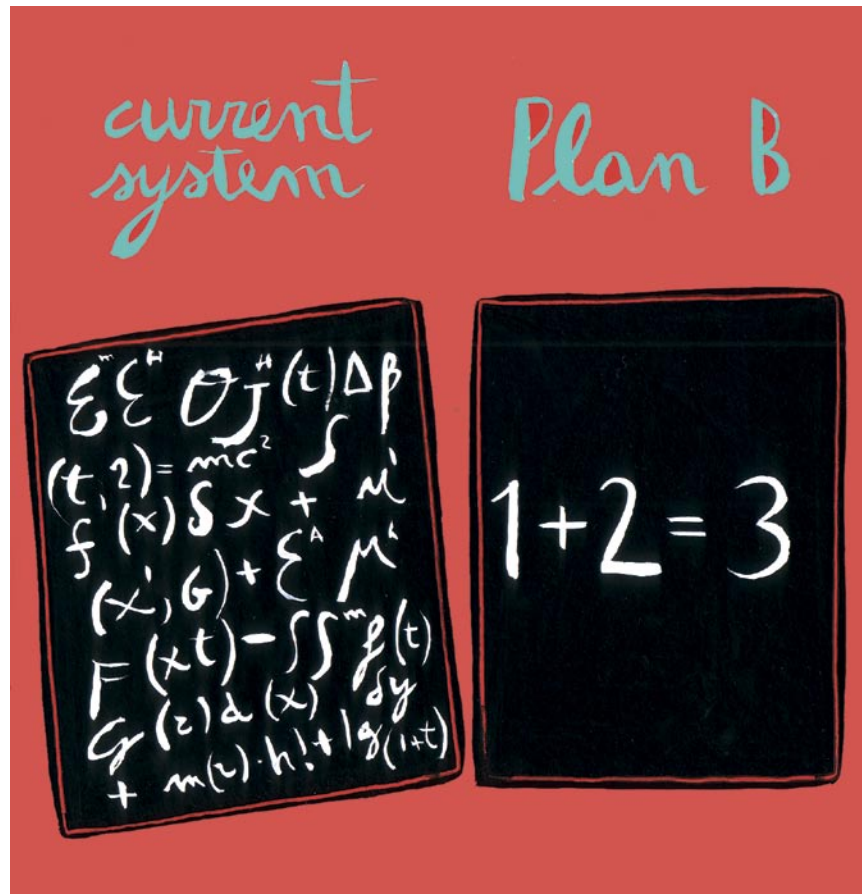


Chapter Seven

The Growth and Investment Tax Plan



Courtesy of Marina Sagona

The Panel evaluated a number of tax reform proposals that would shift our current income tax system toward a consumption tax. The Panel focused on consumption tax proposals that would collect taxes in a progressive manner. These proposals are designed to eliminate the disincentives to save and invest found in our current code, without dramatically altering the way the federal tax burden is shared.

The Panel considered a pure consumption tax that would completely eliminate the difference between the pre-tax and the after-tax return on new investment. It also considered a blended tax structure that would move the current tax system towards a consumption tax, while preserving some elements of income taxation. The Growth and Investment Tax Plan, which is one of the Panel's two recommendations, is an example of a blended structure. It would combine a progressive tax on labor income and a flat-rate tax on interest, dividends, and capital gains with a single-rate tax on business cash flow. Under this tax system, households would file tax returns and pay tax on

their wages and compensation using three tax rates, ranging from 15 to 30 percent. Most households would face lower marginal tax rates than they do under the current income tax system. In addition, the individual tax structure would accommodate the common elements described in Chapter Five, including the Work and Family Credits, the deduction for charitable gifts and health insurance, and the Home Credit. The Growth and Investment Tax Plan departs from a pure consumption tax by imposing a 15 percent tax on household receipts from interest, dividends, and capital gains.

Several panel members were concerned that the Growth and Investment Tax Plan would not move far enough towards a consumption tax because it retains a household-level tax on capital income. The Panel therefore developed a proposal for a consumption tax, referred to as the Progressive Consumption Tax Plan, which would not tax capital income received by individuals. Although the Progressive Consumption Tax Plan proposal did not emerge as a consensus recommendation, the interest in it led to substantial discussion.

Under the Growth and Investment Tax Plan, businesses would file annual tax returns. They would pay tax at a single rate of 30 percent on their cash flow, which is defined as their total sales, less their purchases of goods and services from other businesses, less wages and other compensation paid to their workers. Thus, businesses would be allowed an immediate deduction for the cost of all new investment. Non-financial businesses would not be taxed on income from financial transactions, such as dividends and interest payments, and would not receive deductions for interest paid or other financial outflows.

This chapter begins by summarizing the key differences between income and consumption taxes and explaining the likely impact of consumption taxes on the rate of economic growth. It then describes the Growth and Investment Tax Plan, which offers many of the benefits of a consumption tax even though it retains some elements of income taxation. Next, the chapter explores how adopting the Growth and Investment Tax Plan would affect the distribution of the tax burden. Finally, a brief discussion of the Progressive Consumption Tax Plan considers both how it would differ from the Growth and Investment Tax Plan and how it would affect the saving and investment incentives facing households and firms.

Shifting the tax structure toward a consumption tax would represent a fundamental change in the U.S. tax system. Such a shift would raise a number of implementation issues, many of which are addressed in this chapter. Other issues related to implementation are discussed in more detail in the Appendix.

Comparison of a Consumption Tax with an Income Tax

The key difference between an income tax and a consumption tax is the tax burden on capital income. An income tax includes capital income in the tax base, while a consumption tax does not. Taxing capital income reduces the return to savings and raises the cost of future consumption relative to current consumption. This is likely to cause people to spend more and save less, thereby depressing the level of capital

accumulation.

Our current tax system has both income tax and consumption tax features, such as the provisions that permit tax-free saving for retirement (e.g., IRAs and 401(k) plans) and other purposes. Yet the current tax code imposes a penalty on the return to many types of saving. It also taxes different types of investment at different rates, which leads to a misallocation of capital in the economy. Projects treated relatively favorably by the tax code, such as debt-financed investment, are encouraged relative to projects that are heavily taxed, such as equity-financed corporate investment. A consumption tax would not distort saving and investment decisions, and would treat all investment projects the same way.

Although a consumption tax would remove the tax bias against savings and level the playing field between different types of investments, it is important to recognize that an income tax and the type of consumption tax discussed here would both tax a significant portion of the return to capital. To understand why, it is helpful to distinguish four different components of the return to capital. The first is the “normal,” or risk-free, return that represents compensation for deferring consumption. This is sometimes described as the “return to waiting.” The second is the expected risk premium for a project with uncertain returns – the return to risk taking. The third component is “economic profit” and represents returns due to entrepreneurial skill, a unique idea, a patent, or other factors. This component is sometimes referred to as “supernormal returns.” The last component is the unexpected return from good or bad luck. This is the difference between the expected return at the start of an investment, and the after-the-fact, actual return.

A pure income tax and a “postpaid” consumption tax (described in Chapter Three) differ only in their treatment of the return to waiting. The other components of capital income are taxed similarly under both systems. The return to risk-taking and any additional returns that result from good or bad luck are treated similarly under both an income and consumption tax. In both cases, the government becomes a partner in the risks and rewards of the investment through increased tax revenues in the case of positive returns and reduced revenues if returns fall short of expectations. Supernormal returns are taxed equally under both a postpaid consumption tax and an income tax.

Removing the tax on the first component, the return to waiting, is the key to removing taxes from influencing savings and investment decisions. As discussed later in this chapter, recognizing that these other components of the return to capital are taxed under both an income tax and the type of consumption tax discussed here has important implications for the distributional effects of this type of reform.

