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STATEMENT OF LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE

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Mr. Chairman and Members of the Committee:

Introduction

I am pleased to discuss today proposals for fundamental reform of the tax system. During the last two years, several proposals have been made that would replace all or part of the income tax and payroll taxes with a tax on consumption. The conceptual proposals under current discussion include Representative Armey's and Senator Specter's plans to adopt a two-part flat consumption tax in place of the current corporate and personal income taxes, Representative Gibbons' plan to adopt a subtraction method value-added tax (VAT) in place of the corporate income tax, the payroll tax, and most of the individual income tax, and a plan by Senators Nunn and Domenici to replace the individual and corporate income taxes with two consumption taxes: a flat-rate tax on businesses and a progressive-rate individual consumed income tax. In addition, Chairman Archer would replace the present income tax system with a national retail sales tax or a VAT. Some of these proposals have been introduced as bills, but we understand that some of them are not yet in final form.

The interest in consumption taxes apparently arises for several reasons. The most frequently cited benefit of moving from a system that taxes income toward one that taxes consumption is that a consumption tax will improve saving rates and capital formation, and our standard of living in the long run. Proponents of consumption taxes also argue that a consumption tax would improve economic efficiency -- and thereby increase national output -- and simplify the tax system. Some supporters of consumption taxes point out that most of our major trading partners rely more heavily on consumption taxes, particularly VATs, and that adoption of a VAT in the United States would be more compatible with international practices.

Mr. Chairman, we recognize that the current U.S. income tax system has many defects, and we welcome the discussion on how to reform it. Since radical changes to the tax system -- especially changes that would completely replace the existing system -- involve costs and risks, they should be carefully evaluated according to their ability to achieve the fundamental objectives of a tax system -- fairness, efficiency, and simplicity. We believe a tax system should:

- raise sufficient revenue,
- distribute the burden of taxes equitably,
- avoid excessive intrusion of tax considerations into private economic decisions,
- promote economic prosperity and growth,
- and limit the costs to families and businesses of complying with the tax and the costs to the government of administering it.

Reforms should also include rules to reduce windfall gains and losses during the period of transition to a new system. Consumption tax proposals, in particular, should address the effect of the transition on the tax burden of the elderly, should include rules for the treatment of certain hard-to-tax economic sectors, such as financial institutions, and should address the coordination of a Federal consumption tax with State and local retail sales taxes.

In addition to these general tax policy objectives, the Federal income tax has, over the years, been used to promote widely-held social and economic goals, such as home ownership, private charitable giving, and provision of medical insurance by employers. It is likely that these goals would continue to be seen as pursuits worthy of preference under a reformed tax system. To the extent that a reformed system is to be used to promote social and economic goals, possibilities for simplification and tax rate reduction would be materially reduced.

The strongest argument for a consumption tax is that it will probably increase saving and investment, but the amount of any increase is highly uncertain and could be small. Other ways of increasing national saving -- such as further deficit reduction or expanding saving incentives within the income tax -- can be used to further this objective either more surely or with less overall disruption than a wholesale replacement of the existing income tax.

Replacing the income tax with a consumption tax also raises concerns about fairness, because many consumption tax alternatives would increase the tax burden on low- and middle-income families. Efforts to improve the progressivity of consumption taxes would require significant increases in costs of compliance and administration. Moving from one tax system to another would also be complex and costly and would create both intended and unintended winners and losers. It also would change asset values, and the level of prices and wages.

Replacing the entire income tax with a consumption tax would be a grand experiment of applying theory to a practical application that no other country in the world has chosen to undertake. Proponents of these plans must, therefore, overcome a significant hurdle -- they must show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

The remainder of my testimony will describe (i) various types of consumption taxes, (ii) the distributional and economic effects of replacing the income tax with a consumption tax (including the international aspects of the proposals), (iii) some issues related to specific economic sectors that would have to be addressed in implementing a consumption tax, (iv) observations about simplifying the tax system, (v) the effect of some consumption tax proposals on the underground economy, (vi) coordination of proposals with State and local retail sales taxes, and (vii) transition issues.

Background

Imposing taxes on the basis of income (whether from labor or the return to savings and investment) arises from the principle that an equitable tax system should take into consideration the variation among individuals' ability to pay taxes. The "ability-to-pay" principle is often understood to mean that a tax should be progressive with respect to income; that is, the portion of income that is paid in taxes should rise as income rises. A broad-based income tax with graduated tax rates, as in the United States and other advanced economies, satisfies that criterion. An income tax need not have graduated rates, however. A flat-rate income tax applied beyond some base level of income would be progressive, but not to the same degree as a graduated-rate tax.

What is a consumption tax?

As an alternative to income-based taxes, consumption taxes are levied only on income that is spent on consumer goods and services; or, in other words, income that is saved is exempt from tax. Within this definition, broad-based consumption taxes can be administered in a number of ways. They can be collected wholly from businesses, either on final sales to consumers or on the value-added by all businesses at each stage of production. They can be collected in part from businesses and in part from wage-earners by allowing businesses to deduct wages and taxing them at the individual level. They can be collected wholly from individuals by modifying the current individual income tax to allow taxpayers to claim a deduction for all net saving. Furthermore, the statutory rates under a consumption tax can be flat, or they can differ across individuals or across different types of consumption. And a consumption tax that is collected from businesses can be broad-based, or it can exempt certain goods and services or businesses from tax.

Consumption taxes that are collected from individuals exempt income that is saved from tax in one of two ways: (1) by allowing a deduction from an income base for income that is saved and adding to the tax base the amount dissaved, or (2) by including compensation in the tax base and exempting the return to savings (interest, dividends, and capital gains). To see how exempting income that is saved is equivalent to exempting the return to savings, consider the effect of each approach on a taxpayer who begins a year with $100 of wage income and wishes to postpone all consumption for five years. The taxpayer saves all of his after-tax wage income in the first year and earns a five percent annual return on his savings. At the end of five years, he withdraws his principal and accumulated interest and spends it. In each year, the tax rate is 28 percent.

In the first case, the taxpayer is allowed a deduction for net saving, but is taxed on net withdrawals from savings. The taxpayer deposits his $100 of wages in a savings account. He deducts $100 from his taxable income, leaving him with zero taxable income and zero tax liability. His after-tax consumption in the first year is also zero. Because the taxpayer reinvests the interest income on his savings, he owes no tax on the interest income during the next five years. In the fifth year he withdraws $127.63: his original savings of $100 plus interest of $27.63. At a tax rate of 28 percent, his tax due on $127.63 of taxable income is $35.74. His after-tax consumption is $91.89.

In the second case, the taxpayer must pay tax on his wage income and receives no savings deduction. He pays $28 of tax on his $100 of wage income and deposits the remaining $72 of after-tax income in the bank. He has zero after-tax consumption in the first year. Over the next five years, his interest income is exempt from tax. In the fifth year he withdraws $91.89, his original savings of $72 plus interest of $19.89. His taxable income is zero, and his after-tax consumption is $91.89. Assuming that the taxpayer is in the same tax bracket during the five-year period, exempting the return to saving results in the same pattern of after-tax consumption as allowing a deduction for income that is saved, leaving the taxpayer indifferent between the two approaches.

Consumption taxes that are collected from businesses grant an immediate deduction for purchases of new capital stocks (including machinery, buildings, land, and inventory). This immediate deduction -- or "expensing" -- effectively eliminates the tax on the return from new investment. A consumption tax that is collected in part from individuals and in part from businesses would allow businesses to expense capital purchases and, under the individual tax, either exempt income that is saved or exempt the return to savings. The combination of these mechanisms ensures that income from capital -- the return to saving and investment -- is untaxed at any level.

Relieving new saving and new investment from tax is seen as the primary benefit of taxing consumption instead of income. Because the after-tax return to savers will increase, families will have an incentive to save more. But exempting the return to new saving reduces the tax base, requiring higher tax burdens on wage income. Moreover, because low- and middle-income households typically do not save as large a percentage of their incomes as higher-income households, flat rate consumption taxes are regressive -- effective tax rates decline as family incomes rise. Addressing the regressivity problem is a key challenge in designing a consumption tax that will not add to tax burdens of lower- and middle-income families.

While the key feature of a consumption tax is that it exempts income from new saving and investment, it should also be noted that many forms of consumption tax would reduce the number and types of deductions allowed to businesses. In general, a business-level consumption tax will allow deductions only for payments made to other businesses. Therefore, wage payments and the cost of non-pension employee fringe benefits -- such as employer-provided health insurance -- State and local taxes, and payroll taxes would generally not be deductible to businesses. The disallowance of deductions for fringe benefits and for the employer portion of the payroll tax under some proposals represents a "hidden" tax on employees, since most economists believe that these taxes would be shifted by employers to their employees.

Options for taxing consumption

There are a number of ways to administer a consumption tax, although the various forms would all not tax the return from new saving. The distributional effects and administrative costs would depend on the details of each proposal.

The theoretical model for each general option is described below. Applying theory to practice, however, will inevitably involve some compromises with the pure models. The degree of the deviations will be important in assessing both the possible viability and the overall economic effects of any particular proposal.

1. Retail sales tax (RST). Businesses are the sole collection agents for retail sales taxes -- like those used by most States -- and VATs. A RST is applied to sales of goods and services to households. In order to tax only sales to consumers, the RST must exempt sales between businesses and distinguish between taxable and exempt sales of capital goods. If the RST is levied on a broad base, it is a tax on total consumption. Because a RST is collected only on retail sales to domestic consumers, it automatically taxes imports and exempts exports. State sales taxes in the United States are not broad-based for two main reasons. First, certain purchases, including purchases of housing and necessities like food and medical care, are tax-exempt for social policy reasons. Second, many services are exempt for administrative reasons.

2. Value-added tax. Most countries that have a national consumption tax administer it as a credit-invoice VAT. Under this system, businesses are liable for VAT on their sales, but receive a credit against their tax liabilities for VAT paid on inputs purchased from other businesses. Credit-invoice VATs in effect in other countries tax imports and exempt exports. They achieve this result by not taxing export sales, while allowing exporters a credit for all purchased inputs, and effectively imposing tax on goods purchased from other countries by not allowing their costs to be creditable.

Under a subtraction method VAT (also called a "business transfer tax" or BTT), a business is liable for tax on the difference between its sales and its purchases from other businesses, including purchases of buildings and equipment (but, as stated above, excluding other costs such as taxes paid and labor compensation). If the tax is applied to all goods and services at the same rate, a credit-invoice method VAT is economically equivalent to a similarly broad-based subtraction method VAT or national RST. Under Representative Gibbons' proposal, businesses would be subject to a subtraction method VAT.

3. Two-part individual/business consumption tax. Another form of consumption tax is collected in part from individuals and in part from businesses. The tax could be administered in the same way as a subtraction method VAT, except that it would allow wages to be deducted from the business tax base and would tax them at the individual level. If wages are subject to the same, single tax rate that is applied to businesses, the tax is "flat."

The proposals by Representative Armey and Senator Specter are consumption taxes of this form. In their proposals, wages are subject to a flat tax rate equal to the business tax rate, but wage earners are allowed to claim personal exemptions. These plans are economically equivalent to a VAT with a credit for wages up to the personal exemption amount. Alternatively, the individual portion of the tax could be levied at graduated rates. With no exemptions or deductions, the base of this two-part tax is the same as that of a broad-based VAT or national RST -- total consumption.

4. Consumed income tax. A consumption tax collected solely from individuals would be levied directly on their reported income, just like the current income tax, but would allow a deduction for net saving. The base of this tax is equal to consumption, because consumption is the difference between income and net saving. In order to measure income properly, proceeds from all forms of borrowing would need to be included in the tax base, and all forms of saving would be deductible.

The USA Tax System proposed by Senators Nunn and Domenici is comprised of both a flat-rate tax on businesses that is similar to a subtraction method VAT and a progressive-rate individual consumed income tax. The Nunn-Domenici proposal would not allow a deduction for labor costs under the business tax and would include labor income under the individual tax. This means that wages and salaries and non-pension fringe benefits would be taxed twice: once at the business level and again at the individual level. However, the tax burden on wages would be reduced through tax credits to both employers and employees for payroll taxes paid.

Distributional effects of replacing the income tax with a consumption tax

Replacing the income tax with a flat-rate consumption tax

The effect on the distribution of the tax burden of replacing the income tax with a consumption tax depends on the details of the tax that is adopted and on which taxes are replaced. Generally, however, taxing consumption places a higher burden on low- and middle-income families -- who typically do not save much of their income -- relative to an income tax. Because capital income is concentrated among high-income families, eliminating the tax on income from new capital will disproportionately benefit high-income families.[1] The change will, therefore, shift the tax burden away from high-income families to middle- and low-income families.

Table 1 shows the distributional effect of replacing the revenue of the corporate and personal income taxes (including the earned income tax credit) with a general consumption tax with no exemptions (such as a broad-based VAT or national RST).[2] The revenue-neutral rate of 14.5 percent used for these calculations assumes that the tax is imposed on all consumption in the economy, including consumption services supplied by the government and non-profit sectors, which would probably be exempt from a VAT or RST. In practice,

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[1]For example, about 40 percent of all taxable interest and dividend income reported on 1991 individual tax returns was received by the 6 percent of taxpayers with adjusted gross income over $75,000. See U.S. Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns--1991*, U.S. Government Printing Office, 1994, pp. 28-30.

[2]For an explanation of how to design a consumed income tax that is distributionally neutral across income quintiles, see U.S. Congressional Budget Office, *Estimates for a Prototype Saving-Exempt Income Tax*, Congressional Budget Office, 1994, pp. 19-28.

therefore, the rate that would be required under a broad-based VAT or RST would probably be much higher.[3]

At the 14.5 percent tax rate, the aggregate after-tax income for the group of families in the first through fourth income quintiles would be lower under the flat tax (i.e., a net tax increase), while the aggregate after-tax income for the group of families in the highest income quintile would be higher under the flat tax (a net tax cut). Expressed as a percentage of after-tax income under current law, the proposal would cause a reduction in aggregate after-tax income of between 3.9 percent and 11.1 percent for the groups of families in the first through fourth income quintiles and a 5.4 percent increase in after-tax income for the groups of families in the highest income quintile.[4] This amounts to aggregate increases in Federal taxes ranging from 15.5 percent to 134.1 percent for the group of families in the first through fourth income quintiles, and a 18.6 percent reduction in taxes for the group of families in the highest income quintile.[5,6]

In this analysis, the burden of the consumption tax is distributed to taxpayers according to components of current income. But individuals may base current expenditures on their expectation of future income as well as on current income. For example, college students who earn very little while they are in school might, nevertheless, have high current consumption expenditures if they are able to borrow against the expectation that they will have high incomes in the future. In such cases, annual income understates economic well-being. Annual income may overstate economic well-being in a year when a family receives

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[3]The 14.5 percent tax rate would be applied on a tax-inclusive basis, in a manner similar to the income tax. The equivalent rate calculated on a tax-exclusive basis, as would be relevant under a VAT, is 17.0 percent.

[4]These results are illustrated in Chart 1.

[5]The distributional estimates shown in the Table 1 are based on the assumption that the consumption tax is borne by taxpayers in proportion to their earnings and income from existing capital. Alternative assumptions could be made about who bears the burden of the tax. A traditional assumption is that a consumption tax is borne by consumers in proportion to their consumption. We have not followed this approach, because it overstates the tax cut for high-income families and the tax increases for low- and middle-income families by failing to adjust for temporary income fluctuations and normal life-cycle patterns of consumption and income. In addition, lack of reliable data on consumption by families with very high and very low incomes make distributional estimates based on the traditional approach less reliable than those shown in Table 1. Following this approach would lead to a more regressive distribution of the tax than that shown in Table 1.

[6]The finding that replacing the income tax with a flat-rate consumption tax would redistribute tax burdens from low-income to high-income families is consistent with previous analyses. For example, CBO and JCT find that, under a broad-based VAT, low-income families would pay a higher fraction of their income in tax compared to high-income families. See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 32-7, and Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens*, U.S. Government Printing Office, 1993, p. 54-5.

Table 1

Replace Current Individual and Corporate Income Taxes (Including the EITC) with a 14.5% Flat Rate Consumption Tax with No Exemptions(1)

(1996 Income Levels)

Family Economic Income Quintile (2)	After-Tax (3) Income Under Current Law ($B)	Change in After-Tax Income from Proposal (4): Repeal Income Tax ($B)	Flat Rate Consumption Tax with No Exemptions ($B)	Total Change: Amount ($B)	Total Change: Percentage Change (%)	Percentage Change In Total Federal Taxes (%)
Lowest (5)	171.1	-4.5	-14.5	-19.0	-11.1	134.1
Second	431.0	9.9	-53.1	-43.2	-10.0	70.5
Third	697.9	59.6	-100.6	-40.9	-5.9	27.9
Fourth	1,091.9	126.6	-168.8	-42.2	-3.9	15.5
Highest	2,693.1	536.7	-391.4	145.4	5.4	-18.6
Total (5)	5,054.7	729.4	-729.4	0.0	0.0	0.0
Top 10%	1,899.8	427.7	-264.9	162.8	8.6	-28.8
Top 5%	1,371.5	341.2	-180.5	160.7	11.7	-38.7
Top 1%	683.5	202.7	-81.5	121.2	17.7	-54.6

Department of the Treasury
Office of Tax Analysis

March 7, 1995

(1) This table distributes the estimated change in after-tax income due to the proposal with a revenue-neutral rate of 14.5 percent.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

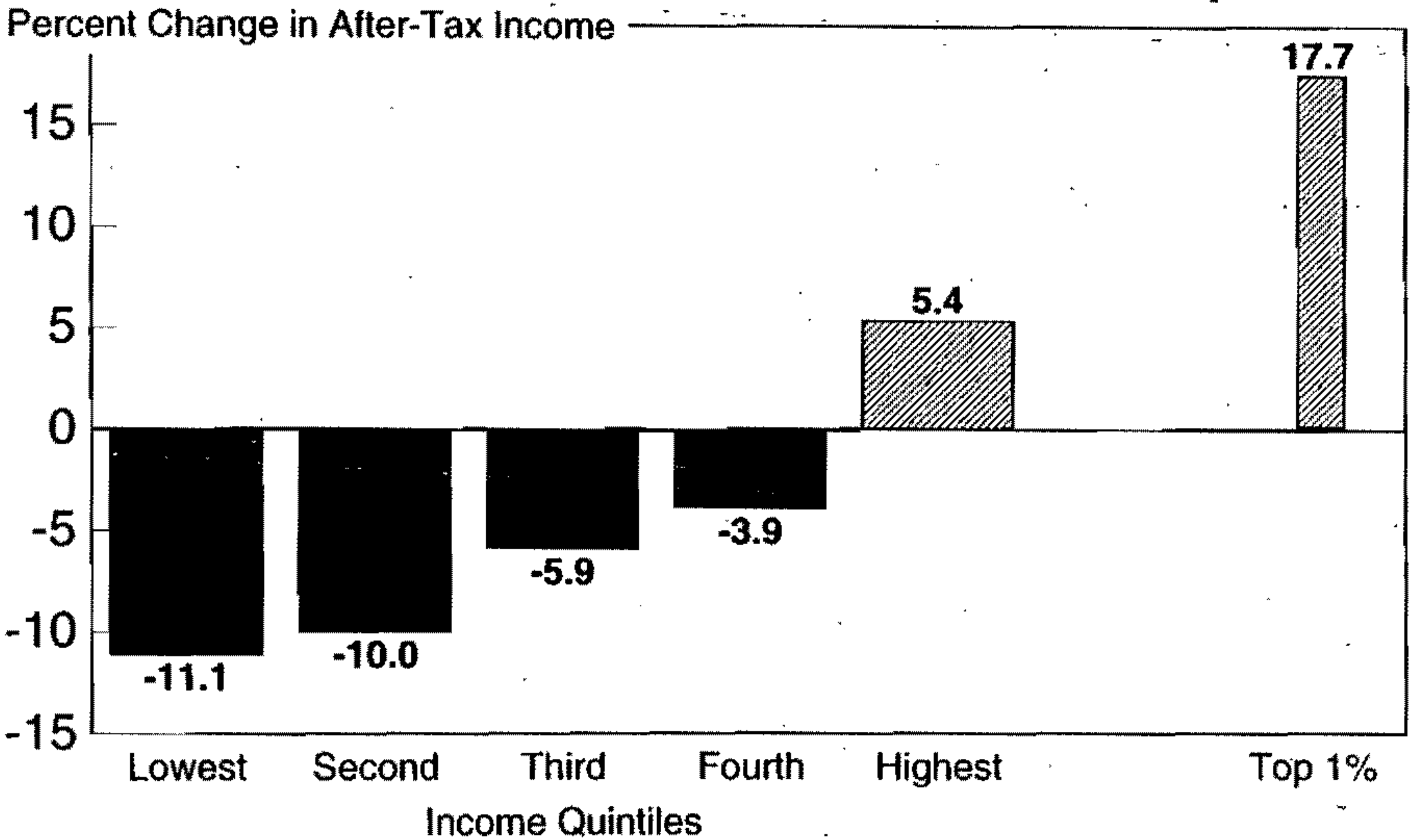
(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The portion of the flat rate consumption tax that falls on wages, fringe benefits, and pension benefits is assumed to be borne proportionately by wages, fringe benefits, and pension benefits. The remaining portion of the flat rate consumption tax, which falls on business cash flow, is assumed to be borne by capital income generally.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,438

Chart 1: Distributional Effect of Replacing Current Income Taxes with a 14.5% Flat Rate Consumption Tax



Source: Department of the Treasury (see Table 1 for details) income from a transitory source, such as a large bonus. For these reasons, some economists argue that lifetime income is a better measure of an individual's long-term economic well-being than annual income. Our analyses, however, do not distribute tax burdens according to lifetime income because future earnings are uncertain, and even if future earnings were known, lifetime income would be difficult to measure with accuracy. In addition, lifetime income is an inappropriate measure of current well-being if individuals are unable to smooth their consumption over their lifetime by borrowing and saving. For example, if the college students mentioned above are not able to borrow against their uncertain future earnings, it may be inappropriate for the tax system to view them as well-off currently.[7] Nevertheless, some studies show that distributing a general consumption tax to families according to their estimated lifetime income makes the tax appear to be less regressive.

