered largely over the problems of cross border portfolio investments.

21           MR. KEEN: Yes.

22           MR. OOSTERHUIS: And so it is a thread that can pull down some pretty big ideas,  
23 including the BEIT.

24           MR. KEEN: Yes. Croatia was part of a broader consumption tax approach. They

1 weren't trying to tax interest or capital gains or anything like that.

2 MR. OOSTERHUIS: Okay. The second thing I would like to comment on is on Julie's  
3 paper with respect to formulary apportionment. I am not sure I have spent as much time on  
4 transfer pricing as Ed does on mark-to-market tax issues, but I think it is close and my reaction  
5 to formulary apportionment is first, as Julie said, if only one country does it, you have a real  
6 problem because companies can probably figure out ways to put all the economic and financial  
7 risk in the formulary apportionment country and yet the formula is going to apportion a lot of  
8 income to the other countries, which they are not going to tax.

9 So the system adopted unilaterally would permit U.S. multinationals to lower their  
10 worldwide tax rate a fair amount, I suspect. But let's assume that there was a broad consensus  
11 among major countries to switch to formulary apportionment. Those countries have to be very  
12 careful what the formula is because most elements are easy to manipulate.

13 If property is a factor, you would look, for example, at the balance sheet book value of  
14 a software company. The factor would not be the fair market value of property because that  
15 gets back into arm's-length pricing; arm's-length pricing determines the annual cash flows, and  
16 fair market value is just a discount of those cash flows—so the problems of arm's-length pricing  
17 are avoided only if the factor is based on book values.

18 If you are using book values as a basis for apportioning, software and other intangible  
19 companies can shift most of their income to places like Ireland because all of their assets that  
20 have book value are things like receivables, computers, and servers that are mobile. So that  
21 clearly doesn't work.

22 Similarly, if you use payroll as a factor, difficulties will result. A few of us here are old  
23 enough to remember the experience with Section 936 of the Code which was authored in 1976  
24 when I was on the Hill. It was a credit based on taxable income in Puerto Rico. We realized a

1 few years later that what we had done was provide an incentive to increase taxable income and  
2 that is what we got in Puerto Rico. We didn't necessarily get increased jobs. We didn't  
3 necessarily get increased investments. We got a lot of taxable income because that is what we  
4 incentivized.

5 When Treasury was thinking about that in the early 1980s, they considered making the  
6 incentive be more directly tied to jobs and payrolls. However, when they looked at the  
7 numbers, they saw tax savings per employee of up to \$300,000 for companies at a time when  
8 the cost of the employee was \$20,000 to \$30,000. So, companies could have made a profit by  
9 hiring somebody not to do anything productive with that kind of income apportioned by payroll.

10 You have to watch these things. My understanding is that the President's Advisory  
11 Panel has been looking at this and I think some of the members are coming to the conclusion  
12 that only formulary apportionment based on sales is workable because sales are more difficult to  
13 move.

14 Even apportionment based on sales creates opportunities. If a company wants to sell to  
15 a country, it either can do it by itself or do it through a third party. That does give an element of  
16 electivity. For example, if a foreign country is thinking about selling to the United States, it could  
17 elect to sell through a third party, in which case its income is measured by arm's-length pricing  
18 by definition and it does not have any U.S. tax to pay. But, if it chooses to sell in the U.S. itself,  
19 it is going to have to pay U.S. tax based on its sales ratio as applied to global income. So there  
20 is still an element of optionality in the system, but at least it is more difficult to manipulate than  
21 are some of the other factors that you might use.

22 Moreover, an income tax where the income is apportioned globally by sales is not  
23 necessarily a very attractive world, it seems to me, particularly to the United States where a lot  
24 of our companies have a high portion of their sales outside the United States but have the bulk

1 of their intangibles inside the United States.

2 I personally think the answer is that we have to deal more effectively with transfer  
3 pricing issues. There is a lot of room to deal with it better than we do today, not so much in the  
4 rules, but in the enforcement of those rules. In the U.S., it is a matter of the Internal Revenue  
5 Service getting more quality people advising it. If we could take the brainpower that is in this  
6 room and apply it to transfer pricing cases, after a transition, the system could work reasonably  
7 well.

8 MR. AARON: Not if they are working for the companies.

9 MR. OOSTERHUIS: Well, that is the problem. You need the kind of resources for the  
10 government to be more sophisticated transfer pricing today.

11 MR. HALPERIN: Okay. The next commentator is Rick D'Avino of General Electric.

12 MR. D'AVINO: Thanks, Dan. There are a lot of interesting themes in both papers.  
13 What I would like to focus on is a common issue as the token capitalist tool here. I think that is  
14 why Bill Wilkins was a member of the committee that invited me to come, and I am going to try  
15 to drive across Ed's bridge. I am going to have to navigate a large multinational across the  
16 bridge that Ed or—is it a tunnel that Julie's paper built?

17 I would like to focus on direct investment, which is something that Ed's paper has a  
18 very provocative recommendation, and is related to Julie's focus on formulary apportionment.

19 In Ed's paper, he conjures up an appealing image of the multinational tax director as a  
20 master blender looking at mixing high taxes and low taxes to come up with a 35 percent rate.  
21 Probably the very best master blenders are looking to have high taxes blend in with nontaxed  
22 income that is otherwise taxed in the U.S. and to have offshore income tax at below a 35  
23 percent rate.

24 Ed quite properly points out that it is the holy grail of at least the U.S. multinational in

1 attempting to have a lower rate of tax on their offshore earnings. The U.S. accounting principles  
2 that Ed describes in his paper allow that to be booked. Ed focuses on that as the reason that  
3 multinationals do the kinds of things that they do. That is all accurate. It is very impressive for a  
4 lawyer to go through that GAAP accounting. You must have spent a lot of time on not only  
5 mark-to-market, but GAAP accounting as well.

6 I would say, as a practical observer, that while that is the result, the reason that  
7 multinationals spend a lot of time on trying to ensure that their effective tax rate is not higher than  
8 it would otherwise be is something that Julie focused on quite well in her paper. She puts it in  
9 very stark market terms that the U.S. doesn't have market power to impose higher rates of tax  
10 on its resident companies than non-U.S. jurisdictions impose on their resident companies. That  
11 is a real market power. Julie's paper includes a discussion on formulary apportionment, that  
12 eloquently demonstrate the reason that some of Paul's comments occur in the United States.  
13 The states are competing with each other for foreign direct investment. That is why right now  
14 you see many states doing things like going to a single factor. They go to a single factor to try to  
15 bring property into the states. Therefore, they don't want to tax property.

16 The states were on the other side of Paul's observation. If property is a big part of our  
17 factor, then when people bring property into our state, which we want to encourage, we will  
18 increase the tax burden on that company. So we will go to a sales apportionment and the states,  
19 in that respect, are quite expensive. We compete with each other.

20 In the same way, foreign governments at some level, and maybe at a higher level than  
21 the United States, compete in that same way. Ed's paper suggests that the U.S. adopt a  
22 principle of taxing all non-U.S. investment currently in the United States.

23 MR. KLEINBARD: By a U.S. person.

24 MR. D'AVINO: By a U.S. person.



1 MR. KLEINBARD: Right. And French people should be taxed in France.

2 MR. D'AVINO: Absolutely. I know you are not the long arm of the law, but when a  
3 U.S. multinational operates outside the United States, it would, under Ed's principle, be subject  
4 to tax in the United States on a current basis. That is repealing what I guess all lawyers and  
5 economists call the U.S. deferral rules.

6 The issue, if everybody did that at the same time and the world had equal tax rates, that  
7 would probably be a nonissue for most companies because the issue for the tax director is the  
8 master blender. The reason that the CEO of a company decides to hire a master blender is to  
9 compete effectively with the CEO's competition around the world.

10 If there is a French company that is allowed to have a master blender because France  
11 did not go along with this same principle, but the U.S. dramatically changed its rules to tax  
12 currently non-U.S. operations, then the issue would be what would happen to the United States.

13 That goes back to a lot of good papers. Who is the United States? From the standpoint  
14 of a U.S. policymaker, I would think you would have to look at what is best for the United  
15 States. The issue, from a U.S. perspective I think Ed's paper raises, is that if the U.S. went to a  
16 system that was out of international norms by subjecting U.S. residents to taxation on their  
17 non-U.S. and everyone else didn't do that, that might have a very predictable effect of  
18 headquarter—U.S.-headquartered companies either being acquired by foreign companies or  
19 foreign companies coming into the U.S. on the back of a much more favorable tax jurisdiction.

20 That would particularly be the case in financial services where small difference in tax  
21 rates, given a commodity that financial institutions are selling, is a very low margin business. And  
22 so small differences in tax rates do get arbitrated across borders and you could very well end  
23 up with a lot of large non-U.S. institutions, a lot of large non-U.S. multinationals.

24 And then from a U.S. perspective, you have to think about whether, from a policy

1 perspective, that would mean jobs outside the United States. At the end of the day, it doesn't  
2 matter where corporations are headquartered. For the U.S., it matters only where the jobs are.  
3 From a U.S. national welfare perspective, I suggest, if I were a member of Congress, and I  
4 would be worried if, as a result of taxing all income currently, I would end up with more foreign  
5 takeovers of U.S. companies with the result, if the result occurred, of having jobs move  
6 offshore.

7 To me that is a fairly provocative piece in his paper even though the COCA, the uniform  
8 thing off on deduction gets a lot more publicity. From the perspective of Julie's suggestion,  
9 dealing with the same problem, how you handle U.S. foreign direct investments.

10 I do think we would have to really carefully think about Paul's points on whether the  
11 U.S. states have been 100 percent successful in assuring taxation of capital income and whether  
12 one factor, two factors, or three factors will really get there. But both papers are provocative in  
13 that regard.

14 The final point I would make on Ed's paper, which is the uniform deduction, I think if  
15 Croatia did it, I mean—

16 MR. KLEINBARD: Is it good enough for you?

17 MR. D'AVINO: Absolutely. I would think the U.S. economy—my wife spent about  
18 two weeks in Croatia this summer and it seems like a pretty nice country. They have a  
19 wonderful water polo team. I will tell you that.

20 The question I asked Ed at lunch on a uniform deduction, I don't know how it affected  
21 Croatian AAAs versus Croatian BB-rated companies, is when the entity is given a deduction at  
22 a uniform rate, regardless of its credit rating and regardless of the amount it is paying to its  
23 stakeholders, in either dividends or interests, you end up, I think, with a AAA company having a  
24 lower effective tax rate than a BB company because the AAA company is probably paying

1 returns to its stakeholders at the same rate as the COCA.

2 So it is getting a deduction at the entity level for its cash outflow whereas a BBB  
3 company may be paying a couple hundred basis points more, but it is getting a deduction only  
4 for the COCA. It works across the economy well. I think it is a wonderful suggestion for a  
5 AAA company and a BB company to be competing for capital, especially during the transition  
6 period.

7 I don't know how that is going to work in terms of capital flowing to the AAA where I  
8 would expect it to flow at least for the transition period, which ought to get me from age 42 right  
9 up to age 65. So I would think that you would want to take a look at what happens while the  
10 capital markets sort out a lower rate of tax on higher-rated entities, especially those that are  
11 debt finance. Thanks.

12 MR. AUERBACH: Have we resolved this? Is it COCA or is it COCO. I haven't—  
13 COCA. I see. Like the plant. Okay.

14 I understand why, under a consumption, to a simulated consumption tax you might want  
15 an ACE or a COCA, but I don't understand why it is necessary or desirable under an income  
16 tax. It seems to me that it generates—if we think of a CBIT as an alternative, comprehensive  
17 business income tax as an alternative, and then you decide to give the business a deduction and  
18 have an offsetting tax on the people who get corporate cash flows, whether they be debt or  
19 equity, that you are generating complexity by doing that because then you have to identify the  
20 appropriate rate of return because you would have to give people a deduction.

21 So what is the rate of return? Well, in order to have the rate of return measure, you  
22 would have to have a position measured. To do that, you have to go through a calculation that  
23 you don't have to do under a CBIT because under a CBIT, you are not identifying who the  
24 beneficiaries are of the returns to the corporation. You are just taxing it all at the corporate level,

1 which I thought was a major simplification of the CBIT, from which it seems to me this  
2 represents a gratuitous deviation.

3 MR. KLEINBARD: I hate to say this, but I am not sure that Alan's question is one that  
4 reflects a careful reading of the paper.

5 (Laughter.)

6 MR. KLEINBARD: If what I was doing was giving a deduction at the corporate level  
7 that was then offset by income at the holder level, that would be a pretty silly exercise. But that  
8 is not the idea. The idea is that the holder's income inclusion tracks the holder's basis in all of  
9 their claims. The premise is the financial assets turn over more frequently than real assets.  
10 Investors don't have capitalization issues, depreciation issues and so on. And that's what we  
11 apply a rate of return to.

12 It happens to be the same number, the same percentage, but it is being applied to a  
13 completely different base at the investor level. I am getting a very accurate measure of time  
14 value of money income at the investor level. At the entity level, I think the fundamental problem  
15 with CBIT is that it only works if you get the right measure of enterprise income and CBIT  
16 never came to grips with that.

17 CBIT had a secret shadow account, because didn't it recognize it would never get  
18 depreciation of capitalization and so on correct. So we had a secret shadow account that was  
19 never developed that would tell claim holders when they got a distribution whether that  
20 distribution was really out of after tax income, in which case it would be exempt, or taxable.  
21 You would have the same interest in the company and your mix of taxable and tax exempt  
22 income would flip-flop from period to period depending on whether the company had  
23 preference income or not.

24 MR. AUERBACH: Just to clarify, I did give the paper a close reading, although not

1 necessarily one with comprehension.

2 Just to clarify, are you saying that you are using the deduction to wash out tax  
3 preferences at the corporate level? Is that the basic—I mean, I understand why you might want  
4 to do that. Is that what you are doing? Is that what you are seeking to do?

5 MR. KLEINBARD: I am seeking to tax, to put the income at the investor level to get  
6 around the problem of preferences at the entity level.

7 MR. AUERBACH: Okay.

8 MR. KLEINBARD: Yes.

9 MR. AUERBACH: All right.

10 MR. WEISBACH: My question was related, I guess, or almost the same question. So I  
11 will just get to it in a different way, which is what is left at the corporate tax, then, if you are  
12 doing this and I would assume that there is still a little bit left? For example, the tax on above-  
13 normal returns. You still need to measure depreciation to do this. I don't see how you get  
14 around any of the criticisms you make of CBIT in your system.

15 MR. KLEINBARD: Well, I am not suggesting that we should be derisive in our  
16 attention to depreciation, for example. I just acknowledged that my understanding and, look,  
17 you guys are the experts. I just try to read your stuff and parrot it back at a different level, a  
18 lower level. My understanding is that depreciation really goes more to time value than economic  
19 rents in terms that the returns—the supersized returns, economic rents—are going to be there  
20 on top of the time value of returns.

21 MR. WEISBACH: Preference income. Suppose we are giving corporations whose  
22 name start with “G” an extra couple million dollars of credit every year.

23 MR. D'AVINO: Now you are talking.

24 (Laughter.)

1 MR. WEISBACH: You still have those kind of things going on at the corporate level  
2 and CBIT has a problem dealing with that.

3 MR. KLEINBARD: I recognize that there will be problems at the corporate level.  
4 What the paper argues is that the problems are particularly acute at assuring ourselves that we  
5 have, in fact, captured a time value of money return to someone.

6 And if that is the key indicia of an income tax, as opposed to a consumption tax, that is  
7 the one part I want to get as absolutely right as possible. I do what I can with the enterprise tax  
8 and I also have a whole series of rules designed to improve and make the enterprise-level tax  
9 more robust. You know, the super consolidation rule creating more realization events by making  
10 all business asset acquisitions and business enterprise acquisitions taxable? Those are all  
11 designed to get to closer results right at the enterprise level.

12 MR. SCHLER: On Julie's point about collecting information for cross border payments,  
13 I would be much less optimistic that this level worked. The EU savings directive that you  
14 mentioned took several years of negotiation.

15 The whole thing is a joke. It only covers payments to individuals. Individuals can go to a  
16 Swiss bank happy to set up a corporate account. The bank will be happy to set up a  
17 corporation for you, invest the money through the corporation, and exempt you from  
18 withholding tax. And, you know, the idea that they might extend it to corporations is probably  
19 another 20 years.