Box 7.1. Differences in the Treatment of Returns to Business Investment Under a Consumption Tax and an Income Tax

To illustrate how a consumption tax treats normal returns differently than an income tax, consider an entrepreneur who has just earned \$100 and can invest in a new machine that will earn a risk-free 10 percent return one year from now. If the tax rate is 35 percent, under an income tax, the entrepreneur pays \$35 of tax on the \$100 of profits and has \$65 left to invest. In the next year, the investor earns \$71.50 and subtracts \$65 in depreciation for the cost of the machine (assuming for simplicity it is only good for one year), leaving taxable income of \$6.50. After paying \$2.28 in tax (35 percent of \$6.50) the entrepreneur would be left with \$4.22. The investor chooses between consuming \$65 today or \$69.22 in the future – an after-tax return of 6.5 percent.

In contrast, when new investments can be expensed, as under a consumption tax, the investor would choose between investing all \$100 in the machine or receiving \$65 after taxes for spending. If the entrepreneur invests, the entrepreneur would have \$110 in receipts in the next year, but no depreciation deductions. After paying \$38.50 in tax (35 percent of \$110), the investor will have \$71.50 left. Thus, the investor can choose between consuming \$65 today or \$71.50 in the future – an after-tax return of 10 percent.

To see how a postpaid consumption tax and an income tax treat supernormal returns equally, assume that the investment described above actually yields a return of 20 percent. Under an income tax, the investor now has \$78 in profit. After subtracting the \$65 depreciation allowance, the entrepreneur would have taxable income of \$13 – representing normal returns of \$6.50 plus an additional \$6.50 supernormal return. After paying \$4.55 in tax (35 percent of \$13), the entrepreneur would be left with \$8.45. Thus under an income tax, the investor chooses between consuming \$65 today or \$73.45 in the future – an after-tax return of 13 percent.

Under the consumption tax, as before, the investor deducts the \$100 investment in the first year, but pays tax of \$42 (35 percent of \$120) in the next year. This leaves \$78 (\$120 less \$42) after taxes. The investor chooses between consuming \$65 today or \$78 in the future – a 20 percent after-tax return. However, the investor pays \$3.50 more in tax (\$42 less \$38.50 in the first consumption tax example) as a result of the project's supernormal returns. This additional tax represents 35 percent of the \$10 of supernormal returns. Thus, the consumption tax described in this example levies the same tax burden as the income tax on supernormal returns.

A Consumption Tax Would Encourage Economic Growth

Taxing consumption rather than income would remove the saving disincentives that are central to income tax systems. Although one cannot know with absolute certainty the effect of raising the return on private saving by lowering the tax burden, most economic models suggest that such a change would result in higher household saving and a greater level of capital accumulation. Allowing businesses to deduct the cost of new investment immediately, rather than to depreciate assets over time, would encourage new investment. It also would eliminate the tax-induced differences between before-tax and after-tax returns on investment projects that are found in our current system.

Numerous studies have evaluated the economic impact of replacing the current income tax with a consumption tax. These studies typically consider reforms that

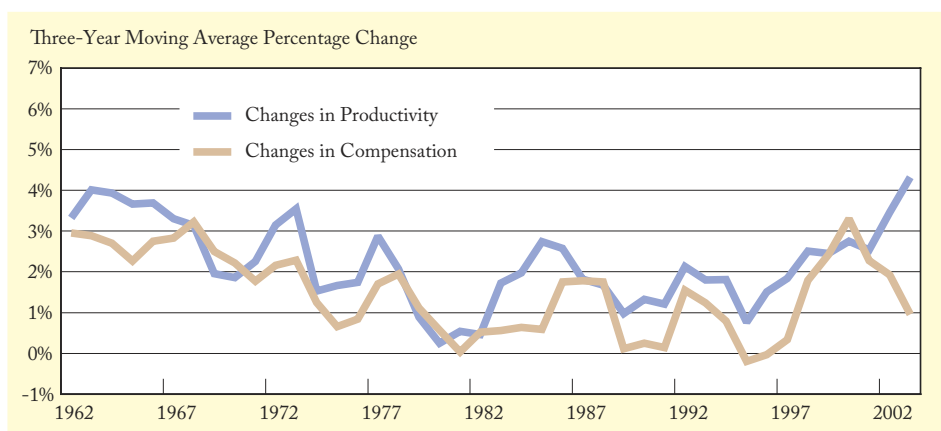
more closely resemble the Progressive Consumption Tax Plan, rather than the Growth and Investment Tax Plan discussed below. These studies use a range of different assumptions in analyzing tax reform, and they consider both the near-term and long-run consequences of modifying the tax structure. While the studies produce different estimates of how taxing consumption rather than income would affect economic growth, virtually all such studies suggest that the long-run level of national income would be higher. The Treasury Department used three different economic models to evaluate both the long-run and short-run effects of adopting the Progressive Consumption Tax Plan. Their findings suggested a long-run increase in economic activity of between 2 and 6 percent. These findings are broadly consistent with the results of previous economic analyses, most of which yielded estimates of at least a 3 percent increase in long-run output. Most of these models do not consider the potential efficiency gains that result from an improved allocation of capital across investments, but focus instead only on the benefits of lowering the overall capital tax burden. The potential economic gains from shifting to a consumption tax may therefore exceed these estimates.

To place these values in perspective, a 5 percent expansion of the U.S. economy in 2005 would increase Gross Domestic Product by over \$600 billion and would likely raise wages and compensation by over \$400 billion. Such an increase in economic output would improve living standards for most Americans.

The increased level of capital accumulation that would follow the adoption of a consumption tax is likely to result in more rapid productivity growth, which is the key to raising standards of living for American workers. Figure 7.1 shows the historical relationship between changes in wages and productivity growth. The two move closely together: wages grow when productivity grows, and wages stagnate when productivity falls.

Productivity growth ultimately depends on investments in human, physical, and intangible capital. Human capital investment is affected by the tax burden that

Figure 7.1. Productivity and Compensation Trends



Source: 2004 Economic Report of the President, Table B-49.

individuals expect to face after they have invested time and money to acquire skills that raise their earning capacity. Both the level and the progressivity of tax rates are important. Low marginal tax rates on labor income make it more attractive for individuals to make investments in education. In contrast, large differences in labor tax rates when individuals forego earnings to obtain new skills, and when they earn the return on those investments, can discourage human capital investment. All of the Panel's recommendations preserve incentives for human capital investment by avoiding increases in (and in many cases, reducing) the marginal tax rates on labor.

The incentive for businesses and individuals to invest in physical and intangible capital is affected by the difference between the before-tax and the after-tax return to new investments. Taxing business investment reduces the aggregate stock of capital that is available to raise worker productivity. Moreover, under the current tax system, investments in physical capital, such as plant and equipment, are taxed at substantially higher rates than investments in marketing, research and development, and other intangibles. Business investments are also taxed much more heavily than investments in owner-occupied housing. This uneven tax treatment of investment leads to an inefficient allocation of investment resources.

An Overview of the Growth and Investment Tax Plan

The Growth and Investment Tax Plan would raise revenue in a progressive fashion, while preserving many of the important features found in our current income tax. It would provide work incentives to low-income taxpayers through Family and Work Credits and encourage home ownership and charitable giving. Like the Simplified Income Tax, it would eliminate the worst features of our current income tax system, such as targeted tax benefits, phase-outs, and the AMT. It would simplify the tax system for individual taxpayers using an approach that is similar to the Simplified Income Tax Plan by incorporating a number of elements that are common to both plans.

