

CATO INSTITUTE

POLICY FORUM

WITH A TAX CUT IN PLACE,
THE NEXT STEP IS MAJOR TAX REFORM

Tuesday, June 26, 2001

Featuring:

R. Glenn Hubbard, Chairman,
Council of Economic Advisors

The Cato Institute
F.A. Hayek Auditorium
Washington, D.C.

P R O C E E D I N G S

MR. EDWARDS: I am Chris Edwards, Director of Fiscal Policy, Cato Institute. Thank you all very much for coming today to today's Tax Policy Forum.

We are delighted to have Dr. Glenn Hubbard, Chairman of the President's Council of Economic Advisers, here today to talk about tax reform. Welcome, Glenn.

I am going to let Bill Niskanen, Chairman here at the Cato Institute, introduce Glenn and tell us a little bit about his impressive career highlights. Bill himself is Chairman here at Cato and was Chairman of the President's Council of Economic Advisers under President Reagan.

Bill.

DR. NISKANEN: Thank you, Chris.

We are honored this morning to have Glenn Hubbard as our featured speaker at the Forum. As someone who has served in that capacity, as Acting Chairman of the Council, he has my condolences and my best wishes.

He had previously served as Deputy Assistant Secretary of the Treasury for Tax Analysis. He has for a long time been the Director of the Tax Program at the American Enterprise Institute. He has been a Professor of Finance and of Public Finance at Columbia University for a long time. And depending on

his remarks this morning, he will be forgiven for having a Ph.D. from Harvard.

You are on, Glenn.

(Applause.)

R. GLENN HUBBARD,
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS

DR. HUBBARD: Thanks very much, Bill and Chris. Either there is a great deal of interest in tax reform or you give away a very nice lunch here at Cato. I hope it is the former.

What I wanted to do was actually spend a few minutes giving some observations about the economy in the U.S. and around the world as a way of setting the stage for where I think we ought to be headed in terms of a tax policy discussion, both in the short term and in the long term.

I think it is fair to say at the moment that the U.S. is in the midst of a growth slowdown. I do not think that the United States economy is in a recession, but it certainly is in a growth slowdown. And I like to think of the current situation as actually a tale of two economies, not one. One economy, the consumer economy, has held up reasonably well. Consumer spending has been quite resilient, especially given recent downturns in household net worth and concerns about the labor market.

So, on the one hand we have the consumer economy that is doing very well. On the other hand, we have a capital goods economy, an investment economy, that is doing much more poorly. And there is of course the much-ballyhooed downturn in the high tech sector of the economy. But the downturn in investment in the United States isn't a high tech downturn; it is an investment downturn. Investment generally has turned down, although there is better news for nonresidential construction.

That investment decline, of course, has most prominently affected manufacturers. If you were to look at where the pain is being felt in the current growth slowdown, it is largely, although not exclusively, in the manufacturing sector, where we have seen robust industrial production growth turn down around the middle of last year toward a slowdown today. And contributing factors to that manufacturing slowdown certainly include the value of the dollar and the weakness of our trading partners in Japan and Europe.

In Japan the situation is more severe than it is in the United States. The Japanese economy is sputtering and likely in a recession. The overall performance in Japan is mirrored in a decline in Japanese exports, which, of course, is showing up in our manufacturing sector, in our economy. The problems in Japan are not of the cyclical nature that they are in the United States; they are structural problems. The Japanese return on

assets is roughly half the level in the United States, and capital is allocated inefficiently in the Japanese economy.

In the absence of policy changes, it is quite likely that the Japanese economy is in for a rough year to come. I think the emphasis in the new administration in Japan on structural reforms of a micro nature -- that is, reforms of the banking system and de-leveraging in the non-financial sector of the economy -- are definitely the way to go, but implementation, of course, remains.

In the Euro zone, despite optimistic statements that one hears from European quarters, I think it is fair to say that conditions in Europe have weakened this year. The data that are the most easily available on a close to real-time basis on investment orders show a weakening not unlike what we are seeing in the capital goods sector in the United States. Complicating things in the European setting, the price stability mandate as perceived by the European Central Bank makes a Fed-style monetary easing that we have been seeing in the United States economy unlikely.

As to the rebound of the euro that is anticipated as the physical European currency is introduced, I would just caution that if one moves away from psychology toward economics, where at least I would be more comfortable, the long-term productivity deficit in Europe relative to the United States

would not be favorable to an immediate and strong rebound of the euro.