20 Even domestically, if I recall correctly, there is a proposed regulation that says all  
21 foreigners who invest in U.S. bank accounts are subject to completing W-8s for portfolio  
22 interests, for bonds, etc. I mean, they proposed that regulation years ago and ever since then,  
23 there has been a total uproar by every foreign bank threatening all their depositors will withdraw  
24 their money from the U.S.—I am sorry U.S. banks saying that they will lose all this money. So

1 every day some Congressman writes another letter saying you can't do this.

2 It is hard to believe anything is going to happen on that. It is hard to see how we could  
3 have anything broader because the concern will be that foreigners will stop investing in U.S.  
4 bank deposits.

5 And 482, I mean, no matter how smart the people are working for the government or  
6 anybody else, ultimately it is a valuation question and I don't see how the government could  
7 ever succeed when, you know every company has hundreds of valuation decisions they are  
8 making every day all favorable to them tax wise.

9 There is no way to fight that, I don't think, because you need armies of economists to  
10 debate the value that they end up with thousands of cases in courts and they all go on for  
11 months. The judges don't understand it. Nobody understands it. I just don't see how 482, as  
12 opposed to some kind of formulary method really will ever work.

13 MR. KEEN: I hate to keep going on about Croatia, but just maybe to answer this part  
14 of your question, what is left of the corporate tax? Croatia was getting two and a half points of  
15 GDP in corporate tax, which given that rate, was not bad. It was certainly as good as the  
16 standards of the region.

17 And depreciation. I think one of the nice things about the ACE that was shared by the  
18 BEIT is you lose a lot of the problems of depreciation because it doesn't matter what rate is  
19 used, it all washes out. You basically don't have to worry so much about what the depreciation  
20 rate is, which is why there is this problem. We can't actually give incentives in the formula to  
21 accelerate depreciation because in present value, it washes out.

22 Finally, I hate to go on about Croatia and I know it is a small country and everything,  
23 but, you know, people ask me "should we copy the U.S. or should we copy Croatia?" I guess  
24 which we say in terms of a good tax system.

1 MR. KLEINBARD: If I could just extend Michael's point. The idea is that the COCA  
2 deduction at the enterprise level has keyed off all the capital invested in the enterprise. I say,  
3 well, gee, the right hand outside of the balance sheet is kind of tough to figure out. Let's be  
4 simple. Let's use the left-hand side because balance sheets balance. The left-hand side is, of  
5 course, just the sum of your tax basis in all your assets.

6 If you have an accelerated depreciation, the consequence of that is you are taking away  
7 a tax deduction risk free—whatever the rate we decide it is going to be on that basis because  
8 you have given up that basis. And so the two tend to cancel each other out in present value  
9 terms.

10 MS. GRAVELLE: I, like Alan, read your paper with care, but I knew I didn't  
11 comprehend it. I think I am sort of understanding what you are saying now. Is the objective of  
12 your BEIT system to treat all—is that what you call—BEIT. Sorry. BEIT. Long "e"s instead of  
13 short "i"s. That doesn't concord with what I learned about the rudiments of the English  
14 language, but I will skip over that.

15 MR. AARON: Is this an economist lecturing a lawyer on English?

16 MS. GRAVELLE: So the question is, is the objective of your scheme to treat  
17 everything as if it were kind of debt by assigning a debt—sort of an interest rate to all of your  
18 capital whether you are debt or equity, deducting that from the corporation, and taxing the  
19 individual and leaving the residual, whatever it is, to be taxed at the corporate level?

20 The question that occurs to me—not the answer, only the question—is what does this  
21 do to the variance relative to the mean if you were to introduce the scheme? I really don't know  
22 the answer right away, but I think that is a very interesting question to ask about it. What is the  
23 expected return to the investor? Suppose the company has a loss. You know, you are going to  
24 get a different outcome than you would in the system where the company is responsible to hold



1 tax.

2 MR. KLEINBARD: Just quickly in answering, losses I try to deal with—and I don't  
3 understand why we don't do this today—by giving a time-value of money increase to loss carry  
4 forward. So you can't use the loss today, it increases by a time value of money component  
5 tomorrow. I stole that from the ACE I admit, as did Croatia.

6 MS. GRAVELLE: We all wish we knew more about what the ACE actually is.

7 MR. KLEINBARD: Well, one of the interesting things I will say, and, you know, I  
8 recognize I should be very grateful to have been asked to do a paper here. This has been a  
9 great experience for me. But it is interesting in reading a lot of U.S. papers how little they refer  
10 to academics outside of the United States. There is this huge literature on the ACE that I thought  
11 was quite interesting. And I found that all out by myself before I even met Mr. Keen.

12 Jane, in terms of your summary, again, you got it mostly right except this really critical  
13 point that the income inclusion is not the same thing as the deduction. The deduction goes by the  
14 asset basis at the enterprise level. That is the self-correcting mechanism. The income inclusion  
15 goes by asset basis at the investor level.

16 There I have got more realization events and there I don't have any preference income.  
17 So I am much more likely to capture every year some mandatory inclusion in income, regardless  
18 of whether I get cash. And so I am much more likely to get a time-value of money returned and  
19 pay current tax on it through that system than through a CBIT-type system.

20 MR. BURMAN: I think this morning someone summarized Julie's paper as saying that  
21 it showed you really couldn't tax international income and that wasn't the way I read it, although  
22 I guess what I want is a straight answer. Can we tax income of multinationals? And then, of  
23 course, the other question is, can we not? It seems like the schemes that you talked about that  
24 make it possible to move capital income overseas would also make it possible to re-

1 characterize compensation so it looks like foreign earnings and that is really the key question.

2 MS. ROIN: That is why I think we really have to get serious about taxing foreigners  
3 income in the United States and the foreign income of U.S. passive investors because if we  
4 don't tax this stuff, we cannot have an income tax in this country because it is just too easy to  
5 evade and more and more people are learning and using the ways to evade it.

6 I mean, it is really rather shocking when in 2003, I think it was, the IRS started to issue  
7 a John Doe summons for foreign MasterCard issuers to identify U.S. individuals who were  
8 paying all of their expenses, or a substantial part of their expenses, using MasterCards issued by  
9 foreign banks out of earnings that they had basically never reported to the U.S. And they came  
10 up with, you know, a figure of, like, 2 million people.

11 That is frightening. Now I don't think that, in fact, all 2 million were evaders, but a lot of  
12 them were, you know, and the fact that people are doing this increasingly means that the income  
13 tax—we have got to do something to better enforce this—the taxation of the income that flows  
14 abroad.

15 Now I actually had two independent remarks. One about formulary taxation. I think that  
16 we can't use property in the formula because there are just too many ways to game it. I am a  
17 little more optimistic about payroll than you are because I think that the Puerto Rican experience  
18 was a function of the incredible profitability of the drug companies that were locating in Puerto  
19 Rico and it was more a function of those being an unusual situation.

20 I don't think that, in general, the problem is going to apply, but I am not sure. I mean,  
21 you have to look at it more and certainly I am not the person who would be drafting this  
22 formula. If any academic was drafting it, I would suggest Walter Hellerstein because he knows a  
23 whole lot more about formulary taxation at the state level than I or I think any other academic  
24 does.

1           And for the information returns, I agree with you, Michael, that it is sort of sad how  
2 limited the EU initiative is and how long it took them to reach agreement on it. I think it is even  
3 sadder that the U.S. wouldn't even go, you know, that small step in that direction. It proves  
4 something not nice about our political system, actually.

5           And it will be hard. But I do think that the bottom line is that all these income tax  
6 systems are going to live or fall together because if that stuff is not taxed because it is not  
7 reported, then that is the only type of income that is going to be around and if other countries  
8 are interested, we ought to be interested too, that is, if we believe in the income tax.

9           Also, about the way that EU savings initiative works. The savings initiative works by  
10 countries having an option. Some of them just issue these information exchanges to the countries  
11 of residence and the countries of residence are supposed to tax this income.

12           Other countries have refused to issue these information returns claiming they don't want  
13 to divulge the identity of the investors and instead, they have to return, I believe they have to  
14 levy a withholding tax at source and give, I believe, it is 75 percent of the proceeds of this  
15 withholding tax to the countries of residence.

16           What I don't see is the split of tax revenues as strange in the residence country direction  
17 because after all, if these participating countries that we are doing the withholding tax and not  
18 the information returns, if they kept all the revenues, they would be getting information returns  
19 that let them tax their own residents on foreign income and keeping all the tax revenues from  
20 taxing foreigners who invested within their—so they would be getting a double pot of money.

21           So I would actually expect all the tax revenues from this withholding tax to go to the  
22 countries of source. What is interesting is that the source countries get to keep some of it and  
23 that is, quite clearly, a bribe because it is like Switzerland. These are the countries that were  
24 least eager to sign on to even this very limited thing.

1 MR. OOSTERHUIS: Could I give one comment? Actually, it is a rejoinder to both  
2 Michael and Julie. I think, Julie, the problem is that transfer pricing is high-value intangibles. It is  
3 not much else.

4 MS. ROIN: Right.

5 MR. OOSTERHUIS: Most transfer pricing issues, if you are dealing services, capital  
6 goods, or other things that don't have high intangible value are pretty routine and typically do  
7 not cause problems between jurisdictions. It is the high-value intangibles, which is exactly the  
8 Puerto Rico type of situation where companies had an incentive to use modest employment plus  
9 financial risk as a way of shifting the value of those intangibles.

10 MS. ROIN: Yes, but everything has some intangibles in it and, you know, with the  
11 slicing and dicing of income—

12 MR. OOSTERHUIS: But again, if the intangible value isn't that high, the transfer pricing  
13 problems aren't that hard.

14 PARTICIPANT: That is where all the money is, in the intangibles.

15 MS. ROIN: Yes.

16 MR. OOSTERHUIS: Yes.

17 MS. ROIN: But even if it is a little bit from everything or 10 percent, it adds up to a fair  
18 amount of money.

19 MR. HALPERIN: Okay. I would like to see if we can turn to the audience and see if  
20 there are questions. Joe?

21 MR. GUTTENTAG: My name is Joe Guttentag, I am retired and I think Henry invited  
22 me here to represent the elderly using that transition. Some of us prefer to be called senior  
23 citizens and as we look at this possible shift to a consumption tax and as we call it planning for  
24 our golden years rather than what Mr. Auerbach calls it those of us who are planning to cash

1 out soon.

2 (Laughter.)

3 MR. GUTTENTAG: Anyway, remember all of you that there is a lot more—those of  
4 you who follow Social Security, as you know, there is a lot more of us now and as we vote,  
5 there could be an issue of support being on the decision on the transitional rules.

6 Turning to the international, I certainly agree that I think that as Michael has taken a  
7 position that we have much greater cooperation internationally. We cannot tax capital. I agree  
8 with Ed and I think it goes way beyond just exchange of information. It has to be enforced. We  
9 may even have to go to collection, international collection, to change our international goals  
10 greatly in that area.

11 I also agree with him that the OECD project, which is a start in this direction, has to use  
12 more than just the stick. We need a carrot. And I actually worked with the IMF, the World  
13 Bank, USAID trying to get them to provide some benefits to the tax savings of the world to—  
14 you don't get any reciprocal benefits—to cooperate. And I think they are going to have to do  
15 more of that.

16 The formulary, another issue which I think we haven't discussed is the administrative  
17 issue. And I think that under a formulary approach, one of the major concerns, going way back  
18 to the Barclay case concerns of many of the UK companies at that time with respect to  
19 California worldwide formulary, was the idea not of California tax collectors, but of Zimbabwe  
20 tax inspectors coming to Stanford to run barefoot through the books of G.E. looking to verify  
21 their sales figures in Zimbabwe or their wage figures or their property figures. I think that is one  
22 of the major concerns at this point that none of the others have discussed here.

23 But I wonder why we have not discussed the issue of competitiveness. In listening to  
24 discussions of international tax in the past five or six years, there seems to be a great focus on

1 the competitiveness of U.S. companies compared with their foreign counterparts and how does  
2 a consumption tax and an income tax bear on that discussion.

3 And also, why is it that despite the fact that 29 other members of the OECD all, I  
4 believe, have a combination at the national level of a value-added tax, or something like that,  
5 and an income tax, why do we figure that we are going to be different than they are and also, is  
6 it possible, without a parliamentary system, to have anywhere near the clean type of either an  
7 income tax or a consumption tax, which I think oil is one?

8 MR. HALPERIN: Peter.

9 MR. MERRILL: On the transfer pricing—Peter Merrill of PriceWaterhouseCoopers.  
10 The transfer pricing issues make it very hard with an income tax in a global economy, but it  
11 certainly struck me that everyone that spoke earlier made the point of saying that consumption  
12 taxes do tax a portion of capital income.

13 So we have all these VATs around the world and as far as I know, there has been very  
14 little concern under VATs that they have led to companies shifting their headquarters, to shifting  
15 their capital, shifting their workers. So it helps that all these transfer pricing problems have been  
16 solved. And I think the answer is the use of one formula—in fact it is sales.

17 MS. GRAVELLE: Sales. Yes.

18 MR. MERRILL: That actually seems to have solved most of the pricing problems.  
19 What it leads one to wonder, and a lot of developed countries would love this idea, could you  
20 actually allocate income tax the way that, you know, we know it on a single factor sales method  
21 and what would that mean.

22 MR. POTERBA: Jim Poterba, MIT. I have a question which is nominally directed to  
23 Ed, but is, in some sense, broader into the rest of the practitioners and the lawyers here. As you  
24 all saw this morning, the tax economists love to think about the various ways we could combine

1 financing with real projects and then make diagrams and boxes and tables on PowerPoint to  
2 think about the different tax burdens that you would find going down different routes combining  
3 debt with a real project or equity finance, whatever.

4 Looking at Ed's paper and thinking about the starting point that it is impossible to  
5 distinguish debt versus equity, it seems as though the presumption is that there are a variety of  
6 financial instruments and financial transactions available, which could essentially allow a firm to  
7 get itself out of an equity tax box, which is the higher tax burden box, and into the more tax-  
8 favored debt treatment box if it is, in fact, going out to do project finance.

9 So the challenge, in some sense, for the economists who like to look at the numbers on  
10 these different things is to understand whether what this tells us is that we should really put  
11 essentially zero weight on the equity finance box where we get the high tax burden.

12 It moves back to Joel's paper this morning in terms of trying to think about different  
13 ways of measuring the tax burden. It would fit into discussions of the kind that Alan and others  
14 have about thinking about what the current tax burdens are versus what we are faced under  
15 consumption tax alternatives.

16 So the open question is: Is there any way that you can offer us a, you know, way of  
17 thinking about the question, does anybody still use plain vanilla equity finance that gets double-  
18 taxed in the way that we know how to write down the tax rules?

19 Is the reality just that a set of people who have good tax advisors, which may be most  
20 of the large multinational firms, do, in fact, find ways of doing feline prides and decks and other  
21 things, which basically get them out of that box, because of a lot of the rest of the economy that  
22 is out there facing those higher tax rates on equity, or is this, in fact, the exotic end of the  
23 financing spectrum where, for a group like this. We hear about how this works, but, in fact, it is  
24 not that broadly diffused.

1           And I am trying to just get a sense of how we would map from this kind of a guidebook  
2 for thinking about the different tax burdens on different financial instruments back to the question  
3 of what is the effective tax burden on capital income. Any help that anyone could offer us on  
4 that I think would be extremely useful for the kinds of calculations that, as you can see, a lot of  
5 us like to do.

6           MR. KLEINBARD: Jim is asking a very powerful question that I think requires more  
7 data points than just me. I have worked in the capital markets a long time. I do believe, in my  
8 heart, that companies use plain vanilla equity for finance—and Rick obviously will correct me,  
9 but they use plain vanilla equity for financing projects to the extent of the irreducible minimum  
10 necessary to keep their credit rating because their credit rating is what really drives the cost of  
11 capital because the credit rating drives the cost of their debt. And so we have whatever  
12 minimum amount of equity is required to do that.

13           There is also another question, which is you do all these exotic things like feline prides  
14 and decks, but is that all just sort of at the margin and sort of interesting and fun to talk about,  
15 but not really where the money is in corporate finance?

16           And my answer to that is that to some extent, these things are at the margin. But that is  
17 because the simplest thing to do is just they should debt and we have a world in which we have  
18 a deduction at one level, no inclusion at the investor level because all debt is held by tax  
19 exempts.