Table 7.1. Growth Investment Tax for Households

Provisions	Growth and Investment Tax Plan
Households and Families	
Tax Rates	Three tax brackets: 15%, 25%, 30%
AMT	Repealed
Personal exemption	Replaced with Family Credit available to all taxpayers: \$3,300 credit for married couple, \$2,800 credit for unmarried with child, \$1,650 credit for singles, \$1,150 credit for dependent taxpayer; additional \$1,500 credit for each child and \$500 credit for each other dependent
Standard deduction	
Child tax credit	
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child: \$3,570; with two or more children, \$5,800
Marriage penalty	Reduced. All tax brackets, Family Credits, and taxation of Social Security benefits for couples are double those of individuals
Other Major Credits and Deductions	
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about \$227,000 to \$412,000)
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be \$5,000 for an individual and \$11,500 for a family).
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans
State and local taxes	Not deductible
Individual Savings and Retirement	
Defined contribution plans	Consolidated into Save at Work plans that have simple rules; AutoSave features point workers in a pro-saving direction
Defined benefit plans	No change
Retirement savings plans	Replaced with Save for Retirement Accounts (\$10,000 annual limit) – available to all taxpayers
Education savings plans	Replaced with Save for Family Accounts (\$10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers
Health savings plans	
Dividends received	Taxed at 15% rate
Capital gains received	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with simple deduction. Married taxpayers with less than \$44,000 in income (\$22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation

For businesses, the Growth and Investment Tax Plan would establish a more uniform tax on investment by allowing immediate expensing of business assets and eliminating interest deductions. One measure that economists often use to describe the net effect

of the tax system on investment incentives is the “marginal effective tax rate.” This yardstick is not the statutory tax rate, but rather a measure of the difference between an investment’s pre-tax and after-tax return. The higher the marginal effective tax rate, the lower the after-tax return relative to the pre-tax return, meaning that some investors would not undertake an investment because of the tax burden. If the effective tax rate is zero, any project that an investor would choose to undertake in a world without any taxes would still be undertaken in a world with taxes.

Table 7.2. Growth and Investment Tax for Businesses	
Provisions	Growth and Investment Tax Plan
Small Business	
Rates	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Business cash flow tax
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)
Large Business	
Rates	30%
Investment	Expensing for all new investment
Interest paid	Not deductible (except for financial institutions)
Interest received	Not taxable (except for financial institutions)
International tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed

Under the current income tax system, effective tax rates differ widely across assets and across projects that are financed in different ways. The average marginal effective tax rate on all types of business investment under the policy baseline is approximately 22 percent. The Growth and Investment Tax Plan would lower the marginal effective tax rate to 6 percent and equalize the tax burden on different types of investments. The Panel is confident that the very substantial reduction in the tax burden on investment would stimulate capital formation, keep American capital that would have gone to other countries at home, and attract foreign capital to the United States.

The Growth and Investment Tax Plan for Households

For households, the Growth and Investment Tax Plan is nearly identical to the Simplified Income Tax. Under the Growth and Investment Tax Plan, households would be taxed on their wages, salaries, and other compensation. The Growth and Investment Tax Plan would incorporate the newly designed ways to help taxpayers receive tax benefits for home ownership, charitable giving, and health insurance coverage described in Chapter Five. It would incorporate the Family and Work

Credits, which would provide a tax threshold that is identical to the tax threshold under the Simplified Income Tax. Like the current system, the Growth and Investment Tax Plan would share the burdens and benefits of the federal tax structure in a progressive manner.

Under the Growth and Investment Tax Plan, wages, compensation, and other compensation would be taxed at three progressive rates of 15, 25, and 30 percent, instead of the six rates used in our current system. As summarized in the Table 7.3, the rate brackets for married taxpayers are exactly twice the amounts for unmarried taxpayers, which would reduce the marriage penalties.

Table 7.3. Tax Rates under the Growth and Investment Tax Plan

Tax Rate	Married	Unmarried
15%	Up to \$80,000	Up to \$40,000
25%	\$80,001 - \$140,000	\$40,001 - \$70,000
30%	\$140,001 or more	\$70,001 or more

An income tax collects more taxes from a family that saves for the future than it would from an identical family that spends the same amount today. The Growth and Investment Tax Plan would reduce, but not eliminate, this distortion. The Progressive Consumption Tax Plan discussed below, in contrast, would eliminate the tax burden on capital income and thereby make a family's tax burden independent of when they choose to spend their earnings.

The Growth and Investment Tax Plan deviates from a traditional consumption tax by imposing a low-rate tax on all household capital income, while also retaining a system of tax-exempt saving accounts that would enable many households to avoid taxation altogether on returns to savings. All dividends, interest, and capital gains on assets held outside these accounts would be taxed at a 15 percent rate. Under current law, dividends and capital gains are taxed at a maximum rate of 15 percent, while interest is taxed at ordinary income tax rates. Lowering the household-level tax on interest income would further reduce the incentive for families to spend now instead of saving more.

The Growth and Investment Tax Plan would incorporate the Save for Retirement and Save for Family accounts proposed as part of the Simplified Income Tax. In addition, the refundable Saver's Credit would provide a match for contributions made by low-income taxpayers.

The Growth and Investment Tax Plan also would provide employer-sponsored retirement accounts that are similar to the Save for Work accounts under the Simplified Income Tax. However, the Save at Work accounts under the Growth and Investment Tax Plan would be "pre-paid," meaning that contributions to these

accounts would be made on an after-tax basis like a Roth IRA. This change would not affect balances in existing pre-tax retirement accounts, which would continue to be tax-free until withdrawn. Allowing future contributions to employer-sponsored accounts to be made on an after-tax basis under the Growth and Investment Tax Plan would provide a uniform treatment of all tax-free saving.

As with the Simplified Income Tax, these savings accounts would ensure that most American families would be able to save for retirement, housing, education, and health free of taxes. Given the opportunity and flexibility of these savings accounts, the Panel expects that relatively few families would pay the 15 percent tax on interest, dividends, and capital gains that would apply to assets held outside these accounts.

Box 7.2. Save at Work Accounts Under the Growth And Investment Tax Plan

The Growth and Investment Tax Plan incorporates back-loaded, or Roth-style Save at Work accounts. These accounts would be similar to recently enacted provisions that will permit taxpayers to make after-tax contributions to their 401(k) and 403(b) accounts beginning next year.

The Growth and Investment Tax Plan differs from the Simplified Income Tax, which provides pre-tax Save at Work accounts that are structured like traditional IRAs and provide a tax deduction for contributions and tax all withdrawals as ordinary income. If a household's marginal tax rate is the same when contributions are made and withdrawn, the two structures offer the opportunity to accumulate assets at the before-tax rate of return. The Roth-style approach has the advantage of being simpler because the traditional IRA approach involves claiming a deduction when money is contributed and reporting income when the money is withdrawn.

These approaches yield different revenue implications over the ten-year budget window. The revenue cost of traditional IRA accounts is recorded "up front," when contributions are made. With Roth-style accounts, the pattern is reversed – there are no up-front revenue costs because contributions are included in taxable income. The discussion in Chapter Four noted that retirement saving programs affect revenues over horizons as long as three or four decades. The Simplified Income Tax Plan's Save at Work accounts would raise less tax revenues during the ten-year budget window than those of the Growth and Investment Tax Plan, even if identical amounts were contributed to these accounts. The Growth and Investment Tax Plan would raise less revenue from these accounts in the years beyond the budget window. It is worth noting that other provisions of the Growth and Investment Tax Plan have the opposite effect – expensing of new investment, for example, overstates revenue losses because deductions are shifted inside the ten-year budget window.

The Panel supports the use of Roth-style accounts in the Growth and Investment Tax Plan on policy grounds. The availability of the tax revenue from the Roth-style approach also made it possible to set the corporate and individual income tax rates lower than they would have been if the traditional IRA structure had been used. Nevertheless, the use of Roth-style accounts is not an essential feature of the plan, and it could be implemented with the traditional IRA-style accounts. If policymakers made the decision to use that structure, the tax rates would need to be higher in order to achieve revenue neutrality.

