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REFORMING TAXATION IN THE GLOBAL AGE

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Panel 1: Tax reform: Strategy and Specifics

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PROCEEDINGS

MR. SUMMERS: As a member of the Advisory Committee of the Hamilton Project, I am delighted to welcome you to this Hamilton Project Tax forum, what surely is a consequential juncture with respect to American tax policy.

I'm going to begin the program by talking a little bit about the main conclusions of the Hamilton Project policy paper, "Achieving Progressive Tax Reform in an Increasingly Global Economy," that was authored by Jason Furman, Jason Bordoff, and myself, and then we'll turn to the panel, which will examine a number of specific policy proposals.

It seems to us that in looking at the tax system and looking at issues in the design of future tax policy, one has to, as is traditional, look at the tax system in terms of the traditional tax imperatives of fairness, neutrality, and simplicity -- the traditional principles around the desirability of progressivity and a broader base with lower rates -- and has also to look at the tax system in the context of the current economic situation and the structural changes that have taken place in the American economy, reflecting the timeless character of the first set of internal tax (inaudible). Our paper is more focused on the set of issues that are raised by the evolving changes in the U.S. economy.

Three trends seem to us to be paramount in thinking about the future of the tax system. The first is the continuing reality that the nation's

finances are on an unsustainable course. There is a frequent debate about the relative merits of deficits, revenue increases, and spending cuts. It is essentially a false debate, because deficits are not an alternative to revenue increases or tax cuts; they are a means of postponing and magnifying them, postponing them because you're borrowing money, magnifying them because of the accumulation of interest; and it is our judgment -- and we are not aware of persuasive contrary judgments -- that if one looks over the medium and long term, there is a clear gap between projected revenues and projected expenditures realistically calculated, a gap that has substantially been exacerbated by the tax policies that have been put in place in recent years.

A second trend is toward a major increase in inequality. The paper calculates using CBO data that by comparing the income distribution in 1979 and 2004 -- that if the -- if in 2004 the income distribution was the same as it had been in 1979, and the level of total income was the same as it was in 2004, those in the bottom 80 percent of the income distribution would have $664 billion more in income each year or $7,000 per person or 14 percent more income than they had previously. In contrast, those in the top 1 percent of the income distribution would have a comparable figure just under $700 billion less in income, that this would represent close to $600,000 per person or a 43 percent reduction in their income. These are annual figures and reflect a very large trend toward inequality. The middle group, from the point view of this calculation, those not in the top

1 percent but in the top 20 percent, has had a share of income that has remained roughly constant. Movements of this magnitude in the degree of pre-tax inequality, which appear to be part of a continuing trend, are entirely without precedent in the post-war period.

A third large trend that is shaping the reality in which the tax system has to operate is the increasing integration, information content, and complexity of the contemporary economy that manifests itself in a tremendous increase in the extent of integration in business activities across international borders. More than half of U.S.-manufacturered trade takes the form of transactions that occur within companies rather than between companies.

The pervasive use of information technology and what that has made possible in the financial sector that has eroded the traditional distinctions between debt and equity, between ordinary income and capital gains, as all kinds of financial flows can be and are contrived, and it seems to us that the proper focus of tax policy has to be informed by these three structural changes. We suggest six principles that give guidance in the years ahead.

First, fiscal responsibility requires both addressing taxes and spending. We reject as empirically falsified by experience the logic of the starve-the-beast theory that tax cuts lead to reductions in spending or that tax increases lead to increases in spending, suggesting instead that commitments to fiscal responsibility lead to both and abandonments of commitments of fiscal

responsibility lead to neither and urge that in the years ahead it is important that deficit reduction be a continuing, though certainly not sole, focus of economic policy.

Second, rising inequality strengthens the case for progressivity in an economy where the benefits to consumers in holding down inflation, in creating markets of international trade, are increasingly manifest in an economy where the benefits of rigorous competition are increasingly clear. The kind of combination of inflation and unemployment that we're seeing today would have been unimaginable at the time when I left graduate school or even in the late 1980s. It is best not to address the enormously salient concerns about inequality by interfering with trade but, rather, by ensuring that the fiscal system works to create a more level and more equal playing field. We suggest in this regard that it is ironic that as inequality has increased, the average tax rate for the top .1 percent of the population has been cut nearly in half since 1960, while the average tax rate for the middle income quintile has actually increased, and we urge that policymakers should restore the tax system's progressivity, at a minimum, by restoring the Clinton-era tax rates for families making more than $200,000.

Third, the tax system in 2007 and beyond, with all that information technology makes possible, should do more to collect the taxes that are owed. Although I don't think the paper says it, I will, that we live in an economy where the American Express, VISA, and MasterCard organizations are successful in

collecting all that is owed within 30 days on expenditures that are placed at 30 million locations around the world. It staggers the imagination that the federal government of the United States is incapable of collecting 15 percent of the taxes that are owed each year. That 15 percent represents today close to $400 billion a year and, over the next decade, $5 trillion. The taxes that are not collected fall on categories of income principally involving in one form or another capital income that are disproportionately received by taxpayers in the upper of the income distribution. We suggest that there are a number of measures that could and should be taken to collect significantly more of the taxes that are owed: improvements in IRS customer service; restoration of the level of enforcement activity, especially for high-income taxpayers and corporations; appropriate reporting requirements on other forms of income that more closely approximate the reporting expected on wages so as to increase tax compliance; and simplification of the tax code.

Fourth, tax reform should strengthen taxation at the business level. Jason, Jason, and I yield to no one in our enthusiasm for basic and applied research. We believe strongly in the crucial role of the patent system in the American economy in spurring basic and applied research, but we are puzzled by the social utility of a patent system that grants patents to tax avoidance schemes as the Patent Office has done on a significant scale in recent years. We suggest that this is the tip of an ice burg of very substantial resource-consuming

avoidance and evasion activity that comes at a very high cost to the Treasury.

The United States currently has the highest corporate tax rate, one of the highest corporate tax rates in the OECD, but nonetheless manages, despite a record level of corporate profitability, in having the fourth lowest corporate tax revenues as a share of GDP in the OECD. Let me say that again -- one of the highest tax rates, one of the lowest revenue shares despite record corporate profitability.

As Professor Desai and others work as documented, this is not unrelated to what is now a gap of nearly $400 billion between the reported income of corporations to their shareholders and their income as reported on their tax returns.

You will hear in a few minutes about a variety of the specific issues which go to questions of international integration, go to transfer pricing, go to questions of transparency, and go to questions of financial innovation and its relationship to the sheltering of income. We suggest that the potential gains from reforms in these areas are surely in the tens of billions of dollars.

Fifth, taxes for individuals should be simplified. We continue to note the complexity of our tax system, the significant losses in revenue that arise from mistakes that in turn arise from the complexity of the tax system, and suggest that policymakers should consolidate tax subsidies with similar purposes, should offer reform-free filing, and that in the years ahead reform or repeal of the

alternative minimum tax in a fiscally responsible manner is an imperative.

Finally, sixth, we suggest that social policy can and often should be advanced through the tax code, but note how important it is that such measures be well designed. We urge that the tax code play an important role in a range of activities, like promoting health insurance, charitable donations, and higher education. We note that for reasons both of a political process and of the global administrative process there may well be situations in which support for families in meeting their needs is more efficiently provided through the tax code than through spending programs but urge that those policies, rather than simply being attacked by tax experts, should be focused on with the objective of making them more equitable and efficient, including by looking at issues of turning deductions into refundable credits, limiting credits to prevent inappropriate subsidies to huge homes or more expensive colleges, and that in the years ahead the theme of using the tax code to discourage things that we wish to discourage, such as carbon emission, because of externalities should occupy a larger role in tax policy thinking.