20           The capital markets are very efficient and they do a very good job of allocating tax  
21 burdens and benefits among people; so we don't have to worry about the tax on debt because  
22 no one pays it. It is all held by exempts.

23           The perfect example of all of what I have just said is this brand new product called  
24 eCaps, of which one has been done, but it is the rage right now on Wall Street. That is to say,



1 Wall Street is in full court press sales mode to sell this product and there will be presumably lots  
2 more variants on them; eCaps is a trade name of one company.

3 But the idea of this is to have a super-long-term, super-subordinated debt instrument  
4 with all sorts of silly features whose only purpose it is to satisfy some arbitrary standards of one  
5 of the two rating agencies, Moody's, to get what is called equity capital treatment for rating  
6 agency.

7 They are getting equity credit from Moody's as a rating agency that said even though  
8 this, in fact, is debt, even though it has all sorts of debt remedies, because it has this deferral  
9 feature and it is very long term and subordinated and so on and so on, we are going to give you  
10 75 percent as much credit as we would have given you had you issued straight equity. And in  
11 the world of eCaps, why would anybody ever issue equity?

12 MR. D'AVINO: I won't correct that because obviously he is uncorrectable, but exactly  
13 right. G.E. is unusual in that we are AAA rated. We are the largest issuer of straight, old-  
14 fashioned money market-preferred stock where you don't get a deduction.

15 So for Jim—you can have a very sophisticated tax team and still issue great debt, but  
16 the problem that eCaps presents is, I think, the central problem, the original sin that Ed's paper  
17 does well address and something needs to be done because either you have to go back to the  
18 Treasury suggestion many years ago that you should link up rating agencies and the tax  
19 treatment and say if you get equity credit—the reason they use that funny phrase that Ed just  
20 used, equity credit, is because people like Ed and Michael would say don't call it equity  
21 because then you are intending to issue equity and then the IRS will get you.

22 Say you are getting equity credit and then you have one little block in building a block,  
23 but I think Ed is certainly right, if certainly like eCaps it is allowed to go forward, then you are  
24 going to have a lot more deductible equity around this country.

1 MR. DELDYNE: Larry Deldyne, ATPI. We have some recent experience, or should  
2 have, based on the recent reduction in the individual tax rate on dividends paid by corporate tax  
3 paying companies. I wonder if anyone here knows of any research or any work that has been  
4 done yet on the consequence of that for administration of the law, how well the rules and  
5 regulations are working? Has it had any impact at all on what corporations and shareholders do  
6 or in the value of assets?

7 MR. KLEINBARD: I can't quote all the literature, but I have seen a fair amount of  
8 research pieces in the financial community that suggests that corporate America has responded  
9 directly to the reduction in tax rate on dividends and has increased dividend payouts. I can't  
10 give you the numbers. The most famous example, of course, being Microsoft that declared a  
11 gigantic dividend of almost 10 percent of its value shortly after the new law became effective.

12 MR. SLEMROD: Yes. There has been a lot of academic research. People who are  
13 interested might go to the web site—guess either of the Birch Center, Alan's shop at Berkeley,  
14 or the Office of Tax Policy Research at Michigan. We ran a conference about taxing corporate  
15 income in the 21st century, which included several papers about the impact of the dividend  
16 change. So people can go look there to see a few papers and references to others. Yes, there  
17 have been a few.

18 Can I also use the floor for a comment? In terms of using a language in a way that  
19 facilitates communication, I think we were—Ed, your use of the term “at the margin” is different  
20 than what an economist—how economists would use “at the margin.” I think you meant at the  
21 margin as meaning not a lot of dollars?

22 MR. KLEINBARD: Yes. Marginal.

23 MR. SLEMROD: Right. So for an economist—

24 MR. KLEINBARD: Frivolous.

1 MR. SLEMROD: To an economist, at the margin is the opposite of frivolous. That is  
2 what we are interested in. So let me focus on the way an economist would think about it. The  
3 question is whether a company considering making another dollar of, excuse the expression, real  
4 investment, if at that margin do these exotic financial instruments mean it is essentially we should  
5 think of it as debt finance or at the margin, do they have to use a mixture of these things so that  
6 the right way to think about the cost of capital isn't to assume the most innovative financing?

7 And you suggested that what some companies do is they get their equity down to the  
8 absolute minimum to keep their credit rating. So the question we want to think about is how that  
9 limit is related to the amount of real capital.

10 If when you have another dollar of real investment, the limit stays the same, then at the  
11 margin, this isn't relevant for understanding how the tax system affects the incentive to invest. So  
12 if you can just think for a second about how the economists use margin, can you say whether  
13 you think, in terms of the incentive to invest, it is all like debt or not?

14 MR. KLEINBARD: I am convinced that it is all like debt and I apologize about my  
15 misuse of the word before. Even I recognized, as I was saying it, that that was a bad thing that I  
16 did. Most profitable companies generally can meet their equity demands through retained  
17 earnings and unless the project is very large, the financing is going to take the form of debt, full  
18 stop, end of story, and then if, in fact, it is very large, then you get into the exotica because the  
19 first thing that you do is issue straight debt. Then if you say, oh, that is not enough then I will  
20 issue exotic debt like eCaps, which I will get equity credit. Then if I am going kicking and  
21 screaming and I am the CFO and I am about to retire, I might issue equity.

22 MR. OOSTERHUIS: You do have to differentiate segments of the economy, though,  
23 because Ed is talking about the Fortune 100-type companies as opposed to the venture capital  
24 companies. There is a huge amount of equity that is being issued all the time, and it is being

1 issued because people want capital gains. The companies are not going to have substantial  
2 earnings anyway in the short run. That is a very large segment of the economy.

3 MR. SLEMROD: I think more generally the high-tech sectors have less debt and in  
4 part, it is for the reasons Ed said and the kind of the startup. You are not going to have income  
5 for a while anyway, but it goes beyond that and there is something else going on that people are  
6 puzzled with from time to time.

7 So in answering Jim's question, that there is variation across industries. And I think you  
8 look at all the kind of measures of who is paying tax and who is doing exotic things. I think we  
9 have often seen those variations across industries. So I think it is at the margin, too, with at least  
10 in some high-tech companies where they don't seem to have a lot of debt for new investments  
11 and they are paying tax.

12 MS. GRAVELLE: Many, many years ago, probably about 20, 25 years ago, I went to  
13 look at the debt-to-asset ratio of the corporate sectors I held and I found it was about a third. I  
14 did that about two months ago or three months ago and I found it was a third.

15 MR. AARON: You have got to do some new work.

16 MS. GRAVELLE: So if marginal investment is being financed by debt, then you would  
17 expect that ratio to be going up. The fact that it has been relatively—this is from the flow of  
18 funds accounts and—

19 PARTICIPANT: It retains earnings.

20 MS. GRAVELLE: Well, it retains earnings as equity, but I mean, what I am saying is  
21 that there doesn't appear to be any important difference in the way corporations are financing  
22 now than they were 25 years ago. They never issued very much stock then, they mostly retained  
23 earnings and the debt-to-asset ratio has not changed very much.

24 So also if you look at the income tax data, you find plenty of dividends that show up in

1 income tax, individual income tax returns. If you look at income tax data, you find plenty of  
2 interest that shows up at individual income tax returns, you find that tax-exempt organizations  
3 hold probably about half of each kind, that is through pension funds and IRAs and so forth.

4 So I just think the aggregate data suggests that eliminating a corporate tax through, you  
5 know, through fancy schmancy things that lawyers think up is not typical. It may happen, but it is  
6 not typical.

7 MR. SCHLER: When you say it is a third debt now and it was a third debt back then,  
8 by "debt," do you mean things that are debt for tax purposes or stuff that is debt for book  
9 purposes because there could be a lot more debt for tax.

10 MS. GRAVELLE: I mean, I am sure there could be a difference. I mean, these  
11 numbers come from the flow of funds account, and so maybe they aren't picking up taxable  
12 debt. But there is also plenty of evidence of retained earnings, of profits in excess of interest  
13 deductions. I mean, there is just data all over the place that tell you that we still have a corporate  
14 tax and we are collecting income from it.

15 MR. KLEINBARD: Not a whole lot.

16 MS. GRAVELLE: And it has been going on for a long time.

17 MR. KLEINBARD: I don't deny that. I am trying to answer the question for the  
18 marginal project where the fund is going to come from and the answer is going to be debt  
19 because it is absolutely true, Paul's point is right, I am talking about Fortune 1000 companies.  
20 Why would I want to work for people who can't pay my bills?

21 So that is the universe, that is the only universe I am speaking to, but, you know, you  
22 can look at Fortune 1000 companies and see how many of them have issued stock in public  
23 capital markets in the last decade and it is going to be ample.

24 MS. GRAVELLE: All I am saying is if marginal investment were financed by debt, we

1 should see the debt ratio increasing over time unless I misunderstand you.

2 MR. KLEINBARD: Well, I think you do actually see that.

3 MS. GRAVELLE: I mean your use of the word "marginal."

4 MR. KLEINBARD: No. I recognize that I have trouble with the word.

5 MS. GRAVELLE: Well, maybe I do, but I have a different notion of it.

6 MR. KLEINBARD: No. I understand your point. I think you do see it because Rick,  
7 you are AAA, you are, what, one of six AAAs left? You know, 15 years ago there were a  
8 dozen AAAs. So what you see is this steady degradation in credit quality among the Fortune  
9 1000, which I believe is directly attributable to additional leverage. I mean what else explains it,  
10 just we all got stupider?

11 MS. ROIN: I just had a couple of last comments about formulary accounting. One is  
12 that you are right, I should think about administration, although I must confess that my  
13 assumption is that if we move to formulary accounting, it will be in conjunction with other  
14 countries and there will have to be some sort of new institutional structure to deal with it if only  
15 to keep every country from changing its rules the day after the formulary thing goes into effect.  
16 Hopefully, that will take care of the Zimbabwe problem, though yes, I could see them generating  
17 full employment for their economy by charging taxpayers for the cost of auditing the company  
18 and then having them all come to the United States to audit.

19 As to Peter Merrill's point, we have seen single factor formulas. A lot of the states now  
20 have single factor based on sales, state income tax formulas, and the question is whether or not  
21 you think they are, as Paul says, ugly, and I am of two minds about whether or not they are  
22 ugly.

23 On the one hand, you sort of say it doesn't make any sense for the country in which  
24 there actually is a factory or whatever and they are providing lots of benefits and they're costly

1 and all that to collect no income tax revenues and for all the income tax revenues to go to the  
2 country where this stuff is being sold.

3 On the other hand, wherever the factory is there are actually going to be employees and  
4 payroll and things like that and there is another way for those countries to collect taxes on the  
5 enterprise.

6 And it may be that we should be looking at the wages and the other ways of collecting  
7 those revenues from the governmental perspective and say, oh well, that makes it less ugly and if  
8 we just keep looking at that, then we could go with the single factor sales formula allocation and  
9 not be upset about it. And you are right, that you can't move sales and you can move everything  
10 else. So it would be the least distorting formula.

11 MR. HALPERIN: Any other comments?

12 MR. AARON: I just have one comment as to the authors. I don't want a stubborn tax  
13 evasion, but if any of you would be willing to accept your honorary in the form of a credit card  
14 of the Bank of the Caymans, it is yours.

15 (Laughter.)

16 MR. HALPERIN: What is the next step?

17 MR. AARON: The next step is a 15 minute break.

18 (A brief recess was taken.)

19 MR. BURMAN: Welcome back to probably the most exciting part of the conference.  
20 We are going to have a debate all on one paper. Michael Schler and Joe Bankman are going to  
21 explain why we can tax capital income or can't and they have asked for a little bit of extra time,  
22 but I don't think you are going to be able to work out all of your disputes today.

23 Actually, there is one more thing. There are two sport coats on the front table that were  
24 left at the computer and recycle your name tags on your way out.

1 MR. BANKMAN: Well, thank you. You know, before we came here, we had some  
2 back and forth e-mailing with the conference organizers and Hank gently suggested the paper  
3 was a little bit turgid for the non-lawyers.

4 We thought it was engrossing reading and so I am not going to assume that all of you  
5 have read it, particularly since I know some of you haven't read it at all. So I am just going to  
6 spend a few minutes giving you kind of the flavor of it, I think, and then maybe we can have  
7 some fun back and forth, although Michael, as always, will get the last word here.

8 So the paper is about tax planning under the flat tax and by "flat tax," what we are  
9 looking at is the flat tax that Bob Hall now says he would have, which is really kind of an X-tax  
10 with progressive rates at the individual level that is expensing at the business level including  
11 expensing of salaries and taxation at the individual level only of wages and then at progressive  
12 rates.

13 We are assuming, following some smart articles of David Weisbach, that we will adopt  
14 some of the features of the European VAT, that is, it will be a credit invoice method, and we  
15 will have the small business subsidized. Obviously that could be wrong, but we can't talk about  
16 tax planning without pinning down, at least somewhat, what it is we are going to plan around.

17 So if you are a tax lawyer, and I guess if you are an economist too, you are looking for  
18 radical discontinuities—things you can arbitrage where you get two transactions that are almost  
19 identical, but you can get different tax treatments if you can just change—tweak some of the  
20 form. And to take an example, I suppose maybe a fifth of our paper, a tenth of our paper, is  
21 about the difference under the flat tax between real transactions, which are in the base, and  
22 financial transactions, which aren't.

23 And to give an example the kind of issue that might raise, suppose someone goes to a  
24 department store and they pay for a good with a credit card and suppose the credit card price



1 is about the same as the cash price. The question is, does the credit card company have income  
2 equal to the gross amount they have been paid. Is that gross income, because it is a real  
3 transaction, they sold a sofa, or is part of the gross proceeds correctly attributable to a financing  
4 transaction, right? The consumer, the buyer is indifferent because she can't get a deduction  
5 anyway. So that is a kind of issue you would have under a flat tax. That is the kind of things you  
6 would be planning around.

7 Now the knowledgeable among you know that the example that I just raised is a real  
8 life example; it came up recently under the European VAT and the issue was litigated in the UK  
9 where the taxpayer tried to attribute part of the sales proceeds to a financing transaction so it  
10 would be out of the tax base, basically tax free proceeds, and the government contested. In that  
11 case, the government won, although, frankly, I think it might have gone either way.

12 But this raises a question. If we are going to import certain VAT-like features and if a  
13 flat tax basically is a VAT with this one big wrinkle, progressive taxation at the wage—at the  
14 individual level on wages, which are deductible at the business level, can we just look at Europe  
15 and find out how the things have worked there and assume it is going to work the same here?  
16 So that is something that we spend maybe another 5, 10 percent of our paper on, what is the  
17 relevance of the European experience and there are pluses and minuses.

18 We know, for example, under the flat tax, that we are not going to have it  
19 supplemented, I would hope, by a retention of the income tax so we have to run two systems at  
20 once. And what this means is that the nominal rates under our flat tax are going to have to be  
21 higher than under the European VAT, although I will sequel this will stress the system more I  
22 think. On the other hand, under a flat tax, wages are deductible relieving some of the pressure  
23 for some purposes on gaming the system since businesses, at least, will have less at stake in  
24 some cases.

1 I suppose the biggest difference between here and Europe, and this really kind of  
2 supersedes the whole idea of comparing this to a VAT, but just thinking about it in general, the  
3 biggest quandary is what happens when the rubber meets the road and our huge supply of  
4 human capital is faced with some kind of obsolescence unless they can think of ways to game  
5 the new system and how confident are we that they won't think of some ways that we can't  
6 think of yet?

7 And I don't think there is any answer for that. It is certainly true that some of the flaws  
8 inherent in the income tax lay dormant for a long time before they were exploited and so there is  
9 a kind of an X factor when you go to a new system that I don't think can be quantified.

10 Some of our paper, and again, maybe this is another 10 percent of the paper, 5, 10  
11 percent of the paper, deals with questions that maybe only a tax lawyer would be interested in.  
12 For example, partnerships are a big part of our economic landscape and partnerships have a  
13 certain tax treatment, they have a flow-through tax treatment.

14 And so the question arises, could we have that under a flat tax and if we could have it,  
15 could we import what is now subchapter K, that is the part of the Internal Revenue Code that  
16 deals with partnerships, could we import that into a flat tax? So that is something, which some of  
17 you might be interested in. Now I found that a fun thing to think about and Mike convinced me  
18 early on, or at least argued early on, that it wouldn't work and in the end, I agreed with him.