Figure 7.2. Tax Return for the Growth and Investment Tax Plan

Form 1		U.S. Individual Tax Return		200X		(99)	
Label (See instructions on page xx.) Use the IRS label. Otherwise, please print or type.		For the year Jan. 1-Dec. 31, 200X, or other tax year beginning , 200X, ending , 20		OMB No. 1545-XXXX			
		Your first name and initial		Last name		Your social security number	
		If married, spouse's first name and initial		Last name		Spouse's social security number	
		Home address (number and street). If you have a P.O. box, see page xx.		Apt. no.		▲ Important! ▲ You must enter your SSN(s) above.	
City, town or post office, state, and ZIP code. If you have a foreign address, see page xx.							
Taxable Amount Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.	1	Wages, salaries, tips, etc. Attach Form(s) W-2	1				
	2	Business cash flow. Attach Schedule 1	2				
	3	Taxable interest and dividends	3				
	4	Gains or (losses)	4				
	5	Taxable distributions (retirement and savings)	5				
	6	Social security benefits	6				
	7	Other income. List type and amount	7				
	8	Total cash flow. Add lines 1 through 7	8				
	9	Charitable contributions	9				
	10	Multiply line 8 by 1% (.01)	10				
	11	Subtract line 10 from line 9. If zero or less, enter -0-	11				
	12	Social security benefits deduction	12				
	13	Health insurance deduction	13				
	14	Add lines 11 through 13	14				
	15	Taxable amount. Subtract line 14 from line 8. If zero or less, enter -0-	15				
Tax and Credits	16	Tax (see page xx)	16				
	17	Home credit (see page xx)	17				
	18	Subtract line 17 from line 16. If zero or less, enter -0-	18				
	19	Family credit. Attach Schedule A if required	19				
	20	Subtract line 19 from line 18. If zero or less, enter -0-	20				
	21	Self-employment tax	21				
	22	Other taxes. Attach Schedule O	22				
	23	Total tax. Add lines 20 through 22	23				
Payments	24	Federal tax withheld	24				
	25	Work credit	25				
	26	Estimated tax and other payments	26				
27	Total payments. Add lines 24 through 26	27					
Refund or Amount You Owe	28	Amount overpaid. If line 27 is more than line 23, subtract line 23 from line 27. If you want to use direct deposit, attach Form XXXX	28				
	29	Amount of line 28 you want applied to your 200Y estimated tax	29				
	30	Amount you owe. If line 23 is more than line 27, subtract line 27 from line 23	30				
Sign Here Married? See page xx. Keep a copy for your records.	Your signature		Date	Your occupation		If married but not filing with spouse, check here <input type="checkbox"/>	
	Spouse's signature. If filing with spouse, both must sign.		Date	Spouse's occupation			Daytime phone number ()
Paid Preparer's Use Only	Preparer's signature		Date	Check if self-employed <input type="checkbox"/>		Preparer's SSN or PTIN	
	Firm's name (or yours if self-employed), address, and ZIP code		EIN		Phone no. ()		
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page xx.							
				Cat. No. 00000X		Form 1 (200X)	

The Growth and Investment Tax Plan would make computing taxes dramatically simpler than our current system and would significantly reduce the amount of information required to be gathered and retained by taxpayers and collected and processed by the IRS. Like the Simplified Income Tax Plan, individual tax returns would be shorter and simpler and would free of the parallel tax structure created by the AMT. The new tax return that would be used under the Growth and Investment Tax Plan would be easy to understand, and would be no longer than one page, as shown in Figure 7.2.

The Growth and Investment Tax Plan for Businesses

The Growth and Investment Tax Plan would impose a flat tax on all business cash flow, defined as sales or receipts less the cost of materials, labor services, and purchases of business assets. The Growth and Investment Tax Plan would modify the current corporate income tax base in four important ways. First, businesses would be allowed to write-off immediately, or “expense” their capital expenditures. Second, for non-financial firms, financial transactions would be excluded from the cash flow computation. Businesses generally would not be entitled to deduct interest paid or be required to include interest and dividends received and capital gains on the sale of financial assets. Special rules would apply to businesses that provide financial services. Third, firms that generate losses would be allowed to carry them forward and to offset them against future tax liability. In contrast to the current tax system, however, losses would accrue interest when carried forward. Finally, international transactions would be taxed under the “destination basis” principle. The cash flow tax would be rebated on exports, and imports would not be deducted from cash flow. The Panel embraced the destination-based system because it is consistent with the use of domestic consumption as the tax base and because it is easier to administer than any other alternative.

Business Cash Flow Taxed Once at a Flat Rate

The Growth and Investment Tax Plan would apply a flat 30 percent tax on all businesses other than sole proprietorships, regardless of their legal structure. Removing the tax differential among business entities would eliminate economic inefficiency caused by the double tax on corporate firms that are unable to take advantage of flow-through treatment under current law for non-corporate organizational forms, such as limited liability companies (LLC), partnerships, or S corporations. The net positive cash flow of flow-through entities would be taxed at the business tax rate, although owners of these entities could report and compute the tax on business cash flow on a separate schedule of their individual returns. Similarly, the net positive cash flow of sole proprietorships would be reported on the tax return of its owner, but would be taxed at the graduated individual rates.

By focusing on cash flow, the new tax base would discard the complicated accounting rules that currently attempt to match income with deductions. Instead, for most businesses the tax base would be the difference between cash received and cash paid out. The business tax would resemble a “subtraction method” value-added tax (VAT), with the important exception that wages and other compensation would be a deductible expense.

Box 7.3. What is the Subtraction Method?

The business tax would be imposed on the difference between receipts and outlays – net cash flow. This is often referred to as the “subtraction method” because businesses subtract all expenses from receipts. It is one of two methods used to implement VATs. The other method is the credit or credit-invoice method. In that method, a business is taxed on all receipts but receives a credit for the amount of tax paid by the seller on the business’ purchases. While the credit method is based on transactions and the subtraction method is based on the aggregate accounts of a business, in practice, the two methods are virtually identical – the subtraction method aggregates all expenses and receipts during the year into accounts made up of individual transactions, while the credit method starts with transactions, but businesses must ultimately aggregate transactions into accounts to file returns.

Any amount deducted under the subtraction method can be converted to an equivalent credit and vice versa. Suppose a business spends \$100 on supplies and the tax rate is 35 percent. Under the subtraction method, the business gets a deduction of \$100, saving it \$35 in taxes that would otherwise be due. On the other hand, under the credit method the business would not be allowed to subtract the \$100 of purchases, but would be given a \$35 tax credit.

Most countries with credit method taxes require invoices to help ensure that a buyer only receives a tax credit if the seller in fact pays tax on the sale. The Growth and Investment Tax Plan, although implemented using the subtraction method, would similarly require that deductible purchases be allowed only from businesses that are subject to the tax, and that these purchases be substantiated. For example, goods or services received from foreigners, who are not taxed in the United States, would not be deductible.

The Growth and Investment Tax Plan would be implemented using the subtraction method because it is closer to current law methods of accounting, which would reduce the costs of switching tax systems.

The flat-tax rate of 30 percent on business cash flow would be the same as the top tax rate under the household tax, reducing tax planning strategies aimed at shifting income between the business and individual tax bases.

Expensing for All Business Investments

The Growth and Investment Tax Plan would enhance investment incentives by lowering the effective tax rate on new investment. It also would reduce distortions under current law that suppress and misallocate capital investment due to different tax rates across different types of business assets.

Our current depreciation system permits businesses to deduct the cost of their new investments from their taxable income over time. Although accelerated depreciation and expensing of some assets under our current system lowers the tax burden on returns from new investment, depreciation deductions provide an imperfect mechanism for measuring the actual decline in value of an asset. Current depreciation rules result in effective tax rates that differ substantially among different types of assets. Mismatches between the actual decline in the value of assets, or economic depreciation, and tax depreciation may discourage new investment in plant and equipment and distort the allocation of investment across asset classes.

Current-law tax depreciation also fails to account for inflation. Businesses claim tax depreciation based on an asset's nominal purchase price, even though inflation may have increased its replacement cost. This means that investors do not recover the full value of their investments. The current income tax leads businesses to forego investing in some projects that would have a positive net present value in a world without taxes, but that fail to earn enough to cover both taxes and the required return to investors. With a pure consumption tax, any project that is attractive in a no-tax world remains attractive.