This is a tax reform agenda with a somewhat different slant than many that are presented, because it is oriented less to the internal imperatives of the tax system but to the external needs of the economy. But we believe that these considerations for the tax system are of paramount importance in the years ahead.

Let me now -- and we will have ample time over the course of the morning to discuss these issues, but let me now introduce Jason Furman, the director of the Hamilton Project, a former PhD student at Harvard University, someone with -- current Senior Fellow at the Brookings Institution with an extensive record of writing in applied economics and economic policy, to carry on the next panel.

Jason.

(Applause)

MR. FURMAN: Thank you, Larry, for explaining our paper much better than I ever could have.

(Laughter)

MR. FURMAN: Wanted to just explain our format to you, very briefly introduce the extensive collection of people we have up here, and then get started.

This first panel -- we're going to be discussing three specific policy proposals that the Hamilton Project is releasing today. They're all discussion papers, and like all Hamilton Project discussion papers, they're offered in the spirit of discussion and debate, not necessarily endorsed by the Project but fit in with a set of themes that Larry just outlined as part of our strategy paper.

We then have -- this Greek chorus will be with us for the whole morning, and any specific comments they have on the first set of papers they'll be

talking about now, and then on the second panel Larry will rejoin us; Bob Rubin, who's also on the Advisory Counsel of the Hamilton Project; and Alan Murray from the Wall Street Journal as moderator and that will be a broader discussion of the tax issues that we've been hearing about all morning.

So, we'll do very, very brief introductions of everyone up here and then turn it over to Lily with the first policy proposal.

Lily Batchelder is an associate professor of law in public policy at NYU Law School. She previously practiced at Skadden, Arps and works on issues about income taxation, wealth taxation, and social insurance.

After Lily, Kimberly Clausing in a paper coauthored with Rueven Avi-Yonah. Kim is a professor of economics at Reed College and was a staff economist at the Council of Economic Advisors and has done substantial work on the taxation of multinationals.

Our third policy proposal will be Ed Kleinbard, who is a partner at Cleary Gottlieb and *Who's Who of Corporate Tax Lawyers* named him one of the 15 top tax lawyers worldwide, and I've gotten to know him well at the NYU Tax Policy Colloquium over the last few years, and he has -- well, you'll hear his very innovative ideas.

And then the panel that we have with us for both this session and the next session includes Bill Gale, who's the Vice President and Director of Economic Studies at the Brookings Institution, and he's the R.J. and Francis

Miller Chair in Federal Economic Policy at Brookings. He's the co-director of the Tax Policy Center, also a former staff economist at CEA and a recognized national expert on all these issues, as everyone else here is.

We have Jon Talisman, who is Capitol Tax Partners, was Assistant Secretary of the Treasury for Tax Policy in the late 1990s and also worked on Senate finance and JCT.

Mihar Desai, who is a professor at Harvard Business School and specializes in corporate and international taxation.

Pam Olson, who is a partner at Skadden, Arps, was Assistant Secretary of the Treasury for Tax Policy in the Bush Administration, replacing Jon Talisman, and formerly worked at the IRS.

And then not here yet but will be here for the second panel, is Mark Prater, who's the Deputy Staff Director and Chief Tax Counsel at Senate Finance where he's worked since 1990. So, a lot of our panelists have actually worked on every piece of significant tax legislation, in some cases for it and in some cases against it, over the last 15 or 20 years. So, we'll be able to discuss some of that in our second panel.

And I turn it over to Lily Batchelder.

MS. BATCHELDER: All right, I'd like to first thank the Hamilton Project and Jason for organizing this event, and I'd also like to thank the Tax Policy Center and especially Laki Khitatrakun for their help on the estimates that

underlie this proposal which I'll be talking about.

So, I think we'll start with a quote from Franklin Delano Roosevelt in 1935. He said that "Inherited economic power is as inconsistent with the ideals of our generation as inherited political power was inconsistent with the ideals of the generation which established our government," and I'd like to suggest that we've strayed too from those ideals, and this first figure shows just how far. It shows that in 2009 the average tax rate on inherited income will be about 2.5 percent, and the average tax rate on all other household income will be about 18.5 percent, about seven times higher.

I think this means we need to fundamentally reconsider the way the tax code handles inherited income, and what I'd like to propose is that rather than repealing the estate tax we replace it with an inheritance tax that's integrated with the income tax and consider having it raise relatively more revenue.

As all of you probably know, we are going to have to confront changing our taxation of wealth transfer somehow pretty soon within the next administration. The reason is that the 2001 tax bill repeals the estate tax in 2010 and then it reinstates it in 2011 with a different rate structure. So, this creates a huge amount of uncertainty. It creates fodder for a lot gruesome jokes, and it also means, though, that we have this unusual opportunity in the next two years to really think about how we should tax inherited income, knowing that some change is going to happen -- has to happen legislatively.

So, this is how the tax code now works -- well, actually in 2009. As always, all income is generally subject to the income tax, whether it's from work or saving or winning the lottery, but if you inherit a gift or bequest, that is not subject to the income tax whatsoever. You just exclude it from your tax return. The only tax that might reach this inherited income is the estate tax, and the way that it works -- I'm just going to focus on bequests, because they're really the lion's share of wealth transfers. The way it works in 2009 is that the first $3.5 million of lifetime gifts and bequests is tax free, and then additional amounts are taxed at a rate of 45 percent, and any tax due on appreciation of an asset that's transferred is just forgiven entirely. What the proposal would do is it would allow people to inherit $2.3 million over their lifetime entirely tax free, and then additional amounts would be included in income and subject to a 15 percent additional tax on those additional amounts above 2.3 million.

This $2.3 million figure is just picked to make the proposal revenue neutral relative to 2009 law. Transfers to spouses will continue to be tax exempt. We could continue to exclude transfers to charities and a variety of other exclusions that exist under the estate tax, and if you inherited an appreciated asset, the heir would pay the tax that was due on that appreciation but only when they sold the asset. There would also be a broader provision for family businesses that's essentially designed to neither encourage nor discourage holding assets in this form.

There are a number of efficiency and simplification advantages to this, but what I want to focus on is maybe the most important advantage of the proposal, which is that it would be more equitable. It creates incentives to give more broadly and to more regular people, and it bases tax burdens not on the success of the person that has built up a large estate but on the privilege and affluence of the people who are fortunate enough to inherit it. And you can see this in these two figures. This is the average tax rate on all inheritances under the proposal and under 2009 law and, as you might expect, the proposal taxes larger inheritances more and smaller inheritances less. The estate tax taxes larger estates more and smaller estates less.

One other thing to note is that the top figure shows that both the estate tax and the proposal are borne predominantly by very privileged heirs, and there's another graph in the paper that looks at this by the heirs' economic income. It's also borne very heavily by the most affluent heirs. What the figures don't show, though, is how the burdens of the two taxes vary at an individual level. So, you might think that these aren't huge differences; it's the sort of work (inaudible).