Addressing the regressivity of a consumption tax

An important difference among the various forms of consumption taxes lies in the mechanisms available for distributing the tax more equitably among families with different incomes. One way that European countries attempt to reduce the regressivity of the VAT is by exempting specific goods and services from the tax or taxing them at a lower rate. This approach does not reduce regressivity effectively because tax relief from exempting specific goods and services is difficult to target to low-income families. While the tax preference does relieve the burden on low-income families, middle- and upper-income households also benefit when they purchase tax-preferred goods and services, requiring higher rates on other goods and services that low-income families buy to raise the same revenue. Other approaches, such as refundable credits and expansion in government transfer programs are more effective ways to offset regressivity, but would add to administrative and compliance costs and require explicit increases in government outlays.

A consumption tax that is collected at least in part from individuals can better account for differences in ability to pay among families and individuals than one that is collected solely from businesses. Such a tax can be made less regressive through standard deductions, as under Representative Armey's and Senator Specter's flat tax proposals, and/or graduated rates, as under the Nunn-Domenici plan. Refundable credits like the earned income tax credit (EITC) can also be used to reduce the tax burden on low-income families, but credits carry with them administrative costs. For example, low-income families, who otherwise might be excluded from the tax system, would be required to file a return in order to receive the credit.

As an illustration of the effect of including standard deductions and personal exemptions in a general consumption tax, Table 2 shows the distributional effect of replacing the corporate and individual income taxes with a stylized flat tax similar to the Armey

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[7]For a more detailed discussion of these points, see Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens*, U.S. Government Printing Office, 1993, pp. 82-6.

Table 2
Replace Current Individual and Corporate Income Taxes with a 22.9% (Modified) Flat Rate Tax (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	After-Tax (3) Income Under Current Law ($B)	Change in After-Tax Income Under Proposal (4): Repeal Income Tax (except EITC) ($B)	22.9% Tax on Wages Over Stand. Ded. (5) ($B)	22.9% Tax on Fringes and Payroll Tax (6) ($B)	22.9% Tax on Business Cash Flow ($B)	Total Change ($B)	Percentage Change (%)	Percentage Change in Total Federal Taxes (%)
Lowest (7)	171.1	3.8	-0.9	-2.7	-1.9	-1.7	-1.0	12.2
Second	431.0	25.0	-11.8	-9.0	-9.5	-5.2	-1.2	8.5
Third	697.9	64.1	-38.7	-17.0	-20.7	-12.2	-1.8	8.3
Fourth	1,091.9	127.6	-91.5	-26.5	-33.8	-24.2	-2.2	8.9
Highest	2,693.1	537.0	-300.1	-39.5	-154.1	43.3	1.6	-5.6
Total (7)	5,054.7	758.6	-443.7	-94.9	-220.0	0.0	0.0	0.0
Top 10%	1,899.8	427.9	-211.0	-21.0	-128.8	67.0	3.5	-11.9
Top 5%	1,371.5	341.2	-142.2	-10.6	-108.6	79.7	5.8	-19.2
Top 1%	683.5	202.7	-58.5	-2.3	-68.3	73.7	10.8	-33.2

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(1) This table distributes the estimated change in after-tax income due to the proposal with a revenue-neutral rate of 22.9 percent (approximately).

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The flat tax on wages (plus pension benefits received) is assumed to be borne by wages plus pension benefits received in excess of the standard deduction. The flat tax on employer-provided fringe benefits (except pension contributions) and payroll taxes is assumed to be borne by employees in proportion to benefits or taxes. The flat tax on business cash flow is assumed to be borne by capital income generally.

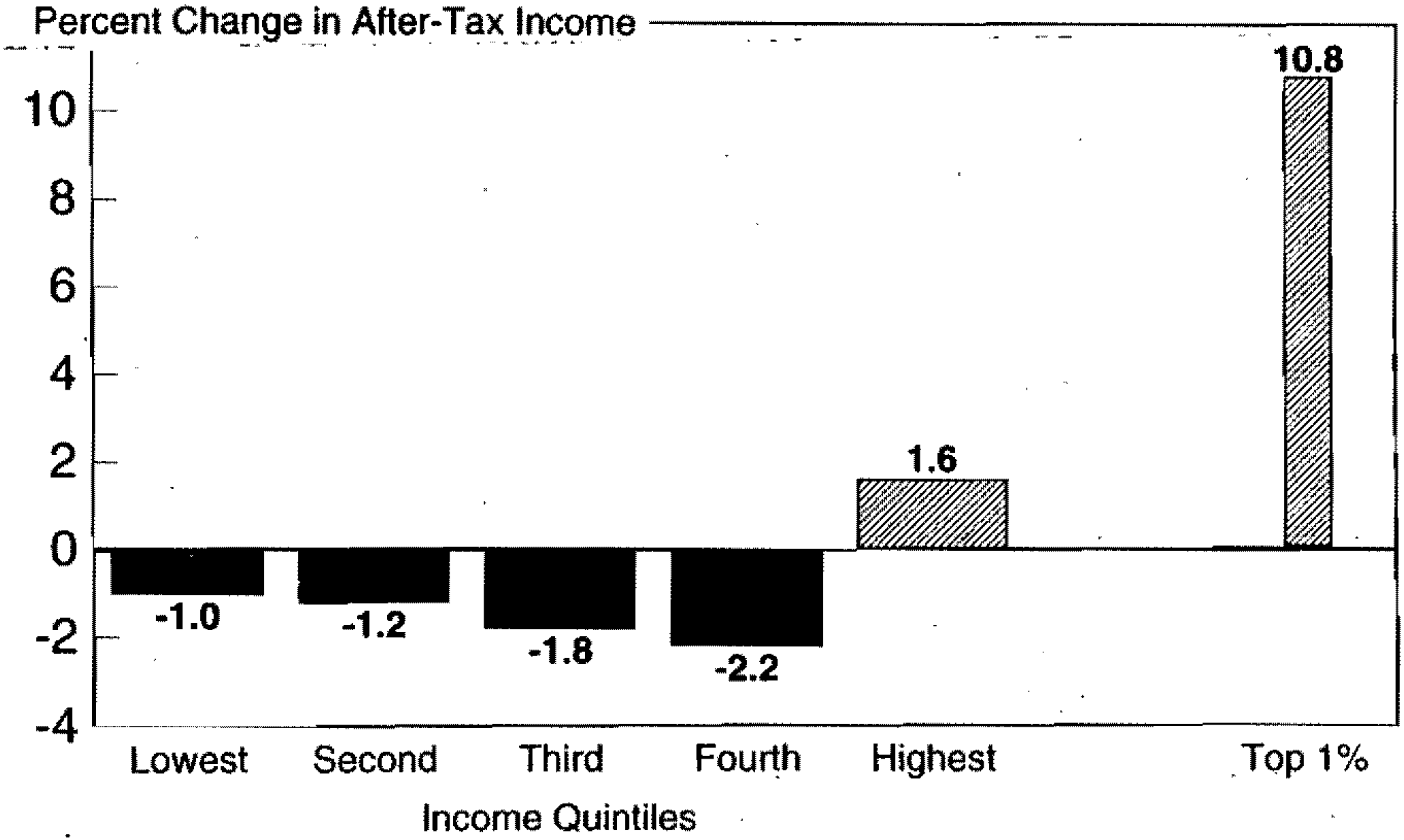
(5) The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.

(6) The proposal would disallow a deduction for employer-provided fringe benefits (except pension contributions) making these benefits (primarily employer-provided health insurance) subject to the 22.9 percent flat tax. The employer portion of payroll taxes would likewise be nondeductible.

(7) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of, Second $15,604; Third $29,717; Fourth $48,660, Highest $79,056, Top 10% $108,704; Top 5% $145,412, Top 1% $349,438

Chart 2: Distributional Effect of Replacing Current Income Taxes with a 22.9% (Modified) Flat Rate Consumption Tax



Source: Department of the Treasury (see Table 2 for details) proposal.[8] With standard deductions of $24,700 (for joint returns) or $12,350 (for single-filers) and a $5,000 exemption for each dependent, the revenue-neutral rate for the flat tax rises to 22.9 percent. Under this version of the flat tax, the aggregate after-tax income for the group of families in the first through fourth income quintiles would still be lower than under current law (i.e., a net tax increase), while the aggregate after-tax income for the group of families in the highest income quintile would be higher under the flat tax (a net tax cut). However, compared to the proposal without exemptions, the Armey-style proposal would cause a smaller reduction in aggregate after-tax income (between 1.0 percent and 2.2 percent of current-law after-tax income) for the group of families in the first through fourth income quintiles. The percentage increase in after-tax income for the group of families in the highest income quintile, 1.6 percent, would also be smaller than the increase shown in Table 1. These changes amount to aggregate increases in Federal taxes ranging from 8.9 percent to 12.2 percent for the group of families in the first through fourth income quintiles (compared to 15.5 percent and 134.1 percent, respectively, under the proposal without exemptions), and a 5.6 percent reduction in taxes (compared to 18.6 percent in Table 1) for the group of families in the highest income quintile.[9]

Table 3 compares the progressivity of the current Federal tax system together with the revenue-neutral, stylized flat tax described above. The last two columns in the table show taxes as a percentage of pre-tax income (effective tax rates) for groups of taxpayers. The current tax system is progressive with respect to income by quintile -- that is, effective tax rates rise with each income quintile -- and the flat tax is progressive through the fourth income quintile, although the effective tax rate falls slightly from the fourth income quintile to the highest. The flat tax proposal, however, ceases to be progressive for the group of families with the very highest incomes. The effective tax rates for the groups of families in the top ten percent, five percent, and one percent of the income distribution fall to 20.2 percent, 18.8 percent, and 16.4 percent, compared with a rate of 21.7 percent for families in the fourth income quintile. Under current law, effective tax rates continue to rise for the families with the very highest incomes.[10] This decrease in tax burden on higher-income families under the flat tax occurs because income from new saving and investment (which is not taxed under a consumption tax) is concentrated among families at the top of the income distribution.

While Treasury has not completed a study of the distributional effect of the Nunn-Domenici consumption tax, their proposal was designed to achieve progressivity through graduated rates under the individual consumed income tax. A top statutory individual tax

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[8]Except for the inclusion of standard deductions and personal exemptions and the disallowance of certain deductions for taxes paid by businesses, the distributional estimates shown in the Table 2 are based on the same assumptions as those in Table 1.

[9]These results are illustrated in Chart 2.

[10]These results are illustrated in Chart 3.

Table 3
Replace Current Individual and Corporate Income Taxes with a 22.9% (Modified) Flat Rate Tax (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	Federal Taxes Under Current Law (3) ($B)	Federal Taxes with 22.9% Flat Rate Tax (4) ($B)	Change in Federal Taxes ($B)	Taxes as a Percent of Pre-Tax Income Under: Current Law (%)	Taxes as a Percent of Pre-Tax Income Under: with 22.9% Flat Rate Tax (%)
Lowest (7)	14.2	15.9	1.7	7.6	8.6
Second	61.2	66.4	5.2	12.4	13.5
Third	146.5	158.7	12.2	17.3	18.8
Fourth	271.8	296.0	24.2	19.9	21.7
Highest	779.5	736.2	-43.3	22.4	21.2
Total (7)	1275.1	1275.1	0.0	20.1	20.1
Top 10%	565.3	498.3	-67.0	22.9	20.2
Top 5%	415.3	335.6	-79.7	23.2	18.8
Top 1%	221.9	148.3	-73.7	24.5	16.4

Department of the Treasury
Office of Tax Analysis

June 5, 1995

(1) This table distributes the estimated change in Federal taxes due to a (modified) flat rate tax with a revenue-neutral rate of 22.9 percent (approximately) which replaces the current individual and corporate income taxes.

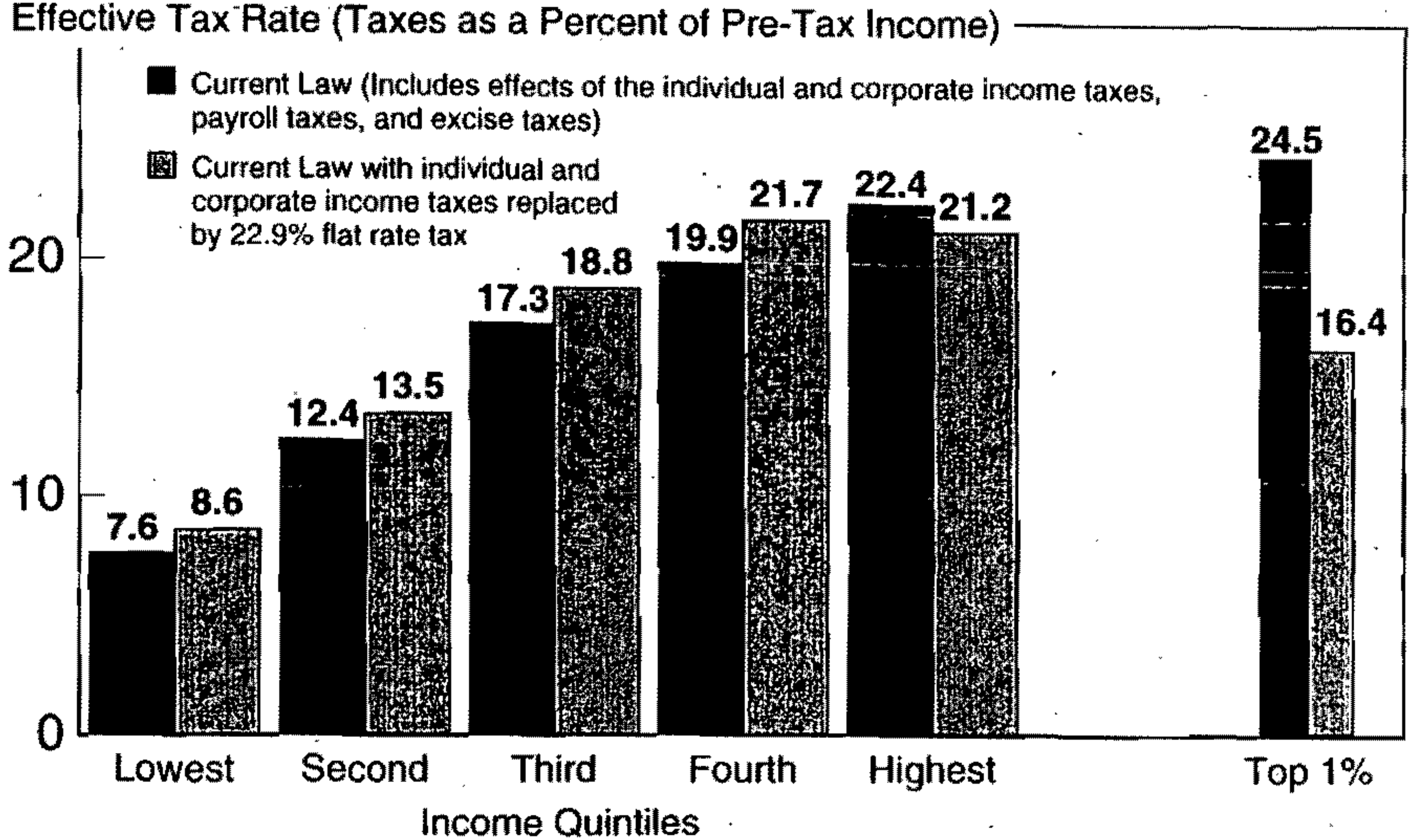
(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The flat tax on wages (plus pension benefits received) is assumed to be borne by wages plus pension benefits received in excess of the standard deduction. The flat tax on employer-provided fringe benefits (except pension contributions) and payroll taxes is assumed to be borne by employees in proportion to benefits or taxes. The flat tax on business cash flow is assumed to be borne by capital income generally.
The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.
The proposal would disallow a deduction for employer-provided fringe benefits (except pension contributions) making these benefits (primarily employer-provided health insurance) subject to the 22.9 percent flat tax. The employer portion of payroll taxes would likewise be nondeductible.

(5) Families with negative incomes are included in the total line but not shown separately.

Chart 3: Distributional Effect of Federal Tax System Under Current Law and With Income Taxes Replaced by a 22.9% (Modified) Flat Rate ConsumptionTax



Source: Department of the Treasury

rate of 40 percent, together with the loss of a deduction for labor costs under the 11 percent business tax, means that consumed labor income in excess of $24,000 (for joint filers) would be taxed at an effective rate of 46.6 percent under the Nunn-Domenici proposal. With the family living allowance and personal and dependent exemptions, a family of four would pay income tax at an effective rate of 46.6 percent on consumed labor income in excess of $41,600.

As an alternative to a complete replacement of the income tax system, a VAT or BTT could be imposed at a moderate rate to replace a portion of the revenue from the income tax. A variant of this approach, taken by Representative Gibbons, would impose a VAT to replace most of the revenue from income and payroll taxes, but would retain an income tax for high-income individuals to ensure that they continue to pay an equitable share of taxes. Refundable credits or other mechanisms could be used to offset the effects of the consumption tax on low-income families.