19 So most of you, of course, I think are not interested in that kind of building block  
20 question about this. That is, you are not interested in, you know, if we have the flat tax, exactly  
21 what will be the kind of treatment of joint venture, say, on the business level.

22 So you don't care about subchapter K or L, M, N, O, P. What you really want to  
23 know is the comparison issue when I talked to you today, that is what interests you all and of  
24 course, this paper really isn't about it. It is as if we talked about what happens if you are hiking

1 in Alaska and we state all the dangers and you want to know, well, is it worse than hiking in  
2 New Guinea. We didn't write that paper, but obviously we have differing ideas on it, don't we.

3 And Mike started off an income tax proponent and is now convinced that we would be  
4 literally insane. The metaphor of Mike's that I like the most is it is like giving the taxpayer the  
5 government's PIN number and then a card to the government ATM to go to the flat tax. I am  
6 on the other side.

7 MR. SCHLER: I vote for daily withdrawals.

8 MR. BANKMAN: Yes, I know. Yes, daily withdrawals, right. And I am on the other  
9 side of the fence and not surprisingly, this didn't change my opinion at all. That is, we agree on  
10 what happens if you travel up north, so to speak. What are the problems of the flat tax. We  
11 don't agree on the most important question, which is a comparison between the flat tax and the  
12 income tax.

13 Mike bargained, because he is a good lawyer, for a little more time. But I think it is  
14 more fun to do a kind of back and forth instead of talking now and Mike is going to talk about  
15 some other aspects of the paper. But if I had to summarize my position in 40 seconds, I would  
16 say that giving a paper entitled "Tax Planning under the Flat Tax" is a big job and at 60  
17 somewhat turgid pages, this is actually small. If we would have talked about dealing with  
18 financial institutions, this could have been multiplied many times.

19 On the other hand, giving a paper entitled "Tax Planning under Realization-Based  
20 Income Tax" would be also an infinite talk. So I still remain convinced that a properly designed  
21 flat tax is going to be simpler in terms of tax gaming than the income tax and I think that is a  
22 strong suit. But now you will hear the other side of the story.

23 MR. SCHLER: Okay. We have these two papers in one here. I think there are two big  
24 problems with the flat tax, which potentially, at least in one case, is much worse than the income

1 tax and the other potentially much worse, namely, both tax shelters and timing.

2 Turn to tax shelters first. By this I mean permanent tax avoidance in ways that are not  
3 intended by Congress, as opposed to mere time deferrals that are built into the system. Jane  
4 mentioned before that the models for the flat tax really don't cover the real world, they are just  
5 very hypothetical. Well, one thing they don't cover in the model is, as Joe mentioned, the army  
6 of tax shelter promoters that will, no doubt, arrive immediately once this taxing is passed.

7 Our paper mentions all sorts of ways you could avoid or evade tax under the flat tax  
8 and which requires anti-abuse rules, all sorts of anti-abuse rules. The problem is, those anti-  
9 abuse rules are for the things we can think of in the abstract and the real problem is, nobody  
10 knows what the tax shelters will be under the flat tax. It is hard enough to figure out what tax  
11 shelters will be under the income tax and we are familiar with the income tax.

12 The problem is that the whole tax system today is a series of responses—the Congress  
13 does something, then the tax lawyers have a response to that, and Congress does something to  
14 respond to that, and that game just goes on indefinitely with the tax lawyers usually ahead  
15 because of how slow the legislative process is and how long it takes the IRS to find out things.

16 But at the least, everybody sort of understands the rule of the game at this point. There  
17 are various doctrines and you sort of know. It is not likely somebody could come up with a  
18 breakthrough that would wipe out all tax tomorrow, although you never know. But the idea of  
19 starting over with a flat tax, which initially is some primitive system, and then everybody goes to  
20 work. The idea of starting that whole game over again where the income tax has been going for  
21 decades, is a real scary process.

22 David Weisbach had in one of his slides—the things he rejects—to quote, an old tax is  
23 a good tax. I think an old tax is a good tax because we are familiar with the ways—the potential  
24 ways—of avoiding it. The game has been played for a while and I really think the idea of

1 starting over with some whole new tax, which, by the way, will also be heavily influenced by the  
2 lobbyists, so we will start off with some loopholes right in there, and the more complexity there  
3 is, the more loopholes there are and the more Congress tries to close it, the more new loopholes  
4 are created—the idea of starting over with that, I just find incredible in terms of trying to collect  
5 revenue. So that is the tax shelter.

6 Now the other aspect of the flat tax, which doesn't arise at all and the income tax is this  
7 concept of legal tax deferral. Under this flat tax—X-tax—we are talking about where you get a  
8 deduction for anything—if you are a business, for anything you invest in—it is really, in the  
9 clearest sense of the word, a voluntary tax system and any business that has a hundred dollars  
10 of income can buy anything for a hundred dollars and wipe out that tax liability.

11 If they want to pay the cash of the dividends to shareholders, that is fine. They can  
12 borrow a hundred dollars and invest in something. They can buy land. You get a deduction for  
13 buying land. It is just unbelievable for somebody who has grown up in the income tax. You buy  
14 land, you get a deduction. You don't have to do anything with the land, you just hold it. And if  
15 you don't even want the land, well, that is fine, you can buy the land and lease it to somebody  
16 and you still get your deduction.

17 But of course, leasing is a primitive way of shifting tax benefits. Flat tax lets you do a lot  
18 better than that because you have to reverse things over time with a lease. Under the flat tax,  
19 you buy the land, you get your deduction, you put it into a corporate sub, you sell the stock of  
20 the sub. The stock is an investment asset. No income. You have got a deduction and no income  
21 and you got your hundred dollars back. So all you did is create a deduction.

22 Now sure, if you sell to a buyer, the buyer won't get a deduction for buying the stock.  
23 So you might say, well, that is a wash in the system, but of course the buyer will be a company  
24 with losses who can't use deductions anyway. And so you have just created a hundred dollar

1 deduction in the system. You can go even further, if the buyer who wants the land isn't a loss  
2 company. Suppose you have a buyer that wants the land that is a profit company. Well, we can  
3 deal with that also.

4 I buy my land, I put my land into the sub, I get my deduction, I sell the stock to an  
5 intermediary loss company who doesn't care, and the intermediary loss company that bought  
6 the stock then sells the land to the profit company.

7 So we get two deductions for one land and nobody has paid any tax yet. And we keep  
8 doing that as many times as we want. You do that today, it is a tax shelter. Those intermediary  
9 transactions are so bad the IRS has it as a listed transaction. So we are going to need listed  
10 transactions in the flat tax to avoid multiplying deductions.

11 And I think our paper shows, in effect, what you get at a very minimum by the ability to  
12 shift losses around. It is like a global consolidated return. Any company with losses will be able  
13 to shift those losses to a profit company and every deduction will move to the place where it  
14 gets the most benefit. So if there are different tax rates in the corporate system every deduction  
15 will go to the person with the highest tax rates.

16 And that is for big companies. Small companies can do all that plus some more and if I  
17 am a sole proprietor of my business and my business is making some money that makes a  
18 hundred dollars and it doesn't know what to deal with the hundred dollars, but it wants to  
19 deduct it, maybe the company can buy a house and then lease me the house. That is where I will  
20 live. I have to buy a house, a new house, because you only get a deduction if you buy from a  
21 taxable person under the system.

22 So I don't see why any individual would ever buy your own house. You have your  
23 company buy the house which is fully deductible. It is just unbelievable. And then when you  
24 want to move, the company sells the house and buys another house and you get a rollover just

1 like the repealed rollover rules for personal residences—all through your corporation that is  
2 sheltering its business income this way.

3 And of course when my business rents me this house, of course I will pay below-market  
4 rents because I don't get a deduction anyway and the corporation has less income this way—so  
5 we permanently shift some income out of the taxable system into the tax exempt system by low  
6 rents to the non-taxpayers.

7 And then the other thing that will happen is that if it is a small business, it will pay very  
8 low salaries, which happens today also for people trying to avoid FICA. Sub S Corps and  
9 every small business will pay a minimal salary to the owner-employee, which, on its face is a  
10 wash also, but then what you are doing is shifting income from the wage tax, which is hard to  
11 shelter under this system, into the business tax, and so you shift the income to the business and  
12 then the business does all these other things to wipe out their income.

13 And so, you know, when the smoke clears, nobody is really paying much tax at all in  
14 the whole system except for the poor people who work—the employees of the big companies.  
15 They are paying tax in their wages, but the business tax, which includes the sole proprietorship  
16 tax and partnerships and all that, that tax is all gone.

17 Well, Jim says, so what. It is all just deferred into the future because, you know, in the  
18 present value terms, if I reinvest, I will make more money later and I will keep deferring for as  
19 long as I want, but eventually, I will have to pay the tax, won't I? And Joe says, sure, the  
20 present—a lot of the economists say, "Well, the present value is all the same so who cares."

21 I think there are two answers to that. One, the government needs the money every year  
22 and not 50 years from now maybe, if they even get it then. And the other is, I mean, do you  
23 really want the whole tax system to be at risk of nobody paying tax now and effectively  
24 borrowing from the government and expecting them to pay later?

1 I mean, a lot of things could happen between now and later. If somebody comes up  
2 with a new tax shelter that wipes everything out right away—you know, this whole system is  
3 sort of analogous to companies now being able to keep their foreign earnings abroad. You  
4 know, if you keep your earnings abroad, you don't have to pay tax on them until they get  
5 brought back.

6 And of course, nobody brings it back, just like everybody reinvests here, and eventually  
7 the government figures out, gee, they can make some money by lowering the tax on bringing it  
8 back. So they do that and everybody brings it back at the low rate. And the same thing could  
9 happen here that nobody is paying any tax and the money could use some money eventually and  
10 so they, you know, they lower the rate for people that agree to pay tax this year.

11 I think there will be an enormous incentive for people for all businesses to defer their tax  
12 as long as possible on the same reason. Why not? Let the future take care of itself. Small  
13 business will certainly do that. No small business would ever pay tax if they don't have to. So  
14 they will minimize the salary they pay to their employees shift the income into the business and  
15 then wipe out the business income under all these techniques.

16 So, I think either of those two reasons alone, either the tax shelter possibility or the  
17 indefinite deferral possibility, is reason enough not to. There is no way—really, I can't conceive  
18 of us having a flat tax for either of those reasons, starting over from scratch with tax shelters or  
19 this permanent deferral.

20 Now Joe, you can have the last word if you want to respond.

21 MR. BANKMAN: Well, I think the danger is indefinite deferrals exaggerates. We get  
22 most of our money from wages and we get almost none from the small business sector right  
23 now. So statistically, we are going to get most of our money from the wages, the kinds of  
24 employees Mike is talking about, like all of us, that aren't going to be able to, like, sink my



1 money back into Stanford University.

2 You know, whether the incentive is to leave it in there forever is a really hard question.  
3 This came up earlier. It really depends on whether you think that people will think that the  
4 effective tax rate is going to get higher and lower. There is more variance in that, but I don't  
5 think there is any intuition that points necessarily in one direction than the other.

6 You might think I will leave it in forever and then I am going to get lucky and I am going  
7 to get a government that is going to let me take it out of the administration tax free. You might  
8 think if I leave that in there forever, I am going to get some liberals back in there. They are going  
9 to think of a way to tax that.

10 So I think the intuition on how long people will leave it in there, the game changes in the  
11 tax rate is very hard to come by and I assume that people will make different calls and that they  
12 will be right about as often as people are right playing the ponies or the stock market.

13 MR. SCHLER: Well, just let me say one thing. I just don't think people are that rational  
14 as somebody said before. I mean, people are not going to try to figure out whether next year's  
15 tax rate is going to be higher than this year's or lower than this year's. They are just going to say  
16 I don't want to pay taxes this year and why should I if I don't have to. I will worry next year.

17 MR. BURMAN: I think, Ed and George have a real challenge given the authors have  
18 pretty much covered every conceivable position. Now commenting on this paper is Ed Outslay.

19 MR. OUTSLAY: I am the only one who brought slides this afternoon and I should have  
20 realized in a world of lawyers, that with this new circular 230, we don't put anything in writing  
21 anymore. So I suppose what I should issue a disclaimer that none of my slides can be used to  
22 avoid penalties under the tax shelter regulations.

23 If Rick thought that he was the token finance person, I guess imagine how George and I  
24 feel being sort of the token accountants in this group. We often talk about accountants as being

1 the people you bring in to bayonet the wounded.

2 (Laughter.)

3 MR. OUTSLAY: So you all look a little bit wounded about now. So in any case, I am  
4 honored to be here and not the least bit overawed by the brainpower in this room so I have  
5 tried to sort of take a big-picture look at this paper from sort of the perspective of the world I  
6 live in.

7 I feel like Persephone who ate those six pomegranate seeds and spent six months in hell  
8 and six months in heaven. So six months of the year I do volunteer income tax and deal with  
9 low-income people and six months of the year I do very high level international tax planning for  
10 multinational companies. So I am not sure which one is heaven and which one is hell.

11 We have talked today about thinking about bringing the debate and this morning we  
12 talked a lot about the theoretical issues of equity and efficiency and this afternoon we have been  
13 thinking more about ease of avoidance and things like simplicity. Twenty years ago we all got  
14 these simplicity buttons. I was hoping I could put mine on this afternoon, but apparently not.

15 And it is interesting to think about the goals of their paper, about the possibilities for tax  
16 planning. The issue is whether it will produce the same sort of undesirable behavior effects that  
17 bedevil the current income tax. So I think what the hell can I talk about here? Well, here is the  
18 take away—we all know the devil is in the details, we learned that.

19 As David said, better the devil we know than the devil we don't know and maybe we  
20 have come to the conclusion that we are damned if we do and we are damned if we don't. So  
21 in keeping with that theme—but in any case, I thought of two quotes that often come to mind  
22 when I read this paper.

23 Obviously one is Judge Learned Hand's comment about there is nothing sinister about  
24 using legal means to keep your taxes as low as possible. Then I thought about Russell Baker.

1 Someone told me there might be someone from the *New York Times* here so I figure I better  
2 quote the *New York Times*. But yes, I regret to say people devote their lives to studying the tax  
3 laws.

4 It is a dreadful thing, for people who do so are often people with minds of good quality  
5 to have them wasted in lifelong preoccupation with absurdities in tax law. It is sad, not to say  
6 disgraceful, for the nation. So I usually tell my students if this law is the one they are thinking  
7 about instead of the previous one, they should lie down for half an hour until the feeling goes  
8 away.

9 So if you did read the paper or read it without comprehension, the devil in the details.  
10 Joe and Mike talk about the details, the transitional leap problems and the small business  
11 exemptions and refundability, all those kinds of things, and then they talk about sort of the devil  
12 we think we know, the legal tax planning, the transfers of losses through leasing, the transfer of  
13 losses through sales or subsidiaries and partnerships, and they go through all these transactions  
14 that might be legal ways to avoid paying tax and if you try to understand those, it is sort of the  
15 tax equivalent to try and figure out who is on first.

16 So again, we see the responses that we potentially might get. They are all the same  
17 responses we currently have in our tax law and one thing that hasn't been discussed, you read  
18 these best-seller books, and they are always guaranteeing if you adopt their tax plan, they are  
19 going to get rid of the Internal Revenue Service. But we haven't even talked about their going  
20 away.

21 So and of course, then there is the devil we don't know. How susceptible is this system  
22 to fraud, illegal tax shelters, and whatever else is form-over-substance tax planning dear to an  
23 accountant and a lawyer's heart. So again, they come to these opposite conclusions. Joe, glass  
24 half-full, let's go for it. Mike, glass half-empty, let's reject it, right? And maybe they are both

1 right.

2 In today's world, at least the world I sort of live in where it is like tax shelters are four-  
3 letter words, I believe Mike is probably right in thinking most people don't use present value  
4 approaches, they are thinking about their tax results.

5 And we were thinking in sort of Mike's case and sort of came to the conclusion it is sort  
6 of like offering a recovering alcoholic a drink, right, and so that, you know, we are going to take  
7 away all these great ideas you had and now we are going to change the tax system and give you  
8 the chance to do them all over again. So here we are trying to wean people off of this and I  
9 guess the concern is that we will give them the opportunity to come back.