So, what we did is we looked at the average tax rate on individual heirs under the proposal and under the estate tax, and we were pretty surprised by what we found. So, this is scatter plot. Each dot represents one heir. If there's sort of a big circle, that means there's a lot of heirs at that point, and you can see that there's not a lot of correlation here. The correlation is .23. The basic reason

is that even though those taxes are only burdening heirs and, as the previous graphs showed, they're only burdening very privileged heirs, estate tax burdens can vary pretty widely for no clear reason. So, just to give you an example, let's say that someone inherits all of a $3 million estate. In 2009 there would be no estate tax that's under the $3.5 million dollar exemption. And then let's take three heirs that evenly share a $9 million estate. Their average estate tax rate would be 28 percent. The inheritance tax rate would be 12 percent for all four of these heirs, because they're all inheriting $3 million. It would actually be up to 12 percent. It would depend on how well off they were otherwise. So, this explains -- I don't have a pointer, but -- why -- if you just look at the inheritance tax rate at .12 why you can see there are a whole bunch of estate tax rates at that level, because some people are paying -- or effectively being burdened zero by the estate tax and some in our example are being burdened 28 percent.

And this final slide shows that the amount of estate can be pretty large for individual heirs, so it looks at the winners and losers under the proposal by inheritance size. All heirs inheriting over $50 million lose under the proposal, and they can lose pretty substantially. They owe, on average, $5.2 million more in taxes. All people inheriting under $1 million that are taxed by one of the taxes win under the proposal, and they can win a fairly substantial share of the amount that they inherit.

So, to sum up, I think that this proposal would do a better job than

the estate tax. The estate tax does a good job of taxing income in aggregate inherited income in a way that bases the tax rate on the heirs' privilege and affluence, but an inheritance tax would do a much better job at the individual level.

And I'm going to leave you with one final thought. The proposal is revenue neutral. But why not tax inherited income more? The slide at the beginning showed that the tax code today is sending a pretty clear message that inheriting income is better than earning it. A lower exemption would bring in more revenue, and it could counter this message. For example, if we just taxed inherited income at the same rate as other household income, we could raise $128 billion from inherited income, which is about 10 percent of income tax revenues. So, my hope is that rather than repealing the estate tax, policymakers will consider replacing it with an inheritance tax that potentially raises more revenue and puts us back on this path that FDR and our founders laid out, a path where we're not a country that protects and intensifies inherited economic power but where we're one that promotes equality of opportunity.

MR. FURMAN: Thank you.

Kim.

MS. CLAUSING: Thank you, Jason. Thank you for having me here today.

I wrote this proposal -- and let me get it up here -- with Reuven

Avi-Yonah and -- how do I get out of Lily's, do you know? Can you help me get out of Lily's? And we suggest reforming corporate taxation to make it better suited to the global economy by adopting formulary apportionments. So, let me begin by just describing what our proposal would do relative to the current status quo.

Under the current system of tax incorporations, we asked each corporation how much income they are earning in each country, and this is based on a separate accounting of income and expenses in each in which they operate. Now, under the current system, it's widely recognized that this provides U.S. corporations, and in fact corporations throughout the world, with a large incentive to do economic activity but also to book income in low-tax countries. In our system, one of the features that encourages this booking of income in low-tax countries is the ability to defer taxation on foreign income until it's repatriated to the United States.

Also this system provides many sources of complexity, as firms need to separately account for their income and expenses in each country in which they operate despite having, in many cases, a very globally integrated production process. Under our proposal, instead of taxing firms based on how much income they have claimed in each country, we would tax them based on their worldwide income and assign a fraction of that worldwide income to each jurisdiction -- in this case, the United States -- based on what fraction of their

worldwide sales are destined for U.S. customers. So, as one example, if a firm had $10 billion worth of worldwide income and 30 percent of their sales were destined for U.S. customers, then the U.S. tax base would simply be 30 percent of that $10 billion, or 3 billion.

This is, in fact, a very similar system to what U.S. states use to allocate income by state. We don't ask each firm how much income did you earn in Massachusetts or in Oregon; we say instead how much income did you earn in the country, and then we attribute a fraction of that to each state. The reason for doing that on a state basis was it was deemed impractical to ask each firm how much income they earned in each state when the production processes are very integrated across state borders, and we would argue that in the system of international globalization that something similar -- a similar (inaudible) would indicate changing the system on an international basis.

So, formulary apportionment we feel responds to these four flaws listed here with respect to the current system. One problem with the current system is it's not suited to a global economy. If your production process is integrated across many countries, that leads to a situation where you're arbitrarily assigning certain profits to certain jurisdictions, and this assignment is fraught with opportunities for tax avoidance because you'd much rather earn the income in Bermuda or Luxembourg or Ireland than earn it in a high-tax country like Italy or the United States. This is particularly problematic for the U.S. in the current

situation, because this chart here shows the evolution of the U.S. corporate tax rate.

In comparison to the other major OECD countries, the main dark line you see in the middle there that's descending downward is the average OECD corporate income tax rate, which a quarter century ago was 43 percent and now stands at 28 percent. The U.S. rate is the dark dashed line that's intersecting that in the middle there, and you see that the U.S. rate started off higher than that of our trading partners in the '80s at 46 percent. It was brought down by the Tax Reform Act of '86 and has now remained pretty similar to that level at 35 percent. It's not so much that the U.S. rate has been increasing over the past period but more that it's been increasing relative to the other countries who have been lowering that rate. So, at present, our tax rate is about one standard deviation higher than that of other OECD countries, which strengthens these income-shifting incentives to earn the income in low-tax countries instead.

This quick bar chart shows us the consequences of these incentives. If you look at five countries -- Netherlands, Bermuda, Ireland, Luxembourg, and Switzerland are five of the top seven profit countries for U.S. multinational firms. These countries combined have a population that's two-thirds that of Spain, but they're earning about -- just less than 50 percent of non-U.S. profits. So, it's clearly -- there are some arbitrary elements associated with the current system.

The third flaw, as I've already mentioned, is that the current system, when you have to source your income and expenses across countries, is very complex, at least to a lot of complexities associated with the transfer pricing rules which have employed many a young accountant and -- so that you know from a perspective of job creation in certain sectors, like accounting, it makes a lot of sense, but with respect to complexity and simplicity the current system is flawed in that dimension as well.

And finally, as Larry noted earlier, the U.S. government revenue from the corporate tax rate, while fluctuating quite a bit with corporate profits and with the cyclical state of the economy, is typically about 1 percentage point of GDP lower than that of our other major trading partners in the OECD despite having this very high tax rate that I've already shown you.

So, the adoption of formulary apportionment would respond to all four of these flaws since the tax burden would be based on your worldwide income rather than your income earned in any particular country. It would eliminate the incentive to shift income to low-tax countries, and it would reflect a more global economic process like we see in the global economy. It would be far less complex, because all you ask firms to determine is the source of their worldwide income as well as the destination of their sales, and we calculate that it would enable substantial revenue savings of tens of billions of dollars or a reduction in the corporate tax rate. If it were done on a revenue-neutral basis, one

could lower the corporate tax rate substantially in tandem with this.

Fifth, there are some issues associated with implementation here. The largest one is this first one with respect to the potential for double or zero taxation. If other countries do not adopt formulary apportionment and the U.S. does, this means that a firm that has operations in both separate accounting countries and in formulary countries could see, you know, situations of either zero or double taxation. Now, firms would respond to these incentives presumably by booking their income in the formulary countries, because if you -- if, like, say, the United States or some European countries adopt formulary apportionment but other countries do not, then that provides firms a massive incentive to shift the income to the formulary countries because their burden in the formulary countries won't be affected by that shifting, whereas they will reduce the tax burdens in the countries that have retained separate accounting. That provides a built-in incentive for other countries to adopt formulary apportionment and hopefully would launch a dynamic through which many countries were using the system. But in the transition period it could be a negative there.