The Growth and Investment Tax Plan would encourage new investment by replacing the patchwork of current incentives and credits with a simple rule: all business investment can be expensed the year when it is made. Moving from depreciation allowances to expensing would lower the tax burden on the returns to new investment and level the playing field across different types of business assets. With expensing, each dollar spent on a new investment asset would generate a deduction worth one dollar, regardless of the asset's type. It would also substantially simplify business taxes by eliminating the need to maintain detailed depreciation schedules and accounting for asset basis.

Because the Growth and Investment Tax Plan retains a low-rate tax on dividends, interest, and capital gains at the household level, it continues to place a tax burden, estimated by the Treasury Department to be approximately 6 percent, on all types of investment. Nevertheless, many projects that are not economical to undertake under the current income tax system would generate an acceptable after-tax return under the Growth and Investment Tax Plan.

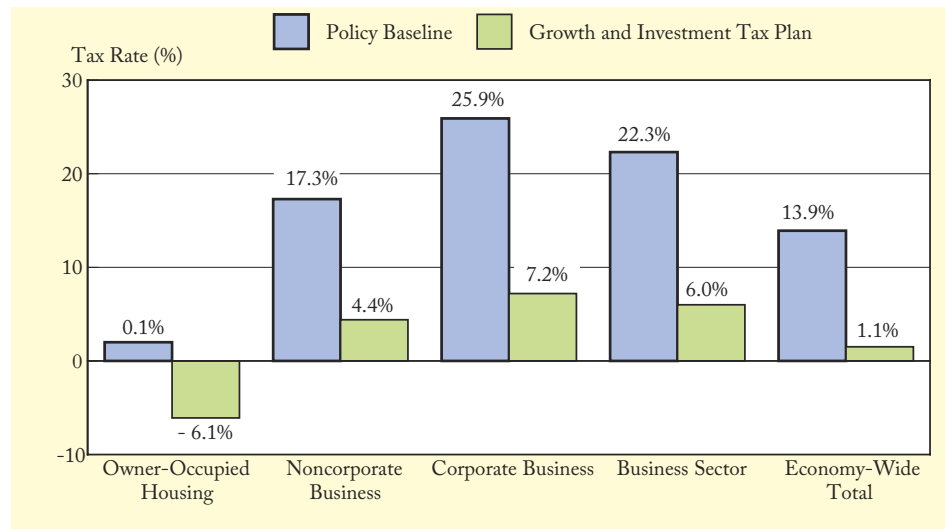
Consistent Treatment of Financial Transactions

The business tax base under the Growth and Investment Tax Plan would not include financial transactions, such as interest paid and received. The elimination of interest deductibility would equalize the tax treatment of different types of financing and would reduce tax-induced distortions in investment incentives. Current law places a lower tax burden on firms that have access to debt financing than on those that use the equity market to finance new projects.

Eliminating the business interest deduction for non-financial firms is an essential component of the Growth and Investment Tax Plan. Allowing both expensing of new investments *and* an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity. Moreover, retaining interest deductibility would preserve differences in the tax burdens on debt-financed and equity-financed projects, thereby retaining distortions across asset and firm types. The Growth and Investment Tax Plan would eliminate the complicated distinctions between debt and equity finance and remove the tax system as a factor in firms' capital structure decisions. Removing the tax advantages of corporate debt also eliminates the tax code's incentive for firms to increase their debt load beyond the amount dictated by normal business

conditions. Figure 7.3 summarizes how the combination of expensing and more equal treatment of interest and dividends provides a lower, more uniform tax burden on the returns of marginal business investments.

Figure 7.3. Comparison of Effective Tax Rates on Different Types of Investment



Note: The tax rates for the policy baseline assume, among other things, that the 2001 and 2003 tax cuts will be made permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a \$5,000 limit) would be enacted.

Source: Department of the Treasury, Office of Tax Analysis.

Excluding financial transactions from the business tax of the Growth and Investment Tax Plan would create special difficulties in the case of businesses that provide financial services. To prevent distortions, financial services should be taxed like any other business good or service. The taxation of financial services is complicated, however, because “implicit fees” are typically imbedded in interest rate spreads and financial margins. For example, a bank typically pays interest to depositors at a lower rate than it collects from mortgage borrowers. Both of these transactions include two components – a service fee and a financial cost related to the use of money – that are included in a single payment of “interest.” The problems with separating the components of financial services are not unique to a consumption tax – income taxes also do not properly tax financial services, but the under-taxation is more visible in a consumption tax. As a result of this conceptual difficulty, countries that administer VATs have adopted special regimes for financial services, with most exempting financial services from the VAT tax base.

The Panel determined that financial services should be taxed under the Growth and Investment Tax Plan. Exempting financial services from tax leads to a number of economic distortions and creates compliance and administrative difficulties. Absent special rules, however, businesses that primarily provide financial services would have perpetual tax losses under the Growth and Investment Tax Plan. This would occur because the cash flow tax base for these financial firms would not include the

revenues that they generate from lending and investing at rates above their cost of funds, but it would allow a deduction for the cost of compensation for workers as well as other purchases.

The Panel considered several options for the taxation of these firms, and recommends an approach under which financial institutions would treat all principal and interest inflows as taxable and deduct all principal and interest outflows. Customers would disregard financial transactions for tax purposes. To prevent the over-taxation of business purchases of financial services, financial institutions would inform business customers of the amount of financial cash flows that are attributed to deductible financial intermediation services. This amount would be deductible as an expense in computing the business customer's taxable cash flow under the Growth and Investment Tax Plan. Rules would be required under this regime to identify which businesses should be subject to the financial institutions regime, especially in the case of businesses that have both financial and non-financial business activities. In addition, an interest rate that would be used as a proxy for the "financial cost" component of financial cash flows would have to be established to determine the value of the separate taxable service component; the simplest approach would be to compare financial inflows and outflows to a single, short-term inter-bank interest rate.

The Panel recognizes that before implementing the Growth and Investment Tax Plan, it would be wise to consider alternative tax rules for financial firms and their potential impact on incentives for firm behavior. The Panel has identified some possible alternatives, which are discussed in more detail in the Appendix.

The Treatment of Tax Losses

The current tax system limits refundability of tax losses because of concerns that such losses can be generated through non-economic, tax-sheltering activity. Firms currently are allowed to carry back losses and to claim refunds for taxes paid in prior years, and to carry losses forward to offset tax liability in future years. Firms that in prior years earned positive income that exceeds their current losses, or that will earn such income in the future, will eventually be able to use their tax losses.

When losses are not refundable, but firms are taxed when they have positive cash flows, the tax system discourages risky ventures with substantial loss possibilities. In effect, such tax rules provide the government with a larger share of favorable returns than of adverse returns, which reduces the after-tax return to undertaking such an investment.

Denying current refunds of losses raises the effective tax rate on marginal investments relative to a system that features refundable losses. Consider a start-up firm that has substantial upfront capital expenditures but little initial revenue. In the early years, the firm has negative cash flow, but it expects to be profitable in the future. If the tax system does not refund losses until a firm is profitable, there is a delay in the receipt of the tax benefits associated with expensing its capital investments. The tax system would discourage firms from undertaking projects expected to have many years of negative cash flows. If there was some chance that the firm might go bankrupt before

receiving the benefit of its start-up losses, this would raise the effective tax burden on new investment.

Under the Growth and Investment Tax Plan, losses would not be refundable. To mitigate the impact that denying loss refundability would have on the effective tax rate on marginal investments, the Panel recommends providing interest on loss carryforwards. If the current interest rate is 10 percent, and a firm incurs a \$1 million loss this year, it may claim a \$1.1 million loss offset next year (adding 10 percent of \$1 million), or a \$1.21 million loss in two years (adding 10 percent of \$1.1 million). Losses would be carried forward indefinitely. By providing interest on the amount of tax later refunded, the tax system would achieve nearly the same effect as having full loss refunds for firms that eventually earn positive cash flows, provided that the interest rate paid on loss carryforwards is equal to the firm's borrowing rate. Allowing interest on losses carried forward alleviates the problem of firms losing the time value of money on carryforwards, but does not eliminate the risk of losing carryforwards entirely if a firm goes out of business.