In the United States we have seen very well-timed policy responses. We have seen for the first time in many cycles a coordinated -- not in the literal sense, but in the economic effect sense -- effects of Federal Reserve easing and the tax cut which was recently passed. The tax cut offers important stimulus to that consumer side of the economy, that I led off with, in the short run, likely adding substantially to growth in the United States in the fourth quarter and also adding to growth next year.

Important from a public finance perspective, the tax cut is not simply adding to growth from a demand stimulus, but adds to growth in terms of its incentive effects, its reductions in marginal tax rates and their effect on work effort and on entrepreneurship.

Now, the short term pressures in the economy and what I view at least as long-term optimism about the economy and its implications for the budget suggest the need to look more broadly at tax policy in the U.S. and in particular at tax reform. I think in thinking about tax reform as opposed to the first step the President took, which was reducing the level of marginal tax rates and returning much of the surplus to taxpayers, in thinking about tax reform, it is important to set very general goals.

And the way I like to think about a tax reform discussion, and certainly what frames the discussion in the administration, is that we have to begin by judging our current tax system through the right lens. And the right lens to think about our current tax system is the degree that it is pro-growth -- or in econ-speak, economically efficient -- how fair it is, how complex it is, and how transparent it is, and how that transparency feeds the taxpayer behavior. I don't have to tell anyone in this room that the current tax system could be substantially improved in all of those areas.

Now, I started off talking about consumer-oriented tax reform, but why should business tax reform be an important part of fundamental tax reform?

Well, first, of course, we have already seen a piece of tax legislation which the President had introduced. It reduced marginal tax rates on households -- some of which affects business because many small businesses, or entrepreneurial businesses, pay tax at the individual rates -- but tax relief has not been seen as much in the business sector. So, I think it is important to think broadly about business tax reforms as well as household tax reforms.

On the issue of complexity, it is not simply that complexity is an irritant -- that is, if you look at the number of pages in the Internal Revenue Code that applied to particular

kinds of business provisions -- it is that it imposes real costs on all of us in the economy as taxpayers. Taxpayers bear the costs in terms of complexity, either directly when we fill out our own returns or indirectly in the prices of goods and services as corporations pay the costs that they incur.

Also important from an economic perspective, complexity raises uncertainty surrounding business decisions, which has a negative effect on investment. These combined costs of complexity can reach into the hundreds of billions of dollars a year and are a pure waste to our economy.

On the issue of transparency, again, I wouldn't have to tell anyone in this room how important a transparent tax system is for encouraging faith in the tax system, compliance with the tax system, and easy communication about the goals of the tax system. I think the current tax system fails the test of transparency and fails most prominently on the business side, where complexity is legion.

On the very important area of efficiency in tax policy, I think there are two big sources of gains that we can still reach for in tax reform. One is a one-time efficiency gain that could be quite large for our economy by moving closer together effective tax rates on capital across sectors of the economy -- types of capital investments and geographic location of those

assets. So, step one would be to remove the tax system as a wedge from deciding what types of assets in which to invest.

A second and still more important gain from fundamental tax reform would be what economists would call dynamic efficiency gains -- that is, gains that would accrue to the economy from reducing the tax-based wedge between the gross return on new investments and the after-tax returns that investors receive. It is these gains that are the real pro-growth element of tax reform.

The key, of course, is that our current system of taxation imposes multiple layers of tax on productive investment. While the recent tax law change that was enacted will reduce marginal tax rates that households face, we still face multiple layers of taxation on productive investments.

We also don't have to choose between these kinds of gains in thinking about tax reform. That is, we don't have to choose going after one-time efficiency gains on the one hand or dynamic efficiency gains on the other. And I will come back to that in a moment.

In the administration, we are at an early stage in talking about prospects for tax reform, and indeed across the administration are looking at broad models of tax reform and how to assess those. Nothing has been ruled in as a serious priority or possibility; that is, no one model has emerged. And the only

options that we would rule out at this stage are those which would involve an increase in taxes or those that would involve an increase in marginal tax rates.

Among the many features of the business tax code that are in need of reform and that have discussion underway in the administration's thinking are changes generally in the structure and rates of corporate tax, the corporation AMT, corporate capital gains, depreciation reform, and the tax treatment of multinationals.

Now, I want to tell you a bit about why I am optimistic for the discussion of tax reform over the next very few years. Partly, I have to confess to you, I have long been optimistic for tax reform. I am one of those people who has spent a career looking for tax reform. But with that as a disclosure, let me tell you why I don't think this is just academic head scratching. I see five events or trends in the real world, as opposed to public finance textbooks, that tell me that a real discussion of tax reform should be and likely is at hand.