There are two other issues surrounding implementation that are pretty serious: defining a unitary business -- we suggest basing this on a test of economic and legal control; determining a location of sales, which we suggest should be done on a destination basis, and we suggest also a look-through rule to prevent the gaming of the system. And then there are issues surrounding

accounting issues so that we can make sure that the tax base is well defined. We argue in the paper that many of these issues are surmountable, but they do raise some implementation issues that one should be aware of.

A final concern is with the stakeholders. Some firms would see their tax liabilities increase in the United States under this system to what they had been previously. Some firms would also see a decrease. What would depend -- what would affect which firms were gaining or losing is whether their sales in the United States were disproportionately high or low relative to their income. So, any firm that had, you know, 70 percent of their sales in the U.S. but only were booking, say, 10 percent of their income in the U.S. would see a tax increase. We feel that one way to respond to this is by lowering the corporate tax rate simultaneously so that more firms would gain not just from the increased simplicity of this proposal but also in the lower rates.

The final thing I would say about our proposal is that I think it does respond to globalization without taking a protectionist bent, and I think one of the nice things about this proposal is it would allow in fact an efficiency enhancing in our perspective response to global differences among countries rather than some of the more protectionist things that have been suggested that would reduce efficiency while responding to globalization. So, I'll leave it at that.

MR. FURMAN: Thank you. Thank you, Kim.

And the last proposal is Ed Kleinbard.

MR. KLEINBARD: Thank you.

Well, I have seven minutes here to accomplish several objectives. First, I need to convince you that our current system for taxing business income is so irredeemably flawed that it should simply be thrown away; second, I need to identify the underlying principles it should serve as the foundation of an entirely new replacement business income tax architecture; and, third, I need to walk you through the business enterprise income tax, which is my proposed new business income tax system, demonstrating, as I go along, both its economic logic and its administrative practicality. So you all will forgive me if I talk quickly.

For our purposes, all income can be divided I think into two parts: returns to human capital -- to labor ingenuity, to talent -- and return some financial capital, that is, returns from investing money. The business income tax is concerned primarily with the latter, that is, how we tax returns to financial capital because, in general, businesses expense the labor component of operating a business enterprise. So, the first question that we have to ask ourselves is how are we doing at taxing businesses? -- which means how are we doing at taxing returns to capital today? And the answer is we're doing just terribly, thank you; in fact, we're doing much worse than most of you think.

Larry Summers and Kim's earlier remarks have already covered some of these points. I'll do them very quickly.

We have today unsustainably high corporate nominal tax rates.

The U.K. and Germany have just reduced their rates. It is not possible to imagine that the United States will remain at 35 percent when the U.K. is at 28. At the same time, we have a disappearing corporate base of which to me the most interesting point is what I refer to here as the mysterious migration of high-value intangibles to Ireland. It cannot be -- it cannot be simply the luck of the Irish that explains --

(Laughter)

MR. KLEINBARD: -- the extraordinary profitability of Irish affiliates of U.S. multinationals. We have, of course, the astounding complexity, which all of you take as given, but we also have a whole other level of crisis; that is, we have completely different tax rules for taxing economically comparable forms of doing business -- a corporation on the one hand, a limited liability company or partnership on the other -- with very substantially different rates, 26 on average versus 20, for example. That's a 30 percent difference in rates. We have different tax rules that impose different economic burdens on economically comparable business assets. Different kinds of equipment are taxed at very different rates, and to me in terms of my academic writing, most interestingly, we have completely different rules for different forms of indirect claims on the assets of a business -- different rules for stock, different rules for debt, different rules for hybrid instruments that combine those futures for derivatives, all of which -- because we have supremely efficient capital markets means that we can mix and

match so as to minimize the collective tax liability of the private sector and in doing so ensure that business income is under taxed.

So, what can we do about all that, having covered my first point? What are the underlying principles? And here the first suggestion I'd like to make is that we not think in terms of tax rules for different entities and financial instruments. This is a fragmented kind of thinking that leaves a fragmented and uncoordinated tax system. We should not think about what is the corporate tax and then separately how do we tax this or that exotic derivative. We need to think instead about the entirety of returns to capital and concentrate less on where we tax and more on what we tax. We do need to think more creatively about the fundamental components of capital income -- returns to capital -- and here tax academic research has been extremely helpful in developing a very clear and coherent theory of the components of income.

Income can be divided -- capital income can be divided into three parts: what are called normal returns; the time value of money -- what you can get by just buying a treasury security; and putting your money in the bank. It's very, very boring sounding because it requires very little cleverness, and Warren Buffet -- you know, you don't make the cover of national news weeklies for earning normal returns. But it turns out that taxing normal returns is extremely difficult, and much of the problem in the business tax system today is that we don't capture this large base of the simple, normal return -- the kind (inaudible) money return to

investing capital. Then the risky returns, you know, the returns you get for taking on more risk, and their economic rents, the super-sized returns, I like to think of them, that you get for having a unique market position or patent or whatever.

And so what we need to do is, say, having identified conceptually those three kinds of capital income, we need to figure out a way to tax each of those categories once and only once, and it does not matter where we tax it, whether we tax it at the entity or tax it to the investor, so long as we in fact collect tax on all those components. So, that's what the business enterprise income tax sets out to do.

The first thing it does is try to create a robust base on which to measure capital income, and I do that by adopting one set of rules for each stage of the business life cycle for choosing the form of the business enterprise so that all enterprises are taxed in effect as corporations. I have one set of rules for the capitalization of the enterprise. It does not matter under the business enterprise income tax whether something is called stock or debt. Your tax results are identical, whether it's called stock or debt. And I have one set of rules for selling business assets or entire business enterprises. And, finally, I have the new Cost of Capital Allowance, which is the critical component of the business enterprise income tax that is designed to accomplish the critical purpose of capturing the taxation of time value of money returns. So, the COCA is the heart of the business enterprise income tax, which, by the way, I pronounce as "bite" on the

theory that that's a good -- it's sort of a name for tax, you know, that's a tax bite.

(Laughter)

MR. KLEINBARD: Because COCA is designed to tax normal time value of money returns at the investor level and risky returns and rents at the enterprise level. So, we have a consistent and coherent system where each is taxed once but at different levels. And to an economist, what this means, in effect, is that at the enterprise, looking at the business by itself, the tax that is imposed on business is, in effect, a consumption tax because normal returns -- the time value money returns -- are excluded from the company tax base. So, from the point of view of management of a business, management operates in a consumption tax environment, which is a nice, happy place to be because buying and selling assets, for example, is completely tax neutral. And then on top of that there is, at the investor level, the income tax on normal returns. You put all three together and it's an integrated matter. It's an income tax. But from the point of view of company management, they see themselves operating in a consumption tax environment.

So, the sum of the three is a single income tax on all capital income as a result of a number of base-broadening proposals plus what I believe will be the additional revenues raised through the cost capital allowance system, because for the first time it will systematically capture and tax normal returns, which today largely escape tax, and you can see that in some of this CBO data

that's in the paper we ought to be able to reduce company taxes to something in the 25 to 28 percent range.