While consumption taxes can be made less regressive, there is a clear and important tradeoff between progressivity and simplicity. The forms of tax that are the simplest and probably the least costly to administer and with which to comply (the RST and VAT) cannot be made progressive without retaining some income-based taxes on high-income families and credits for low-income families. The forms that are collected solely from individuals are more easily made progressive, but would be at least as complex -- and probably *more* complex -- than our current tax system. Consumption taxes collected from individuals -- such as the individual portion of the Nunn-Domenici USA Tax -- would impose numerous reporting requirements on taxpayers and would introduce complicated tax calculations in ways that would be new to taxpayers, tax preparers, and the IRS. I will describe some of these complexities in more detail later in my testimony when I evaluate the effects of tax reform on simplicity.

Transition from the existing income tax to a new consumption tax raises an additional series of issues regarding equity, compliance, economic efficiency, and the impact on wages, prices, interest rates, and the values of assets. These important issues are also discussed below.

Economic effects of replacing the income tax with a consumption tax[11]

Saving and investment[12]

The main reason to consider replacing the income tax with a consumption tax is that this change could encourage domestic saving and capital formation and promote economic growth. A consumption tax would not tax the return to new saving and investment. The income tax does tax this return, and thereby discourages saving and investment to some degree. The key issue is whether substituting a consumption tax for an income tax will raise saving enough to overcome its other problems.

1. National saving. The low rate of U.S. saving is a serious concern. The national saving rate in the United States has declined in the 1980s compared to the previous three decades (Table 4). Although private saving decreased during this period, it remained positive. Public saving, however, has been consistently negative as a result of Federal budget deficits.

Table 4. Components of Net U.S. National Savings as a Percentage of GDP: 1950-1994

Year	Net Personal Saving	Net Business Saving	Total Net Private Saving	Public Saving	Total Net National Saving
Average 1950-59	4.7	2.9	7.6	-0.1	7.5
Average 1960-69	4.7	3.6	8.2	-0.1	8.1
Average 1970-79	5.5	2.6	8.1	-1.0	7.2
Average 1980-89	4.5	1.5	6.0	-2.4	3.6
Average 1990-94	3.4	1.8	5.1	-3.1	2.1

Source: Department of Commerce, Bureau of Economic Analysis

[11]This section analyzes the long-run economic effects of switching to a consumption tax system. The short-run effects could be quite different from the long-run effects, but analysis of short-run effects is beyond the scope of this testimony.

[12]Discussion of the points made in this section of the testimony appears in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 44-52; U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, Congressional Budget Office, 1992, pp. 51-5; and Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1995, pp. 63-72.

The reasons for the decline in private saving rates in the United States are unclear. It could be due to demographic factors that may reverse as the baby boom generation enters later middle age and saves for retirement. It may also be attributable to an increase in the availability of insurance and Social Security benefits, which reduce the necessity for private saving.[13] The decline in saving does not appear to have been caused by changes in tax policy. Marginal tax rates were lowered substantially during the 1980s and new saving incentives were introduced, but the rate of saving still fell.

According to a recent report by the Organization for Economic Cooperation and Development, the saving rates of our major trading partners also have declined since the 1960s.[14] All of these countries except Japan, however, rely more heavily on consumption taxes for revenues than does the United States, both as a percentage of gross domestic product (GDP) and as a share of total tax revenues (Tables 5 and 6). While Japan depends the least on consumption taxes for revenues, it also had the highest saving rate during the 1980s (Table 7) and the highest rate of growth in real per capita GDP (Table 8).

The most direct way to increase national saving is to reduce the Federal budget deficit. The Federal government may also be able to affect private saving through changes in tax policy. However, if tax policy changes also increase the Federal budget deficit, there may be no net increase in national saving.

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[13] For a more detailed discussion, see Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1991, p 72.

[14] Organization for Economic Cooperation and Development, *Taxation and Household Saving*, 1994, pp. 17-24.

Table 5. Tax Revenues by Type of Tax as a Percentage of GDP for Selected Countries: 1992[1]

	Total	Income & Profits	Social Security	Property	Goods & Services	Other[2]
Canada	36.5	16.4	6.0	4.0	9.5	0.5
France	43.6	7.6	19.5	2.2	11.7	2.7
Germany	39.6	12.7	15.2	1.1	10.6	0.0
Italy	42.4	16.6	13.3	1.0	11.4	0.1
Japan	29.4	12.5	9.7	3.1	4.1	0.1
United Kingdom	35.2	12.7	6.3	2.8	12.1	1.3
United States	29.4	12.2	8.8	3.3	5.0	-

Source: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965-1993, 1994.

[1] Includes taxes at all levels of government.
[2] Includes certain payroll taxes that are not earmarked for social security, taxes imposed on other bases not otherwise identified or identifiable and fines and penalties.

Table 6. Tax Revenues by Type of Tax as a Percentage of Total Taxation for Selected Countries: 1992[1]

	Income & Profits	Social Security	Property	Goods & Services	Other[2]
Canada	45.0	16.5	11.1	26.1	1.4
France	17.3	44.6	5.0	26.8	6.3
Germany	32.0	38.4	2.7	26.9	-
Italy	39.1	31.3	2.4	26.9	0.3
Japan	42.4	32.8	10.5	14.0	0.3
United Kingdom	36.1	17.8	7.9	34.4	3.7
United States	41.5	29.9	11.4	17.1	-

Source: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965-1993, 1994.

[1] Includes taxes at all levels of government.
[2] Includes certain payroll taxes that are not earmarked for social security, taxes imposed on other bases not otherwise identified or identifiable and fines and penalties.

Table 7. Average Net National Saving Rates for Selected Countries

Country	1980's	1990	1991	1992
Canada	8.4	5.0	2.5	1.5
France	7.9	8.6	7.6	6.5
Germany	9.8	12.5	10.4	9.8
Italy	9.8	7.8	6.8	5.2
Japan	18.2	19.8	20.0	18.2
United Kingdom	4.8	3.6	2.4	2.0
United States	4.5	3.1	2.8	1.9

Source: OECD, National Accounts 1980-1992, 1994.

Note: Data are based on the OECD System of National Accounts (SNA) methodology which differs slightly from the U.S. National Income Accounts System.

Table 8. Average Annual Growth Rates of Real Per Capita GDP for Selected Countries: 1980-1992 (percent)

Country	1980 to 1990	1990 to 1992
Canada	1.9	-1.9
France	1.8	0.4
Germany	2.0	2.0
Italy	2.0	0.9
Japan	3.5	2.4
United Kingdom	2.5	-1.8
United States	1.8	-0.1

Source: Organization for Economic Cooperation and Development

2. Tax policy and private saving. Two effects from substituting a consumption tax for the income tax could boost total private saving. Economic theory suggests that if the after-tax rate of return on savings goes up, individuals would increase saving to consume more in the future since the "price" of future consumption in terms of foregone current consumption is lower. However, most empirical studies find that the effect of increasing the

rate of return on the level of saving would be quite small.[15] In addition, some people are "savers," while others consume essentially all their income. Shifting the overall burden of taxes from saver to consumer households can increase aggregate private saving, but it would also result in an increased concentration of private wealth.

While a pure consumption tax would encourage private saving more than a pure income tax, the effect on saving of substituting a consumption tax for our existing income tax is less clear. Our current income tax includes powerful incentives for employees to receive part of their compensation in the form of retirement savings plan contributions, and for employers to provide such plans for all their employees -- including low-income employees who would not be likely to respond to direct tax incentives. The incentive to establish retirement plans would be much weaker under a consumption tax.

An alternative way to use tax policy to increase private saving is to broaden saving incentives within the framework of the existing income tax. Provisions that directly encourage people to deposit some of their earnings in tax-favored accounts, such as IRAs and 401(k) plans, could be more cost-effective ways of increasing saving without replacing the entire tax system. Toward that end, the Administration's budget has proposed an expansion in the eligibility rules for contributing to IRAs.

3. <u>Saving and investment</u>. Advocates of replacing the income tax with a consumption tax often discuss effects on saving and investment as if they are interchangeable. But saving and investment can diverge significantly because of the increased amount of international capital flows in today's global economy. More specifically, the relative effects on saving and investment would depend in part on the extent to which the consumption tax revenues were used to reduce corporate or individual income tax rates. Eliminating the corporate tax would increase domestic investment more than private saving, while eliminating the individual tax would increase private saving more than domestic investment.[16]

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[15]See Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1995, p. 46. For additional discussion of this point, see Organization for Economic Cooperation and Development, *Taxation and Household Saving*, 1994. In *Descriptions and Analysis of Proposals to Replace the Federal Income Tax* (U.S. Government Printing Office, 1995, p. 69), the staff of the Joint Committee on Taxation states that the results of studies of the empirical response of saving to changes in the after-tax rate-of-return are inconclusive.

[16]Under U.S. tax rules, corporate income tax is imposed on the return to equity-financed capital used in the United States regardless of who owns it, whereas the individual income tax is imposed on the return to capital owned by U.S. residents regardless of where it is used. (U.S. corporations are taxed on their worldwide income, but receive a tax credit for foreign income taxes paid. The residual U.S. tax rate on active foreign-source income of U.S. corporations, after accounting for foreign taxes, is generally quite low.) Eliminating the corporate tax would be expected to increase domestic investment more than saving, because it would reduce the cost of capital to both U.S. corporations and foreign corporations investing in the United States by much more than it would increase the after-tax return to U.S. savers. In contrast, eliminating the individual income tax would be expected to increase saving more than domestic investment because it would increase the after-tax return to U.S. personal saving invested both in the United States and abroad, but, with internationally-linked

4. Interest rates. It is not clear how a switch to a consumption tax would affect U.S. interest rates in the long run.[17] The net demand by U.S. investors for interest-bearing assets would be expected to increase, pushing bond prices up and yields down. This would occur because the consumption tax would remove interest flows from tax calculations. Also, under a consumption tax, domestic borrowers would not be willing to pay as high a rate of interest because interest would no longer be deductible, and U.S. lenders would be willing to accept a lower rate of interest because interest income would no longer be taxed. But in today's world economy, the U.S. interest rate is closely linked to rates in other advanced countries. With foreign interest rates unchanged and debt capital flowing freely across international borders, any reduction in U.S. interest rates would be dampened significantly. The likely result is that U.S. interest rates would fall somewhat, but by much less than the initial tax benefit to savers. After-tax yields to U.S. savers and after-tax interest costs to U.S. borrowers would increase.

Prices and wages

A frequent concern is that the introduction of certain types of consumption taxes, particularly RSTs and VATs, would lead to a higher price level because such taxes are generally added to the price of the product.

It is likely that such a one-time increase in the prices of consumption goods could occur. In addition, the indexing provisions of social welfare benefits and some labor contracts could lead to continuing inflationary pressures in later periods as a delayed effect of the initial price level change. The extent of this one-time increase and any further increases in the price level depend on the actions of the Federal Reserve. Such price increases can only occur if the Federal Reserve provides accommodative monetary policy.[18,19]

If the introduction of a consumption tax does lead to an increase in the overall price level, wage-earners will suffer a proportionate reduction in their purchasing power. If the price level does not rise, however, after-tax payments to factors of production such as wages would have to be reduced. In either case, the net after-tax returns to labor are likely to be reduced under a consumption tax because of the need to obtain revenues to offset the reduction in taxes on capital income.

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capital markets, would not provide a relative advantage to capital invested in the United States.

[17]The short-run effects on interest rates would depend on actions taken by the Federal Reserve during the period of transition to a new tax system.

[18]For additional discussion of the effects on prices of adopting a VAT, see U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, Congressional Budget Office, 1992, pp. 64-65.

[19]If the consumption tax is a replacement for part of the income tax, however, there may be decreases in the prices of investment goods that would produce an offsetting effect and further reduce the likelihood of price increases.

Asset values

Changing from income taxation to consumption taxation is likely to have material effects on the values of different kinds of assets. It is clear that there will be major winners and losers. But it is difficult to identify all effects on assets because such effects depend in complex ways on the details of specific proposals and on the economic responses to some of the changes. We can only comment generally on what some of the effects might be.

Several economists have argued that expensing of new investments under a consumption tax will adversely affect stock prices to the extent that those prices reflect the value of existing capital.[20] Expensing of new investment lowers the rental price of capital that is required to make new investment profitable. These lower rents, in turn, depress the value of claims to existing assets. But the actual effect on the overall level of stock prices is likely to be less than predicted by these studies. These studies are based on changing from pure income to pure consumption taxes, but the current income tax system already incorporates some features of a consumption tax such as accelerated depreciation and savings preferences. The short-run adverse effects on overall levels of stock prices are likely to be further cushioned because the adjustment costs associated with incorporating new investment will reduce the rate at which the capital stock increases. This will keep rental returns of capital from falling by maintaining the value of scarce capital.[21]

The exemption under a consumption tax for interest income and the elimination of interest deductions would tend to reduce interest rates, pushing up the price of existing taxable bonds. But in today's international capital markets, high-grade bonds of different countries are close substitutes. Consequently, a change in the tax treatment of debt in the United States is not likely to affect world interest rates. On net, interest rates in the United States would probably fall only slightly in response to the imposition of a consumption tax, pushing bond values up only slightly.

If the consumption tax is collected from businesses, and the Federal Reserve accommodates the tax by expanding the money supply, the price level will rise. Increased prices will effectively transfer real wealth from lenders (current holders of long-term bonds) to borrowers (current issuers of long-term bonds). New borrowers and lenders would be unaffected by this wealth transfer.

Tax-exempt interest rates would be expected to rise in response to a switch to a consumption tax because, under most consumption tax proposals, tax-exempt bonds would no

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[20]See, for example, Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987, and David Bradford "Consumption Tax Alternatives: Implementation and Transition Issues," paper at Hoover Institution Conference, May 11, 1995.

[21]See Andrew Lyon, "The Effect of the Investment Tax Credit on the Value of the Firm," *Journal of Public Economics*, 38 (1988), pp.227-247.

longer be favored relative to taxable bonds. Consequently, existing holders of long-term municipal bonds would suffer a capital loss.

Under the current income tax, investment in owner occupied housing is substantially tax favored compared to other forms of investment. These advantages include allowing deductions for certain homeownership costs, such as mortgage interest and property taxes, even though housing produces no taxable income. Under most consumption tax proposals, housing would lose its relative advantage over other forms of investment. The switch to a consumption tax would affect housing most directly through the repeal of the mortgage interest deduction and corresponding elimination of the tax on interest income. Consequently, the cost of both debt and equity capital invested in housing would increase.[22] The loss of preferential treatment means that the consumption benefits from housing would rise relative to the returns from other investment. This would lower the price of existing housing and substantially reduce the number of new homes that are built.[23] In the absence of special transition rules or a continuation of tax preferences, housing values could fall considerably in the short run. Over time, the housing stock would be expected to decline, and the resulting scarcity of homes would push the prices of existing houses back towards their initial level.

Economic efficiency

1. Allocation of capital.

Because a consumption tax does not tax the return to new investment and treats all businesses uniformly, it would not favor some assets or industries over others. Unlike the current U.S. income tax, it would not favor non-corporate over corporate investment or investments in capital owned by State and local governments, owner-occupied housing, consumer durables, and other personal assets over business investments. As a consequence, investors would be encouraged to hold assets that were expected to produce the highest economic returns. Investment would be expected to shift out of the sectors that enjoy favor under the income tax -- owner-occupied housing, other personal assets, and noncorporate and State and local capital -- and into corporate capital. In addition, a consumption tax, unlike the current income tax, would not favor corporate debt over equity financing, reducing tax considerations from business financial decisions.

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[22]A similar conclusion is drawn in Joint Committee on Taxation, *Descriptions and Analysis of Proposals to Replace the Income Tax*, 1995, U.S. Government Printing Office, p. 86.

[23]The decline in housing prices would be proportionately greater for high-priced homes than for low-priced homes. The owners of high-priced homes are typically in high tax brackets, making the mortgage interest deduction relatively more valuable to them, while the owners of low-priced homes may be in low brackets or may be non-itemizers.

The resulting gains in economic efficiency are substantially reduced if the replacement consumption tax departs from a very broad base. However, such departures may be desired for a number of reasons. For example, most countries attempt to reduce the number of taxpayers in the system by exempting small businesses from the VAT. Some industries, such as banking and insurance, are typically excluded from the VAT because their tax bases are difficult to define. Some forms of capital, such as owner-occupied housing, might be given a preference to support social and economic goals. Each such exemption reduces the efficiency and simplification benefits attributable to the uniform treatment of capital.

2. Taxation of existing wealth.

Economic analyses show that much of the gain in economic efficiency predicted to result from a switch to a consumption tax arises from the taxation of wealth in place at the time of transition to the new tax. Saving and investment that take place after the imposition of a consumption tax will be exempt from tax, but consumption out of existing wealth will be taxed, unless provisions are made to relieve this burden explicitly. Economists believe that a tax on existing wealth will not distort taxpayer behavior. Therefore, collecting revenue through this non-distorting tax will allow lower tax rates on the remainder of the consumption tax base, significantly increasing economic efficiency. Nevertheless, a full or partial exemption for existing wealth might be desired to prevent savings that had been taxed under the income tax from being taxed a second time under the consumption tax. An exemption for all existing wealth would effectively convert the consumption tax to a tax on wage income alone, however, requiring higher tax rates on wages to compensate for the lost revenue.[24] Consequently, allowing a full exemption for existing wealth under a new consumption tax will substantially reduce, and could entirely eliminate, the gains in economic efficiency that many economists expect from the switch.[25]

3. Labor supply.

Both an income tax and a consumption tax affect the choice between work and leisure by reducing the relative purchasing power of wages. An income tax reduces the relative value of wages by taxing them directly. A consumption tax that is collected from businesses reduces the value of wages to the extent that the business tax is passed forward to consumers in the form of higher prices or back to workers in the form of lower wages.[26]

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[24]A consumption tax with an exemption for existing wealth would be levied not only on wages, but would also collect revenue on profits that reflect "economic rents," for example, profits resulting from the ownership of a monopoly.

[25]For a discussion of the relative economic benefits of a consumption tax, wage tax, and income tax, see Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987.

[26]See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, p. 57.

The effect on labor supply of switching to a consumption tax depends on changes in effective tax rates. Effective tax rates reflect the combined effects of the statutory rate structure and other tax proposal provisions, such as denying deductions for wages and employee fringe benefits at the business level and retaining payroll taxes. Examining the proposed statutory rate structure alone would overstate the possible decline in tax rates and the increase in work incentives.

4. Consumption-saving choice.

One source of economic inefficiency under an income tax is the distortion the tax imposes on a consumer's choice of how much to save. Because an income tax is imposed on the return to savings, it effectively increases the "price" of consumption in the future in terms of consumption foregone today. That is, under an income tax, a consumer must deposit more money in the bank today to finance a given amount of spending in the future than would be required in the absence of the income tax. Economic theory suggests that this increase in the price of future consumption reduces consumers' incentive to save. A consumption tax, which does not tax the return to savings, does not increase the price of future consumption relative to current consumption. A consumption tax is, therefore, neutral with respect to the consumer's choice of how much to save. As I stated earlier in my testimony, however, while economic theory suggests that individuals might increase saving in response to the higher return to saving resulting from the switch to a consumption tax, most empirical studies find that the effect of increasing the rate of return on the level of saving would be quite small.