Development number one: A majority of American households now own stock. Now, why should we care about that? Well, I'll give you an example. Ten years ago when I had the privilege of working in the Treasury Department, in the Office of Tax Policy, the Treasury put out a study of corporate tax integration, that is, of eliminating one of the layers of

taxation on corporate equity. And I think it is fair to say that while the book was incredibly attractive, it had a nice green cover and a nice heft that denoted academic respectability, it was probably not the most widely read story in town.

Now, there could be a lot of reasons for that. I can't accept the reason that it may have been poorly written; that can't be the case. So what might it have been? Well, it might have been the case at the time that since one of the things the Treasury was proposing was eliminating taxes on dividends and providing for adjustment relief in the taxation of capital gains, that that was viewed as being too pro-rich; that is, too much a story about rich people who get dividends and capital gains and not enough of a story about all of us.

That, of course, is a serious error in thinking, because we all know that as an economy we suffer if the taxation of corporate capital is too high. But I submit to you the discussion of tax policy toward corporate capital is different in a world when a majority of us now see ourselves as having a direct stake. And of course we all have an indirect stake.

So, step one that I think will be important is this realization that there is no more "us versus them," and capital taxation is important.

Step two, the President, of course, has appointed a Social Security Commission. And the Commission is engaged in its

work both to document issues surrounding Social Security and to inform the President about its views on the implementation of individual account proposals. Now, what does this have to do with tax reform?

Well, I would suggest to you quite a bit. The discussion of the Social Security Commission, both inside the Commission and outside as the Commission's report goes to a larger world, is almost bound to spark a discussion of retirement saving policy more generally. It would be hard to believe that we would have a very serious discussion of Social Security modernization without, at the same time, thinking of how we treat retirement saving generally in the United States and how that might be reformed and how it might be made more generous.

So, one could easily see a discussion of an expansion of certain kinds of saving incentives as a part of a broader discussion of retirement saving policy; and move toward exempting capital from tax is, of course, an important part of what most economists would assign as fundamental tax reform. So, the second trend in the world, the idea that the retirement saving policy is bound to come up as a bigger issue, I think, pushes us toward thinking about what the "right level of tax" on saving ought to be.

A third concern, I think, emerges from the current cyclical condition of the economy. When I led off, I told you

that I think it is fair to say that the economy is right now two economies. There is a consumer economy and an investment economy, faring quite differently. The concern over investment and capital accumulation has led many to suggest the need for a shift toward a more generous treatment of capital investment. I would call it, as an economist, not more generous but more neutral treatment of capital investment; that is, shifts towards expensing as a limit or depreciation reform and relief on the alternative minimum tax.

I don't have to remind anybody here that all of those would be steps that we would see in a move toward fundamental tax reform, even though the discussion might come out of a current conditions discussion of the economy.

The fourth trend that is prominently displayed in discussions in the media is the perennial desire for simplification of the tax code, and, in particular, simplification of the tax treatment of business-generated income. Here again I think we will see a natural discussion of at least two items that are grist for the mill of thinking about fundamental tax reform. One is capital gains, the treatment of which is quite complex under current law; movements toward reduced capital gains taxation, of course, would be a part of any income tax reform that would push us toward integration or a consumption tax reform that would push us toward relieving

capital taxes; and also moves toward expensing create a substantially simpler system. So, the desire for simplification, I think, could be easily connected to what we would all think of as moves toward fundamental tax reform.

The fifth item in the news that I think will stimulate discussion or thinking about fundamental tax reform is the decision over what to do about the foreign sales corporation provisions currently in the tax law. Any reform of those provisions should lead to a rethinking perhaps of how we treat multinational corporations for tax purposes. That opportunity is on the table and easily connected to fundamental tax reform.

So, in addition to the fact that academics write big books and plunk them down on the tables, we have at least five -- they are my five and I am sure you have many others -- examples of discussions ongoing in the world that point us toward fundamental tax reform.

Now, having said all of that, there will be several obstacles thrown up in the way of tax reform. "It can't happen no matter what your five things are." And the usual "it can't happen" fall into three things. And I just want to raise them and tell you why I am more sanguine perhaps than the consensus.

One feature that is often raised is, well, putting aside some pieces of tax legislation like the 1986 Act, it is important to have a tax cut -- that is, a substantial change in

average tax rates in the economy -- at the same time as having tax reform. And given that we just had a fairly significant tax cut, it would be unlikely perhaps to have another significant one soon. I think that is not a real obstacle.

The President's putting forth his tax plan was premised on the idea that that tax plan would improve economic growth and improve revenues. That, of course, is not scored in our budget process. It is not scored internally in the administration in the Treasury Department nor would it be scored on Capitol Hill in the Joint Committee. We do, however, believe in the administration that those gains are real. They will show up in revenues and provide funds for tax cuts in the future.