So, how does COCA work? And obviously that's the reason why the paper is long to go through the details. It's extremely important to work out those details, because in fact tax law requires a lot of thinking about practical implementation as opposed to just grandiose strategy, and I think in the end it is a completely administrable idea. But basically what we do is we get rid of the interest expense deduction as such, because, remember, capitalization of the firm no longer is driven by whether something is called debt or equity. So, the business enterprise simply deducts a COCA expense each year, which is the COCA rate. Let's -- you know, just by hypothesis -- one-year Treasury rates plus 1 percent in this example multiplied by the enterprise's cost basis for all of its assets.

The COCA allowance replaces the interest expense deduction, and it applies -- because it applies to all assets of the firm, it's effectively giving the firm a deduction for equity-capitalized assets at the same rate as debt-capitalized assets. Today we have for equity-capitalized corporate investments an effective tax rate, according to CBO, of about 36 percent. For debt investments, we have a rate of negative 6 percent -- a 42-percentage point swing. This eliminates that.

At the investor level -- now having given that deduction to corporations at the investor level, I have an inclusion called the minimum

inclusion, which is the same rate applied to each investor's individual costs and each individual's investment in stocks, bonds, whatever that he or she has purchased. That replaces the current law's taxation of interest and dividend income. It is includable even if you don't get the money in cash -- and we can talk more about that if you'd like. It's not as horrible as it seems, because you also have standard savings allowances that would effectively take all but the wealthy out of this system at the investor level and losses reversed -- prior inclusions. That's similar, for those of you who are familiar with tax law, to original -- to what we call today original issue discount.

There is an additional -- what I call small compensatory additional tax at the individual level that's analogous to capital gains today, hopefully around the 10 percent-type range to deal with the number of issues described in the paper.

So, why, in summary, would one see the COCA as an attractive alternative to move to? First, we're taxing normal returns, which is the problem in the income tax of business today. It is the bulk of aggregate income, and it is what consistently escapes tax today. We're going to tax those normal returns, not where they're impossible to measure -- which is the business level -- but where they're easy to measure at the investor level, because the investor doesn't have accelerated depreciation and all sorts of other preferences that effectively erode the tax base on which they measure normal returns and instead that we have a

much simpler cost investment on the part of investors. They also turn over their assets more quickly, and so we get closer to an ideal mark-the-market system than if we were trying to measure this critical component at the level of the business enterprise without any of the distortions, and meanwhile management of businesses couldn't be happier, because they're operating from their perspective in what's essentially a consumption tax environment. So, that's what I mean when I say the business enterprises function in an economically neutral environment; and the resulting system, although quite different in its details, is roughly analogous to current law's division of the corporate tax. That is, we have -- today companies deduct interest expense. Someone in theory includes the income of (inaudible); in reality, the majority of corporate interest deductions does not correspond to an inclusion in our tax base. But because we're going to have a deduction at the corporate level, the cost of capital allowance which replaces the interest expense, we have a deduction at the corporate level, and then we're going to have inclusion at the investor level. We have an allocation of liabilities that has at least a rough analogy to current law, which eases the transition issues, which are very important issues, especially when grappling with some of the other fundamental tax reform proposals.

So, that in a nutshell is what the business enterprise income tax and its cost of capital allowance component attempts to do.

MR. FURMAN: Thank you, Ed.

And what I'd like to do, although I can't see half of you, would be to start with our panelists in any specific questions or comments that you have on the proposals, and if you don't have any that's fine, we can -- you'll join us for the second part of the conversation.

MR. DESAI: Should we start with a particular paper or should we --

MR. FURMAN: You can start with a particular paper or link multiple papers, and somebody could probably take this away, too.

MR. DESAI: Sure. So, in general I want to just congratulate the authors on providing a very stimulating set of papers. These are not small ideas. These are big ideas, and I think the Hamilton Project and the authors should be congratulated for thinking, you know, big.

Having said that, obviously as Ed mentioned there are a number of details that are puzzling in some of these proposals, and maybe I'll get things kicked off by starting with Lily's paper and maybe mentioning some things about the other papers as well.

So, on Lily's paper, I think of her proposal as a combination of three things, and this might be incorrect, but I think of it as a combination of, one, a slight reduction in wealth transfer taxes due to the fact that you're taxing things at the heir level as opposed to the estate level. Estates can be divided up, and that can result, in some sense, in reduction in taxes paid. And then I think there are

two tax increases, in some sense, in the wealth -- in the proposal that you put forward. One is there is still a slightly higher tax rate. This 15 percent surtax is probably higher than 45 percent in most of your calculations.

But then the other thing which is important, and I think is worth thinking more about, is the repeal of the step-up basis at death. And Lily didn't talk about this very much, but from what I would guess in your calculations, the repeal of the step-up basis at death is going to be a big chunk of the revenue consequences of this.

So, you know, two questions. One is, you know, is that right, which is how important is the repeal of step-up basis at death? And just to be clear, what would happen instead is there would be carryover basis. And for those of you -- just to be very clear about what this means is that instead of at the time of death having a basis stepped up so that there is no payment of capital gains tax on that capital gain, instead, that capital gains obligation would be transferred over. So, you know, the issue that rises is, one, I could see that easily getting lost in the legislative process, and I think it's important to think about how important that is to your proposal; and the second is to think about the distortions associated with that, which could be significant. You know, in particular, this idea that people would be holding onto assets well after they should be -- heirs would be holding onto things in some sense long after they should be. So, it would be nice to hear a little bit more about that.

Maybe I'll mention comments on the other two papers and then I'll --

MR. FURMAN: Sure.

MR. DESAI: Okay. So, on Kim's paper I think it's really fun. I work in this area. I think it's interesting. I think that they're really big in problems, but I think there are two things that are worth exploring in Kim's presentation and I'd love to hear your thoughts about it.

One is as you mentioned, the consequences differ markedly, depending on how other countries respond, and so at first approximation I think the likelihood of coordination on this issue is very small, and so that's my gut instinct about the way Asia and Europe would respond to this, and so if we go to a world where there is not coordination, you know, there are going to be concerns about multiple taxes, and I think that's got to be dealt with in some way.

The second point I would like to make just more generally is the allocation rules based on sales -- now, the obvious point here is that's going to give people a curious set of incentives about where to locate sales, and so one piece of that is it's in some ways an export subsidy. You can conceptualize this almost as an export subsidy even if the WTO doesn't conceptualize it as an export subsidy -- you know, we might just conceptualize it as an export subsidy to reduce your taxes the more you sell abroad.

Now, the reason that's problematic -- well, there are many reasons

that's problematic. One is export subsidies in general are weird things and not clear they are terribly good. But the more problematic thing I think is that sales destinations I think in the paper are viewed as being not movable, you know, which is people are going to sell what they're going to sell, so it doesn't really matter, and so in some sense we've got it just right, because we'll target it on sales and customers don't move, and that's going to make it (inaudible). Well, you know, I think that is a tenuous premise, which is customers can move, and in some very curious way we're going to give people an incentive to make sales decisions abroad, and so for example Intel could sell chips to Dell, and where are they going to sell chips to Dell? Are they going to sell chips to Dell in the U.S. or are they going to sell chips to Dell outside the U.S.?

Now, one of the consequences of that is that we may end up actually moving production off shore in the process of having the sales rule, and so I'm kind of concerned about how you might think about that, and in general I'm concerned that the proposal maximizes the income booked in the U.S. but may not maximize the productive activity that happens in the U.S. So, I think that's worth thinking about.

Final thing on Ed's paper -- I've talked to Ed about this. I think it's a really ambitious paper, and I think it's -- you know, it's the kind of paper which may not pay off tomorrow but can pay off in 20 years, and I mean that as a compliment.