International trade

It is sometimes argued that, because indirect taxes can be imposed on imports and refunded on exports, the adoption of a VAT or other indirect consumption tax to replace part or all of our current income taxes would encourage U.S. exports. However, trade economists generally agree that such a tax change would not permanently improve either U.S. exports or the U.S. trade balance.[27]

To see how a refund or exemption for exports under a consumption tax and the imposition of the tax on imports (called border tax adjustments), in fact, amount to neither a subsidy for domestic exports nor a penalty on imported goods, consider a very simple example. Imagine that both New York and New Jersey produce apples for consumption within the state and for "export" to neighboring states. Assume a competitive market for apples sets the price per bushel at $5.00. Now imagine that New York adopts a broad-based, 10 percent VAT that exempts exports and is imposed on imports. The price of apples produced and bought in New York would be expected to rise to $5.50. Since the New

[27]See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, p. 63. A similar conclusion is drawn in Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*, U.S. Government Printing Office, 1995, pp. 69-70.

Jersey apples that are trucked into New York are subject to the 10 percent VAT, they would also sell for $5.50 per bushel. Imports into New York would, therefore, not be penalized relative to domestic produce. Over the border, New Jersey apples would still sell for $5.00 per bushel, as would imported New York apples that are exempt from New York's VAT. The exemption for exports, therefore, results in no subsidy for New York's exports.[28]

While adopting a consumption tax with border tax adjustments is generally considered to have no long-run effect on the balance of trade, eliminating or substantially reducing income taxes could affect the trade balance, because income taxes may discourage both saving by U.S. residents and investment in the United States, and lowering U.S. income taxes could affect private saving and investment by differing and uncertain amounts. If private saving increased more than investment, the United States would import less capital and net exports would increase; if investment increased more than private saving, net exports would decline. Which effect would dominate depends on the specific form of the income tax cut and on the relative responsiveness of saving and investment.

Eliminating or reducing U.S. income taxes could also affect the relative competitiveness of different industries, because the income tax imposes different effective tax rates on production in different economic sectors. For example, reducing the cost of capital in the United States would generally favor the production of capital-intensive goods over labor-intensive goods. This differential benefit would affect the composition of trade, because goods that became relatively more expensive to produce in the United States would be increasingly imported, and goods that became relatively inexpensive to produce at home would be increasingly exported. However, there is little reason to believe that the net trade balance would be much affected by this change in relative trade positions.[29]

Although border tax adjustments under a consumption tax are generally considered to have no long-run affect on the balance of trade, it should be noted that some types of consumption taxes are accepted as border-adjustable under the General Agreement on Tariffs and Trade (GATT), and others are not. Indirect taxes, such as credit-invoice VATs used in most other countries, are border-adjustable under the GATT. Consumption taxes collected wholly or in part from individuals, such as a consumed income tax and a flat-rate tax of the type proposed by Representative Armey and Senator Specter, are unlikely to be refundable under the GATT. Although a broad-based, single-rate subtraction method VAT is

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[28]It is not necessary to have border tax adjustments to obtain this result. If the market price for apples is $5.00, it will not be possible for producers to increase the price charged or lower the price and remain in business. Labor will bear the burden of the tax through a fall in wages and there will be no effect on trade between New York and New Jersey. In the international context, it is also possible for the currency of the country that imposed the tax to depreciate, offsetting the effect of the tax on the exported good.

[29]The Joint Committee on Taxation finds that replacing part or all of the corporate income tax with a VAT does not directly affect the U.S. trade balance. See Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 303-4.

economically equivalent to a similarly broad-based credit-invoice VAT, a GATT ruling would consider other factors. Whether a subtraction method VAT would survive a GATT challenge is an untested issue.[30,31]

Sector-specific issues of adopting a consumption tax[32]

Special treatment may be appropriate for specific business sectors under those forms of tax that are collected at least in part from businesses. High administrative and compliance costs relative to revenue collected may justify special treatment for certain sectors and for small businesses. Special rules are required for taxing goods and services with hard-to-measure tax bases, such as financial services.[33] The tax base for these services is not explicitly separated from other charges, and it is difficult to apportion the benefit from financial services to those who receive them. For example, the charge for intermediation services provided by banks is included in the difference between the interest rates charged to borrowers and paid on deposits. That difference also includes the return to equity-holders. Moreover, it is difficult to allocate the intermediation charge to a specific savings account or loan.

While the current version of the Armey and Specter proposals contain no special rules for the treatment of financial institutions, the Nunn-Domenici plan would tax banks and insurance companies under a separate set of rules from those applied to non-financial businesses.[34]

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[30]These points are discussed in more detail in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 302-4, and U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 63-4.

[31]The Treasury Department responded on February 3, 1995, to a query by Senators Nunn and Domenici on this issue.

[32]These issues are discussed in detail in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Congressional Budget Office, 1991, pp. 314-20, and U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 26-30.

[33]For a discussion of the difficulties related to taxing insurance and other financial services under a VAT, see Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 315-18.

[34]This is less of a problem under two-part consumption taxes like the Armey and Specter proposals than under other forms of consumption taxes, because the portion of value-added generated within the financial services sector by labor would be captured under the wage tax. Only the portion of value-added generated by capital would be lost.

Taxing governments and non-profit organizations is difficult because there often is no market price for their production and many are currently not subject to tax. Most countries with VATs attempt to tax the commercial operations of this sector, but this approach requires differentiating between taxable and non-taxable activities which can be administratively complex. While special treatment for specific sectors might ease administration of a consumption tax, exclusions from the tax base would increase economic distortions relative to a very broad-based consumption tax. The business tax portions of the Nunn-Domenici proposal would generally include the commercial activities of governments and many currently non-taxable non-profit organizations in the tax system.

Taxation of housing and consumer durables also raises important issues. To minimize economic distortions, rental housing, owner-occupied housing, and other durable goods should be treated similarly. When businesses are allowed to expense capital purchases, purchases of buildings or durables for use as rentals would be deductible, and rental receipts would be taxed. However, the same theoretical treatment of owner-occupied housing and durable goods would require taxing the total purchase price, which reflects the current value of the services the home or durable good provides over its useful life.[35] This approach can lead to significant tax bills for buyers and windfall gains for current owners, who would not owe tax on the consumption of their existing housing or durable good.

Many consumption tax proposals assume that exports will be relieved of the tax and imports will be taxed. Making the appropriate adjustments can be difficult if the tax base is not broad or if tax rates vary. Border adjustments for certain services also create complexity, because it is generally more difficult to determine the location of supply or purchase in the case of non-tangible services than for goods.

Simplicity

Simplification of the tax system is a primary goal of many tax reform proposals, and one which we support. A simpler tax system would have lower compliance costs for individuals and businesses, such as the costs related to learning the tax rules, recordkeeping, and preparing tax returns, and lower administrative costs for the government, such as the costs of processing tax returns and conducting audits.

To evaluate reform proposals on the basis of simplification, however, it is useful to examine the sources of the complexity that plagues our current system. One source of complexity, the measurement of capital income, would be reduced under some forms of consumption tax. Three other sources of complexity, the desire to distribute the tax burden equitably, the necessity to measure the consumption component of business income properly, and the use of the tax system to advance certain non-tax social and economic policies, would

[35]See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 28-9.

likely persist under any consumption tax. If a consumption tax were implemented in the United States, the final form of the tax would likely differ from the ideal for these same reasons. Divergence from the simple, broad-based, flat-rate, consumption tax model -- for whatever reason -- will tend to lead to complexity, with higher administrative and compliance costs, higher tax rates overall, and reduced efficiency gains.

Correctly measuring capital income is difficult, and approximations designed to reduce that complexity can invite tax avoidance and an inefficient use of economic resources. Therefore, one of the attractions of a consumption tax is that many of the onerous calculations related to capital income would be eliminated, and no tax would be owed on interest, dividends, and capital gains. Under a RST, capital purchases by businesses and capital income are excluded. Under a consumption tax levied at the business level, such as Representative Gibbon's VAT or the business tax portions of the Armey and Nunn-Domenici proposals, depreciation and other cost-recovery provisions would be replaced with expensing. Administrative and compliance costs would be reduced, since it would not be necessary to maintain records on asset costs in order to compute cost-recovery allowances and gains on the sale of assets.

Unlike the existing income tax, however, a consumed income tax collected from individuals would require the measurement of annual changes in wealth. As suggested earlier in this testimony, a consumed income tax system like the Nunn-Domenici individual level tax could, therefore, be at least as complex as the current system, posing numerous new taxpayer reporting requirements and introducing new tax concepts and calculations. Compliance costs are likely to be significant for individuals who must report their net savings, particularly for taxpayers that both borrow and save and roll over prior savings into new accounts, and for the banks, mutual funds and other businesses that would be required to provide reports on investment and borrowing activities of individuals. Under one approach to a consumed income tax, proceeds from all forms of borrowing -- whether through a loan or a balance carried over to the next year on a credit card -- would be added to a family's tax base. The net contribution to all forms of savings would be deducted from the tax base and withdrawals from savings would be taxed. It might not be complicated to calculate tax liability under this approach for a family that borrowed no money during the year, had no end-of-the-year credit card balance, and only made contributions to a passbook savings account. But in the modern U.S. economy, even a moderate-income family might in a typical year purchase deductible mutual fund shares through a dividend reinvestment plan, sell a taxable bond, and carry taxable balances on several credit cards. Some proposals might not require families to pay tax on some minimum amount of borrowing, such as under the Nunn-Domenici proposal, or might allow tax-free withdrawals from savings in cases of hardship, but these modifications would require complex rules to determine eligibility for exemptions and to prevent tax avoidance.

Distribution of the tax burden

Most of the mechanisms available under a consumption tax for minimizing the regressivity of the tax introduce complexities and their resultant costs. Exempting certain goods and services from a national RST or VAT and taxing others at alternate rates increases the compliance burden on businesses that would have to determine which rates to charge for their products and, in some cases, would be required to apportion their deductible costs among taxable and non-taxable sales. To make up the revenue loss from reducing tax on some goods and services, tax rates on the remaining goods and services would have to be raised. None of the proposals discussed in this testimony exempt specific goods and services, though State retail sales taxes in the United States and VATs in most OECD countries do use this approach.

A tax that is collected wholly or in part from individuals can be applied at graduated tax rates, which would complicate the tax slightly: it is not much more difficult for taxpayers to look up their tax liability on a table -- as they do now -- than it would be for them to apply a single rate to all taxable income. In the case of a two-part consumption tax, like the Armey proposal, ensuring that the same top statutory rate applies to both individuals and businesses would lower administration and compliance costs by enabling taxes on some forms of income to be collected wholly from businesses.

Many consumption tax proposals, such as those of Gibbons, Armey, and Nunn and Domenici, offer large standard deductions and exemptions for dependents in order to relieve some income from tax and to remove large numbers of people from the tax system altogether. The latter benefit is reduced, however, if refundable tax credits -- like the EITC -- are used to minimize the burden of the tax, as is done in some proposals. Low-income families that otherwise might not be required to file a tax return would have to fill out a return in order to receive the credit. So that credits can be targeted to needy households, a family might be required to calculate income, which it otherwise would not have to report under some forms of a consumption tax. The relative increase in administrative and compliance burdens of offering refundable credits might be small in the case of a consumed income tax, under which much of the income tax structure would be retained. The relative burden would be more significant, however, if the income tax had been completely replaced by a business-level consumption tax.

Measuring consumption

Like the existing income tax, a consumption tax that is collected from businesses, such as a VAT or two-part flat tax, would require rules for determining deductible business costs. Some business purchases have a consumption component that should be excluded from deductible business purchases. For example, a business' purchase of a company car that is also available for an employee's personal use has a consumption component, as do many business expenditures for travel and entertainment. The rules for determining allowable costs under a consumption tax would be similarly complex to the related rules under the income tax. Moreover, the timing of deductions for capital purchases would make the problem more serious under a consumption tax. Under a consumption tax, business assets would be expensed, accelerating the benefit received by the taxpayer -- and tax revenue lost to the government-- from circumventing the rules.

Promoting social and economic goals

A U.S. consumption tax is likely to be used to advance certain widely-held social and economic goals. To the extent that these goals are promoted through the tax system, administrative and compliance costs are increased under a consumption tax as they are now under the current income tax system. Home-ownership is treated preferentially under the current income tax primarily by allowing families a deduction for interest they paid on their home mortgages. Allowing current law treatment of mortgage interest under a consumption tax would encourage homeowners to incur additional borrowing beyond their financing needs. Because mortgage loan proceeds under current law are not included in taxable income, while the amounts deposited in a savings account under a consumption tax would be deductible, mortgage loans used to transfer money to a savings account would reduce tax liability. In addition, allowing only some forms of loans to be exempt, such as under the Nunn-Domenici proposal, would introduce complexity and distortions relative to a system that treated all borrowing equally. As under the existing income tax, taxpayers would have an incentive to reclassify all forms of household debt as mortgage debt to maximize the benefit of the tax preference.

Deductions for charitable contributions and State and local taxes paid could be allowed for families under a consumed income tax and for wage-earners and businesses under a two-part consumption tax. A tax preference for employer purchases of health insurance and fringe benefits could be provided under a two-part consumption tax by allowing businesses to deduct these costs. Under an individual-level consumption tax, employer-provided health insurance and other fringe benefits could be taxed by imputing their value to the recipients and including the imputed value in taxable income; not imputing the value to recipients would treat these benefits preferentially relative to other forms of compensation. Each of these tax preferences, however, would require rules to determine which fringe benefits are included in or excluded from the tax base, and these rules would be equally complex as those under current law. Rules would also be required to determine which business expenses to include or exclude from the tax base. The Armey and Specter proposals would disallow deductions for state and local taxes, and the employer portion of the FICA tax. The Nunn-Domenici proposal also would disallow those deductions, but would permit a credit for the employer portion of the payroll tax.

The underground economy

The underground economy consists of illegal activities and those which are "informal," but not illegal. A suggested benefit of a consumption tax system is that it may promote greater compliance with the tax laws from those presently operating in the underground economy. Some commentators have suggested that a consumption tax collected at the business level would enable tax to be imposed on income of the underground economy, particularly the informal sector, that is untaxed under the current individual income tax.

This benefit may easily be overstated. The reporting of income and sales from illegal activities, such as sales of illegal drugs, is unlikely to be affected by changes in the tax system. Incentives for not reporting income or sales from informal activities are likely to be similar under an individual income tax or a business-level consumption tax. For example, an electrician who does not pay income tax can charge a lower price, just as an electrician who does not collect a national RST or VAT for his services. Since income and sales from purchases of goods and services in the legal sector by the underground economy, such as the electrician's tools and supplies, are taxable now, it is unclear whether additional revenues would be obtained from this source by switching to a consumption tax.

Coordination with State and local sales taxes

An additional administrative consideration is the coordination of a Federal consumption tax with State and local government tax systems. Historically, States have depended heavily on retail sales taxes and excise taxes for revenues.[36] The adoption of a national sales tax or Federal VAT is likely to be seen as an infringement upon this important revenue source for State and local governments. In addition, a Federal VAT or national sales tax would create a new type of tax for businesses to administer. Some businesses would be responsible for either the VAT (or national RST) or a State sales tax, while others would be liable for both. The amount of State sales tax or VAT (or national RST) collected would depend on which tax was applied first and whether that tax was included in the tax base for the other one. Particular goods and services might be taxable under a VAT (or national RST) and exempted under the State sales tax, or vice versa, thereby creating additional administrative and compliance problems. Although sales taxes are generally under the purview of the States, the closeness of the tax bases would put the States under pressure to conform to Federal law.

Transition to a consumption tax and the tax on existing wealth

The most significant issue in converting from an income to a consumption tax system is deciding how to treat the return to wealth that was accumulated out of after-tax income under the income tax. The return to new saving and investment would be exempt under a consumption tax, but without an explicit exemption for old wealth, the return to and withdrawals from the stock of existing assets that are not reinvested will be taxed. For example, imposing a Federal VAT would automatically tax all withdrawals from existing savings that are used for consumption -- even if those savings were accumulated out of after-

[36] See Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Volume 2*, Washington, DC, 1994, Table 31, p.4.

tax income. A full or partial exemption for current wealth might be desired to relieve the tax burden on individuals with accumulated savings, many of whom are elderly. But such an exemption would reduce the taxes paid by the holders of wealth, making the tax less progressive. In addition, economists believe that a tax on existing wealth would not distort taxpayer behavior, and that this non-distorting wealth tax is the source of much of the gain in economic efficiency predicted to result from a switch to a consumption tax. Consequently, an exemption for all existing wealth would effectively convert the tax into a tax on wage income alone, requiring higher tax rates on wages. The effect would be to reduce significantly, and possibly completely eliminate, the gains in economic efficiency that some economists expect from a consumption tax.[37]

To illustrate the magnitude of this problem, consider the value of current household wealth. The total wealth of U.S. households is estimated at about $23 trillion.[38] Much of this wealth is in the form of assets, such as pensions and unrealized capital gains, which have not yet been taxed. Excluding housing, the basis of private assets in the United States could be as much as $10 trillion. Rules governing the treatment of consumption financed by existing wealth during the period of transition to the new tax will determine to what extent this significant amount of previously taxed savings is subject to the consumption tax. In this case, transition rules are not merely an inconsequential technical issue; how existing wealth is treated during the transition could have material economic effects.

Transition rules could be designed to relieve completely the tax burden on savers who have already paid income taxes on their savings and would otherwise be taxed again when those savings were spent under a consumed income tax. For example, without a transition rule for past savings, a retiree who accumulated $100,000 in a savings account out of after-tax income before the imposition of a consumption tax would be taxed on withdrawals from that account that are for consumption expenditures. A transition rule could allow savings that were accumulated under the income tax to be segregated from "new" savings and deducted from income. This rule would treat the $100,000 as tax-paid savings and would enable the retiree to make tax-free withdrawals from the savings account. It is difficult, however, to design rules that differentiate between individuals who reduce their accumulated savings in order to consume, and individuals who only rearrange assets among accounts. Allowing tax-free withdrawals from past savings, for example, would enable any individual with accumulated wealth to gain a tax deduction simply by transferring old assets into "new" savings accounts. Such a rule would enable a millionaire living off the interest on her accumulated assets, for example, to receive the equivalent of tax-free interest income -- a

[37]For a discussion of the relative economic benefits of a consumption tax, wage tax, and income tax, see Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987.

[38]Board of Governors of the Federal Reserve System, *Balance Sheets of U.S. Households*.

substantial benefit compared with current law.[39] The Nunn-Domenici plan includes detailed rules that would prevent the taxation of most previously-taxed savings while prohibiting taxpayers from generating savings deductions out of existing savings. While these rules would largely prevent the imposition of unfair burdens on elderly households, they would add to the complexity and costs of the tax system and would result in lower economic benefits than if the return to accumulated assets were subject to tax.

A similar problem exists for businesses that have purchased equipment prior to the tax change and have unused depreciation allowances. Denying depreciation deductions under the consumption tax would mean that businesses would not be able to recover fully the cost of those capital purchases, and that income from capital purchased before the effective date would be overtaxed. It would impose windfall losses on firms that invested prior to the effective date, placing them at a disadvantage relative to businesses that purchased equipment just after the effective date of the new consumption tax.

Transition rules could reduce windfall losses in this case, but they would likely sacrifice tax revenue and lead to greater complexity. For example, if the consumption tax is collected only at the business level, businesses could be allowed to deduct immediately the balance of their depreciation allowances, though little revenue would be collected from businesses during the early years of the tax under this scheme. Extending the depreciation deductions over a number of years, an approach taken by the Nunn-Domenici plan, would spread out the revenue loss, but it would require businesses to segregate old and new assets during the transition period and, therefore, would increase complexity.