10 So my big thoughts on the matter, I thought to myself—I don't have very many big  
11 thoughts any more, but in thinking about the world we have been talking about—individuals,  
12 closely held companies, whatever—I think we tend to think of them living in sort of one-  
13 dimensional tax worlds, right? How much tax am I going to pay?

14 Corporations, the ones, at least, that I deal with live in a two-dimensional world where  
15 they have got tax returns to worry about, financial statements. We haven't talked about the  
16 implications at all today about changing systems and the impact this might have on financial  
17 statements regardless of whether we go to a consumption tax or not, right?

18 Many of the companies that we see today are still going to be living in an income world  
19 when it comes to things like their financial statements, right, and if we go to a consumption tax,  
20 you are still going to be paying income taxes in the states in some cases. Outside the U.S., you  
21 will still be paying income taxes. And so one of the questions we might be thinking about is, you  
22 know, even from a financial reporting perspective, right, what might happen if we go from an  
23 income to a consumption tax.

24 One thing, of course, is we might lose some of that transparency. Right now we have

1 sort of developed these monitoring effects where you have got people like the SEC and people  
2 like investors, like Bob McIntyre, Citizens for Tax Justice, right, who try and figure out whether  
3 or not you can tell if a company were paying taxes or not from their financial statements,  
4 whether you lose some of this transparency.

5 We have seen some issues of financial reporting creep into the tax law—this issue of  
6 whether to have a deduction or a rate reduction for the domestic production activity. Deduction  
7 had some issues of whether it created deferred tax assets and liabilities on balance sheets.

8 You go to a system that creates zero basis in assets, you are still going to have a basis  
9 for financial reporting purposes and if you think taxes are tough, tax accounting sometimes is  
10 even more complicated. So we would see huge changes on balance sheets for corporations,  
11 which may again have some impacts on things like the capital markets.

12 All right. And so in some sense we need to think a little bit maybe about this group of  
13 taxpayers and whether they are unique relative to, say, my Vita clients who really don't worry  
14 about capital taxes either, right? But again, the Treasury hasn't traditionally kept track of how  
15 much publicly traded companies pay into our tax system relative to, say, privately held  
16 companies.

17 The data I could get from my colleagues is roughly about 65 percent. But again, that is  
18 assuming that if you took just a cut in the data and said hey, corporations that have assets and  
19 say two and a half billion might be a surrogate for publicly traded companies.

20 So again we see the publicly traded companies contribute significant portions of  
21 corporate revenues. And so I think we have to keep that in mind as we do think about what tax  
22 reform is going to do, not just to their tax returns, but maybe to their income statements and  
23 balance sheets as well.

24 And the thing that is depressing is that we have just now gotten to a point, after years of

1 tax avoidance, that companies now are competing with each other to see who pays the most  
2 taxes. So, in 2003, Warren Buffet announces, “We paid \$3.3 billion to the federal government”  
3 and a year later Wal-Mart says, “Oh, yeah, well, we paid \$4 billion. So take that.”

4 Now we don’t want to go back to a system any more where, in Mike’s world we say,  
5 “Okay. We are done with that. So let’s stop paying taxes.” So again, I know Alan Murray  
6 would like to hear this. I can’t believe I am even bringing it up, but again, if you are thinking  
7 about, as Jane has said, you know, thinking about it in a practical measure, maybe even thinking  
8 about this group of taxpayers.

9 You know, there has been a lot of discussion of whether we ought to think about maybe  
10 converging those two numbers.

11 And I had this dream, sort of the John Lennon school of pipe dreaming, I guess, about  
12 having—we have a FASB, maybe we could have a TASB, right, a tax accounting standard  
13 board. What I think we have talked about today is the fact that these changes—the unseen  
14 gorilla in the room was Congress of course and, you know, how are they going to keep their  
15 fingers out of this pie, whether it is to influence behavior or increase their campaign  
16 contributions.

17 And so, again, you know, we hear people talking about lower rates and a broader  
18 definition of income, which would certainly be one that is more in the lines of financial reporting  
19 might allow us to do that.

20 So again, in thinking a little bit about the problems of tax shelters, you know we ought to  
21 think of tax shelters distorting taxable income, but a lot of these tax shelters actually distorted  
22 financial reporting income. They created these things we call deferred tax assets, which actually  
23 distorted their financial accounting income.

24 And so we might be thinking about the world that we see today and is it any different

1 from the one we might create? We have got so much regulation today. Someone once said that  
2 the practice of taxation has become more complicated than the tax code and I would agree with  
3 that especially today.

4 Charles Boynton and Ellen were kind enough to loan me some new data. We have got  
5 these monitoring devices looking at these differences between financial reporting and taxable  
6 income which have been under a great deal of scrutiny later. I don't want to steal George's  
7 thunder because he has done a lot of work here.

8 We started to see this convergence and of course now we are seeing a divergence again  
9 and but again, you know, at least we have some sense that this is something we can perhaps  
10 monitor under the current system. I don't know what happens when you go to a consumption  
11 tax type of a system.

12 And again, for those of you who don't practice tax, the world of tax is really today  
13 more risk management than it is almost anything else. The world that we lived in the '90s, which  
14 was one of shareholder value, is now a world of risk—tax risk management, and that has  
15 significant impacts on the way people approach doing tax planning today. And I think that is an  
16 important consideration to keep in mind. And so again, we even see today what is your goal as  
17 a tax director. It is to stay off the front page of the *Wall Street Journal*.

18 And with my last slide, all right, obviously one thing seems clear: the IRS is still going to  
19 play it by the rule in whatever system we create and I can put my button back in my pocket  
20 because I won't be wearing it. So thank you.

21 MR. PLESKO: Thanks. I am rather agnostic on today's topic, at least I thought that  
22 before I started reading today's paper, and, you know, I will admit, I am comfortable with the  
23 current tax system and focused on measurement and reporting incentives and the administration  
24 of the current income tax.

1           And one of the things that should come out by now that makes this paper interesting is  
2 that when you read through the paper, you see two people sort of looking at the same facts and  
3 then coming to different conclusions on it. Part of my role, then, as I went through this paper  
4 was to say, in the spirit of September in Washington, is that I can be an umpire and I can be  
5 nonjudgmental, impartial, and just decide which of them is right and we can all move on.

6           But I also have the benefit of having read the other papers here. So I am going to focus  
7 today, much like Ed did, on a lot of the implementation issues that we would deal with and I am  
8 going to start with a little bit of an overview and tip my hand because at least as the paper  
9 stands now, and maybe this is only going to provide strong incentives for one of the other  
10 authors to really invest in a rewrite, I came down on the side of Mike with concerns over the  
11 move to a consumption tax.

12           I share his overall concerns of how we get from where we are now to where we would  
13 eventually be and what the world might look like in the future and I don't think that I am afraid  
14 of uncertainty; this is an uncertainty that I most comfortable with.

15           But one of the benefits of this paper and I think some of the other papers we have seen  
16 today and some of the other papers that are out there is that thinking hard about what might  
17 happen if we go to a consumption tax or the issues involved might really help us think harder  
18 about how we could incrementally reform the current tax system to take care of some of these  
19 issues, whether we are staying with the financial instruments that Ed talked about or even other  
20 research that has been done over the years.

21           Like the first thing that came to my mind was the AOI reporter's report on private  
22 business enterprises of ways of rationalizing the smaller business side of the taxation. And a key  
23 thing that I thought about, as I went through their paper and going through—again, feeling  
24 stronger about this because of Ed's paper on financial instruments, is that I think in the short run,



1 at least, people will adapt faster than structures.

2 In essence, if I want to again cast this in a current debate, I think that the intelligent  
3 design of a new tax system is going to be, for a very long time, trumped by the evolution and  
4 natural selection of the participants. And the one thing that comes from their papers that I think  
5 both authors agree with is that if you move from the current tax system to a consumption tax  
6 system, there will be fewer constraints than under current law in terms of ways of trying to avoid  
7 paying the tax.

8 Now I am going to say this right now, that, with only having gone through these papers  
9 in the last couple of weeks, I need to think a lot more about, and I will defer to Ed and Mike  
10 any questions that challenge that assumption.

11 But the last observation I make in terms of the generalities of the system, before diving  
12 into some specifics that I am concerned about, is that I also will vote with the idea that I am  
13 concerned about—the timing of receipts. I think that the timing does matter.

14 I think that there is an inherent, at least in the way in which it was presented in this  
15 paper—we are giving up some control and some structure over the way in which receipts might  
16 be received by the federal government and I am also concerned that I think we have ample  
17 evidence, that Mike even mentioned, that when we get to situations where we allow significant  
18 amounts of deferral, something else can happen to make sure that the expected present value of  
19 those taxes end up not being realized.

20 The first one that he came up with, which was my second one, is we have had this  
21 growth in the amount of unrepaid foreign earnings in which firms have not booked any  
22 reserves—not booked any liabilities for financial accounting purposes. They have not had to pay  
23 any tax on them, and we have reached the point where at least it appears that all of a sudden  
24 there is pressure to bring it back and whatever the political climate is, puts that repatriation on

1 sale so that there seems to me, at least, casually to observe that there tends to be political  
2 pressures that coincide whenever we see this kind of wealth transfer take place.

3 The second one that again comes to mind is that if I read, and certainly I can only go by  
4 what I read from places like Brookings and the Urban Institute and the *New York Times* and  
5 everywhere else, that we are on the cusp of a very significant demographic shift where we are  
6 going to have large transfers of accumulated wealth from one generation to another. And I now  
7 have my second data point that we are also in a situation and we see an enormous amount of  
8 pressure to all of a sudden repeal or otherwise minimize the effect of the estate tax.

9 Now to address Joe's point, I think the basic issue then becomes when we get to the  
10 future at some future point in time where there is, all of a sudden, pressure to somehow realize  
11 this, realize and pay tax on it, we really have to roll the dice right now of whether or not we are  
12 going to be in the political climate of the 1990s or the political climate of the 1890s and frankly,  
13 I don't know and I don't expect to be here in the 2090s.

14 So what I want to add to the final discussion—how much time to do I have left? Plenty.

15 PARTICIPANT: Are you going to infinitely live, George?

16 MR. PLESKO: I might infinitely live. No, but I think my kids might be. At least I am  
17 worried about when they go to college.

18 What I really want to add and sort of take off on what—the comments that Ed made is  
19 talk about some additional administrative issues. And let me start with a general observation,  
20 which Ed also made, but in a slightly different setting, and that is that if you think about  
21 measuring income, and I felt this particularly on income at the corporate level, the notion of  
22 corporate income and measuring corporate income predates not only the U.S. income tax, but  
23 at least my reading of history suggests that it does predate the European discovery of America  
24 so that we have the concepts of putting together income and measuring income for some sort of

1 purpose for a very long period of time.

2 And I would note, therefore, that there is an enormous infrastructure that is built on, at  
3 least, some sense of measuring income, however well or poorly defined it is. And I will note  
4 these without comment and ask that we add them to the record of additional transitional issues  
5 that someone will have to deal with at some point.

6 For example, the national income and product accounts—note not the national  
7 consumption and product accounts, but the national income and product accounts—are both  
8 primarily derived from statistics from income data driven by, for example, on the corporate side,  
9 corporation income tax returns in order to try to approximate economic income.

10 State taxes, something like 46 to 47 of the states, will start with effectively what is on  
11 the first page of the tax return at the federal level in order to be able to have their state income  
12 tax systems set up, which leads us to one of two things happening. Either one, which we can  
13 probably predict happening since we are sitting here, that all of these states will have to go  
14 through substantial changes in their own systems, and that is a battle for another time, or  
15 alternatively, in theory, they could impose the same kinds of reporting requirements that they  
16 have now because they can just say if you are going to file, we are still going to use the income  
17 as the base.

18 The third situation, and the third issue that I want to address and spend the rest of my  
19 time on, as Ed alluded to, is financial reporting. Even aside from the idea that if we could move  
20 seamlessly to a consumption tax and assume that not only is all the legislation, but all the  
21 regulations are in place by January 1st of 2006, I do want to point out that the IRS will still have  
22 to devote substantial resources to auditing the income tax return for at least another four to five  
23 years. And I have a feeling if I look around to the practitioners, they are going to tell me that I  
24 am grossly underestimating the amount that it might take to clear the docket of income tax

1 returns.

2           So what I want to touch on, in terms of some additional issues that haven't be raised  
3 yet, is just the idea that when corporations go out and have business or other types of economic  
4 activities, as Ed already mentioned, you are subject to two different sets of accounting rules in  
5 order to measure them. One set, which is based on the tax return for the government, and the  
6 second, which provides financial reporting to external financial statement users.

7           And what I think happens is, as what has developed over time, because this has been  
8 an evolutionary aspect of the U.S. capital markets, is that these two related but distinct  
9 measures provide very significant reinforcement and provide more additional information than  
10 having just one of them.

11           Now let me give you three very simple issues in 1.74 minutes. The first one is audit and  
12 the fact is, in the case of auditing a corporation income tax return, the starting point nowadays,  
13 at least seems to be even trending more obviously, is the financial statements because you have  
14 a common basis of income by which to start measuring whether or not there is compliance at the  
15 corporate level.

16           We also have the addition of the Schedule M-3—for the uninitiated, the revision to the  
17 tax return—which makes the link between the tax return and financial statements even more  
18 explicit. In the absence of a tax system based on income, we have to come up with some other  
19 external validation in order to start the audit.

20           The second piece of information I want to touch on is just the general nature of financial  
21 reporting and financial information. And that is that even though I would agree that there is a lot  
22 of research suggesting that we don't get a lot of information out of the tax footnote when we try  
23 to understand exactly what a firm's tax liability is. Nevertheless, the empirical evidence suggests  
24 that there is incremental information to the market when it comes to valuing firms knowing

1 something about the way in which they report their income taxes.

2 And I will leave sort of a greater discussion on whether or not maybe consumption tax  
3 information might be better than the current information we have, but I want to note that we  
4 know, as a first order effect, that we are going to lose some information that is used to value  
5 firms.

6 The last point that I want to make goes really to the heart of the tax shelter debate and  
7 the notion that we have a dual accounting of the same underlying activity. Under the current  
8 structure, we have built into it a set of checks on the types of behavior that many firms would  
9 undertake. That is, to the extent that the firm wants to be overly aggressive on its financial  
10 reporting side, there are some inherent limitations to be able to do that because of the  
11 repercussions it may have for tax reporting.

12 The reverse of that is that there are a number of aggressive tax positions, which have to  
13 be either creatively addressed or may not be able to be fully addressed without actually  
14 decreasing; for example, the amount of earnings that a firm reports to its shareholders and that  
15 there is strong evidence that suggests firms have to balance this.

16 Moving to a consumption tax base in the context of tax shelters suggests that we have  
17 now eliminated this tradeoff; that changes that are done in order to try to aggressively avoid the  
18 consumption tax would have, essentially, no financial reporting context and vice versa from the  
19 financial reporting side. And therefore some of the inherent checks that our system has evolved  
20 into are going to go away and make both systems worse in terms of the kinds of information  
21 they have.

22 So let me just stop by saying I think that it is not the accounting, and I think it is the case  
23 that accounting and accounting research hasn't thought a whole lot about the economic  
24 foundations of capital income taxation and some of the legal issues. But I think there is a lot

1 there and there is a lot of accounting implications that will be addressed and do need to be  
2 thought about.

3 MR. BURMAN: So you can be glad that Hank and Dan talked me out of bringing my  
4 air horn.

5 MR. SLEMROD: If my voice sounds funny, I am in this weird magnetic field between  
6 the two authors here.

7 (Laughter.)

8 MS. GRAVELLE: But I notice you are sitting closer to Mike.

9 MR. SLEMROD: Mike had stole Joe's watch during the presentation I noticed too.

10 MR. SCHLER: No, vice versa.

11 MR. SLEMROD: See, it is a weird feel. Just a quick question for the doomsday  
12 scenario that Mike outlined about the flat tax or the X-tax. Am I right that the problem arises  
13 because of the immediate deductibility? I mean, couldn't you do a present value equivalent of  
14 the deductibility and just do it over time or the CBIT, which has depreciation?

15 Does that solve the problem? If so, I understand, then, we have to keep track of this  
16 weird thing people call basis and It might be a little bit more complicated, but tell me if would  
17 solve this problem or not.