(Laughter)

MR. DESAI: I do. Actually I really do mean that as a compliment, and I think it's, you know, Bradford asking its ambition. The things it gets really right are organizational form -- Larry didn't mention this, but I think a lot of what we see happening at the corporate level is happening at the subchapter S and LLC levels and Ed's really tackling that head on. You know, I guess my major concern is this effort would put enormous strains on the information environment. So, we'd really have to measure specifically kind of market values and book values right, and I haven't gotten my head around how that would work in Ed's proposal, frankly. When I look around at capital markets, I see ratios of market values to book values ranging from .1 to 100, and I'd need to understand more how we're going to capture that in this tax. There's what's called an excess distribution tax, which captures all that stuff, and I'm a little worried that he may get that right, so the whole idea of measuring intangible assets, measuring human capital contributions to enterprises and getting that right I think is what I would, you know, focus on in terms of what I would I want to hear about from Ed.

MR. TALISMAN: Jason --

MR. FURMAN: Okay, why don't we --

MR. TALISMAN: Okay, do you want to respond or --

MR. FURMAN: If it specifically builds on any of Mihar's

comments, why don't you make them; otherwise, why don't we hear what the authors have to say.

MR. TALISMAN: Well -- and, actually I think they do. And again I want to compliment the authors, too, in particular as a proponent of an income tax, anything that's designed to sort of preserve the current income tax and the progressivity of the income tax I think is a very useful dialog.

With respect to Lily's paper, I think Mihar raised an interesting point, and I'm always intrigued by the notion of an inheritance tax, because I think people are more sympathetic to taxing Paris Hilton and Baron Hilton.

(Laughter)

MR. TALISMAN: But I do think that one of the issues is you sort of build this inheritance tax as an income inclusion model, as an add-on to the income tax, and yet you don't have stepped-up basis, so you sort of this notion of a double tax, which I think was something that I think politically you're going to run into problems with. I also think that there is a fairness issue which you talk about again the benefits of an inheritance tax as breaking this up into -- encouraging people to break up into smaller bequests. I do think there's an issue, though, where small families may be taxed more heavily than large families and is that fair as an equitable matter, and I think that's something that the paper needs to at least address. And so I think -- and, again, you also have the administrative issues of dividing the collection point for the tax amongst various people as

opposed to having the collection point, obviously, on one estate, which I think is an issue for an inheritance tax.

With respect to Kim's paper, obviously formulary apportionment is an issue, and the states obviously use it in our system. I do think that there are issues. I think you are converting, in effect, an income tax to being a tax on sales and sales being the primary -- it's really a -- it turns it into a tax on the factor, which is sales. I think -- as Mihar points out, I think you be encouraged to set up sales subsidiaries abroad as well, and the question would be whether you recognize those sales subsidiaries for purposes of where the factor is taking place.

I also think it is very difficult, frankly -- and I think the paper makes a little bit short tripped of this -- I do think the issue of the unitary basis and determining how it's allocated amongst an entire group of corporations, sort of piercing the corporate veil -- I think all of that is more difficult than the paper lets on as far as an administrative matter and, as Mihar points out, I think obviously the most important thing is coordination amongst countries. If you don't have coordination, then there's always going to be sheltering and the whole effort sort of mooted at that point, so.

With respect to Ed's paper, Ed and I have had a dialog on his paper. Every time I read it I'm further confused by his paper, because he's obviously thinking at a far higher level than I'm able to, but the one thing that obviously strikes me in his paper is the notion of the COCA being taxed at the

individual investor level. I worry about having to explain to my grandparents that they're paying tax on phantom income, which they have this OID concept in COCA, and if you're being taxed as the investor on corporate earnings that in fact aren't being distributed to you I do worry that that's a possible problem.

I also worry in Ed's paper that he's got this super consolidation concept, and I worry that, you know, the Mars family may have difficulty if Citigroup is considered to be a major shareholder of the Mars family because they've lent money to the Mars family and therefore have some sort of control over the tax return, so.

There are other issues in Ed's paper, but I'm going to sort of turn it over to the rest of the panel.

MS. OLSON: Okay, sorry to take so long before the authors got a chance to respond to some of the questions or comments. These are a great set of papers and very provocative.

I'm going to start with Lily's paper as well. I applaud work on the concept of an inheritance tax. It seems to me that it's clear we will need the revenue. The questions are what should the rate be and what should the exemption be? I'm reminded of the line that the goal is to pluck the goose with the least amount of hissing, and in that regard I think that the rates that you're talking about are an add-on to the income tax rates, particularly in the context of if there's no step-up in basis, which I would note as a footnote has been cited a

number of times over the years as a huge administrative problem, and so that in itself is a reason to find a way to move to a marked market approach. But it's -- as a practicing lawyer, I've dealt a number of times with estates who are trying to grapple with paying the estate tax, and even if we split it up among different heirs, if we're dealing with something that's a closely held business, the exemption level, coupled with a rate that's going to be around 50 percent or higher if we see tax rates go up, is going to mean that they are saddled with such a huge amount of debt that they really probably can't sustain the business, and so I think the rates are just going to turn out to be unacceptably high from the standpoint of what we want economically and what's salable politically.

Turning to Kim's paper, the proposal was described as a worldwide approach. I guess I would think of it as more of a territorial approach but one where we're throwing out the arm's-length standard, and there's a great debate right now about whether we ought to have a territorial approach or whether we ought to have a worldwide approach. We've spent years working on the arm's-length standard, which is of course in many ways almost the polar opposite of formulary apportionment. We like the arm's-length standard. The reason that we like the arm's-length standard is because it measures the actual -- or at least attempts to measure -- maybe we're not very successful at it, but at least attempts to measure economic activity within a jurisdiction and to acknowledge each sovereign's right to tax that economic activity within its own jurisdiction. And

the formulary apportionment really doesn't go in that direction, particularly when you limit it to a sales factor. I think there are a number of administrative issues that Mihar and Jon have already alluded to that would go with that, and so I really -- I really question whether or not this is the right way to go.

I would also note that tying it sales is an interesting thing, because as we look at the U.S.'s share of the global economy today, obviously we're on the large side -- 25 to 30 percent -- but that is declining over time and so over time, which you might see with it tied to sales, is our base shrinking.

I also think that the likelihood of us finding a way to coordinate particularly again with the leadership role that the U.S. has played over the years in fighting for the arms-length standard as the best kind of a system to run -- if we look at what's going on in the E.U. trying to move to a comprehensive, coordinated, consolidated tax base -- I can't -- corporate tax base -- I can't remember what all their c's stand for, but three c's and TB -- and they're having a lot of difficulty in moving in that direction. If we look here in the U.S., I mean, the states have never done a really terrific job on coordinating their tax bases or on formulary apportionment, with the result that in some situations here in the U.S., despite the fact that we're one country and 50 states ought to be able to work together, we have in many instances double taxation; in other instances, no taxation. If we look at what's been going on in the states for several years now in the sales tax area, we're trying to get to a streamlined sales tax base so that we can

more easily allow the states to collect sales tax, but we can't even get them to agree on that, which would seem to be a little less important than agreeing on a tax base on how to apportion it.

I think it's -- this is a very important concept, because I think we do need to address tax planning disparities and the differing taxation of entities that can occur just because some entities put more resources into it and are better at tax planning than others, and that's probably a lousy basis on which to decide how much a company should pay in taxes.