Conclusion

A change as dramatic as replacing the income tax system with a consumption tax should only be attempted if the expected economic benefits of taxing consumption are reasonably certain to be larger than the total costs, burdens, and risks of moving to a completely new tax system. In making such a determination, it is misleading to compare a theoretically ideal consumption tax and the income tax system in place today. A realistic comparison would recognize that exclusions would likely be made under the replacement system -- either for administrative reasons or to support social and economic goals -- and that those exclusions would reduce the economic benefits of the change and increase complexity. A realistic comparison would also recognize that what we call an income tax in the United States is really a hybrid tax system. While it is based on income, it incorporates a number of consumption tax features that help promote saving. For example, contributions to

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[39]Under a transition rule that treats withdrawals from existing savings that are deposited into new savings accounts as new savings, an individual could draw down existing savings, deposit the amount in a new savings vehicle, and receive a tax deduction for the amount deposited. If the return to this "new" savings is used for consumption, the individual would pay tax on that return. But the original tax deduction would provide a benefit that would be equivalent to receiving the interest income tax-free. For an illustration of this result, see the example in the "Background" section of the testimony.

pensions, deductible IRAs, and other types of retirement savings are deducted from taxable income, and the earnings on these savings are not taxed until they are withdrawn. Most of the savings of middle-income Americans are in assets such as pensions and home equity that are already exempt from tax. Proposals for further reduction in taxes on income from savings of middle-income Americans, such as the proposal in the President's budget to expand the use of IRAs, should be carefully examined before we consider doing away with the income tax.

Based on all of the considerations described in my testimony today, we are not convinced that the case for completely replacing the income tax with a consumption tax is compelling. The most frequently cited economic benefit of such a change, an increase in private saving, is uncertain and could be small. The fairness of replacing the income tax with a consumption tax is also a concern. Moving to a flat-rate consumption tax would increase the tax burden on low-income families and lower the tax burden on high-income families. Efforts to improve the progressivity of consumption tax proposals result in complexity. In addition, the effect of switching to a consumption tax on wage and price levels, interest rates, and value of existing assets -- including homes -- is uncertain.

In general, divergence from the simple, broad-based, flat-rate, consumption tax model -- for administrative reasons, to address distributional problems, or to promote social and economic goals -- will result in more complicated tax calculations, higher tax rates overall, and reduced efficiency gains. In addition, the transition could take many years to complete, and could be very costly and complex. Absent special transition rules, the move to a consumption tax could create many unintended winners and losers. New savers would be advantaged relative to those who saved in the past, including many of the elderly. Businesses that invest after enactment of the consumption tax would have a competitive advantage over businesses that invested just prior to the change. Rules could be designed to address these situations, but they would be complex and could lead to significant reductions in the economic benefits expected from a switch to a consumption tax.

We commend efforts to develop consumption tax proposals that are progressive and revenue-neutral. We recognize that the details of some of the recent tax reform proposals have not yet been provided, and that the details will affect the analysis of any particular proposal. However, we believe that completely replacing the income tax with a consumption tax ultimately could be excessively complex and could create economic disruption. Moreover, while there has been substantial international experience with credit-invoice VATs and broad familiarity within the United States with State retail sales taxes, adopting a form of consumption tax other than a credit-invoice VAT or national RST would be venturing into the unknown. We can only speculate as to how a consumption tax collected at the individual taxpayer level would work. There is no experience upon which to gauge its effects on the U.S. economy or its administrative and compliance costs, and no way to anticipate all the potential tax avoidance schemes that could be designed to exploit the new tax rules.

Other countries have typically introduced consumption taxes, not as replacements for progressive income taxes, but in place of existing distorting sales or turnover taxes. Most of our trading partners now rely on a mixed tax system that combines income and consumption taxes. Consequently, a wholesale replacement of the income tax with a consumption tax would represent a grand international experiment. The burden lies with the proponents of consumption taxes to show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

Mr. Chairman, the Administration is keenly aware of growing taxpayer frustration with the complexity of the income tax system, and we think that greater weight should be given to simplification in evaluating tax reform proposals than has been given in the past. A simpler tax system would have lower compliance costs for individuals and businesses and lower administrative costs for the government. Moreover, while the debate is in process, simplification should be given greater weight in evaluating any changes to our existing tax law. In this regard, we note that last year's House of Representatives passed H.R. 3419, the Simplification and Technical Corrections Act of 1994. We urge the Committee to consider this legislation again on an expedited basis. We look forward to working with the Congress on these and other initiatives to improve our tax system. While continuing to work to improve our current income tax, we will give serious consideration to broader reform proposals that meet the tax policy objectives set forth above -- proposals that would simplify the tax system and improve economic incentives without sacrificing revenue or fairness.

Contents

Talking Points on Flat Taxes

- Several proposals have recently been made to replace the existing income tax system with a "flat tax." These proposals are effectively consumption taxes and have three common characteristics:

  (1) they would replace the graduated rate structure of the income tax with a single rate;
  (2) they would tax consumption instead of income and effectively exempt capital income (interest, dividends, and capital gains); and
  (3) they would eliminate many of the deductions and exclusions that are allowed under the current income tax.

- Flat tax proponents claim that their proposals would result in increased private saving. While economic theory predicts that families would have a greater incentive to save under a consumption tax than under the income tax, the amount of any increase in private saving from switching to a consumption tax is highly uncertain and probably small.

- The analysis of any particular proposal will depend on its details, and many of the details of recent proposals have not been provided.

- Replacing the existing graduated tax rates with a single rate raises concerns about fairness. A flat rate tax would shift the tax burden from very high-income taxpayers to low- and middle-income taxpayers. Proposals that would allow a generous exemption amount below which a family would pay no tax would relieve the poor from any tax burden, but would necessarily raise the burden on middle-income families.

- Because low- and middle-income families consume a higher percentage of their incomes than high-income families, a flat-rate tax on consumption is generally considered to be regressive.

- Consumption tax proposals would effectively eliminate taxes on income from capital -- interest, dividends, and capital gains. Inevitably, the tax burden on labor income would have to be raised to make up the difference.

- A flat rate consumption tax would allow businesses to deduct immediately the cost of all capital investments instead of claiming depreciation deductions over time as the investments produce income. Immediate expensing is equivalent to eliminating tax on the return to business investments.

- Under current law, businesses are allowed to deduct the cost of many fringe benefits they provide for their employees, including health insurance premiums. Most flat tax proposals, however, would disallow business deductions for fringe benefits other than retirement benefits. This means that employer-provided health insurance and other forms of non-cash compensation would be taxed at the business level.

- Under current law, businesses are allowed to deduct the employer portion of the payroll tax. Some flat tax proposals would disallow this deduction, which would increase the effective tax rate on labor income relative to a system that allowed the deduction.

- The disallowance of deductions for fringe benefits and the employer portion of the payroll tax represents a "hidden" tax on employees, since economists believe that these taxes will be shifted by employers to their employees.

- Many of the deductions that are allowed under the current income tax are intended to promote certain widely-held social goals. These include deductions that encourage homeownership, charitable giving, and employer contributions for health insurance coverage, and deductions for State and local income and property taxes. Some flat tax proposals would eliminate these incentives without providing substitute programs.

- Other flat tax proposals would retain some preferences, such as the deductions for home mortgage interest and charitable contributions. Continuing these preferences, however, would result in more complicated tax calculations, higher tax rates overall, and reduced efficiency gains relative to a simple, broad-based, tax on all consumption.

- Many of the goals -- such as simplification, base broadening, and lower tax rates -- stated by supporters of moving to a flat consumption tax can be achieved within the context of the existing income tax. Replacing the entire income tax with a consumption tax would cause substantial economic disruption and transition costs and would make it harder to achieve a fair distribution of the tax burden.

- Some flat/consumption tax proposals would disproportionately burden past savers -- including many of the current elderly -- who have already paid income taxes on their savings and would be taxed again when those savings were spent under a consumption tax.

- Many businesses that purchased equipment prior to the transition to a flat/consumption tax would have unused depreciation allowances. Denying depreciation deductions for existing equipment under a flat/consumption tax would impose windfall losses on firms that invested prior to the effective date of the new flat/consumption tax. This would place those firms at a disadvantage relative to businesses that purchased equipment just after the effective date, and would, therefore, be allowed to deduct the full cost of those purchases.

- Consumption taxes call for special rules governing the tax treatment of certain sectors, including non-profits, governments, housing and other consumer durables, and imports. Because a consumption tax exempts financial income, financial institutions cannot be subject to the same tax treatment as non-financial businesses. Any serious consumption tax proposal must include rules governing the treatment of financial institutions.

- We recognize that the current income tax system can be improved, and we look forward to working with the Congress on ways of simplifying our tax system. In particular, the Administration will give serious consideration to proposals that would reduce the costs of compliance and improve economic incentives without sacrificing revenue or fairness.

Office of Tax Analysis
April 28, 1995

Talking Points on the Armey Flat Tax

- Representative Armey has proposed that the United States adopt a two-part flat tax to replace the current corporate and personal income taxes. The proposed tax would be collected in part from individuals and in part from businesses. The base of the tax is total consumption, but the proposal exempts from tax a portion of wage income by allowing standard deductions for individual taxpayers and their dependents.

- The Armey proposal comprises:

  (1) a tax on individuals' wage income at an initial flat rate of 20%, falling to 17%, with standard deductions for taxpayers and their dependents, and

  (2) a tax, levied at the same rates as the individual tax, on all business cash flow with deductions for purchases of capital and for wages (but not for non-pension fringe benefits, the employer portion of the FICA taxes, and State and local taxes).

- Under the Armey proposal, individuals would be taxed only on compensation for labor. Interest, dividends, and capital gains would not be included in individuals' taxable income.

- Businesses -- whether corporate or non-corporate -- would not be allowed a deduction for interest and dividends paid to the owners of the business. Consequently, distributions of income from existing assets would be taxable at the business level and not at the individual level. But individual investors would pay no tax at any level on income from government bonds or overseas assets.

- Businesses would be allowed to deduct the full cost of purchased capital assets. This treatment, called expensing, means that income from new investment would be effectively tax-free at both the business level and the individual taxpayer level.

- The Armey proposal in its current form is not self-financing.

  -- Preliminary analysis by the Treasury indicates that replacing the current corporate and individual income taxes with a flat tax similar to that proposed by Representative Armey would result in an estimated revenue shortfall of $186 billion per year. To be made revenue-neutral with Armey's proposed standard deductions, the tax rate would have to be increased to 22.9 percent. To be revenue-neutral at a 17 percent rate, the standard deductions would have to be reduced to about 32 percent of their proposed amounts. Reducing the standard deduction amounts would increase the proportion of workers' wages that is subject to tax.

-- Representative Armey has indicated he would consider making up any estimated revenue shortfall with a combination of higher tax rates, lower standard deductions, or spending cuts.

- Replacing the existing graduated tax rates with a single rate would shift the tax burden from very high-income taxpayers to low- and middle-income taxpayers. Proposals that would allow a generous exemption amount below which a family would pay no tax would relieve low-income families of taxes on their wages, but would necessarily raise the burden on middle-income families. Furthermore, because low-income families consume a higher percentage of their incomes than high-income families, a flat-rate tax on consumption is generally considered to be regressive.

  -- Preliminary analysis by Treasury indicates that replacing the current individual and corporate income taxes with a revenue-neutral (22.9 percent) flat tax similar to that proposed by Representative Armey would lead to a net tax increase for the group of families with incomes below $200,000 and a net tax cut for the group of families with incomes above $200,000.

- Under current law, businesses are allowed to deduct the cost of many fringe benefits they provide for their employees, including health insurance premiums. The Armey proposal, however, would disallow business deductions for fringe benefits other than retirement benefits. This means that employer-provided health insurance and other forms of non-cash compensation would be taxed at the business level.

- Under current law, businesses are allowed to deduct the employer portion of the payroll tax. The Armey proposal would disallow this deduction, which would increase the effective tax rate on labor income.

- The disallowance of deductions for fringe benefits and the employer portion of the payroll tax represents a "hidden" tax on employees, since economists believe that these taxes will be shifted by employers to their employees.

- Many of the deductions that are allowed under the current income tax are intended to promote certain widely-held social goals. These include deductions that encourage homeownership, charitable giving, and employer contributions for health insurance coverage, and deductions for State and local income and property taxes. The Armey proposal would eliminate these incentives without providing substitute programs.

- The Armey proposal does not include rules to minimize windfall losses during the transition to the new tax system. For example, many businesses that purchased equipment prior to the transition to the Armey flat tax would have unused depreciation allowances. Denying those depreciation deductions under the new tax would place those firms at a disadvantage relative to businesses that purchased equipment just after the effective date, and would, therefore, be allowed to deduct the full cost of those purchases. Transition rules could be designed to minimize these losses, but such rules would erode the tax base and reduce tax revenue.

Office of Tax Policy
April 28, 1995

Talking Points on the Nunn-Domenici Unlimited Saving Allowance (USA) Proposal

- Senators Sam Nunn and Pete Domenici have proposed replacing the individual and corporate income taxes with two consumption taxes: a flat-rate tax on business cash flow and a graduated-rate individual consumed income tax. The two taxes comprise the "USA Tax System," which is intended to replace all of the revenues now collected under the individual and corporate income taxes.

- The USA Tax System proposal is a serious, detailed proposal that addresses many of the problems associated with consumption taxes.

  -- The proposal includes transition rules that would allow some depreciation deductions for existing business assets.

  -- The proposal includes transition rules for previously-taxed savings that are designed to (1) prevent the taxation of these savings a second time under the USA Tax and (2) disallow a tax deduction for shifting old savings into new savings vehicles.

  -- The proposal provides for the taxation of banks, insurance companies, and other financial institutions.

  -- The proposal's authors claim it would be revenue-neutral and would make the tax system slightly more progressive. (Treasury has not estimated the revenue and distributional effects of the USA proposal.)

- The two major concerns with the USA proposal are that: (1) it could make the tax system more complex and (2) it would significantly increase effective marginal tax rates on labor compensation by raising the top marginal tax rate and by taxing wages at both the individual and business level.

- All businesses would be taxed at a proposed rate of 11 percent on a base equal to gross receipts less expenses for domestic operations -- including purchases of equipment and structures, but excluding labor costs -- measured on a cash flow basis. Financial receipts, such as interest and dividends, would not be included in receipts. Interest and dividend payments would not be deductible.

  -- All labor costs -- cash wages and non-pension fringe benefits -- would be non-deductible. But businesses would receive a credit for the 7.65 percent employer portion of the payroll tax.

- The USA proposal would tax all non-pension fringe benefits at both the individual and business level. Under current law, businesses are allowed to deduct the cost of many fringe benefits they provide for their employees, including health insurance premiums.

The USA proposal, however, would disallow business deductions for fringe benefits other than retirement benefits. This means that employer-provided health insurance and other forms of non-cash compensation would be taxed at the business level. The USA proposal suggests that these benefits would also be subject to tax under the individual portion of the tax: the value of non-cash compensation would be imputed to individuals and included in their taxable income.

- The loss of a deduction for labor costs under the business tax and the inclusion of labor income under the individual tax means that wages and salaries and non-pension fringe benefits would be taxed twice: once at the business level and again at the individual level.

- All individuals would be taxed on a base equal to their gross income less net saving. To make the tax less regressive, tax rates would be graduated, and families would be allowed personal and dependent exemptions, a family living allowance (FLA), and an earned income tax credit (EITC).

  -- Wage-earners would also receive a tax credit for their 7.65 percent share of the payroll tax.

- In general, additions to savings would be deducted from income and not taxed. Net withdrawals from savings, however, would be included in taxable income. For example, if savings were withdrawn to make a downpayment on the purchase of a car, the amount of the withdrawal would be taxed. The effect of this is proposal is that capital income (interest, dividends, and capital gains) would be <u>exempt</u> from tax. (See the accompanying note on the equivalence of USA Tax treatment of savings and interest exemption.)

- The proposal includes three individual tax rates for 1996: 19 percent, 27 percent, and 40 percent. The lower two rates would gradually fall through 2000 to 8 percent and 19 percent respectively.

  -- The 40 percent rate would begin at $24,000 of taxable income for joint returns, $21,100 for a return filed by a head of household, $14,400 for single filers, and $12,000 for married individuals filing separately.

- Taxable income would be reduced by a family living allowance of $7,400 for joint returns, $4,400 for single filers, $5,400 for head of household filers, and$3,700 for married individuals filing separately. Households would also be allowed personal and dependent exemptions of $2,550. The total amount of exempt income for a family of four would be $17,600.

- Because labor compensation is taxed at both the business level and the individual level, taxable labor income in excess of $24,000 (for joint filers) would be taxed at an effective rate of 46.6 percent. With the family living allowance and personal and dependent exemptions, a family of four would pay tax at an effective rate of 46.6 percent on consumed labor income in excess of $41,600. (Earnings below the OASDI wage base -- $61,200 in 1995 -- are subject to the payroll tax. Under the proposal, workers would receive a credit against their USA Tax liability for their 7.65 percent share of the payroll tax. Earnings in excess of the OASDI base are not subject to the payroll tax, and, consequently, would receive no additional USA Tax credit.)

- The USA proposal would continue to allow individuals to deduct charitable contributions and a limited amount of home mortgage interest. In addition, the proposal would introduce a deduction for qualified educational expenses. All other deductions allowed under the existing income tax, including deductions for State and local income and property taxes, would be eliminated.

- The USA proposal would allow businesses to deduct the full cost of purchased capital assets. This treatment, called expensing, would effectively relieve income from new investment of tax at the business level. Deducting net savings under the individual tax is also equivalent to exempting income from capital. Expensing under the business tax combined with the savings deduction under the individual tax, therefore, ensures that income from capital would be untaxed at any level under the USA proposal.

- It is not clear that the economic benefits of the USA Tax System would exceed the costs, burdens, and risks of moving to an entirely different tax system.

  -- Private saving could increase in response to replacing the income tax with the USA Tax System, but economic studies suggest that the amount of the increase is uncertain and probably small.

  -- Because marginal tax rates on wage income would increase, however, work effort may decline. This could offset some of the economic benefits from increased saving.

  -- The proposal would probably not make the tax system simpler and could make it more complex. Although it would simplify tax compliance by eliminating calculations associated with measuring income from saving, it would retain many of the complicating features of the existing individual income tax and would introduce new tax calculations and reporting requirements that would increase burdens on taxpayers and the Internal Revenue Service.

Office of Tax Analysis
April 28, 1995

Equivalence of USA Tax Treatment of Savings and Interest Exemption

The first two examples below illustrate how the treatment of savings under the Nunn-Domenici USA Tax proposal is equivalent to exempting interest income from tax. The third case illustrates income tax treatment of savings, and shows that after-tax consumption from savings is lower under an income tax than under a consumption tax.

In each case, the taxpayer begins with $100 of wage income in the first year. He wishes to postpone all consumption for five years. The taxpayer saves all of his after-tax wage income in the first year and earns a five percent annual return on his savings. At the end of five years, he withdraws his principal and accumulated interest and spends it. In each case, the tax rate is 28 percent.

Case 1: USA tax proposal

Under the USA proposal, a deduction is allowed for net savings, and net withdrawals from savings is taxed. In the first year, the taxpayer deposits his $100 of wages in a savings account. He deducts $100 from his taxable income, leaving him with zero taxable income and zero tax liability. His after-tax consumption is also zero.

Because the taxpayer reinvests his interest income on his savings, he owes no tax on the interest income during the next five years. In the fifth year he withdraws $127.63: his original savings of $100 plus interest of $27.63. At a tax rate of 28 percent, his tax due on $127.63 of taxable income is $35.74. His after-tax consumption is $91.89.

Case 2: No deduction for saving; interest income exempt from tax

In the first year, the taxpayer must pay tax of $28 on his $100 of wage income. He deposits the remaining $72 of after-tax income in the bank. He has no after-tax consumption.