Another strategy for allowing firms to capture the full value of the tax benefits associated with negative cash flow is to allow losses to be traded from one firm to another. If trading is not costly to firms, then allowing such trading may be equivalent to allowing full and immediate loss refundability. The Panel decided that losses should not be tradable under the Growth and Investment Tax Plan. Allowing tradable or refundable losses may encourage tax avoidance schemes in which the taxpayers make investments that would not have been worth undertaking in a no-tax setting. The value of tax losses created by such an investment may be a key component of its appeal. In addition, allowing loss trading could make it much more important to police so-called "hobby losses" and losses generated by various forms of disguised consumption, rather than investment, because those losses could generate tax savings even when the person incurring them would never realize offsetting positive cash flow.

Under current law, several provisions prevent the transfer of losses to taxpayers with positive income and the transfer of income to taxpayers with losses. One set of rules generally limits the ability to apply the losses of one corporation against income from another when the corporations are combined. Similar rules would be adopted under the Growth and Investment Tax Plan to limit the transferability of negative and positive cash flow.

“Destination-Basis” Taxation of Cross-Border Transactions

International transactions, including both imports and exports of goods and services, as well as financial transactions such as the repatriation of earnings by corporate subsidiaries, pose important challenges for all tax systems. The Growth and Investment Tax Plan is no exception. The tax could be implemented on either a “destination-basis” or an “origin-basis” to address international transactions. The former treats all domestic consumption equally, while the latter treats all domestic production equally. The Panel recommends using the destination-basis to implement

the Growth and Investment Tax Plan.

A destination-basis consumption tax levies the same tax on consumption that occurs in the United States, regardless of where the good was produced. Under this system, sales to customers in other nations (exports) are excluded from the tax base while purchases from abroad (imports) are included. Thus, if a domestic manufacturer produces a product in the United States at a cost of \$90 that it sells abroad for \$100, the manufacturer is not taxed on the \$100. The manufacturer receives a rebate of the tax on the \$90 of production costs. This has the effect of eliminating the tax burden on goods that are sold abroad. The tax rebate that the manufacturer receives at the point of export is commonly known as a border tax adjustment. Purchases from abroad are taxed by either making them nondeductible to the importing business or by imposing an import tax.

The alternative “origin-basis” system taxes goods based on where they were produced – their origin. The tax base is domestic production, which equals domestic consumption plus net exports. Exports are included in the tax base because they are part of domestic production and imports are excluded because they are not. If a manufacturer produces a product in the United States at a cost of \$90 that it sells abroad for \$100, it is taxed on the sale. This means that identical items produced for domestic and for foreign consumption are taxed in the United States in exactly the same way. Purchases from abroad are either deducted by the importing business or not taxed at the point of entry into the United States.

Border Tax Adjustments and International Trade

The VATs imposed by our major trading partners are implemented on a destination-basis. They include border tax adjustments. While these taxes are often viewed as subsidizing exports because they exempt exports and tax imports, economic analysis indicates that destination-based taxes do not affect the balance of trade. To illustrate this proposition, suppose that the United States was trading with a foreign country in a completely tax-free environment. Trade would be conducted at a level at which each country enjoyed comparative advantage – selling to others the products and services that nation produces best. Now suppose that the United States imposed a destination-basis consumption tax. A domestic exporter would still sell its product in the foreign country at the same price as without the tax.

Similarly, a good sold in the United States by a foreign producer would be subject to the U.S. consumption tax. As a result, the foreign importer would compete in the United States on the same basis as local sellers. Consumers in the United States would make the same choices regarding imports and domestically-produced goods as they had made before the tax was imposed, since both are subject to the same tax. Economic theory suggests, therefore, that imposing a destination-basis tax does not affect a country's trade position.

The preceding discussion might suggest, in contrast, that an origin-basis tax could disadvantage domestic producers relative to foreign producers in the worldwide market. However, border tax adjustments are not the only mechanism working to

maintain neutrality. Adjustments that take place through the market, such as changes in exchange rates or in other economic variables, including wages and the prices of other inputs, should wholly offset any potentially detrimental trade effects on the value of exported goods under an origin-basis tax.

Returning to the previous example, assume instead that the United States imposes an origin-basis tax. Before the tax is imposed, the United States is trading in a completely tax-free environment. Recall that under an origin-basis system, exports are taxed and imports are exempt. If markets are competitive, the exporter will not be able to reduce his price and remain in business after the tax on exports is imposed. However, the U.S. currency may depreciate so that although the nominal price increases by the amount of the tax, the price paid for the export by foreign consumers in their currency is unchanged from its before-tax level. Therefore, trade will not be affected. As explained above, however, if exchange rates did not fully adjust, the price adjustment could occur through adjustments in domestic prices and wages.

The observation that a neither a destination-basis nor an origin-basis tax distorts the pattern of trade that would exist in the absence of any taxes does not imply that moving from the current income tax structure to a consumption tax would not affect trade. The current tax system places heavier burdens on some industries than on others. Replacing the current tax system with a system that is equivalent to a system with no taxes at all could raise exports in the industries that are currently taxed heavily.

Administration

The Panel recommends imposing the Growth and Investment Tax Plan on a destination-basis because such a tax will be easier to administer than a comparable tax on an origin-basis. An origin-basis system will engender serious disputes as a result of “transfer pricing.” The term transfer pricing refers to amounts charged (or not charged) for sales and transfers between related entities, often controlled by a single corporate parent. Because the different entities are related, they do not really care what price they charge each other. If they are located in different taxing jurisdictions they may have an incentive to set prices to minimize overall taxes rather than to reflect the actual value of the goods and services they are providing one another. Current tax rules use the internationally accepted standard for setting transfers prices; these prices must be set at the level that would have prevailed if the parties had been dealing at “arm’s length.” The application of this standard raises difficult compliance and administrative problems.

Under a destination-basis tax, transfer prices do not affect the computation of tax liabilities. Border adjustments make the tax base domestic consumption, which at the business level equals domestic sales minus domestic purchases. As a result, the prices established for cross-border transactions are irrelevant, and there are no opportunities to use transfer prices to minimize tax liabilities.

The same is not true under an origin-basis tax. Transfer pricing would continue to be a problem since export sales would be taxable and imports would be deductible. There

is an incentive, as in the current system, to overcharge for imports and undercharge for exports to shift income out of the United States. Related but more complex tax avoidance schemes are more difficult to accomplish under a destination-basis system for similar reasons (see Box 7.4 for an example).

Box 7.4. An Example of a Tax Avoidance Scheme under an Origin-Basis System

A foreign company purchases a \$100 product from a U.S. business by promising to pay \$110 in one year (a purchase on credit). The transaction is documented as the purchase of a \$90 good with \$20 of interest. By overstating interest on the sale, the business reduces its taxable receipts under an origin-basis tax while not changing its cash flows. The foreign company is indifferent to how the transaction is structured. Under a destination-basis system, the transaction with the foreigner is not subject to tax since it is an export and, as a result, there is no incentive to engage in this tax avoidance scheme in the course of cross-border transactions.

Besides reducing incentives for tax-minimizing transfer pricing, a destination-basis tax is easier to apply to royalty income from abroad. Royalties received from abroad represent payments for exports of intangible assets, and so would be exempt from taxation under the Growth and Investment Tax Plan. The owner of the intangible would be taxed when he uses the proceeds to consume. Royalties paid for foreign-created intangible assets would not be deductible since they are payments for imports. Transfer pricing problems may be particularly severe in the case of royalties, because it is difficult to establish arm's length prices for intangible assets. The destination-basis tax closes down opportunities to inappropriately set transfer prices since the prices established for cross-border royalty transactions would be out of the tax base.