With respect to the "bite" term -- I was going to call it "beet," Ed -- but I do like the ideas of eliminating the distinctions between debt and equity and among entities I think those are really important things. You know, as we look at the decline in the corporate tax receipts over the course of the last X number of decades in this country, it's clear that a whole lot of the decline in the share of receipts contributed by corporations is attributable to the fact that companies have converted to partnerships or LLCs or have made S selections in order to eliminate the double tax. What else have they done? They have done things like issued a lot of debt instead of equity because of course that is deductible.

The COCA concept sounds similar to me. It is something that I think they do in the Netherlands.

MR. KLEINBARD: Belgium.

MS. OLSON: Belgium. But it's -- I think it has the issues that Jon

mentioned about how do you explain to your grandparents about what's got to be included.

The other thing that's interesting about it is that it leaves some of the holes in the system that currently exist. For example, if we look at who the holders are of stock or dead instruments, a large percentage of them are held by tax exempt entities -- the Harvard endowment as one example -- and so those -- the receipts that would go to those entities would continue to fall outside of the tax base and so we would continue to have that hole in the tax base. That's one of the reasons that when the Treasury Department has worked on concepts like this -- for example, like the divident exclusion proposal that was considered at the Treasury in the '90s and again at the beginning of this decade. We went in the direction of taxing the income at the corporate level and ensuring that it was taxed at the corporate level and not at the shareholder level. Thank you.

MR. FURMAN: Thank you. And so we'll collect all of them and then listen to our authors.

MR. GALE: All right, thank you.

I want to start by thanking the authors for three very stimulating papers, and I want to link several of the comments to the analysis of the proposal with the overarching thought that we can't let the perfect be the enemy of the good here. We are so far from a good or functioning or effective tax system that if we wait for the perfect proposal to come along we're going to be waiting for a

long time. So, just a couple of comments on each of the papers.

On Lily's paper, I just want to clarify it looks like the exemption goes down. There's a 3.5 million exemption in the estate tax and the 2.3 million exemption in the inheritance tax. But I think it's right that the 2.3 million is per recipient. The 3.5 is per donor. So, for anyone with two or more nonspousal recipients, the exemption actually goes up. Is that right?

MS. BATCHELDER: Yeah.

MR. GALE: Okay, good.

Second, there is actually a wealth of European and American state experience with the inheritance tax that I think lends more credibility to the idea, that is, the idea that it could actually be done, that it is not some vastly new tax that's never been attempted anywhere.

And the third thing is I thought the lack of correlation among inheritance tax payments and estate tax burdens imposed on inheritors among wealthy inheritors was quite striking, and I was wondering how long it was going to take before someone mentioned Paris Hilton, so Jon wins, but the inheritance tax is clearly taxing people like her rather than people that are inheriting, you know, a $2 million family business, and that's a good thing from the perspective of policy.

In Kim's paper, I wonder just if it's possible that going to worldwide at the national level would also simplify and help unify state corporate

taxes. As Pam mentioned, they're a mess. But if there were a federal kind of standard of income and then you apply some fraction to that and that's your federal tax, maybe you could imply some state equivalent, add a fraction to it, and get your sales tax in sort of -- with one line of effort.

I'm intrigued by the idea of coordinated action on the formulary apportionment. If we're interested and the European community is interested, maybe if all those countries act in concert, something could happen that might hit and stick whereas if just one country does, maybe it wouldn't.

And I guess I'm also interested in the -- there are two changes here. One is we use worldwide income instead of U.S. income, and that has some benefits in terms of simplification; and then the second is we have to impose some tax based on worldwide income, and that's the issue of using the percentage of sales that are in the United States. That creates all sorts of issues, of course, but coordinated action might be able to address some of that with a formulary apportionment where just, you know, the U.S. gets X percent, the European community gets Y percent. Maybe that's crazy, but at least it would have the benefit of being exogenous. It would then take taxes out of firm decisions. Are they differing national taxes out of firm decisions and remove the location issue.

So, those are some ideas. I'd like -- and then in both Kim's proposal and in Ed's proposal, which I find quite stimulating, I guess I'd like to hear a little more about how to deal with the scope of the entity questions that a

couple people raised. It seems like what we define as a tax unit is not the same as what we define as a financial unit, and that might be a critical issue for those proposals.

MR. FURMAN: Okay, so why don't the three of you respond. Don't feel the need to respond to each and every point but to the most important ones.

And I have just one question for you, Kim, as part of it. How much could some of these objections be addressed by changing the formula you used and would another formula potentially be better, or you have rejected formulas much along the lines of what the states did and presumably because you felt that raised even bigger problems than what sales did?

We'll start with Lily.

MS. BATCHELDER: All right, so first just to address some of the revenue estimating issues that Mihir raised. I should preface this by saying that the revenue estimates and distributional analysis are very rough. This is the first time this has ever been done, and we had to impude a lot. It's based on a linked dataset of estate tax returns and heirs' income tax returns that's understandably restricted by the IRS, so we don't actually have it; we could only get tabulations. But the proposal is intended to be revenue neutral, and there are two general limits to the revenue estimate. First, we don't include behavioral responses, so as Mihir said, that might tend to reduce the revenue collected if people actually

respond to the incentives to give more broadly. We also don't include carryover basis, which should tend to raise revenue, and there's not very good estimates on that, but one that I found suggested that it might raise about 12 percent of current -- well, actually 2001 wealth transfer tax revenue. And -- so, it's not -- it shouldn't really be raising effective rates on average overall. You are right that the people inheriting the most -- the Paris Hiltons of the world -- will face a higher marginal tax rate once you get into those, you know $50 million inheritances.

On carryover basis, there are a bunch of issues raised, and in terms of the fairness issue that Jon raised, I think that's kind of a philosophical issue. I don't think of it as a double tax for the same reason that I don't think of an income tax as a double tax. I mean, some people would say that we shouldn't tax capital income because that's a double tax. I think we've decided as a normative matter that income is the right tax base, and so in that sense the fact that we are taxing capital income that wasn't taxed previously is fair.

There are, as was mentioned, some cross-counting efficiency tendencies within carryover basis. On one hand it will tend to improve efficiency from the donor's perspective, because they no longer face this really large incentive to hold on to appreciated assets, but then if they actually do hold onto them and pass them to the heir then faces a new incentive to hold on to them, because they get the carryover basis. I think on balance it would improve efficiency. My preference would have been just to treat it as a realization event,

but the experience cross nationally suggests that that wouldn't really fly, that it would be, at least by the public, viewed as a double tax if we both imposed realization and had an inherited tax. Canada actually tried to do both at the same moment of time, and very quickly the estate tax was eliminated, so now they only tax appreciated assets at death; and Ireland, which actually is the closest to the proposal, decided not to have carryover basis or -- sorry -- not to do anything about appreciated assets.

And, finally, I think it would be administrable because -- for instance, Japan and German, some pretty large economies actually do carryover basis, so it seems like it's worthwhile. I think in the U.S. we got a little burned by the 1976 experience with passing carryover basis. It was in -- supposed to go in effect for a couple of years. We ultimately repealed that, and I've talked to some of the people that were involved in that, and they really thought that was a function of the fact that it was a pretty poorly designed provision. It had this weird amnesty section where you needed to value everything as of one date. There were a number of other problems with it, and they made some suggestions about how to actually implement it in a way that would work. I think also the fact that we are much more computerized than in 1976 makes it a lot easier to track basis.