Over the next five years, his interest income is exempt from tax. In the fifth year he withdraws $91.89 his original savings of $72 plus interest of $19.89. His taxable income is zero, and his after-tax consumption is $91.89.

Case 3: Income tax

In the first year, the taxpayer must pay tax of $28 on his $100 of wage income. He deposits the remaining $72 in a savings account. He has no after-tax consumption.

In each of the next five years, he must pay tax on his interest income. His after-tax return on his savings is reduced from five percent to 3.6 percent. In the fifth year he withdraws $85.93: his original savings of $72 plus interest of $13.93. His after-tax consumption is $85.93.

Office of Tax Analysis
April 28, 1995

Talking Points on Replacing the Income Tax with a National Sales Tax

- A retail sales tax and a value-added tax (VAT) are both forms of national sales taxes. As under any consumption tax, income is effectively taxed under a sales tax only when it is spent on consumer goods or services; income that is saved is exempt from tax until it is withdrawn from savings and spent. Representative Archer has proposed replacing the income tax with a national sales tax.

  -- A retail sales tax is collected from businesses and applied only to sales of goods and services to households. Most States that have sales taxes attempt to tax only final or retail sales and exempt sales between producers.

  -- Under a credit-invoice VAT, businesses pay VAT on all their sales to both households and other businesses, but receive a credit against their tax liabilities for VAT paid on inputs purchased from other businesses. Most OECD countries have credit-invoice VATs.

  -- Under a subtraction method VAT (also called a "business transfer tax" or BTT), a business is liable for tax on the difference between its sales and its purchases from other businesses, including purchases of buildings and equipment. However, labor costs are not deductible. If the tax is applied to all goods and services at the same rate, a subtraction method VAT is economically equivalent to a similarly broad-based credit-invoice VAT or retail sales tax. Most of the VAT proposals in the United States have been in the form of a subtraction method VAT.

- Because low-income families consume a higher percentage of their incomes than high-income families, a flat-rate consumption tax is generally considered to be regressive. While retail sales taxes and VATs are considered to be the simplest and the least costly forms of consumption taxes to administer and comply with, they are not easily made progressive.

  -- These taxes can be made less regressive by exempting some forms of consumption or taxing them at lower rates, but this introduces complexity and increases compliance costs. In addition, this approach does not reduce regressivity effectively because tax relief from exemptions and preferential rates is difficult to target to low-income families. While the tax preference does relieve the burden on low-income families, middle- and upper-income households also benefit when they purchase tax-preferred goods and services, requiring higher rates on other goods and services that low-income families buy to raise the same revenue.

- A VAT or national retail sales tax would effectively exempt interest, dividends, and capital gains.

- A VAT or national retail sales tax would disproportionately burden past savers -- including many of the current elderly -- who have already paid income taxes on their savings and would be taxed again when those savings were spent under the new tax.

- Most countries have chosen a VAT rather than a national retail sales tax because a VAT is considered to be more difficult to avoid -- especially for the providers of services -- when compared to a retail sales tax.

- Most countries exempt exported goods from the VAT and apply the tax to imports. Many business groups believe that such border tax adjustments can improve the balance of trade. Economists, however, believe that border tax adjustments for consumption taxes have no permanent effect on the trade balance.

  -- Some types of consumption taxes are accepted as border-adjustable under the General Agreement on Tariffs and Trade (GATT), and others are not. Indirect taxes, such as credit-invoice VATs used in most other countries, are border-adjustable under the GATT. Although a broad-based, single-rate subtraction method VAT is economically equivalent to a similarly broad-based credit-invoice VAT, a GATT ruling would consider other factors. Whether a subtraction method VAT would survive a GATT challenge is an untested issue.

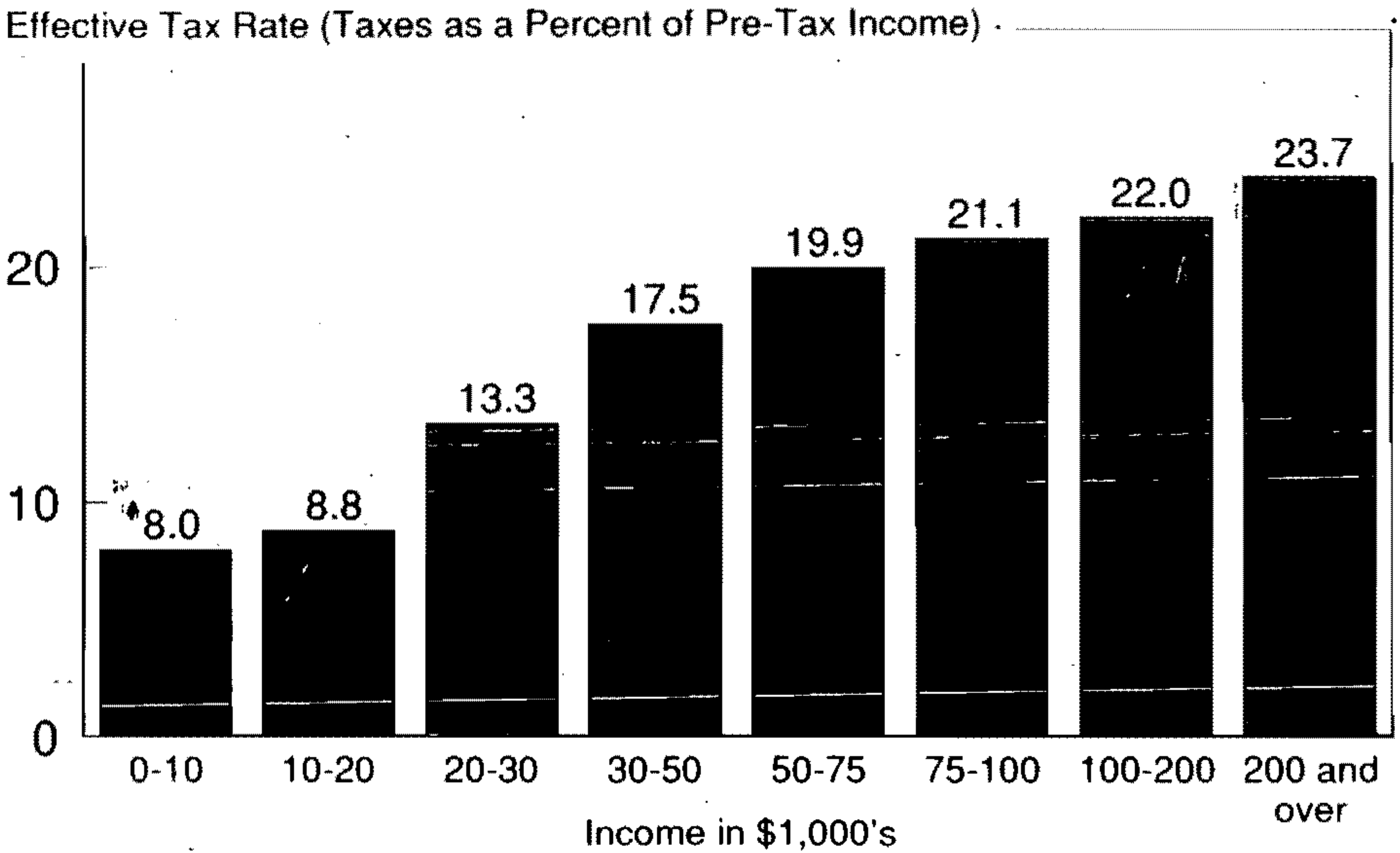
- The adoption of a national retail sales tax is likely to be seen as an infringement upon what has traditionally been an important revenue source for State and local governments.

- One alternative to replacing the income tax system with a national retail sales tax or a VAT would be to impose a VAT at a moderate rate to replace a portion of income tax revenues. A version of this approach, proposed by Representative Gibbons, would impose a VAT as a substitute for the payroll and income taxes, but retain an income tax for high-income individuals. A VAT at a moderate rate would reduce the tax burden on saving and produce smaller windfall gains and losses, thereby minimizing the need for complex transition rules. Retaining the income tax system would ensure that high-income individuals with low consumption continue to pay tax on their investment income. Most of our trading partners rely on such a mixed tax system that combines income and consumption taxes, albeit with a higher share of revenue raised by consumption taxes than the United States.

  -- A VAT that is adopted in addition to the current income tax system, however, would impose significant additional administrative costs on the government and compliance costs on businesses.

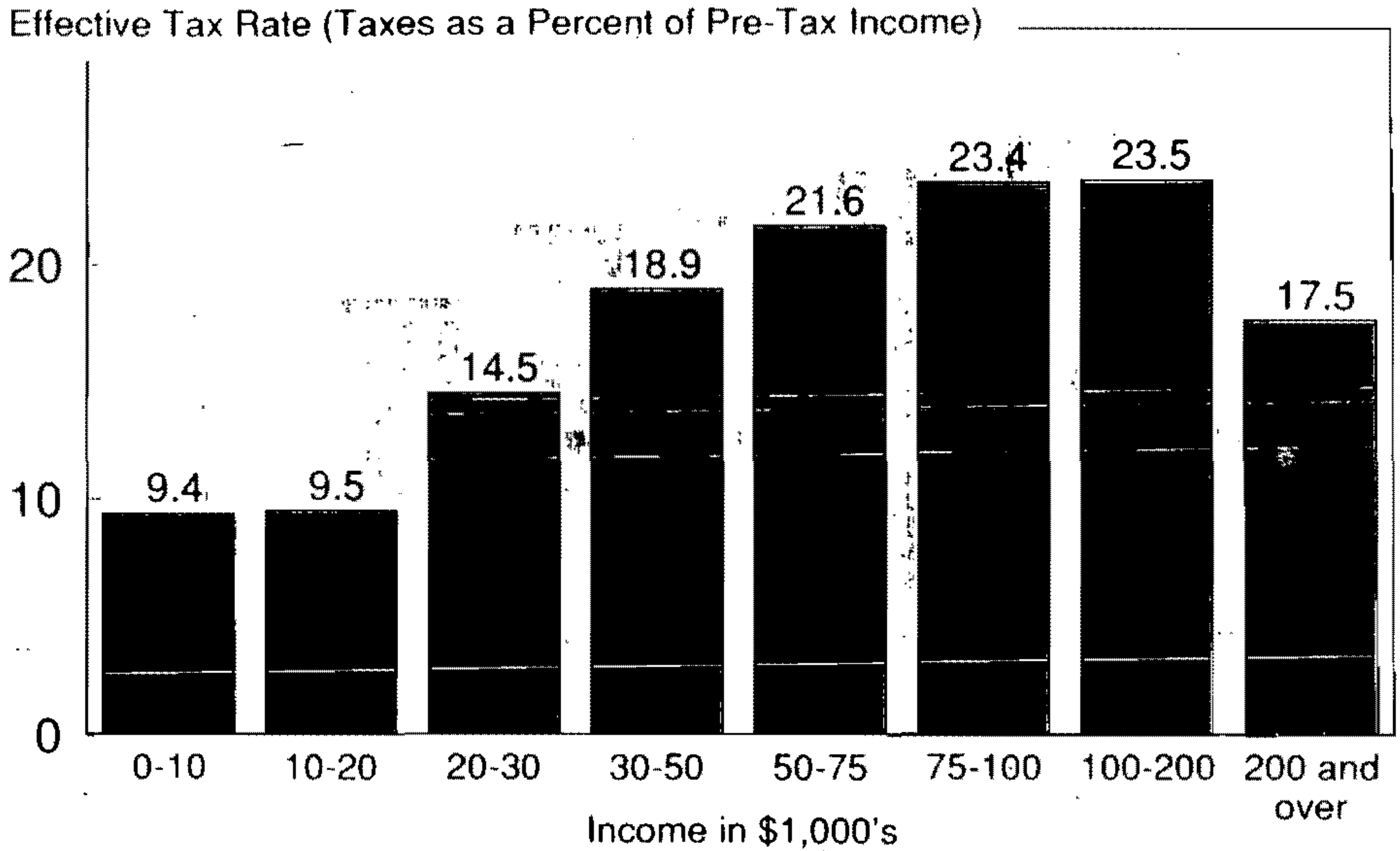
Office of Tax Analysis
April 28, 1995

Distributional Effect of Current Federal Tax System [1]



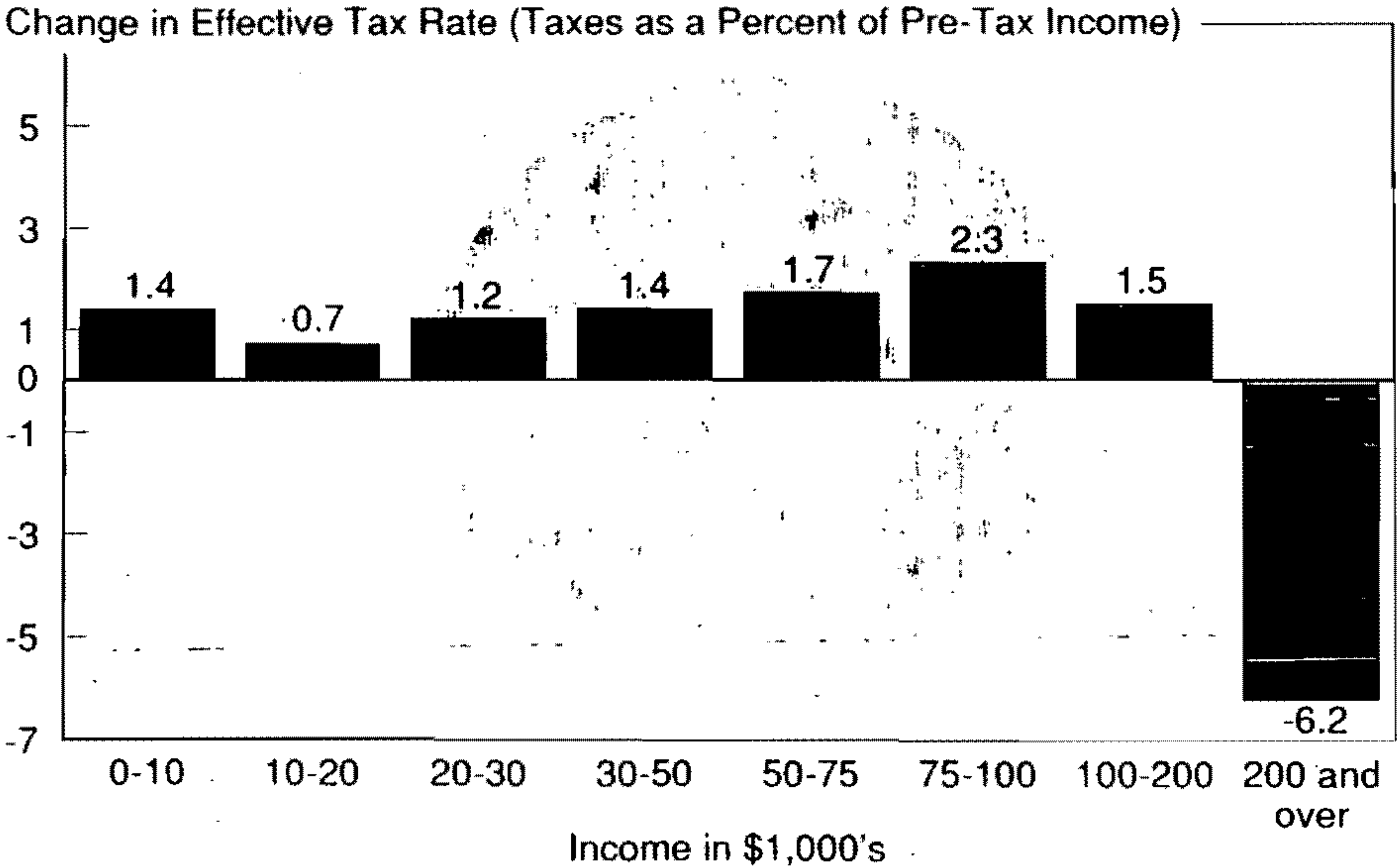
[1] Includes effects of individual and corporate income taxes, payroll taxes, and excise taxes.

Distributional Effect of Federal Tax System With the Individual and Corporate Income Taxes Replaced by a 22.9% Flat Rate Tax [1/]

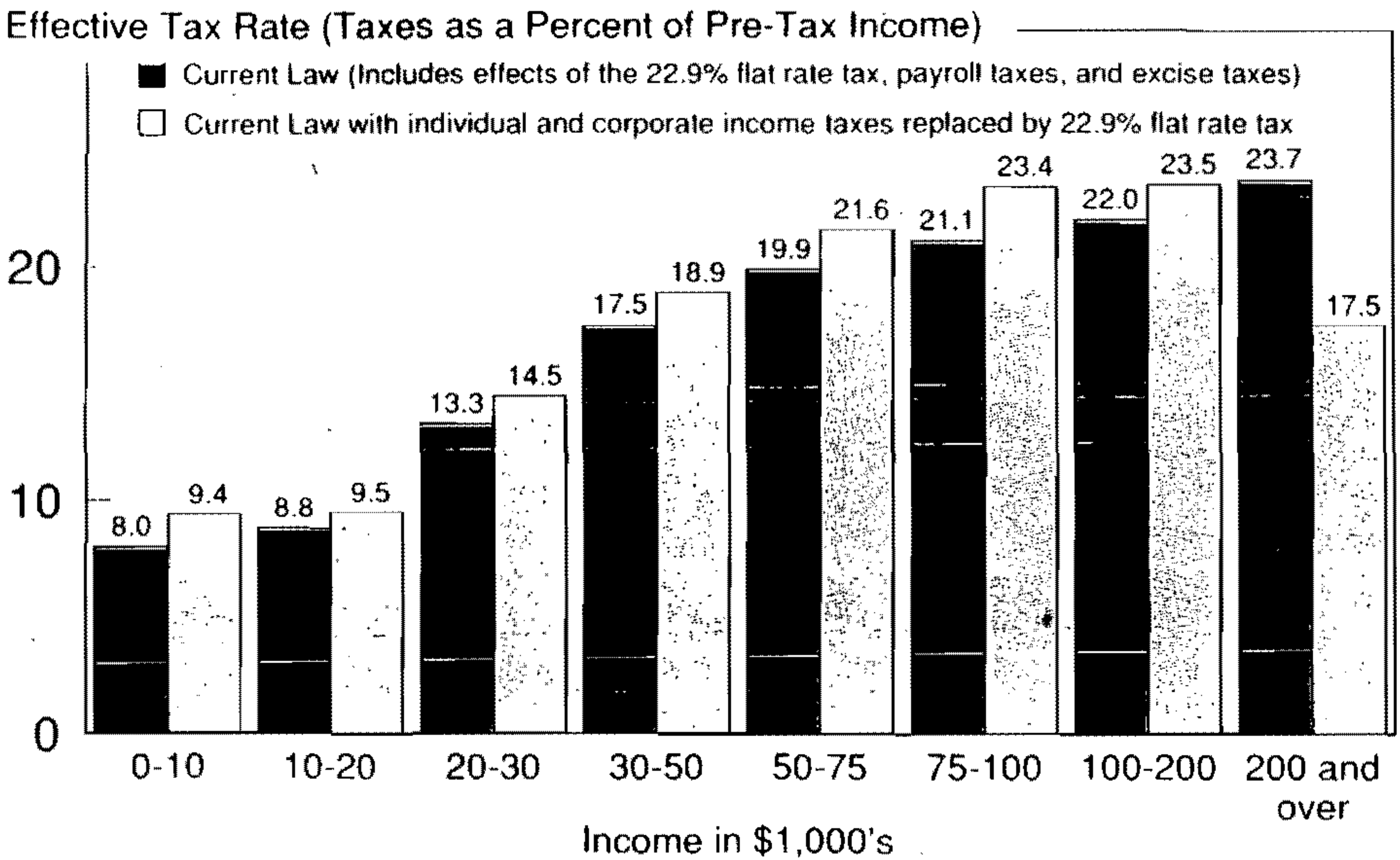


[1/] Includes effects of the 22.9% flat rate tax, payroll taxes, and excise taxes.