18 MR. SCHLER: Yes. I mean, that would solve the problem of unlimited deferral of this  
19 year's tax, but as you say, it gets you much closer to the present system. To the extent there is a  
20 benefit of—one of the big benefits of a flat tax is simplification and one of the reasons for that is  
21 totally eliminating the concept of basis and now we are back to basis and—give me basis and I  
22 can also play games with basis. That is a whole new vista for tax shelter opportunities.

23 MR. HALPERIN: You have to buy five pieces of land instead of one.

24 MR. SCHLER: Well, you can do that today, too, with first-year depreciation, but

1 immediate deduction is so much easier.

2 MR. SLEMROD: So basis is not as bad as immediate deduction.

3 MR. SCHLER: Well, they are both immediate deductions and let you wipe out this  
4 year's tax. Basis doesn't do that, but it creates other problems.

5 MR. BANKMAN: Although I think the kind of Auerbach–Bradford approach to this,  
6 which is just you get a basis deduction, you get it over nine years regardless of what happens to  
7 the underlying asset might resolve some of those obviously with some complexities.

8 MR. AARON: David?

9 MR. WEISBACH: I actually had the same question, but I am not satisfied with your  
10 response, which is no matter what you do we can play games because, you know, we have a  
11 basis in the current law and if the comparison is with, you know, what we can do under income  
12 tax or current law and what the flat tax or X-tax is going to look like, you can't just say, well, it  
13 is going to be horrible.

14 I think you have to say if the problem you identify, the immediate deduction and infinite  
15 deferral of tax, is not there with the basis system, then it is incumbent upon you to say well, what  
16 really is there rather than just saying something is going to be horrible.

17 MR. BANKMAN: You are looking at Mike, though, right?

18 MR. WEISBACH: Yes. Yes.

19 MR. BANKMAN: I have one supporter in the audience and if he turns against me, I  
20 am in trouble.

21 MR. SCHLER: No, you are right. But then don't say that one of the benefits of a flat  
22 tax is simplification. You could take that off of your slide if that was on a slide, because once  
23 you have basis, that simplification is gone.

24 MR. WEISBACH: You still have improvements. This is not about—your claims of, you

1 know, drastic improvements might not be there, but you still have improvements. You are still  
2 not trying to measure income.

3 MR. BANKMAN: You don't have a realization basis.

4 MR. SCHLER: Well, it depends how you do basis. But you are right, that would  
5 eliminate the ability to defer tax, all tax, and you would have to buy more stuff. It would make it  
6 harder. You would have to borrow more money to buy more stuff.

7 MR. BURMAN: Eric?

8 MR. TODER: I think we all agree that whether we tax the time-value of money or not,  
9 the proper basis of tax is U.S. residents for the U.S. income tax and they are the ultimate  
10 beneficiaries of the public sector and should be the ultimate payers.

11 When I look back to the last—the first Brookings conference on this subject I went into  
12 and looked at what has changed in the last 30 years, I think the two biggest changes in the  
13 world are the internationalization of the economy. Did I say something funny?

14 MR. AARON: Gray hair.

15 MR. TODER: Oh, gray hair. Okay. That too.

16 MS. GRAVELLE: I don't actually have that.

17 MR. TODER: Some of us envy gray hair anyway. The internationalization—

18 (Laughter.)

19 MR. TODER: The internationalization of the economy and the other than has been so  
20 that—and I think that really means we have a lot of multinational corporations and we can't any  
21 longer say that taxing U.S. corporations is equivalent to taxing U.S. shareholders now that there  
22 is multinational ownership and lots of foreign mutual funds and so forth.

23 And the other, computerization. I point out that 85 percent of people, individual returns  
24 are now filed on a computer and of the people who this conference is really talking about, I



1 suspect that percentage is a good deal higher.

2 So I am kind of wondering why there is this push towards shifting the collection and  
3 liabilities tax from the individual to the corporation as is done in CBIT and in the flat tax. It  
4 seems like it is, today, easier to administer taxes on individuals than it used to be and more  
5 difficult to administer a tax on multinational corporations. And so I was wondering if Joe and  
6 Mike would both comment on that and also raise the question of whether they think an R plus F  
7 base for a consumption tax would be either harder or easier than the flat tax.

8 MR. SCHLER: Well, I think the flat tax is shifting the burden from corporations and  
9 businesses to individuals because if I am half right about being able to avoid the business-level  
10 tax, all you are really talking about is a wage tax.

11 MR. TODER: But I am not talking about the incidence, you know, whether people  
12 avoid it. I am saying that you are collecting it from the corporations rather than the individuals  
13 and I might agree with you that that facilitates the avoidance in the shifting of the ultimate liability.  
14 But I am talking about where do you impose the tax on business and can it be imposed at the  
15 business level and at the individual level?

16 MR. SCHLER: There is a deduction for wages and so the employees are really  
17 taxed—I am not sure I understand the question.

18 MR. TODER: The taxation of interest income, the taxation of profits. The wage tax kind  
19 of remains the same under both systems. So that has not changed. It is really the taxation of  
20 entrepreneurial returns. The only difference is you don't tax the time value under the flat tax, but  
21 you are still taxing all these other profits.

22 MR. BANKMAN: What you see, Eric, is that—I understand the point that all of these  
23 folks are going to use Turbo Tax and have preparers and the like. But I would think that we are  
24 talking about the most wasteful planning it seems to be, when people look at it, is at the business

1 level and that is what—that is the kind of simplification you would hope to get under the flat tax.

2 So I would take the simplification to be on the whole at the business level where there is  
3 more tax planning, it is more expensive per dollar, but what is the problem with this? Why don't  
4 you rephrase this. Yes.

5 MR. TODER: I guess you have laid out this whole series of transactions where you  
6 have a whole bunch of individuals who are outside of the tax base and businesses are inside the  
7 tax base and there are all these games between individuals who have now become taxing  
8 different parties from the—

9 MR. BANKMAN: Oh, I see.

10 MR. TODER:—persons and businesses who were taxable.

11 MR. BANKMAN: Oh, I see. Okay. So your point is why don't we put the individuals  
12 back in the tax rates.

13 MR. TODER: Right. Right.

14 MR. BANKMAN: And then see what we can do. You know, I will be honest—can I  
15 say I didn't write that paper? Not to avoid the question, but only because I thought about the  
16 problems under the flat tax as outlined and putting the F back in, which is something that Alan  
17 mentioned the other day too. I have some things to say about that, but it is a big subject and I  
18 haven't thought that through.

19 PARTICIPANT: I think that is a whole separate conference.

20 MR. BURMAN: Ron or Eric.

21 MR. PEARLMAN: Let me pose my question this way. While my instinct tells me that I  
22 am leaning towards Mike's view, what troubles me about that view is that there are lots of  
23 business tax planning prospects under an X-tax or a flat tax, but compared to what?

24 I mean, if you assume, as I have assumed, that in a multinational world—in a global

1 economy—I want to make it even broader—that the income tax is—that the taxation of any  
2 income from capital under the income tax is at considerable risk, notwithstanding what receipts  
3 look at, like today, notwithstanding whether there is capital income being taxed today or some  
4 corporate profits being taxed today.

5 That if you look down the road some number of years that income from capital is very  
6 vulnerable to tax; so therefore, if you assume that, okay, under an X-tax, let's say we get to the  
7 same place, that we are essentially not going to tax income from capital under an income tax  
8 even if we tried because people can just move money around pretty easily and we may not be  
9 able to tax very much income from capital on an X-tax for the reasons you suggest in the paper.  
10 Then in either case, the question then becomes well, if the tax is essentially a wage tax, what are  
11 the vulnerabilities under an X-tax to an erosion of the wage tax base.

12 And it seems to me that should be one of the central questions. And so things I have  
13 been worried about are what do you do about fringe benefits. Forget the guy that incorporates  
14 the closely held business who, you know, who can play around with the home.

15 Let's talk about the millions—I mean, there may not be any factory workers 10 years  
16 from now, but assume there are real people in the world who aren't self-employed and are able,  
17 you know, able to work for big companies and that they earn wages and those wages, at least  
18 nominally, are subject to tax under the flat tax, but that the law continues to struggle with the  
19 notion of fringe benefits, that is, the law will develop so that some fringe benefits, whether it be  
20 housing provided for the convenience of the employer remains excludable, in other words, not  
21 treated as wages. I don't know what the items will be, but there will be, presumably, some  
22 items, parking, whatever, that won't be subject to tax.

23 So there will be continued pressure on fringe benefits and I could conceive that a lot of  
24 us, a lot of regular, everyday wage people, might all of a sudden decide it makes sense to be

1 living on the premises of the employer because the employer demanded it.

2 So all of a sudden employers start building big apartment buildings and, of course,  
3 expensing them and providing that housing to the employer because certainly, in Rick D'Avino's  
4 case, the chairman of G.E. will say, "D'Avino, we want you here tonight so that if a tax planning  
5 issue comes up, we don't have to worry about you traveling from your house." So that is one  
6 issue it seems to me.

7 The other one is, to what extent (and I think there are many others) can equity  
8 compensation be, in the form of options or restricted stock, be used as a subterfuge for wage  
9 compensation therefore raising timing and/or valuation questions regarding compensation.

10 So I guess my question is, to what extent do you think a wage—let's accept Michael's  
11 argument that there isn't going to be much left, if any, of the business tax so that we are talking,  
12 essentially, about a wage tax. To what extent do you believe, either of you believe, that the  
13 wage tax itself is vulnerable, the wage tax base itself is vulnerable under a flat tax?

14 MR. SCHLER: Keep in mind under this system, it is not just the corporate income tax,  
15 it is all the small businesses that are run through pass-through entities now, which is almost all of  
16 them, as far as I know, sub Ss and LLCs and whatever—and all that is part of the business tax  
17 that would be under the system. If it is the way we describe, you get an immediate deduction,  
18 you can wipe out your tax. But there is a lot of money collected from that whole system today.

19 MR. PEARLMAN: With the current data, most of the income that is collected in this  
20 country is collected from wage earners. I mean, yes, we get some self-employment income, but  
21 it is not a huge portion of the income.

22 MR. SCHLER: No, but I agree that if you are basically down to a wage tax—either by  
23 calling it a wage tax or by calling it a flat tax, when people do the things we are talking about—  
24 then you are putting an enormous amount of pressure on what wages are because if you wipe all

1 the other stuff, you probably have to raise the rates. And so there is going to be more pressure  
2 to do fringe benefits and things.

3 And we talk about that a little bit in the paper, but I agree, you really would have to  
4 have a very complete definition of wages. Presumably, you would want to cover pension plan  
5 contributions and health insurance and all that stuff. The less you cover, the higher the rates.

6 MR. BANKMAN: It is a problem now. That is, incentives don't obviously change.  
7 Right now you can get money out tax free, so to speak, if you can do it in the form of fringe  
8 benefits. That would be true in the future. We get almost all of our money from wages now, and  
9 we will in the future.

10 So the real question is, how much of an incremental problem is this? How much of a  
11 problem is this under the flat tax? Fringe benefits are a pretty big problem now. I think when  
12 people look at distortions and the like you can look at them as a real problem. That may be a  
13 little bit more in the future, but that is my thought.

14 MR. BURMAN: It seems like the incremental problem is for things like housing  
15 allowances where it is the difference between capitalizing them and expensing them, right?

16 George?

17 MR. PLESKO: I have a question to the authors. It is a question I wanted to ask before.  
18 It was actually a question I asked of Eric before and I want to pose it to you. In Eric's paper,  
19 there was this issue of all of this wealth and it was in the highest income groups.

20 Jim Poterba asked the question about all of this wealth that, you know, that you  
21 essentially said in your paper would escape taxation and the comment was, well, you know,  
22 during this transition period, there would be changes in asset values. There would be other ways  
23 in which the wealthiest would end up paying or having to be subject to some sort of change in  
24 the amount of wealth they had in going to this tax.

1           In your paper, you have a section in there about how people could gain the anticipation  
2 of moving to this tax by selling something now and buying it back later. What I really want to do  
3 is pose to you the same question that was posed to Eric.

4           If there is an enormous amount of wealth concentration, is it possible in your views that  
5 they would be able to substantially escape a lot of transition hits to that wealth through  
6 transactions along the lines that you describe in your paper?

7           MR. BURMAN: I am impressed, George, as to what you are able to gain in the time  
8 limits for discussants.

9           MR. SCHLER: No, I think if there is not going to be transition relief, then all basis is  
10 going to be wiped out. Then I think, sure, anybody with an asset now with basis will sell it—we  
11 will sell it to each other maybe—and eventually under the new system, deduct it and buy the  
12 asset back. So I will sell my assets to somebody and buy it back and get a deduction and  
13 basically get to use my old basis as a deduction now.

14           MR. AUERBACH: I will rise on a point of privilege here. You can't make assets  
15 disappear. I mean, if the flat tax is going to be enacted tomorrow and we all realize it today and  
16 we all try to sell it today, the asset—the loss in asset value that would have occurred tomorrow  
17 is going to occur today. The only difference would be the loss in incremental—the delay in the  
18 timing of incremental investment and if it is far in the future, that is a big deal.

19           So if we are thinking that the flat tax is going to be enacted in five years, that could have  
20 significant announcement effects or if we find out this month that the flat tax is going in next  
21 month, we can't escape it by selling assets.

22           MR. BANKMAN: Well, you take the real loss. The question is do you get a tax  
23 benefit?

24           MR. SCHLER: The investment banks fill find companies with giant NOLs that will buy

1 up all these assets and then sell them back to you after the system is in place.

2 MR. BANKMAN: It is not the real loss that you can escape. The question is depending  
3 on the transition rules, are you going to get the benefit of your tax loss and not escape the real  
4 decline in asset values.

5 MR. BURMAN: We would like to have some questions, comments from the floor. Line  
6 up behind Bill Gale or any other microphone.

7 Bill?

8 MR. GALE: Thanks. Bill Gale. Maybe this question is for Alan. I agree you can't get  
9 the benefit if domestic companies all sell to each other, but why can't they all sell to offshore  
10 entities that are created for this purpose and then buy back from them after the flat tax is in  
11 place and take a deduction?

12 MR. SCHLER: Under the system, if you buy something from a tax-exempt, you don't  
13 get a deduction for buying it. So you couldn't do that. You have to find a taxable person to sell  
14 it to. That is why I used the example of a company with losses.

15 MR. GALE: Okay. That works as well. Let me make the other comments I want to  
16 make. The deferral issues, I am not certain if deferral becomes dominant; but if it does, then it is  
17 obviously a big issue because it has to be roughly neutral over 10 years. They have some  
18 gigantic increase in revenues 50 years from now. That doesn't help them. Or maybe they only  
19 had the revenue in five years. I am not sure, but 50 years from now—

20 MR. SCHLER: Well, even if all the money was being deferred to the tenth year, that  
21 may help the tax reform panel, but it wouldn't help the government.

22 MR. GALE: The example you gave us that they could first extinguish their tax liability by  
23 buying land instead of just leaving the money in a bank account and earning, you know, the  
24 market return, essentially that is a choice between a traditional IRA and a Roth IRA and

1 certainly in the environment like we have now, whereas Alan and Doug Holtz-Eakin were  
2 talking earlier, expenditures are going to go up, you might be well advised to pay your taxes  
3 now and not take your chances on future tax rates, which almost always have to go up. So I  
4 agree that if deferral becomes the name of the game, then it is a big issue; but it is not obvious to  
5 me that people are going to want to defer forever.

6 On the second issue of tax avoidance. In the conference line that Henry and I did almost  
7 10 years ago that people have mentioned a couple of times, Jim Poterba and John Gruber had a  
8 paper on health insurance where they raised the possibility that even if you got rid of the  
9 deductibility of the firm's provision of health insurance, the firm could just hire the doctors and  
10 the nurses and then it would be labor cost and it would be deductible. So there are even more  
11 tables of avoidance there than first meet the eye. Another thing to mention is that—

12 MR. SCHLER: Bill, the deductibility of benefits is okay as long as it is income to the  
13 employee. So you would have to tax the employee not just on the premiums, but on the actual  
14 in-kind provision of services.

15 MR. GALE: Presumably, that wouldn't happen. The doctor would be an employee of  
16 the firm and would provide the services free to the other employees.

17 MR. SCHLER: No, but you would have to tax the employee on the value of the  
18 services. That is right, you would have to enforce—that is a fringe benefit.

19 MR. GALE: If they did that, you are right, but the notion is that if you had to tax  
20 workers on the imputed value of the health services they receive, you would be out of the simple  
21 world of flat tax.