Choosing the destination-basis for the treatment of cross-border transactions under the Growth and Investment Tax Plan "closes" the tax system. This means that businesses are only able to claim deductions from the tax base that are offset by corresponding inclusions in the tax base. Closing the system through border adjustments precludes tax avoidance opportunities that involve structuring cross-border transactions to generate tax deductions for payments to foreigners who are outside the system.

While closure is attractive on balance, it has some drawbacks. Deductions should only be allowed for purchases from domestic suppliers and sales should be exempted only if they are truly to foreigners. This makes it essential to monitor deductions and exemptions. Moreover, citizens of the United States can avoid import taxes by consuming foreign-produced goods purchased outside of the United States. This creates an incentive for citizens to buy goods abroad.

Location Incentives

The presence of expensing for new investment under the Growth and Investment Tax Plan would make the United States an attractive place to invest foreign capital. The investment incentives discussed above would apply to all firms operating in the

United States, not just to firms headquartered in the United States. At the same time, the tax code would no longer give U.S. multinational corporations an incentive to move production overseas because the tax burden would be based on *sales* within the U.S., regardless of where the goods are produced. As explained in detail earlier in this chapter, the Growth and Investment Tax Plan also would eliminate many of the complex cross-border tax planning activities that reduce the revenue collected under current corporate income taxes. Reducing the incentive for such tax planning would be an important step toward simplifying the tax system.

Refunds for Exports

The border tax adjustment described above would provide tax refunds to exporting firms. The amount of the refund would be determined by the costs incurred in producing an export, including the firm's labor costs. For firms that sell primarily in the export market, their border tax adjustment rebate could exceed any tax liability that they face on their domestic sales. Exporting firms whose border tax adjustments exceed their taxes on domestic cash flow would be provided a refund for their excess border tax adjustment. In addition, until exchange rates or domestic prices adjust after the imposition of the tax on imports, businesses that import significant amounts of goods could operate at a loss after taxes, because they would receive no deduction from income for the costs of their imports. They could thus be paying taxes greater than their net pretax cash income.

Although the excess deductions generated by an export business and those generated by a domestic business suffering losses are conceptually similar, they would be treated differently under the Growth and Investment Tax Plan. Domestic firms suffering losses would most likely prefer an immediate rebate of taxes if given a choice, notwithstanding that their loss carryforwards would be increased by an interest factor under the plan. Thus, special rules may be needed to police the allocation of expenses between domestic businesses generating losses and export businesses when both are operated within the same firm or through affiliates.

Border Tax Adjustments and the World Trade Organization

Multilateral trade rules originally developed as part of the General Agreement on Tariffs and Trade (GATT), and now incorporated into the rules of the World Trade Organization (WTO), affect the use of border adjustments. GATT/WTO rules treat border tax adjusting "direct taxes" as a prohibited export subsidy. In contrast, "indirect taxes" on exports may be border adjusted so long as the amount remitted does not exceed the amount of indirect tax "levied in respect of the production and distribution of like products when sold for domestic consumption."

Many developed countries with border-adjustable VATs couple those VATs with a single-rate tax on capital income at the individual level. Some of these countries also have wage subsidies, progressive taxation of wages, or both. The Growth and Investment Tax Plan is equivalent to a credit-method VAT at a 30 percent rate, coupled with a progressive system of wage subsidies and a separate single-rate tax on capital income. The Panel therefore believes that the Growth and Investment Tax

Plan should be border adjustable.

However, given the uncertainty over whether border adjustments would be allowable under current trade rules, and the possibility of challenge from our trading partners, the Panel chose not to include any revenue that would be raised through border adjustments in making the Growth and Investment Tax Plan revenue neutral. If border adjustments are allowed, then the plan would generate about \$775 billion more revenue over the ten-year budget window than is currently estimated in the scoring of this plan.

Other Issues Associated with the Implementation of the Growth and Investment Tax Plan

The Growth and Investment Tax Plan, like any other tax system, will rely on rules and definitions that must be broadly applied to a wide variety of taxpayers and activities. Taxpayers inevitably respond to taxes by altering their behavior to minimize or avoid taxes. In addition, complexity is added as rules are crafted to prevent tax avoidance or abuses. For example, current law distinguishes between interest and dividend payments by corporations. This creates opportunities for tax planning and avoidance that, over the years, have spawned countless complex rules to clarify definitions and deny favorable treatment in specific circumstances.

In designing the Growth and Investment Tax Plan, the Panel attempted to avoid distinctions between types of taxpayers, transactions, or activities that would create distortions and complexity. However, there would still be a need for some rules to delineate when specific transactions or activities are subject to tax. For example, rules to distinguish between financial and non-financial transactions, and rules regarding the treatment of transactions between businesses and taxpayers not subject to the cash flow tax (such as individuals and non-profits), are likely to be particularly important to the implementation of the tax. These issues, and others, are examined in more detail in the Appendix.

Transition

Replacing the current income tax with the Growth and Investment Tax Plan would affect the value of many assets. The Panel recognizes that transition issues are central to the analysis of fundamental tax reform, and therefore recommends providing some transition relief.

The basic issues associated with transition relief can be illustrated by considering an owner of business assets that were recently purchased for \$100 and that could be depreciated under the current income tax system over ten years. This business owner would not be able to recover this tax basis in an immediate and transition-free switch to a cash flow tax. Returns on the asset – either on the sale of the asset or through cash generated by deploying the asset – would be taxed, but pre-enactment basis could not be used to offset this income. For example, if the business owner sold the asset for \$100 soon after the new tax system with a 30 percent tax rate was in effect, all \$100 of the sales proceeds would be taxable and \$30 of tax would be due – even though the owner's economic position had not changed. On the other hand, investors who purchased new, but otherwise identical, physical assets after the Growth and

Investment Tax Plan took effect would be able to expense their purchases, effectively receiving \$30 of tax benefits for purchasing \$100 of new equipment. This transitional loss would be offset by future gains that the business owner would receive under the Growth and Investment Tax Plan, as returns from new investments would be taxed at a lower rate.

The Growth and Investment Tax Plan also would affect the tax treatment of existing financial assets, such as bonds and mortgages. For borrowers, eliminating interest deductions will increase future tax liabilities. For lenders, these effects will vary greatly. Individuals would pay a lower 15 percent tax on interest income, providing a windfall to these debt holders. Similarly, non-financial businesses will no longer pay tax on interest income and the value of their loans would increase.

The Panel recognizes that adoption of the Growth and Investment Tax Plan might have a negative impact on a number of households and on some business taxpayers. The Panel therefore recommends several types of transition relief. First, there should be transition relief on existing depreciation allowances. Depreciation allowances on assets put in place prior to the effective date for the Growth and Investment Tax Plan should be phased out evenly over a five-year period. In the year when the Growth and Investment Tax Plan is enacted, taxpayers with depreciable assets would be able to claim a deduction for 80 percent of the depreciation they would have been eligible to receive under the old system. In the second year this percentage will drop to 60 percent, the third year it would be 40 percent, the fourth year it would be 20 percent, and it would be zero after five years.

Second, for businesses with outstanding debt, the Panel recommends the same five-year phase-out structure, followed by deductions of 60, 40, and 20 percent. Eighty percent of an interest deduction that would have been allowed under the old law would be permitted in the first year after the effective date of the Growth and Investment Tax Plan. A similar set of rules would apply to interest income that would have been taxed under the old tax regime. Eighty percent of such interest would be included in cash flow in year one, followed by inclusion shares of 60, 40, and 20 percent. Any modifications to existing contracts would be treated as new contracts, and would terminate the transition relief for these contracts. Sales of physical assets would similarly terminate the benefits of pre-enactment depreciation allowances. As described in Chapter Five, transition relief would also apply to the deductibility of interest on home mortgages that were outstanding on the effective date of the Growth and Investment Tax Plan.