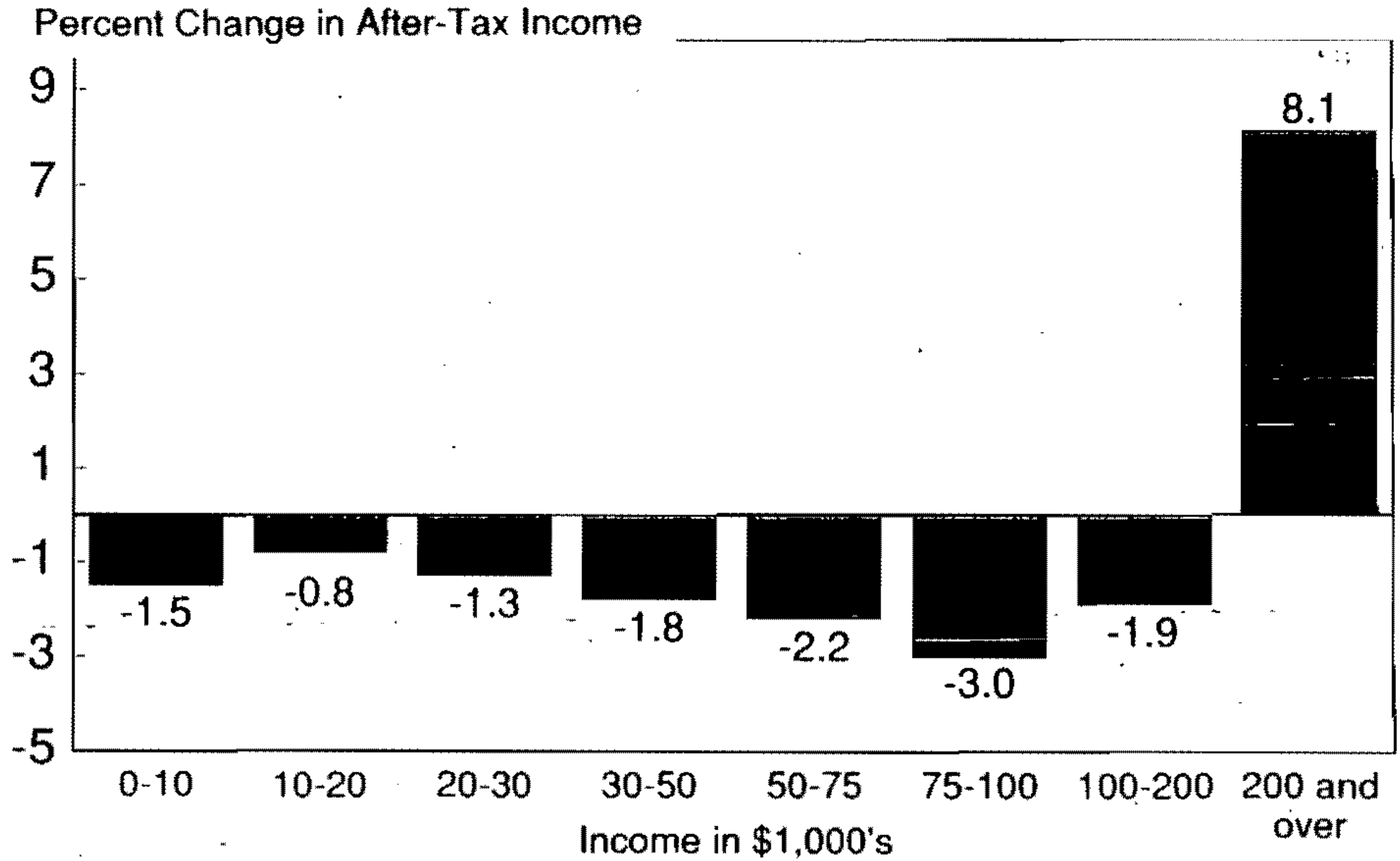
Distributional Effect of Replacing Indvidual and Corporate Income Taxes With a 22.9% Flat Rate Tax



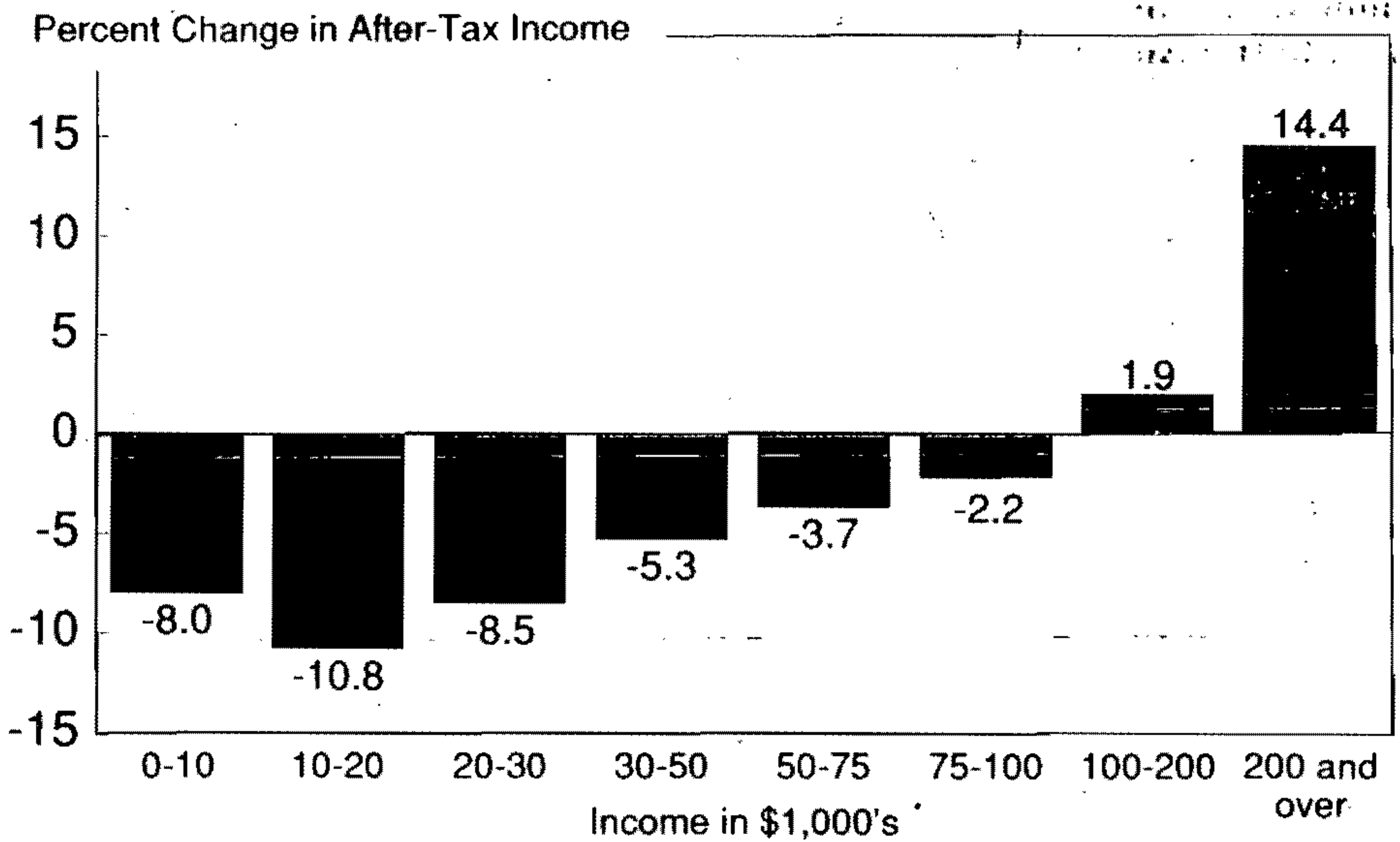
Distributional Effect of Federal Tax System Under Current Law and With the Individual and Corporate Income Taxes Replaced by a 22.9% Flat Rate Tax



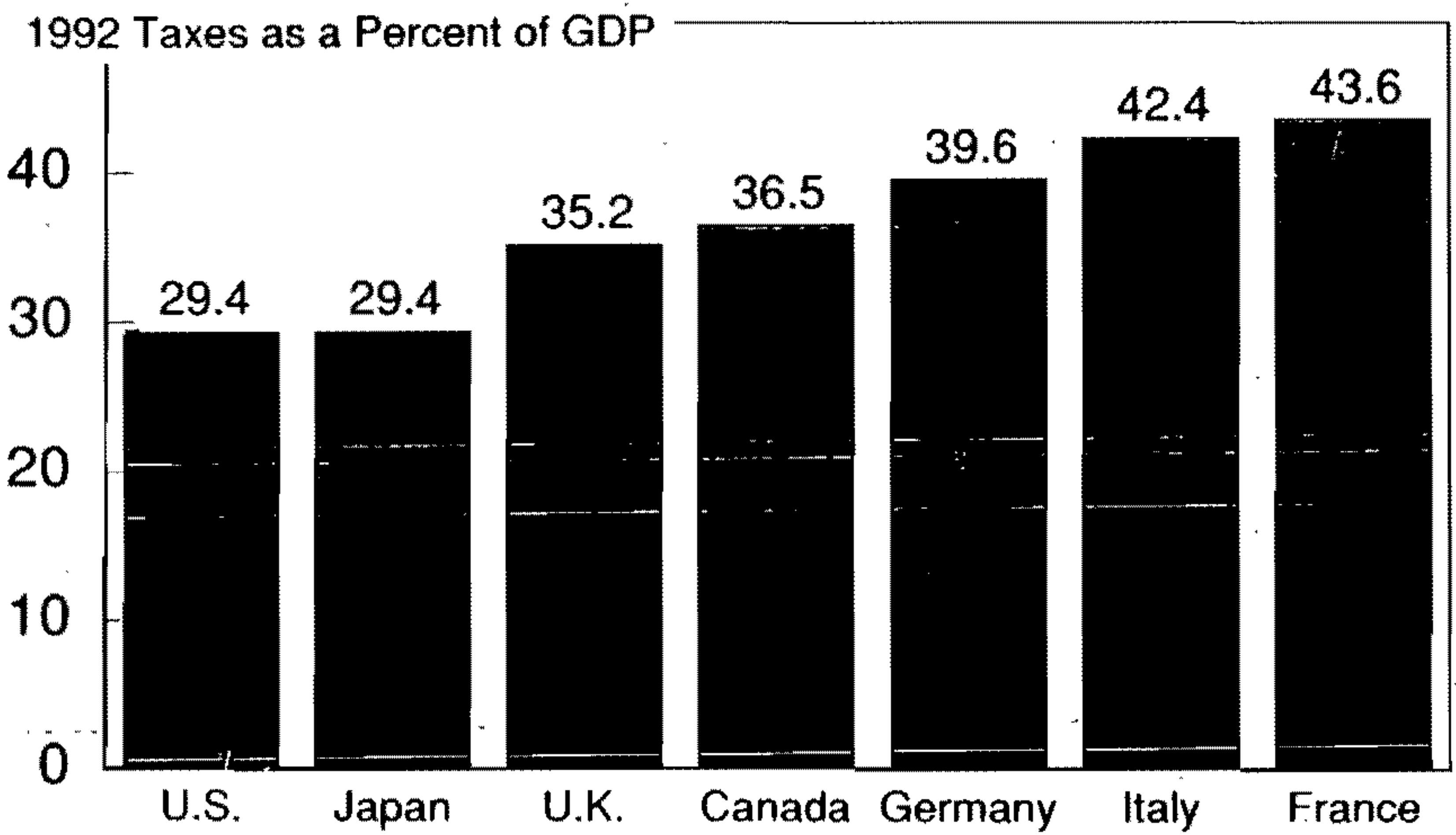
Distributional Effect of Replacing Income Taxes with a 22.9% Revenue-Neutral Flat Tax with Standard Deductions



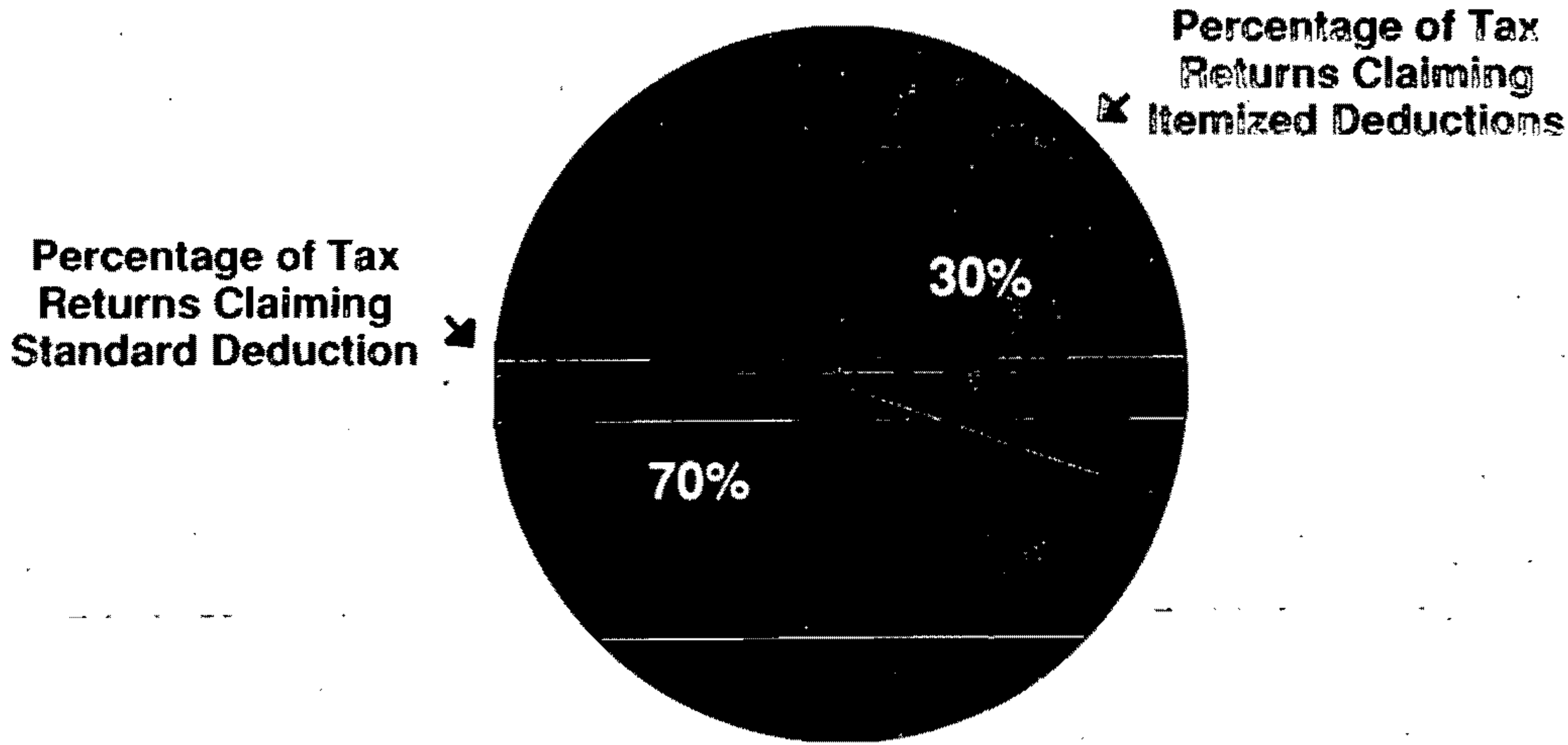
Distributional Effect of Replacing Income Taxes with an Illustrative 14.3% Flat Rate Consumption Tax



U.S. Among Lowest Taxed of Major Economies



Most Taxpayers Claim the Standard Deduction



ROBERT J. SHAPIRO: THE EMERGING FORM OF TAX REFORM • FARMING THE GOVERNMENT

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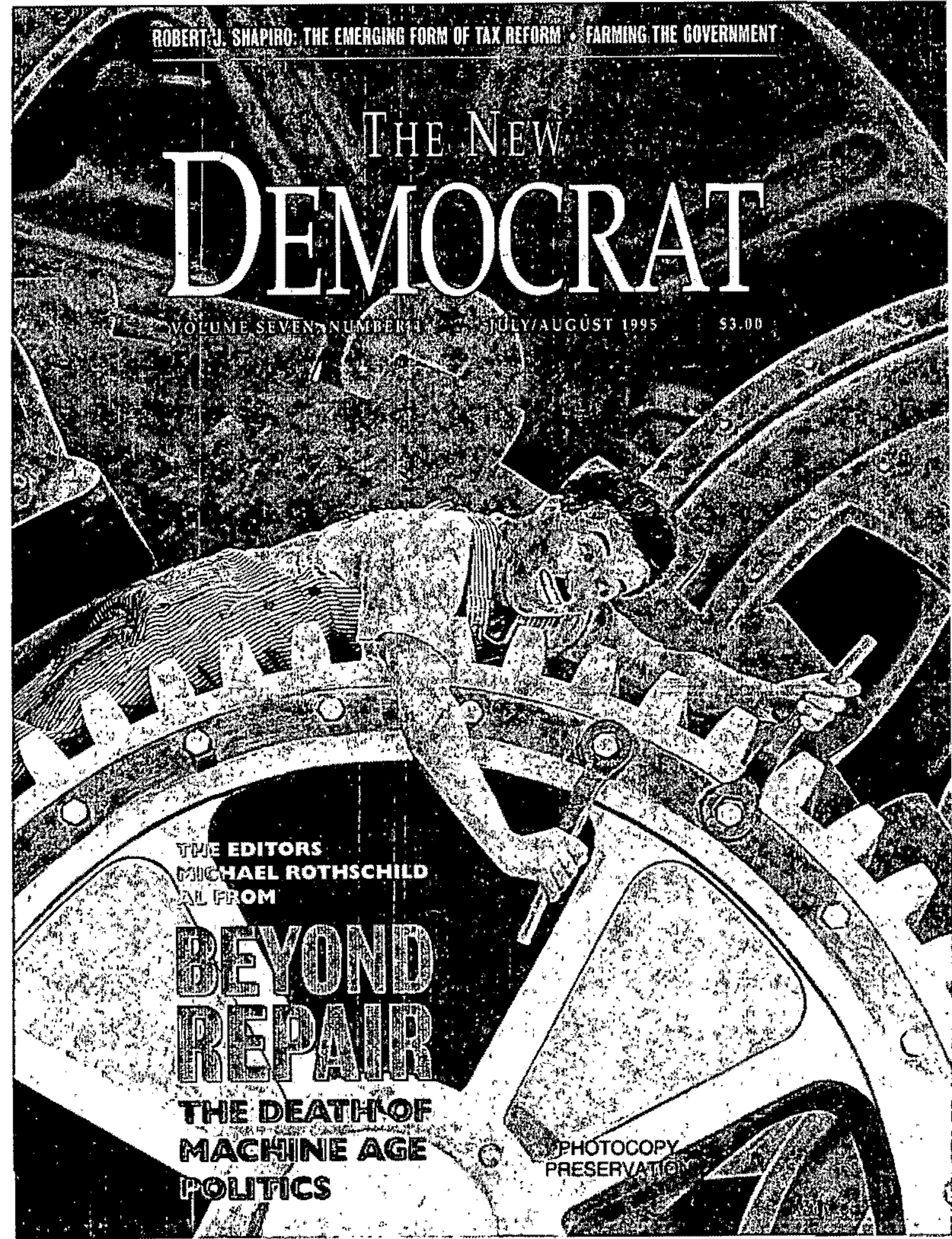


THE EDITORS
MICHAEL ROTHSCHILD
AL FROM

BEYOND REPAIR

THE DEATH OF MACHINE AGE POLITICS

TAX RETURNS

Reforming the Tax Code Is Back at the Top of the Policy Charts

BY ROBERT J. SHAPIRO

Tax reform is coming, no doubt about it. But before we begin unraveling the tax code, we should stop to ask two basic questions. The first, simply and seriously, is "Why should we reform taxes?" The second is "What are the real agendas of tax reform proponents?" or alternatively, "What are the likely consequences of the most prominent proposals?"