22 MR. SCHLER: That is true.

23 MR. GALE: So, if you want to retain the simplicity you could avoid the loss of tax  
24 deductibility of health insurance by hiring them into the companies themselves.



1           And just another point I want to raise. We were talking earlier about FAS or reporting  
2 and tax reporting. Under the flat tax you would get situations where firms have reported losses,  
3 but nonetheless have big tax liabilities because FAS reporting—FAS measures of income of the  
4 taxable base would be so different.

5           And that may raise other political economy issues to those who would object to why  
6 they have to pay taxes in a loss situation and we talked earlier about how hard it is to explain to  
7 individuals that under a flat tax, capital income tax would be paid at the business level. Having  
8 dealt with a lot of corporate individuals, my guess is that would be hard to convince them or get  
9 it down to convince their boards that their companies should be paying taxes when the company  
10 is in a loss position. So that could also erode the integrity of the tax.

11           MR. SCHLER: Well, even today you can have a book loss and taxable income and  
12 more likely it will be the reverse. I would think under the new system, you are more likely to  
13 have tax losses because you are deducting everything up front. So I don't think that is any  
14 worse than today.

15           MR. BANKMAN: The variant that might be worse—well, instead of an obvious one, is  
16 whether you could ever get an active system, which takes financial transactions out of the base  
17 for individuals. So a rich person sells his stock and gets dividends tax free, so—which is just  
18 kind of a play on that, right?

19           MR. BURMAN: Dan Feenberg?

20           MR. FEENBERG: Yes, Dan Feenberg, NBER. I understand how an individual firm can  
21 perform its taxes or whatever, but if I understand the mathematics involved, whole revenues  
22 would be determined by an aggregate consumptions of rate and the facts that any particular firm  
23 individuals has deferred their taxes on income as—because income isn't really part of the base,  
24 consumption is the base. But it isn't that significant.

1 MR. SCHLER: Consumption is not the base under this system. I mean, it is really not.

2 MR. BANKMAN: I mean, it is an argument. I mean, the firm is just an argument, I  
3 guess, that people aren't going to be consuming forever, I mean, if you think of that, right. And  
4 then whether it is a problem or not I guess depends on current revenues.

5 MR. FEENBERG: There is eventual consumption based on confusing personal  
6 consumption expenditures with business expenditures, which I think is already a problem of the  
7 income tax system. It is not a new problem with the consumption taxes. And some of the other  
8 examples depend upon an consumption tax, which I think is a well known problem of retail  
9 sales taxes and any kind of consumption tax system. You would not get revenue from purchases  
10 made abroad and it is something worth considering, but it is not exactly a loophole.

11 MR. BANKMAN: I agree.

12 MR. BURMAN: Doug Shackelford?

13 MR. SHACKELFORD: Doug Shackelford, University of North Carolina. I feel what  
14 we are doing is comparing a virgin conception to a consumption tax—

15 Income tax is 80 years old and in comparison it is the favorite it seems to me in this  
16 write-up because we just attack this thing viciously. But I think there may be another paper  
17 coming and that paper would be to think of what the legal judicial principles will come out that  
18 will solve this whole thing.

19 So you think about the income tax, as some replacement of the income tax, someone  
20 would have—it seems the only tower of tax that this paper believes that the law already has. So  
21 what we need is to be thinking about what would be the legal principles that the government  
22 would create. They have to create the paths in order to counterbalance some of this ability just  
23 run rampant with the current set of government constraints.

24 The second thing is I am not even sure, as I think about the issues raised about financial

1 statement effects and I think it is a very important implication. I am not even sure this would  
2 qualify for financial accounting purposes as income tax.

3 So I am not even sure if you end up with an income tax law on the financial statements.  
4 The whole attempt to reconcile financial accounting income and taxable income don't even seem  
5 to be messed up. The thing would have to be somewhere else. So the ability to look at financial  
6 statements for anything about the tax situation I fear would be lost and I am not saying that is  
7 good or bad, but it would profoundly change the disclosure and the knowledge that we  
8 currently can infer with some difficulty, of course, from the current situation we have got.

9 MR. SCHLER: I think that second paper may have to wait because we don't even  
10 have the statute yet. So we have no idea what the abuses will be. It is clearly the unknown party  
11 so it is hard to know what possible response there could be to the unknown abuses. About all  
12 we can do is look at the doctrines we have already, you know, form substance and anti-abuse  
13 rules and things like that and the problems are those you know we have a code as a result of all  
14 that stuff and case law.

15 And, you know, you read some of the VAT decisions in Europe for similar kinds of  
16 things. They read remarkably like *Gregory v. Helvering* and all that. They are all the same  
17 things. Economic substance. A couple of cases we cite, I read them. It is hard to believe that  
18 they are not U.S. courts deciding on some tax shelter. I mean, it seems to be a universal set of  
19 doctrines that we have already defined all over the world.

20 MR. SHACKELFORD: I think that if you were able to do the first paper, I am sure  
21 that you would be able to figure out how to do the second paper.

22 MR. SCHLER: I don't know, maybe Joe.

23 MR. BURMAN: Two more quick questions and then Ed will get the last questions.

24 MR. BRAZELL: David Brazell. Mike, you are thinking like a lawyer and not like an

1 economist.

2 MR. SCHLER: I agree. I am guilty.

3 MR. BRAZELL: Just to take some of your examples, your land example. If I purchase  
4 land, I get a deduction. Whoever I buy it from has to include that in their income.

5 MR. SCHLER: Unless they are a loss company.

6 MR. BRAZELL: If they are a loss company, then what we have done is restored  
7 symmetry to the tax code where losses are taken in full as well as income. I mean, what we are  
8 doing under the income tax today is we have got this basis treatment where the government  
9 benefits when there is gain and the government benefits when there is a loss. The point is, I  
10 think, the—this came up in '81 in the safe harbor leasing.

11 Most economists, I would think, at that time thought those were great ways to move tax  
12 benefits from taxpayer to taxpayer in order to restore some symmetry. I would say most tax  
13 lawyers opposed those provisions and saw them as tax shelters and labeled them as such.

14 MR. SCHLER: Well, let me just say I think if you combine effectively what is  
15 refundability of losses with immediate deductions for buying the land, that means if I buy enough  
16 land, I basically—the more I buy, the more money I get from the government. I mean, that puts  
17 a big premium on tax shelter. If any time you find any tax shelter you find you get a refund from  
18 the government. That is fantastic.

19 MR. BRAZELL: No, but every time you buy that land, someone else is included at the  
20 same time.

21 MR. SCHLER: But that assumes no tax—a world without tax shelters.

22 MR. BRAZELL: It is my understanding, under current law, most tax shelters really have  
23 to do with the deductions for debt, for interest, and deferrals that are involved and under the flat  
24 tax, both those things go away. Immediately I think you have a lesser problem there. And just

1 more in general, I don't see anything that you have mentioned—I didn't read the paper, I am  
2 sorry, but from what you said that doesn't occur under current law today.

3 We have gone through several years now of depreciation. There are some that can buy  
4 an asset and deduct 70 percent of that asset in the very first year. And I haven't heard much in  
5 the way of tax shelters. This is an environment where you can deduct interest on debt as well.  
6 And I haven't heard that that has been a real problem. Maybe it is just because of its temporary  
7 nature. I don't know. Let me just finish.

8 MR. SCHLER: Yes.

9 MR. BRAZELL: The pressure points, I think, in a flat tax are always slated business to  
10 nonbusiness transactions—business-to-business transactions. And I think if you went to an R  
11 plus F base, you eliminate a lot of the problems that will occur under the flat tax between the—  
12 in other words, we haven't escaped valuation of assets completely in an R base tax when we  
13 are dealing with business—the household business to fall under business with—whatever.

14 Those types of transactions can lead to problems or at least require some valuations of  
15 assets. You have to make decisions about what is real and what is financial. If you went to an R  
16 plus F, I think that solves a lot of the problems. The problem with that is that people in this room  
17 have gone eclectic just going from depreciation to expense and if you went to an R plus F base  
18 where—including the value of loans in your taxable income—it would have some business. So  
19 perhaps the easier solution is just not to. It is too big of an issue.

20 MR. BANKMAN: I mean, adding the F tax gets complicated a lot. On the other hand,  
21 it avoids certain problems and it is really a tradeoff.

22 MR. BURMAN: Harvey Galper.

23 MR. GALPER: Harvey Galper. A lot of this is the way that initially consumption goes—  
24 we talk about consumption of tax as a concern and what the concern here is that somehow we

1 are going to have less money than we anticipated because the money is not going to the  
2 consumer because how are they going to get the consumer. They are going to take it out of  
3 business. Now I would be in favor of R plus F tax. I think that also tightens up.

4 What we are saying here is that it is going to go crazy and we are worried the money is  
5 not going to come out and nobody is going to consume. Now we are not measuring the  
6 consumption, we are measuring it by the other side. We are measuring it by wages and a  
7 distribution of income to people, so the big concern here is that savings is going to go wild and  
8 the tax base is going to go up.

9 MR. HALPERIN: No, that is—Harvey, no. As long as you can borrow, that is not  
10 true.

11 MR. GALPER: That is why I think the R plus F base is—

12 MR. SCHLER: Yes, but that is not going to happen. That is a whole different system.

13 MR. GALPER: If you can take out the extent to which consumption has been taxed by  
14 loans, the basic argument that seems to be made that rises to a concern here is the money is not  
15 going to come out to people who will consume it. We seem to have found ways of getting  
16 money in the hands of consumers.

17 So if this is a problem that we could have, I am just trying to understand the logic here. I  
18 am not saying I favor one approach or another approach, but the argument that seems to me is  
19 that money is not going to come out to people so they can consume it because if it comes out, it  
20 will be taxed. So it seems to me that is the problem we should be considering.

21 MR. SCHLER: Yes, but we are not worried about the increase in savings. You can  
22 borrow the money and get a deduction with it under the system we are talking about.

23 MR. GALPER: So make it the opposite.

24 MR. SCHLER: Yes, that would solve a lot of the problems. I agree.

1 MR. HALPERIN: Ed Kleinbard.

2 MR. KLEINBARD: Just a little footnote, a little follow-up on, I guess it was Doug  
3 Shackelford's comments about this paper being one that Michael has the better of the  
4 arguments. But the next paper Joe will because we will think more creatively about solutions—  
5 extra statutes and other solutions to the problems identified in the paper.

6 One of the interesting themes that I sort of noticed today and in other similar settings is  
7 that practicing tax lawyers as a group I predict—I obviously have not taken a formal poll—but  
8 practicing tax lawyers who try to think about these issues probably are, on balance, like Michael  
9 more comfortable with an income tax than a consumption tax. And there are a number of  
10 reasons why that might be so.

11 And it goes to the idea that was referred to in Doug Shackelford's comment. And one  
12 possible explanation is because, you know, we want to protect our livelihood. And I don't think  
13 that that one actually holds water. Michael and I at least are old enough not to care.

14 MR. SCHLER: Yes, but the more things change, the more money we make.

15 MR. KLEINBARD: Another reason, which David would suggest, except we are too  
16 dim to get it, which may be true. But I think there is this other theme that does come up in some  
17 of Doug's comment that Michael alluded to as well, I think, a minute ago, which is that we have  
18 80 years of history, which represents a tremendous investment of intellectual capital in the  
19 current system.

20 And yes, we have got lots of things wrong, but by the same token, there are also tens of  
21 thousands of other things, which we tried and rejected. We have tried all sorts of experiments,  
22 we have gone down all sorts of avenues that turned out to be dead ends.

23 So there is this huge investment of intellectual capital in the current system and I think  
24 there is a natural—I think an admiration of that may be perverse, but true, among practicing tax

1 lawyer and a concern that that second paper that Doug alludes to would be one that would take  
2 another 50 or 60 years before we would know enough to write.

3 MR. BURMAN: I think we have a brief wrap-up session. We are going to still try to  
4 stay a little bit ahead of schedule.

5 You don't want to hear what we have to say, Jane?

6 MS. GRAVELLE: Well, I am going to listen, but I am going to listen over there.

7 MR. BURMAN: Hank, you want to start?

8 MR. AARON: I have written out some comments, but I have become more modest  
9 about my confidence in them so I am simply going to cover one of the points that occurred to  
10 me before the meeting.

11 Like more than most people here, I have learned a lot from this conference in large  
12 measure because I haven't been keeping up with the literature as well as many people here in  
13 the room and it has forced me to do so. And the thing that I spent, perhaps, more time on than  
14 anything else was what I will call the "it doesn't make much difference" literature of which David  
15 Weisbach has an excellent article in the *University of Chicago Law Review*. There is a paper  
16 by Gentry and Hubbard often referred to today. George Zodrow's paper here, Al Warren has  
17 a paper as well, and Joe Bankman.

18 I think the result of this literature is that all that is at stake in the debate between an  
19 idealized pure consumption tax and an idealized pure income tax is the rate of time preference  
20 multiplied by the value of the capital stock where the rate of time preference is taken to be very  
21 low and I think Joe has suggested as low as half a percentage point. I am going to round that up  
22 and assume it is 1 percentage point for the sake of my comments. What I am going to suggest is  
23 this is a debate that is important and a lot is at stake even if one buys fully into that framework.

24 Here is the line of reasoning. The U.S. GDP this year will be about \$13 trillion.



1 Economists tend to take the capital output ratio to be about three. So that gives you a capital  
2 stock of about \$39 trillion and I am going to ignore whether that capital is owned by U.S.  
3 citizens or tax subjects or foreigners. That implicitly treats cross ownership as zero. That is not  
4 quite right. The United States has become a net debtor, but forgive me.

5 I am also going to take what is sort of conventional among economists, which is that  
6 labor share is about seven-tenths of output, capital share is about three-tenths of output, and at  
7 the average tax rate, federal, state, and local, there is about a third.

8 But if we take Joel's estimate, then the average effective rate of tax on capital income is  
9 about .1. I am rounding down just a bit. You will see why. It is for numerical convenience. So  
10 let's take the riskless rate of return as 1 percent, which is a bit higher than Joe's number. Then  
11 the riskless yield on the U.S. capital stock of \$39 trillion is \$390 billion a year.

12 That is a large number and it seems to me that it would justify a fair bit of debate and  
13 attention. It is not chump change. I have ignored, in citing that number, the very substantial  
14 amount of redistribution among and within income classes and among businesses that would  
15 result from replacement of the current tax system with a wage tax on individuals and a value-  
16 added tax on businesses.

17 We all know that distribution matters and it would matter a lot whether we accept the  
18 Toder–Rueben estimates or the Gentry–Hubbard estimates. In any event, this is a big debate. It  
19 isn't just the time value of money times the capital stock here as if that didn't amount to much. I  
20 think it amounts to a lot.

21 Gene Steuerle isn't here. He helped organize the conference and he sent in some  
22 comments written after looking at the various papers and I would like to put them on the record  
23 as well. They may provoke some discussion.

24 Gene writes, "I can't figure out why we put so much emphasis on putting the rich into a

1 consumption tax while leaving the poor and middle class in an income tax world where they will  
2 almost inevitably remain because of the fadeout benefits of various programs ranging from  
3 educational aid to wage subsidies. No one is arguing to move them to a consumption tax. Why  
4 don't we start by giving exemption from capital income for those with modest amounts of  
5 income or for the first few percentage points of return on assets?"

6 He hazards the guess that the answer is political, not economic. He then goes on to say,  
7 "If that argument is correct, we would, in fact, need to retain much of the income accounting that  
8 is associated with an income tax so that a great deal of simplification is simply out the window  
9 outside of things like expensing versus depreciation. And in this world, we would have both a  
10 consumption tax and income tax accounting and reporting systems to some extent."

11 He then goes on to write, "The compliance issue is big in a consumption tax"—here I  
12 think echoing Schler—"because the amount at stake is sometimes bigger than it is in an income  
13 tax as shown by various examples in their paper. Taxpayers do try to reduce taxes now on the  
14 hopes that later the law will change, they won't be caught, or if they are bankrupt, somebody  
15 else will be left with the tab. This throws all the risk on the government for making the equivalent  
16 of loans, even at market rate, to individuals. In other words, who is left insuring the loan."

17 The next comment he made was "The general equilibrium models never said that a pure  
18 consumption tax was the most efficient of all worlds. What they said, combining supply-side  
19 effects related to marginal rates, elasticities of saving assumed to be higher assumed to be higher  
20 than elasticity of labor supply," which he says as an aside, he thinks is an unproven assumption,  
21 "and inefficiencies that arose with the square of the tax rate. What the literature says was that  
22 the tax rate on capital should be lower than that on labor, but not zero."