Our own internal estimates are quite close to those that Martin Feldstein has produced in the academic literature -- that the cut in marginal tax rates would lead to about a 30 cents on the dollar ultimate feedback effect.

A second item that is always thrown up is, Oh, you can't do tax reform, despite the preconditions for it; it has transition costs. You can't do tax reform because tax reform has winners and tax reform has losers, and as long as there are losers you can't do tax reform. I view this as a kind of variance of the argument of, Well, you can't do tax reform without a tax cut."

It is certainly possible, and I would argue likely from an economic perspective, that many transition costs are overstated. Not to plug any competing think tanks, but another think tank in town that begins with an "A" -- that is all I'll say -- has a recent volume that I had edited in a previous life, along with Kevin Hassett, that has chapters by various economists documenting the small size likely of transition costs for tax reform.

So, I think the argument that transition costs stand in the way is at best overstated. And to the extent that there are legitimate transition costs, they can be dealt with in terms of phasing ins and grandfatherings. Again, I would invite you to go back to the old Treasury study for integration which did precisely that.

The third and perhaps heartiest of the objections, if you will, to fundamental tax reform, despite the preconditions, has to do with distribution. And here the argument is that a move from the current tax system to fundamental income tax reform, which would have been, say, the Treasury Report 10 years ago, or to fundamental consumption tax reform, many variants of which have been discussed in this venue and many others around town, necessarily involve unfairness. The reason that that claim is made is that moves toward fundamental income tax reform or fundamental consumption tax reform appear to be relieving

components of capital income from tax. And the argument is somewhat casually made that, well, it must be that wealthier households get the bulk of capital income and therefore these are distributionally unfair.

Now, I'll give you a short answer and we can talk more in questions if you like. And the short answer is that is absolutely nonsense. If you think, for example, about the difference between a textbook income tax -- that is, an income that taxes all forms of income once -- and a textbook consumption tax -- that is, a tax that would involve expensing for investment or not taxing that form of capital income -- what is the difference between those two tax systems?

Well, the difference between the Treasury Department's model 10 years ago, which was fundamental income tax reform that virtually every economist, liberal or conservative, by the way, endorsed it at the time, and fundamental consumption tax reform has to do with the tax treatment on the safe rate of interest, the default, risk-free real rate of interest in the economy. That is a number over a long period of time which is very small and over some significant periods of times, close to zero. Those two kinds of tax reforms, often held up as arch foes, treat identically what actually generates wealth in America; that is, returns to taking risks and what economists would call

infra-marginal returns: returns to skill or entrepreneurial ability.

Those two kinds of tax reforms are exactly the same. They are not enemies. Their only difference is a very small thing. So, when somebody says, "Aha, moving to a consumption tax is distributionally unfair," the question is, "What do you think is unequal in the distribution of capital income? If you think rich people in the United States got rich by saving up at the risk-free interest rate, the distribution argument is right.

I suspect that most of you who would have knowledge of people who are well-to-do probably don't have knowledge of too many people who simply saved themselves into being wealthy, but people who made money from risk taking or from entrepreneurship.

Well, what about going from the current tax system to one of those reforms; why isn't that unfair? Well, it is important to remember that a chunk of what we call progressivity in the current tax system is really multiple layers of taxation of productive investments -- that is, the multiple layers of tax that we put on productive capital. That is something that clearly makes us all worse off as an economy and, put that way, I think, makes us think a little bit differently about fairness.

So, while I realize that the fairness distribution issue is prominent in the tax reform debate, I would submit to

you that it is at best oversold, and at worse, quite often, mis-argued.

To close, what I would like to leave you with is just a thought from somebody who has advocated tax reform for more years than I care to admit. I do think that the stars are in alignment, in the sense of the strong commitment of the President to thinking about tax modernization and tax reform in America. The conditions in the world that are pushing toward tax reform -- far more important than what economists might happen to be musing on in tax reform -- those conditions are there. And I think the arguments against tax reform can be hit quite hard.

With all that in mind, though, I would caution all of us with an interest in tax reform to do two things. One, to make sure that in our discussion, which necessarily takes a while for a major modernization effort, to coalesce on what principles we want our tax system to accomplish. I articulated some of those a few minutes ago. A second practical admonition is for all of us not to let the best be the enemy of the good. It is too often the case in discussion of tax reform that people become wedded to very particular prototypes when in fact many of the prototypes are very close in accomplishing tax reform objectives.