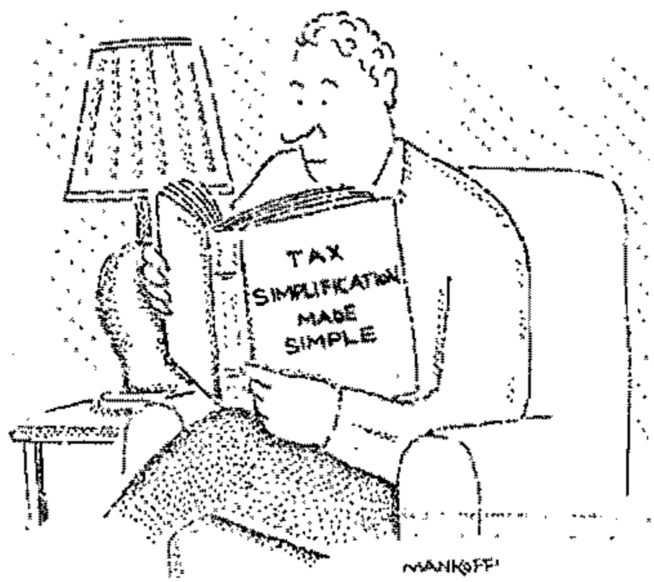
The chief Republican proposals—which would replace individual and corporate income taxes with a flat tax on wages or with a national sales tax—would do the economy little if any good, and could do the federal budget and the pocketbooks of many middle-class Americans considerable harm. A bipartisan strategy also under consideration that would exempt personal and business savings and investments from taxation could produce some benefits, but probably not enough to solve the economy's real problems.

In the end, tax reform may make sense, but only as part of a larger strategy to increase national savings and investment.

The question "Why reform taxes at all?" deserves top priority for two reasons: first, because any significant tax change can have far-reaching economic implications, and second, because the mere effort to reform federal taxes can entail large costs.

As soon as Congress turns to tax reform, businesses and individuals will be forced to make tax-sensitive decisions under considerably greater uncertainty. Simply deciding to reform taxes, therefore, will tangibly strain the economy's efficiency. Rewriting the tax code will also tie up members of Congress, their senior staffs, Administration officials, and private tax experts for months. In short, the President and Congress cannot tackle tax reform without turning away from other important issues, such as health care, welfare, and perhaps even the budget deficit.

Moreover, any reform of consequence that is enacted would affect our ability to address those issues. For example, if a new tax code leaves the value of employer-provided health insurance and other fringe benefits untaxed, health care reform would have to depend on other, less market-oriented measures to discipline demand for medical services. Or, if the Earned Income Tax Credit for working poor people were eliminated, as proponents of a flat tax urge, work-based welfare reform would become more problematic. And if the next round of tax reform were to reduce federal revenues, as the tax reforms of 1981 and 1986 did, deficit reduction will be even more difficult to achieve than it is today.



Tax reform will have to produce very substantial benefits to outweigh all of these costs. The problems that it claims to address should be genuinely significant, and its likelihood of solving them should be genuinely high.

Keeping Things Simple

Today, two problems meet those criteria: the unnecessary complexity of current taxes, and the nation's low personal savings and investment rates.

The rationale for tax simplification is straightforward: Administering and complying with the thousands of provisions in the current code costs businesses and individuals an estimated *$100 billion* a year. That's a dead-weight loss to the U.S. economy roughly equal to 1.5 percent of total gross domestic product. Eliminating most special deductions and credits could cut that cost in half. Tax simplification would also enable the Treasury to collect as much revenue as today with lower tax rates, reducing disincentives to earn income and allowing our markets to better allocate the economy's resources. The end result: greater efficiency and stronger growth.

The tax code's complexity, therefore, represents a problem of real significance. And, at least in theory, dramatic tax simplification could substantially cut the costs associated with the problem.

All of the major tax reform plans feature drastic simplification:

• The flat tax proposed by House Majority Leader Richard K. Armey of Texas and now endorsed by many GOP presidential hopefuls would eliminate virtually all deductions and credits from the personal income tax and replace most corporate tax preferences, including the deductibility of wage costs, with a one-year write-off of capital expenditures.

• Similarly, the national sales tax plan supported by GOP presidential hopeful Sen. Richard G. Lugar of Indiana and House Ways and Means Committee chairman Bill Archer of Texas would end *all* current credits and deductions as well as the personal and dependents' exemptions.

• And the savings-exempt tax plan introduced recently by Sens. Sam Nunn (D-Ga.) and Pete Domenici (R-N.M.) would end all personal deductions except mortgage interest, property taxes, charitable contributions, and educational expenses, and on the business side preserve a firm's ability to deduct wage costs but replace all other corporate tax preferences with a one-year write-off of all capital investment.

While dramatic simplification is a sound goal of reform, it is not, in itself, related in any essential way to the *other* features of these three major proposals. Simplification could be achieved nearly as easily, for example, with progressive tax rates or with a flat rate; with or without a tax exemption for capital income; and with or without a broad tax exemption for net savings and investment.

Moreover, all of the current proposals would still involve substantial administrative and compliance costs. The Armey plan, for instance, would end automatic tax withholding, which would enormously increase some compliance costs. As for the Lugar plan, long experience with sales taxes indicates that when the sales tax rate reaches 13 percent to 15 percent, people begin searching for ways, legal and other, to avoid paying the tax. Yet to replace the revenues collected today by the income tax, a national sales tax would have to be set at 22 percent or higher. Consequently, this plan cannot really reduce the dead-weight losses of the current system—and if a new sales tax were used to replace only part of the income tax, total compliance and administrative costs would increase. Finally, the Nunn-Domenici proposal would probably reduce overall costs, but it would still preserve various personal deductions and many of the compliance features of the current corporate depreciation system.

Savings and Investment

Like tax simplification, the rationale for reforms that encourage savings and investment is clear and compelling. And like tax simplification, encouraging savings and investment will be hard to achieve.

Since the 1960s and 1970s, our national savings rate has fallen from between 7 percent and 8 percent to less than 2 percent. The personal savings rate has dropped precipitously, from a respectable 7.8 percent in the 1970s to just 4.6 percent thus far in the 1990s. And despite sometimes massive foreign investment in the U.S. economy, net fixed business investment, which not long ago grew at an average annual rate of 7 percent, expanded by just 2.3 percent a year over the last decade.

As our savings and investment rates have declined, so too have the productivity gains of our workers and firms, falling from roughly 3 percent annually in the 1950s and 1960s to less than 1.5 percent annually over the last decade. And slow productivity growth has cut the real income gains achieved by working Americans by fully one-third to one-half.

Each of the three major tax reform proposals claims that it would significantly and permanently increase U.S. savings and investment. But could any of them actually do it?

Unhappily, the preponderance of hard evidence suggests that most tax breaks for savings and investment produce, at best, very modest results, especially if the particular incentive depends upon *how* a taxpayer saves or *how* a company invests.

The 1981 Reagan tax reforms, for example, created a new personal tax deduction for savings deposited in special individual retirement accounts, for up to $2,000 a year or nearly 7 percent of average family income. Reaganomics also created a host of deductions and credits to spur business investment. Yet personal savings rates and net business investment rates kept falling through most of the 1980s.

The truth is, we may be trapped in an economic cycle that tax reform alone cannot break:

• Changes in total business investment seem to depend less on the prevailing tax rate than on the economy's underlying rate of return and the nation's overall savings rate.

• These in turn depend significantly on the size of government deficits and the personal savings rate.

• Changes in personal savings rates depend primarily on how fast personal income grows.

• Personal income growth depends mainly on our rate of productivity gains, which in turn depends on (and brings us full circle to) business investment rates and personal savings rates.

If this is how our economy really works, tax reform would have to deliver a *very* large and systematic incentive for savings and investment to be at all effective. A partial reduction in the tax rate on certain capital gains, George Bush's favorite tax reform, clearly fails this test. Despite four successive cuts in the capital gains tax burden from 1977-85, net investment rates continued to decline.

The three leading reform proposals get poor to decent grades for savings and investment.

Lugar's national sales tax plan is at the bottom of the class. There is little hard evidence that sales taxes affect savings rates at all; whether they are applied at the retail level or at intermediate points under a value-added tax, and *no* evidence of a savings benefit if the tax exempts basic necessities such as food, housing, and medical care.

In the middle of the class is Armey's flat tax plan. His theory is that savings and investment will rise if all income and gains from savings and investment are tax-free. To achieve this, Armey, in effect, transforms the personal income tax into a higher payroll tax, since his plan would tax only wages, salaries, and pension benefits. His mistake is that, under his proposal, income or gains from *existing* savings and investment also would be tax-free, as would all inheritances, delivering an enormous windfall to current savers and investors even if they spend every dollar they have on consumption.

The Nunn-Domenici approach gets the highest grade of the three. How you use your money, not how you got it or get it, is what counts under their plan. If you save or invest it, it's tax-free; if you spend it, it's taxed. This approach, then, would create a form of wealth tax, since it would tax existing wealth as it is consumed.

Economic modeling cannot prove that this approach would produce greater savings and investment than the Armey plan—that is, *if* Armey had also proposed taxing the returns and gains from *existing* savings and investment. But common sense suggests, at the least, that the Nunn-Domenici approach would create a more systematic incentive for savings and investment, and without providing a stealth windfall to current investors and savers. Nunn and Domenici would also shift less of the tax burden from high-income people to middle-class families, because they apply progressive tax rates to the income that people consume instead of Armey's proposal for a flat tax rate applied only to the income people earn by working.

Making Reform Worth the Effort

Ultimately, *neither* strategy can demonstrate that it could truly overpower the basic economic forces that have always prevented tax incentives from raising savings and investment rates by much. Is comprehensive tax reform really worth the effort?

The answer for now is yes, if and only if tax reform is accompanied by additional measures to reinforce and amplify its effects on savings and investment; namely, deficit reduction and *mandatory* private savings.

The hard truth is that the most important single reason for low national savings and investment is *not* the tax system, but our willingness to allow government to absorb up to half of our personal and business savings to finance its deficits. Based on the record of the last 15 years, spending cuts alone will not eliminate these deficits, especially if the political parties cannot build a new consensus about what responsibilities now financed at the federal level should be devolved to the states, localities, or private entities. They also will have to redefine the ways in which we, collectively and individually, ensure health care for elderly people along with everyone else and income security for retirees. Otherwise, any genuine and serious pro-savings tax reform will also have to raise additional revenues to reduce those deficits.

Once again, the Armey and Lugar plans fall far short. Armey's flat tax would sharply expand the deficit and thus seriously reduce national savings and investment, since it would raise roughly $160 billion a year *less* than the current income tax system. The Armey proposal could be made revenue-neutral by increasing its flat tax rate from 17 percent to 22 percent or 23 percent. But doing so would also increase the current tax burden on roughly one-third of all middle-class Americans.

Lugar's 17 percent national sales tax would expand the deficit and vastly increase the tax burden on lower-income people now exempt from income taxes. In theory, a national sales tax could be revenue-neutral if its tax rate were set in the mid-20 percent range. But in practice, at that level compliance would fall sharply and the deficit would increase again.

The Nunn-Domenici proposal is already revenue-neutral, with tax rates similar to those under the current income tax. It could expand national savings by reducing the deficit with either somewhat higher rates or, better still, by eliminating some deductions it now preserves, such as those for charitable contributions and for property taxes.

After the budget deficit, the second largest factor in low national savings and net investment is still not the way we tax consumption and savings, but the impact of the Social Security system. While most economic research shows that tax incentives cannot greatly increase personal savings and investment, research also suggests that the expectation of public pension payments has significantly decreased private retirement saving.

How can we reform Social Security to address this problem without undermining the system's great achievement in virtually eliminating poverty among the elderly?

The most promising approach would be to gradually transform Social Security and the taxes that finance it into mandatory private savings, supplemented by a minimum public retirement benefit for low earners. We could start by redirecting the payroll taxes that currently produce the so-called Social Security surplus—about 2 percentage points of today's payroll tax—to mandatory, individual private retirement accounts.

To have any real impact on national savings, however, this reform would have to be accompanied by other budget changes so the deficit doesn't rise as we channel these surplus payroll-tax revenues to private savings. And the next step would be to raise the retirement age and implement other benefit reforms, so that the remaining payroll tax could still cover benefits as more people retire. Over succeeding decades, the share of the payroll tax directed to mandatory individual private savings accounts could be raised, as the size of the publicly financed pension benefit becomes smaller.

At the conclusion, there would be a mandatory private savings rate of up to 10 percent—much higher than today's rate—so that most people could provide for the major part of their own retirement security.

By tying mandatory private savings to consumption-based personal and corporate taxes that also reduced the deficit, at least we would create a genuine systematic bias towards savings and investment. No one can guarantee that even this approach could transform the economy. But it seems certain that anything that is less systematic or fails to reduce the deficit wouldn't be worth the effort. ♦

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A Flat You Can't Fix

Five Flaws That Should Halt the Flax Tax Bandwagon

BY M. JEFF HAMOND

Advocates for replacing today's graduated federal income tax with a flat tax have worthy goals in mind: simplifying the system and eliminating the double-taxation of savings and investment. The flat tax, they argue, will tax all income only once, eliminating many of the current system's inefficiencies.

But if the primary object of tax reform is to treat *people* fairly, not *dollars*, as economist Nicholas Kaldor once noted, the flat tax falls terribly short. Several plans are on the table, the leading one being House Majority Leader Richard K. Armey's proposal for a single 17 percent rate with no deductions (after an initial period with a 20 percent rate). Another is Republican Sen. Arlen Specter's proposal for a flat tax that would maintain deductions for mortgage interest and charitable contributions.

All have serious flaws. Here are five issues to consider before jumping on the flat tax bandwagon:

♦ *First, the personal flat tax proposals under consideration would apply only to wages, salaries, and pensions.* So the tax would be a boon to people who receive substantial income from investments, most of them well off.

Under a flat tax, people with identical incomes could have vastly different personal tax bills; likewise, people far apart in income could wind up paying the same sum. Should someone whose entire income comes from a $50,000 salary pay higher taxes than someone with a $40,000 salary and $10,000 in capital income? Maintaining equity both as one moves up and down the income ladder as well as at each rung of the ladder should be more important than rising marginal tax rates when determining whether a tax system is "fair."

Flat tax proponents say individuals would be treated fairly under their plans because the business portion of the flat tax would capture income from capital. All income would be taxed only once, whereas the current system taxes some business income before and after it is distributed.

On closer examination, the flat tax begins to resemble the Balanced Budget Amendment, term limits, and other simplistic, bumper-sticker solutions to complicated problems that the GOP has advanced.

But the flat tax ignores most capital income from the sale of nonfinancial assets such as real estate or collectibles. In addition, it is an unresolved economic question whether short-term profits from stock-market speculation would be captured by the business tax. Stock prices, after all, fluctuate based on expectations of *future* profits, not current profits—and the rise and fall of a stock's price can often be traced to factors other than a firm's profitability.

♦ *Second, Armey misleads the public when he implies that with one low rate everyone would get a tax cut.* It's simply not true.

Even the original proponents of the flat tax (Robert Hall and Alvin Rabushka of the Hoover Institution, whose plan has *both* lower exemption levels and a higher tax rate than Armey's to make the system revenue-neutral) say that under Armey's plan, some of the tax burden would be shifted from upper-income to middle-income workers, even with large personal exemptions.

At Armey's personal exemption levels (for example, $13,100 for a single individual and $36,800 for a family of four), the Treasury Department estimates that a single rate of *over 22 percent* would be required to raise the same revenue as the current income tax. At that flat rate, with no deductions, most middle-income people will pay more, not less, than they do now. In addition, people with annual incomes of more than $200,000, on average, would receive a tax cut of *over $54,000* if the business tax is passed forward in higher prices.

♦ *Third, even with high exemption levels, the working poor would be hit hard by the flat tax.* How could that be, if they would owe no income tax? It would happen due to the elimination of the Earned Income Tax Credit, under which millions of poor workers now get a wage supplement that pulls them up to the poverty line. The Congressional Budget Office estimates that, due to the EITC, people at the bottom 20 percent of the income scale now have a negative effective federal income tax rate. The flat tax would raise that rate to zero—negating the flat taxers' "generous" exemption amounts and any work incentive the EITC provides.

♦ *Fourth, even after adjusting for Armey's complaints about its original analysis, the Treasury Department estimates that his plan will cost the government $160 billion in lost revenue a year, not the $40 billion that Armey claims.* Higher deficits would stunt our economic growth and lead to higher taxes. They also would reduce national savings, an outcome directly at odds with tax reform's main objective of increasing both personal and public savings.

♦ *Fifth, Armey's plan would eliminate tax withholding.* While some may consider this a great idea—"Let's emphasize the cost of government by making everyone file a tax return every month!"—it would encourage cheating, force the IRS to hire an army of workers to process hundreds of millions of additional returns, and lead to more audits. Eliminating withholding would result in more government and higher taxes—the antithesis of what Armey claims to seek.

The flat tax looks great at first glance. But on closer examination, it begins to resemble the Balanced Budget amendment, term limits, and other simplistic, bumper-sticker solutions to complicated problems that the GOP has advanced. There are other ways to accomplish the dual goals of tax reform: reducing the burden on savings and investment while still ensuring fairness. Progressive Democrats need to play a role in ensuring those goals are achieved. ♦

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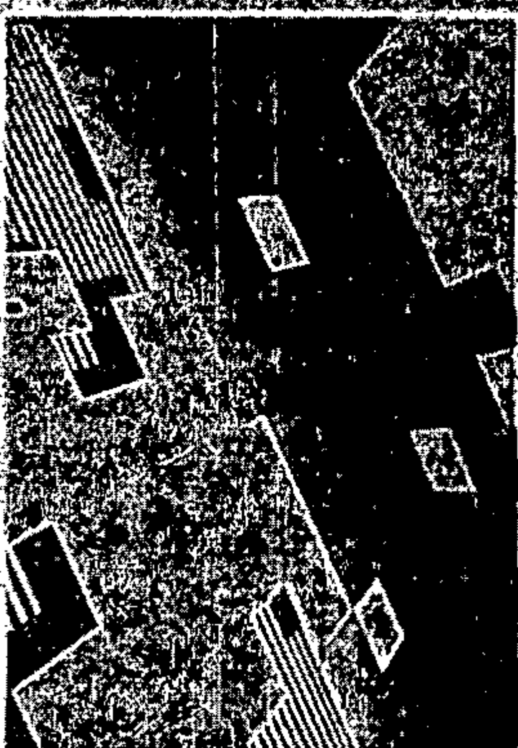
Taxes & The New Economy

Why Fairness Matters

Progressive Versus Flat Taxes



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