23 He concluded by saying—well, no, there are two—there is one other point first. Gene  
24 expressed the belief that the benefit theory of taxation leads to the taxation of individuals for the

1 benefits they receive now like defense and a legal system that allows the accumulation of wealth.

2 “Consumption tax has suggested we should not pay taxes on our benefit from the  
3 government, at least currently.” Then Katrina did come into this. “Similarly, who should pay for  
4 helping people after Katrina if we make a societal judgment to share the losses.”

5 And his final remark was, “If I were summarizing for the conference, however, I would  
6 state the one or two items that still lean toward consumption taxation: the equity of the saver  
7 versus the spender, all other things being equal, and the fact that we essentially expense  
8 educational expenses because most are provided by the government or by businesses who are  
9 learning on the job. So it is not clear why physical investment should be treated worse than back  
10 to a ways of getting at then, in effect, labor income, human capital.” So let me stop.

11 MR. BURMAN: Dan?

12 MR. HALPERIN: I guess I remain skeptical about whether a change makes sense. I  
13 think the last few pages of Eric Toder’s paper, which he ran over in about six seconds, do  
14 summarize pretty much what I think and David Weisbach’s slide up about why we are still  
15 skeptical did raise the question that I would raise.

16 I think it is not enough to know that the direction of “improvement” might be in favor of  
17 a consumption tax as opposed to an income tax. We need to know a lot more about magnitude.  
18 If we are going to undertake an experiment of this size and this uncertainty, it seems to me you  
19 want some evidence that—or strong evidence that there is a potential big payoff, not that there  
20 is a potential payoff.

21 And since I think there is almost no chance that we wouldn’t have generous transition  
22 rules, the evidence, at least as I see it, indicates that you have to be skeptical about how big the  
23 payoff will be in terms of future growth.

24 I am also very concerned about whether we can keep the same distribution of after tax

1 income. Eric's paper showed that that would require significantly higher rates than we have  
2 today and I think what would make it even more difficult is that most the people who would be  
3 subject to this 45 percent rate would actually have a significant tax increase.

4 It is only the very few who get almost all their income from capital and very little from  
5 labor who would get the tax cut and to suggest that we are going to get this group of people to  
6 be subject to this kind of high tax rates when it does lead to a tax increase strikes me as very  
7 problematic.

8 I am also troubled by the argument that it is going to be both simpler and less distortive.  
9 Putting aside what we have heard over the last panel, I agree with what Alan said earlier: zero is  
10 not the minimum. Congress is going to want to continue to have tax expenditures and to provide  
11 incentives through the tax system. Much of the distortion in the income tax is, as was also said  
12 earlier, self-inflicted and not the result of the technical difficulties of measuring income.

13 Favoritism for housing and the mortgage interest deduction. I would be shocked if that  
14 disappeared. I think state and local governments are going to insist on preferences for issuing  
15 bonds and all kinds of other sectors that have preferences today are going to want to continue  
16 to have them.

17 We saw that difficulty with efforts to get integration or efforts to turn—make dividend  
18 relief depend upon whether the corporation actually paid taxes. Those with preferences fought  
19 that effort to reduce the overall tax burden on corporations to zero. Those who were closer to  
20 that didn't want that to happen.

21 I think also the question of whether we are actually going to get significantly more  
22 savings, particularly if you expect generous transition rules. It depends a lot if you believe the  
23 evidence that suggests that the difference between the two taxes are fairly narrow. That would  
24 suggest to me that the chances of change of increasing savings have got to also be fairly small.

1           And I think you have got to worry about the fact that qualified plans will no longer make  
2 any sense and therefore they will not exist any more. Therefore, even if we do get more savings,  
3 we are likely to get a lot less savings by lower, moderate workers unless we do something else  
4 to change that situation.

5           I do worry, on the other side that, as Ron suggested, that the income tax system, with all  
6 the pressures that are on it, may well self-destruct, political forces will help, and you could end  
7 up with no tax on capital and an interest deduction and if that is the world we are headed to,  
8 obviously a consumption tax would be preferable. And I think that is the concern on the other  
9 side.

10           But I think we are certainly not there yet and if there is a will, I think a lot of the  
11 discussion today indicates we can improve the income tax system. We may not have the will to  
12 do it, but if we are talking in the world of possibilities, it is certainly possible to do it.

13           MR. BURMAN: I am looking at my notes and I am thinking about the old saying that  
14 everything has been said, but not everybody has said it and my reward for having been quiet  
15 through the whole conference is I get to repeat what everybody else has said. No, this was all  
16 new when I wrote it last night.

17           So what did we learn. We learned from this conference I think that there is still a huge  
18 amount of uncertainty, for everybody except for David, about the current tax system and a  
19 plausible real world consumption tax. Do we tax capital income? Maybe. You know Rueben-  
20 Toder pointed out that low- and middle-income people are already effectively under an income  
21 tax regime because most of their savings are in houses and retirement plans and thus tax free. So  
22 the debate is really about how we tax people at the top.

23           Slemrod and his colleagues argue that we don't collect much tax from capital income.  
24 Jane Gravelle says, oh, yeah, we do. We certainly could do a better job of taxing capital income

1 at least if we let Roin and Kleinbard tighten things up.

2           Should we tax capital income? The same answer. With all the criteria of good tax  
3 policy, we can't say for certain, or at least with unanimity, what the right answer is. According  
4 to Schler, shifting to a consumption tax would open new avenues for evasion and avoidance.  
5 Coauthor Bankman says the shift would be a big improvement over current law. Zodrow  
6 reviews the economic evidence and finds small but significant efficiency gains under plausible  
7 circumstances and believes that vertical equity concerns could be addressed.

8           Rueben and Toder look at the same evidence, but they are more skeptical of the  
9 modest efficiency gains in the real world and raise practical concerns about maintaining  
10 progressivity. It is not even clear this shift to consumption tax would increase savings because of  
11 the reasons that Dan just said.

12           Would a consumption tax be simpler than our income tax? Probably. But not by as  
13 much as assumed by many proponents. There is a strong argument that if a broad-based  
14 consumption tax is fairer on horizontal equity grounds, then why tax savers more than  
15 spendthrifts? But that is not necessarily decisive.

16           Theoretical consumption taxes are things of beauty, sort of like theoretical income taxes,  
17 but how good would a real world consumption tax be? Consumption tax proponents seem to  
18 conclude that the loopholes in the current system are inherent in income tax, and certainly the  
19 experience after 1986 suggested that the income tax reform is transitory, but they also tend to  
20 assume that a flat tax and an X-tax would be less prone to distortion by political forces and  
21 certainly George argued that in his paper.

22           Maybe, but the experience in the rest of the world with the VAT suggests the  
23 exceptions and preferences are the norm just as under the income tax. And the flat tax-or the  
24 X-tax deductions and credits are just as feasible as under the income tax. So why would they

1 be the less prevalent? And if we do have a loophole-ridden X-tax, would we be able to raise  
2 enough revenue with capital exempt to finance the government without pushing rates through the  
3 roof?

4 Can we really not tax capital income even if we want to? Schler says that exempting  
5 capital income gives taxpayers a huge incentive to re-characterize compensation as capital, but  
6 there would still be, at least implicit, income taxes for low- and middle-income people, Gene's  
7 point, which Hank read, and as states continue to have income taxes, individuals would still have  
8 to measure income for state purposes.

9 My conclusion is that the shift from an income tax to a consumption-based tax would be  
10 the largest riverboat gamble undertaken by this country since the enactment of the income tax.  
11 So does that mean we shouldn't try it? Well, not necessarily. I mean, the immediate winners  
12 from such a policy would be those with high incomes, at least those who don't plan on spending  
13 and consuming everything right away. If they want to take the risk, why not let them.

14 The concerns about the riverboat gamble rest on, I think, two noneconomic issues.  
15 First, the potential gain in economic efficiency produces the potential for a system that works  
16 better for everyone, including those with low and middle incomes, in the sense that the pie could  
17 be much bigger, but there is still a problem with how the pie is sliced up.

18 The apparently inexorable trend of the past 30 years has been increasing in inequality  
19 and stagnation at the bottom and there is a concern that the shift to a consumption-based tax  
20 would make that worse. Second, without taxes on capital income or the normal return to  
21 capital, there is the possibility there would be massive accumulations of wealth and power  
22 among a few households.

23 Notwithstanding the rhetoric sometimes used by the right, the efficiency gains, even if  
24 assured, are not sufficient to justify an economic policy shift unless the losers are compensated.

1 And in this case, as in almost all of the others, they never are. But why—I guess the question for  
2 policy is—if we actually wanted to move to a consumption tax, why not build compensation  
3 mechanisms into the tax policy process?

4 Bob Schiller, in his recent book, suggested the tax system be indexed for inequality. He  
5 proposes this as a way to provide insurance for economic risk so that the market can't. But his  
6 scheme would also make potentially growth enhancing shifts much more attractive to people at  
7 the bottom.

8 His scheme, which would adjust transfers in tax rates to prevent inequality from  
9 worsening from year to year guarantees that people, throughout the income distribution, would  
10 gain from increases in economic growth. So the question is whether the cost of such a  
11 compensation mechanism would be worth the expected gains.

12 Basically this is a way to buy low- and middle-income people into the system where,  
13 alternatively, you could institutionalize a strong economic safety net for low and middle income  
14 people. For example, by guaranteeing health insurance coverage, an issue that could be a whole  
15 other conference, and subsistence income for working families at the same time the tax system is  
16 streamlined for growth.

17 The deal would be the progressives get the safety net they want in exchange for getting  
18 conservatives the tax system they want. Again, the question would be whether the tax system  
19 would be worth having given the tax rates would be necessary to finance the expanded safety  
20 net.

21 The point is that when you think about a potentially growth-enhancing policy, you have  
22 to also think about the cost of the compensation mechanism. Otherwise, don't be upset when  
23 you discover that the lower-middle-income people who are bearing the risk don't want to buy  
24 into it and in a democracy, it just doesn't happen. And the concerns about the intergenerational



1 transmission of wealth and power can be addressed via the robust inheritance tax. There—I will  
2 just go right by that one.

3 There are other issues, of course, as Rueben and Toder point out, in any progressive  
4 consumption tax, there will be a lot of redistribution within the very, very top. Is it a problem if  
5 Bill Gates pays a little less tax and Bill Gale pays a little more. Not for me, but Bill Gale gets  
6 really ticked off at the notion. I am really sorry he is not in the room now.

7 (Laughter.)

8 MR. AARON: And he knew you were going to say that.

9 MR. BURMAN: I think so. Any comments? Questions?

10 MR. KLUMPNER: Just one final thing.

11 MR. BURMAN: Jim Klumpner.

12 MR. KLUMPNER: Jim Klumpner, Senate Budget Committee. It was the point that  
13 Doug made at lunch, which is all of these analyses are based on a false premise, which is that  
14 the Congress will change the tax code and leave it alone for a long period of time and that all the  
15 tax lobbyists will open bed and breakfasts in Vermont or something.

16 We have had four tax changes in the last three years. How would your analyses change  
17 if you built that assumption into your projections, that we would be constantly changing the tax  
18 code? You don't have to say anything. It is a rhetorical question.

19 MR. BURMAN: Jane?

20 MS. GRAVELLE: I think we kind of glossed over the transition issue with consumption  
21 taxes. If you stop and think what the transition issue involves, it involves the accumulated  
22 depreciation of entire capital stock that we would have to give to people. If we wanted to really  
23 restore their asset value, we have to give it to them right away, that day. Well, we can't spread  
24 it out. That reduces the present value.

1           The accumulated inventories for sale would not be deductible unless you had a transition  
2 rule. Any asset that you sell like a building would have a zero basis for capital gains. I mean,  
3 Congress can't even stand a 15 percent tax rate for capital gains with basis. You are going to  
4 sell a building, you are going to have pay the tax on the whole amount.

5           In a flat tax, if you use that approach, you don't need a price accommodation, which is  
6 nice for the macroeconomy, but it is a killer for equity owners because they have to pay the tax  
7 on assets not only for their equity share, but for the whole thing. So if you have got a building  
8 and your tax is 20 percent, then half of it is debt-financed, you have a 40 percent hit on that  
9 building. If it is heavily leveraged, you have a tax that is bigger than your equity interest in an R-  
10 based system where you don't have financial assets.

11           The amount of revenue that you would have to spend to do anything close to  
12 compensating people for these assets is enormous. We keep talking about we can do transition,  
13 we can pay people off. Somebody ought to sit down and add up all those numbers and talk  
14 about what we would have to do in present-value terms to offset that transition cost.

15           If you don't, then I think maybe businesses will live with losing their depreciation  
16 inventories. But I don't think these real estate guys are going to be willing to pay tax on the  
17 entire value of their building when they sell it and I think that, if nothing else, it is going to create  
18 an insurmountable barrier to doing a consumption tax without transition. So I just think transition  
19 is everything in this.

20           MR. AARON: Just at the risk of putting in a plug, the book that Bill Gale and I edited,  
21 to which he referred before and I am now referring again, published by Brookings about a  
22 decade ago, did exactly what Jane asked for. So if you would like to take a look, they are stale  
23 numbers, but if you want to get a flavor for what are the numbers that were involved then, we  
24 did do it then.

1 MR. BURMAN: Actually, you reminded me. Gene Steuerle wanted me to tell you that  
2 there is an article of his out there that spelled out his argument about the requirements for  
3 income measurement under a consumption tax.

4 David?

5 MR. WEISBACH: I will object to you saying that it is conservatives that support  
6 consumption taxes. I have never considered myself a conservative and yet I support  
7 consumption taxes and people that care a lot about the plight of the poor can care about  
8 consumption taxes.

9 And the second thing, on transition with Jane, I guess I do want to see numbers, but we  
10 have had negative taxes in capital before, we have had zero taxes in capital, we have had  
11 positive taxes in capital. We have managed to do it. We maybe have not done it very cleverly,  
12 but we have managed to do it. I don't see why we couldn't not have the government go  
13 completely bankrupt. We had deficits at the time, but it wasn't undoable, unimaginable, let's not  
14 even talk about it, let's go home and, you know, do something better with our time. We have  
15 done it before. I don't see why we couldn't manage to do it again.

16 MR. SCHLER: So if we give those people a big credit for their basis so they sell this  
17 building, they don't pay tax, they sell it for their basis, let's say, which includes the debt, then  
18 they buy another building with the proceeds. Are we going to give them a deduction for that  
19 also? So no tax on the sale and you get a big deduction. Everybody will be rolling over their  
20 buildings and getting these giant deductions.

21 MS. GRAVELLE: Well, if you want to compensate people for the capital hit, you have  
22 to pay them off instantaneously in the amount of their loss in capital. So all the people who own  
23 stock who, say, with a 20 percent tax and a third debt, their stock value should, now they might  
24 not, should, if this is going to work, fall by 30 percent. You need to pay them off 30 percent of

1 their stock if you don't want them to lose it and you can't do it over time, over 10 years. That  
2 will be a different present value, you have to do it today.

3 Just some—I don't know what kind of games people can play if you do pay people up.  
4 I mean, you probably know more about that than I do. But I am just saying this is a huge, huge,  
5 huge, huge cost and I think before anybody talks about going to a consumption tax, they need  
6 to think about whether you can get by with this hit on old people or—sorry, Henry, I know we  
7 talked about gray hair a lot today—this hit on existing capital or whether you think you can  
8 figure out some way to pay it off. Otherwise, I think we ought to go home and think about  
9 something else like maybe improving the income tax.

10 MR. BURMAN: David, let me just clarify. I was talking about the political debate. I  
11 know you have taken seriously distributional concerns in everything you have written, just like  
12 David Bradford did. But the problem is in the political debate, as you noted on your slide earlier  
13 where there was a high correlation between people who would like to starve the beast and  
14 people who would like to replace the income tax with a consumption tax.

15 Are there any other comments or questions?

16 (No response.)

17 MR. BURMAN: I would like to thank all of the presenters and I would like to thank  
18 you all for staying to the bitter end and we will be posting revised papers and eventually there  
19 will be a volume available. Thanks very much.

20 (Applause.)

21 (Whereupon at 4:55 p.m., the conference was concluded.)

22 \* \* \* \* \*