So, to conclude, I think that the conditions in the current economy, conditions that are going on generally in the marketplace and a strong leadership interest from the President

point toward tax reform. I think this is the beginning of a discussion that will be very, very fruitful.

(Applause.)

DR. NISKANEN: I am going to start the questions with two questions directed for Glenn. One is that he has described an economy with a strong consumer sector and a temporarily weak capital sector. And the question is: In that case, taking money out of capital flows and sending it in checks to households, how does that strengthen the economy?

The second question is the question of whether tax reform is politically sustainable. Tax reform typically involves broadening the tax base in order to reduce tax rates. But that provides an enormous incentive have a subsequent increase in rates on the broader base because it generates so much more money. The 1986 reform is the broadest reform that we have had in our adult lifetime, and it was eroded within a matter of a few years, both by reducing the base again and by a significant increases in rates.

So, the first question is: What is the economic rationale for this check that we will all get in the mail within the next few months? Second, what does it take to make tax reform a politically sustainable policy measure?

DR. HUBBARD: Well, two tough questions to start with. I guess anybody, of course, who doesn't want their check, my office is 314 OEOB, you can send it to me.

(Laughter.)

DR. HUBBARD: I think the right way to think about the check that people are going to be getting is not analogous to the rebate experiments of the mid-1970's. Formally, the check is a down payment on a permanent tax cut. If you calculate what your check is, it is the amount that accrues to you from the introduction of the newer bracket, the new low bracket, the 10 percent bracket, made retroactive.

That is in part a communications issue for us and the White House and for the Treasury to make sure that point is clear. But I don't think it is fair to talk about the tax cut as a combination of a one-time gimmicky rebate and then a tax cut. It is really all a permanent tax cut. So, the way I would see it is the purpose of the tax cut was to return as much of the on-budget surplus as practicable to the American people.

As to the issue of reform, I share your concerns. When I left the Treasury I kind of got into trouble because I actually had shellacked on the blackboard, "Broaden the base and lower the rates." And I had to pay to have it cleaned up when the Clinton team came into town.

But, as Bill said, it is very, very hard to make that stick. And 1986 comes to mind. I think what is needed to "make it stick" are two broader debates, which I hope will be part of the tax policy debate. One is: What is the right size of the state? The fundamental question is really the size of government. Taxes and debt are just means of financing. And I think in terms of calibrating how big the rate is on the broad base, we have to think about that.

The second goes back to the issue of fairness that I mentioned in my remarks. I think to get to a broad-based, low marginal rate system, we have to remind everybody that low marginal rates aren't unfair; they are economically efficient. But I certainly share your worry list on that.

DR. NISKANEN: We'll take questions now. Please identify yourself and wait for the microphone.

MR. SIMONSON: I am Ken Simonson with the Office of Advocacy of the Small Business Administration.

One concern that came up in the 1986 Tax Reform Act and since then was the relative rates between corporate taxation and personal taxation. As you know, most businesses are actually taxed directly at the personal level. And we had, first, a reversal in 1986, and then that change has been eroded by changes both in the personal rate and somewhat in the wide spread of the individual alternative minimum tax.

I wondered if you think this should be one of the concerns of tax reform now, to achieve some kind of parity, or whether there is a preferred relative ratio of corporate and non-corporate tax rates.

DR. HUBBARD: Well, of course, as the current tax law is fully implemented we will have a "parity," at least in terms of the top rate. More broadly, I think it doesn't make sense to distinguish between corporations and non-corporations.

If you were to think of fundamental tax reform, you would surely think of businesses as business. The original Treasury study would have done that and almost any consumption tax reform would do that. So, I think it is important to think of the business sector generally, which raises both the issue of corporate rates and how you treat debt for tax purposes. I think that is the right way to go.

MR. HODGE: I am Scott Hodge with the Tax Foundation.

To what extent is the U.S. corporate tax system uncompetitive now in the global economy? We have seen Ireland cut its corporate tax rates to 12 and a half percent. Other European countries are cutting their corporate tax structures to remain at least partially competitive with Ireland. Where do we fall now? Are we becoming uncompetitive? And could that be a driver for tax reform of the corporate tax system here?

DR. HUBBARD: I think you quite rightly point to the role of corporate taxes in multinationals' decisionmaking. And those decisions could be about where to locate or conditional on where you locate, how much to invest. I think it is fair to say that most of the work in the academic literature that has been done over the past decade has documented that taxes matter a great deal for those location decisions.

So, to the extent that U.S. tax rules toward multinationals discourage that kind of investment, the nation may be worse off. Many of our models that we use in public finance are unfortunately models of perfectly competitive firms, where the nation never really loses much at the margin.