On the family business issues, I won't go into too much detail, but there is this provision that would allow people to defer, with interest, the tax due

on any inherited family businesses or liquid assets to the extent that they don't have liquid assets with a cushion that are inherited to pay for it. And I think that -- so, first of all, you wouldn't sort of immediately have to sell the family business. It's true that you would have this accrued tax liability, but the problem is if you forgive that tax liability, you're going to create a huge incentive to invest in family businesses rather than other assets. So, I was trying to sort of make it as neutral as possible in terms of what people hold their wealth in.

And then, finally, I think Bill sort of covered some of the administrability issues. Actually, there are inheritance taxes in place in 27 countries that are much more common cross nationally, and each of these elements is part of them. So, I think it would be administrable. It is proposing reporting by estates, and you could have withholding by estates to sort of cut back on the collection problem, and actually it does propose withholding on trusts, which is sort of the way that most wealth is transferred in large estates.

MS. CLAUSING: Okay, a couple of comments here. First on the international coordination question, I think it would be great if the countries could coordinate, particularly given the European Commission's intention of implementing formulary apportionment. I think that is a useful motivator for the Europeans. That said, sometimes if you wait for an international coordination, that's just a way of dooming anything to failure, and I do think that there are a lot of previous innovations even in the domain of international tax that have occurred

partly through the leadership role of the United States, including the arms'-length standard itself in the history but also elements of the foreign tax credit and so on, so one possibility is for the U.S. to act first. Now, if the U.S. were to act first and other countries did not, this launches a sort of taxpayer response at this point. It's sort of relevant to Larry's comment earlier about the credit card companies collecting every cent that was due but the U.S. government not being so agile, and I think that if we rely on taxpayers to avoid double taxation rather than relying on governments to avoid double non-taxation, I think taxpayers will probably be pretty effective at getting the income only taxed once through behavioral responses, and if the U.S. is the one adopting the formula, the formulary countries won't be subject to this because their income tax will be based on a fraction of worldwide income rather than based on what the firm's behavioral responses are, which is little solace to the countries that don't adopt in the short run, because they're going to be losing revenue. So, that's a real issue for them and something to worry about.

Regarding the location of sales and the determination of the formula, we chose sales rather than a weighted formula that would also consider payroll and assets partly because the idea was to find something that would be less responsive, so the concern of using a payroll and assets-based formula is that it would discourage payroll and assets in high-tax countries, whereas many high-tax countries also have a lot of rich and plentiful customers, and so you always

want to be able to sell to rich and plentiful customers, and so the idea was that sales would be less sensitive to behavioral responses. And if you look at econometric analyses of U.S. multinational operations, you do find that the tax elastices for sales are significantly lower than for employment assets or income, certainly. The income is the most elastic of them all, and -- which gets to this question about whether the perfect is the enemy of the good since I think that everything is going to be somewhat responsive to taxation. All firms are going to try to avoid taxation when they can, so the question is what can we find that's minimally subject to those types of avoidance, and sales was our best guess. And if you look at the fact that, you know, 45 percent of worldwide profits are in five countries with a population two-thirds that of Spain, it's not clear you could do the same thing with sales, that Intel could really say okay, we're selling 10 percent of our stuff to Bermuda when there are only 60,000 people in Bermuda, and so that's why we chose sales, although it's important to have a look-through rule and other legal provisions to try to combat gimmicks that would get around that.

The state experience in the U.S. has also suggested that states have moved gradually toward increasing the weight on sales, so that might help also foster international cooperation in that domain.

One more comment on the territorial question of adopting a territorial system. That's something that policymakers have considered as well. The problem with adopting a territorial system where we simply exempt foreign

income from taxation without adopting formulary apportionment is that then you're really strengthening all the incentives that we've been talking about so far in the sense that if we simply exempt foreign income from taxation and don't even attempt to tax it, then there'll be even more of this sort of income shifting, so we view formularies as a way to sort of get at the territorial outcome without exacerbating the income shifting issue, so, thanks.

MR. FURMAN: Okay, great.

And because we're running late, Ed, phantom income is something everyone raised, so why don't you confine yourself to addressing that one question.

(Laughter)

MR. KLEINBARD: Okay, there are -- we'll just say that I like all the questions, because in fact there are answers to all of them somewhere in the paper and I'll be glad to, for anybody who's interested, explain those answers apparently somewhere else.

(Laughter)

MR. KLEINBARD: The answer on phantom income is very simply this. If you remember that under this system, companies deduct a cost of capital allowance measured by their asset basis. Individuals include an income as a minimum amount -- so it's called minimum inclusion -- the same rate applied to their basis of their investments, which P.S. answers the information issues, and

the consequence of that is imagine that the rate happens to be 6 percent. If you own an investment in Apple Computer -- a stock of Apple Computer, let's say -- and Apple Computer does not pay a 6 percent dividend in that year, you would nonetheless include 6 percent of your tax basis, of your -- whatever you just paid for the stock -- in income, and it would compound from period to period if Apple never paid the dividend. And the thought what are we going to about Jon's grandparents is the concern here. And the first answer is well, they must be very rich --

(Laughter)

MR. KLEINBARD: -- because in fact the bite is intended to work with a deduction for classic IRA, 401(k)-type savings plans so that most financial investments of most households would be completely tax sheltered through the 401(k), IRA-type plans and the result is that the rule would apply only to the wealthy.

Now, those of you in the audience who happen to be wealthy may not find that a sufficient answer, but a couple of additional thoughts. The first is that it is to be expected that in a world where the corporate tax burden goes down, both because of the rate and because of the COCA deduction, the companies will change their payouts in respect of equities in particular. As is for debt, this isn't the problem; it's a problem only for equity, so I expect that people will change their payout patterns.

Third point is, guys, you can't have your desert without eating your spinach.

(Laughter)

MR. KLEINBARD: The question should be what is my aggregate tax burden on my investment, and my investment is growing a very rapid rate, more rapidly than it ever could have before in the bizarre and distorted tax environment we have now, and as a result I have to sell a couple of shares in order to pay my tax bill. I ought to, frankly, be very happy because I'm getting, in effect, an investment which is taxed on a rational basis, a single basis, so that there is only one level of tax on the investment, and in particular, my economic rents, the big, super-sized returns, are being taxed at a much lower marginal rate, so net I should be happy and the price of that is to pay a fair fate at the investor level on my actual returns.

Last point is -- well, you say they're not real returns, because if they were real I would have gotten them in cash and I say no, that's not right, if you make an investment, you are doing so in order to get a return, not to root for your favorite team. This isn't the Chicago Cubs, you know, when you make an investment decision, and holding onto an investment is itself an investment decision, so if you choose to hold an investment because it's a sentimental favorite, then you should hire a professional investment manager.

(Laughter)

MR. KLEINBARD: So, if we put all those together, the phantom income issue is really, in my view, vastly overstated except as a political matter, and that's why I've begun here and not with Iowa caucuses in terms of presenting the idea.

(Laughter)

MR. KLEINBARD: But if you don't expect to earn more than Treasuries on your investment, sell your investment and buy Treasuries, so that's how you fund your investment.

MR. SUMMERS: Thank you, Ed. Thank you to our authors.

Because we got a late start and we're running a little bit behind, we are just going to take a stretching break, not a moving anywhere break, to give time for -- to switch up over here. Alan Murray will be moderating the next panel. He's the assistant managing editor and columnist for *The Wall Street Journal* and also author of *Showdown at Gucci Gulch*, the definitive book on the 1986 tax reform, and Bob Rubin and Larry Summers will be joining us on the Advisory Counsel of the Hamilton Project and both, of course, former Treasury Secretaries.

(Applause)

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