In fact, firms don't become multinationals by being simple textbook competitors. They have brand names in pharmaceuticals, in soft drinks, and I think the nation loses when that foreign direct investment is lost. So, I think that it is certainly an important item and it is certainly one that the Treasury Department is keenly interested in.

MR. HANSON: I am Dave Hanson from CCH.

I was at a discussion earlier this morning where a Democratic member of the Senate said there is really no money left over this year for any more major tax cuts, especially a business tax cut. And I wanted to ask, do you think there is

going to be any surplus left for a major tax cut this year and what tax cuts will the Bush administration push for next?

DR. HUBBARD: Well, really there are two parts to your question. We are in the middle in the administration of this so-called mid-session review of updating the budget, so I don't really want to comment since we don't have the report out. There are things that you can see in the world: the slower growth in the U.S. economy this year and the fact that the tax cut is more front-loaded than what the President had proposed.

I see no long-term structural budget problems at all for the U.S. And I think the timing and amount of the next steps in tax policy really depends, as much as anything else on, one, ascertaining the current situation in the economy; and, two, trying to figure out what makes sense for the broadest sectors of the economy.

MR. GERSEMANN: I am Olaf Gersemann with Wirtschaftwoche Business Weekly.

Mr. Hubbard, you briefly mentioned the problem that America has with its foreign sales corporation. Could you elaborate a bit on how this international dispute might be solved through this fundamental tax reform you were talking about?

DR. HUBBARD: Well, I don't really want to comment on a matter that is an ongoing policy issue. The point I made I could just try to restate. The fact that the foreign sales corporation

rules are up for discussion and rethinking would offer a natural opportunity for the administration and for the Congress to rethink multinational tax policy. Beyond that, I don't really want to comment on an ongoing legal matter.

MR. CANFIELD: I am Norman Canfield, a retiree.

In the last Congress a bill was introduced, H.R. 2525, I think, called the Fair Tax, by Representative Linder and others. I understand it is planned for reintroduction this year. I wonder if you have any comments on that particular proposal.

DR. HUBBARD: Again, in the administration we are in the very early stages of thinking through tax reform. The national retail sales tax would be one form of a broad-based consumption tax. Many economists feel that there are other ways of accomplishing consumption taxation that might be simpler to implement and also offer more opportunities for progressivity at the low end. But, again, we are certainly at the very early stages of thinking about all those forms.

MR. SASS: Steven Sass, Crestline.

Actually, a little bit of a follow-up: I had a chance to meet with a very liberal congressman, and raised the issue of a fair tax, and to abolish the income tax. He actually agrees that the income tax is too complicated, too involved. He wants to do away with it, but he came out in favor of a value-added tax. I wonder what your thought is of a value-added tax in place

of the income tax, particularly in comparison to a national sales tax.

DR. HUBBARD: Well, if you thought of the simplest systems, where there is just one rate on everything and one base, just to fix ideas, all of these are taxes on consumption. So, a value-added tax, whether it is implemented European style, a credit invoice, or as some economists here talk about a subtraction method or the national retail sales tax, these are all variants of consumption taxes. They offer some important institutional differences and some important simplicity differences, but they are really all part and parcel of the same thing.

I think that in the discussion of tax reform, though, we shouldn't lead ourselves to believe that if we move to one of these new systems that we can simply tear up everything that is in the Internal Revenue Service. Every system that raises actual revenue requires an administrative apparatus. So, something like an Internal Revenue Service is here, alive and kicking, irrespective of these systems, at least as long as you have a government the size that we have.

MR. MITCHELL: Dan Mitchell, with the Heritage Foundation.

On the trends that you mentioned, actually I wanted to make a quick comment on the fifth trend, the WTO decision. You

said you can't comment on it, but I hope that you will use this opportunity to junk our worldwide system and go to territorial. That would make the E.U. rue the day that they forced us into that decision, because it would make us so much more competitive.

But I think there is one trend that you didn't touch on, and it sort of relates to Scott's question, which is, jurisdictional tax competition. If you look at all the OECD countries that cut tax rates following the Reagan tax rate reductions, and if you look at the corporate tax rate reductions that have been triggered by Ireland, I think that is one of the most powerful forces in terms of forcing politicians in the right direction. And this, of course, brings us into the whole issue with the E.U. and the OECD trying to stamp out tax competition. And the administration has been generally good, but somewhat ambiguous, about how much we will limit particularly the information exchange that the OECD and E.U. are demanding to try to impose taxes on a worldwide basis. I was hoping you could comment on that.

DR. HUBBARD: Well, to start with your first point, I think you are absolutely right that tax competition, in and of itself, is a good thing and not a bad thing. It improves efficiency. It imposes discipline on the size of government. It is something that the vast majority of economists would endorse.

And I think that certainly the White House and the Treasury have been pretty clear about this. I, myself, took a good deal of heat from the OECD, in this country and in Paris, on it. So, I am familiar with their concerns.

The administration, though, is firmly behind the Treasury's position -- which must be the case -- that we have to enforce the U.S. law. So, I don't think there is much ambiguity. I think the Treasury is quite clear that it wants to enforce laws against tax evasion. And, indeed, Secretary O'Neill has very helpfully initiated a review of the whole area and a review of money-laundering activities, as well. But I think you can count on the administration's position on tax competition as rock solid.

MS. MCGUIRE: I'm Monica McGuire, with the National Association of Manufacturers.

I wanted to bring up the corporate AMT issue; you mentioned it a couple of times. Manufacturing is clearly in a recession. The economy is in a slump. We know that the corporate AMT is a perverse tax, in the sense that companies pay actually higher taxes and they fall into AMT when the economy is in a slump.

Could you comment on what the impact was of the last economic downturn in 1990 and 1991 of the corporate AMT in terms

of investments and jobs and how you see it affecting companies now as more and more companies fall into AMT.

DR. HUBBARD: Well, certainly the corporate AMT has exactly the feature that you mention. Indeed, the last round of real concern over the corporate AMT came about during the downturn in 1990 and 1991. I think almost all economists would agree that we really need AMT reform. Indeed, one could question, from an economic perspective as opposed to a political perspective, why we have an AMT at all. Suffice it to say that it is an item of observation as the administration thinks about business tax policy for precisely the reason that you mentioned.

MR. ENTIN: Steve Entin, Institute for Research on the Economics of Taxation.

You mentioned transparency as one of the most important elements of a good tax system. There are many types of consumption-based taxes. Some are collected at the business level, such as the VAT or the retail sales tax; some are collected partly or wholly at the individual level. Who pays business taxes, and how important is it for people to see their tax liability and what government is costing them in making an informed vote?

DR. HUBBARD: The first question is easier for me to answer as an economist than the second, which is more political. The first question is easy. People pay taxes; not businesses.

So, we all pay taxes that are levied on business. Some of them we pay in the prices of goods and services. Some we pay in factor income shifted on to wages or shifted on to profits. But we should never, never kid ourselves that there is such a thing as business paying taxes.

The perception as to how visible a tax should be is really an important political question. There may be very important simplicity reasons for doing taxes that are collected at the business level. And, going the other way, there may be important reasons for people to see the size of the tax they pay.

From an economic perspective, it doesn't matter; it is all going to be borne in the prices of goods that they pay. But I agree with you, it is an important question whether households see that transparent difference.

MS. NITSCHKE: I'm Lori Nitschke, with CQ.

You focused mostly on business issues. I am just wondering if there are any individual taxpayer complexity issues that you are looking at, perhaps, such as the AMT. Then, maybe looking for a little more of a time line, is this something that you expect to see in the next few years? Are we looking at next year? If you could just give me a little more indication?

DR. HUBBARD: Since I was basically talking about fundamental tax reform, I did mostly business. But on the individual side, there are at least two things that are certainly

very important for consideration. One would be the individual AMT, that you mentioned, which, for both complexity reasons and for reasons of raising tax burdens for some households, are important to look at.

The other is the area of capital gains taxation. Going back to the comment that I made about multiple layers of taxation on productive capital, it certainly makes the capital gains tax, or taxes on corporate equity broadly, an item of discussion.

As to timing, there are really two features of the landscape that will shape the timing. One is the general discussion going on in the policy community, and not just in the administration but also in the Congress, about relative priorities. The other would be the budget position of the government as to what the exact timing of tax cuts could be. It is certainly a high priority in the administration, and I think it is fair to say it is a high priority for the AMT and capital gains in many sectors of the Congress, as well.

DR. NISKANEN: Glenn, should we be willing to tap into the so-called Social Security surplus to finance major tax reform or major Social Security reform?

DR. HUBBARD: I think it is important, not just as a rhetorical device but as a matter of making sure people have transparent budget principles, to wall off the Social Security surplus at the present time. The reason I say that is this

President is not committed to accounting games with Social Security that we have seen too many times, but is committed to the creation of individual accounts which will be funded Social Security assets for all of us. So, I think it is very important to keep that distinction.

Obviously, if we were in a very severe economic situation, one would want to rethink the boundaries for fiscal policy but, at least at the present time, I think it is important to keep the Social Security surplus for Social Security.

MR. HUTCHINSON: Martin Hutchinson, United Press International.

A number of us over the last few months have been propounding a theory that because of the huge run-up in stock prices we are, to some extent, on the edge of an economic precipice and have a very deep recession ahead of us. If this is to happen -- and obviously at the moment you think it is not, but we can, neither of us, really know -- if this was to happen, what is it going to do to the process of tax reform and indeed the tax reform that we have already had?

DR. HUBBARD: To take both parts of your question and reiterate what I said before, I do not think the U.S. economy is in a recession. I do not think the U.S. economy is imminently headed toward a recession. I think that that view would be pretty widely shared among commercial forecasters and with people

who are playing for real money, i.e., the prices of assets in the economy.

As to the issue of what that would do for tax reform, it could go either way. One possibility is if you have a deep recession, you certainly weaken the finances of the government, especially since we have progressive taxes in place. The other is, going back to one of the trends that I mentioned from the world, that a concern over the need for additional capital deepening in the economy promotes a desire for tax reform. So, I really couldn't speculate which of those effects might dominate.

MR. REDDERSON: Thank you, Glenn. My name is Jay Redderson, with the firm of Bond Beebe.

An observation, and I would be interested in your comment. Clearly, in the tax structure you have a lot of moving parts. You have an international structure. You have a corporate structure. You have individual structures. It seems to me that this is really an educational process; that you have to conduct this in the public view. And if you are waiting for the nightly news to explain the vagaries of the economic consequences of tax reform, you will never get there.

It seems to me that we need to show the public how it benefits them not merely in terms of tax savings but how it simplifies their lives. In other words, if you could construct a structure in which you would have the revenue collection, but you

would have, say, less of a compliance process for the individual, whereby you had third-party reporting and collecting and you could show them how their life was simplified, not to mention the inherent economic and cost-savings, that it is an easier battle to fight. I would be interested in your thoughts.

DR. HUBBARD: I agree with you 100 percent. During the big interest in flat taxes and their variants in the mid- to late-1990's, I did an experiment with my brother. My brother is a pretty well-known country and western singer. And he travels all over the country, seeing real Americans all the time. He asked what was the feature of things like the flat tax in these tax discussions that interested people and that were very popular at the time. The answer that he almost always got had nothing to do with what people like me talk about, which is marginal tax rates and efficiency; it was about sizes of postcards and simplification. And I agree with you, if we can get out there with that message of a simpler tax system, we will be way ahead.

I still think, though, that there are other issues. Again, the fact that the foreign sales corporate rules are on the table at the moment, while I don't expect that it is typical dinner table conversation for most families to talk about the FSC -- maybe for families in this room, but probably not generally across America -- the idea that American business and American jobs may be affected is a news hook. So, I think part

of a communication device is to focus on simplification and on areas where we reach into people's lives, with incomes and jobs, but it is a very hard task.

DR. NISKANEN: Yes, one more question here.

MR. DUNN: Robert Dunn, from George Washington University.

I wonder about the issue of double taxation of corporate profits encouraging excessive leverage on balance sheets. Since interest income is taxed once, corporate profits twice, doesn't this push companies toward excessive leverage on the right-hand side of the balance sheet, and then when we get into a recession or hard times, companies end up in bankruptcy court that otherwise would not? And if this is even a bigger problem in Japan and a few other countries, then it becomes an additional argument for integrating the personal income and corporate tax, to get rid of the incentive for excessive leverage.

DR. HUBBARD: It is certainly true that one of the features of classical tax systems, where you have double taxation, is the tax bias against equity or the tax advantage for debt. And there are abundant empirical studies by economists documenting this. There is a concern that a company could take an amount of leverage that is in the private interest of the firm but impose social costs -- that is, inefficient liquidations

would happen should we get bad macro-economic news. So, I think that is a problem.

It is also a problem over time as we play a constant cat and mouse game between, say, the Treasury regulators on the one hand and New York, Wall Street types on the other, of labeling what is debt and what is equity. In today's economy, what exactly is a debt contract is the subject of significant debate among economists and lawyers, and yet we have to keep playing this game. If we don't have a tax system that tries to discriminate, we are not in this box where otherwise very good people spend all their time thinking about tax planning instead of economic growth.

DR. NISKANEN: Let's close off the questions at this time and thank Glenn.

(Applause.)

DR. NISKANEN: I commend him for a talk that is both professional and politic. You are all invited to continue the discussion upstairs over lunch in the Wintergarden. Thank you.

(Whereupon, the Cato Institute Policy Forum was concluded.)