Third, the Panel proposes special transition relief for firms that might be affected by border tax adjustments. If exchange rates do not adjust as rapidly as economic theory predicts they should, then border tax adjustments would place an undue burden on imports and importers. The Panel therefore recommends a four-year phase-in period for border tax adjustments. The phase-in rules would be administered on a firm-by-firm basis, and they would be limited to a base amount, calculated as the average value of import purchases, or export sales, in the two years before the Growth and Investment Tax Plan took effect. In the first year, an importer would be able to deduct 90 percent of import purchases up to their import base. Imports that exceeded that base would not be deductible. Exporters would pay tax on 90 percent of exports up to the base amount. Exports that exceeded the base would not be taxed. In the second

year, 60 percent of imports up to the firm's base amount would be deductible and 60 percent of exports would be taxed. The percentage would be reduced to 30 percent in the third year. In the fourth year, the border adjustment would be fully phased in: Cash flow taxes on exports would be rebated at the border and imports would not be deductible from cash flow.

Finally, the Panel recommends specialized transition rules for financial institutions. If the Panel's recommended approach to the taxation of financial institutions is adopted, special transition rules would be needed to determine the status of outstanding loans made by these companies. Because financial firms never received a deduction against cash flow when raising the capital for outstanding loans, it would be unfair to levy tax on returns of capital when the lending firm receives them. Interest on loans extended prior to the effective date of the Growth and Investment Tax Plan, however, would be taxed as a component of individual cash flow. As with debt contracts for homeowners and non-financial businesses, any modifications to existing contracts would be treated as new contracts and not entitled to transition relief.

The Panel recognizes that there are other potentially important transitional issues, such as the tax treatment of existing tax loss carryforwards and tax credits and the treatment of inventory holdings when the Growth and Investment Tax Plan is implemented. In addition, the transition to the Growth and Investment Tax Plan would have a substantial impact on the financial statements of many large companies as the expected change in future tax liabilities – after considering transition relief – must be recorded for financial accounting purposes. The Panel does not specifically address these transition issues, but it recognizes that they are important concerns that would need to be addressed.

There is a fundamental tradeoff between the amount of transition relief provided when a consumption tax is adopted and the growth and efficiency gains from the tax reform. Providing generous transition relief to households and firms that lose tax benefits that are available under an income tax, but not a consumption tax, reduces the efficiency gains of reform. This occurs because financing such transition relief requires raising tax rates in the consumption tax regime, which increases tax-induced distortions in labor supply and other aspects of household behavior. If transition relief is financed with a temporary increase in tax rates for some period after tax reform is enacted, then the efficiency costs will be concentrated in this period, and the net growth impact of adopting a consumption tax may be much smaller than the long-run analysis suggests. Once the transition period ends, however, the economy will ultimately achieve the long-run gains associated with the consumption tax. If tax rates are raised permanently to finance transition relief, then there will be some reduction in long-run economic growth relative to the benchmark case of no transition relief.

The revenue costs of the foregoing recommendations regarding transition relief are incorporated in the Panel's calculations of the Growth and Investment Tax Plan's ten-year revenue cost. More generous transition relief would require higher tax rates on businesses and individuals, or tighter limits on mortgage interest deductions, the exempt amount of employer-provided health insurance, or other tax subsidies. More limited transition relief, by comparison, could be paired with even more significant tax rate reductions.

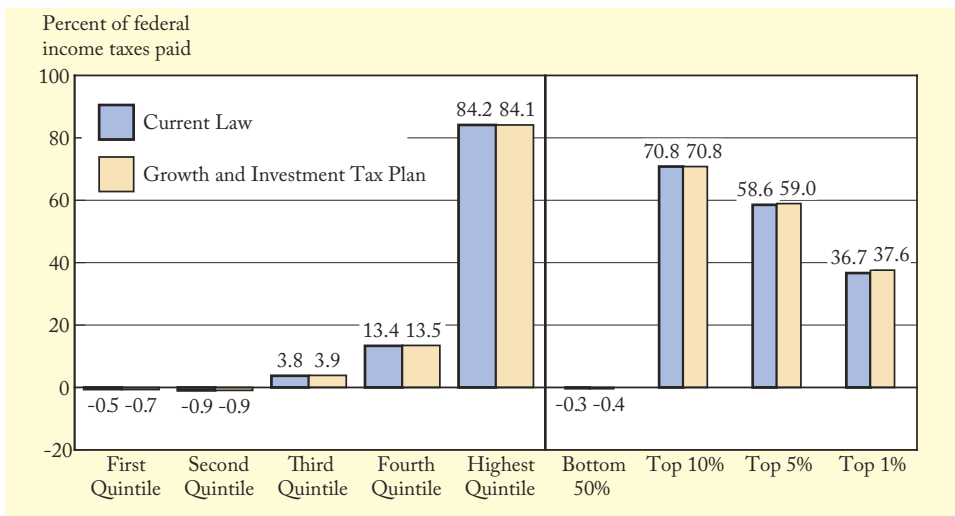
The Panel views transition relief as a critical and very difficult issue in moving from the current hybrid income tax to a consumption-based tax system. Ultimately, the political process must determine the appropriate level of transition relief. The Panel urges those who consider transition issues to recognize that the costs of transition relief are measured not just in the additional revenue needed to fund transition provisions, but also in the reduced efficiency gains that flow from higher marginal tax rates.

A Progressive Tax System

The Growth and Investment Tax Plan removes impediments to saving and investment, and promotes long-term productivity growth, while largely preserving the current distribution of the federal income tax burden across income classes. While there are some variations in the income classes shown below, the overall distribution closely tracks current law.

The Treasury Department provided distribution tables for the Growth and Investment Tax Plan. Estimates for 2006 are shown in Figures 7.4 and 7.5. Similar to what was presented for the Simplified Income Tax Plan, Figure 7.4 breaks the population into fifths – or quintiles – and also shows the bottom 50 percent of the population (ranked by income), along with the top 10, 5, and 1 percent of the population. Figure 7.5 groups taxpayers by using income levels ranging from zero to \$15,000 of income to more than \$200,000 of income.

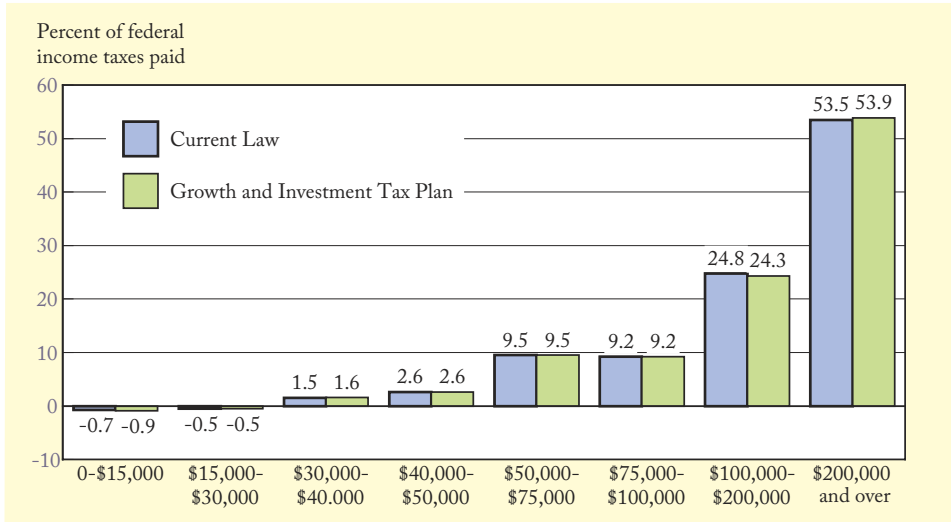
Figure 7.4. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.5. Distribution of Federal Income Tax Burden Under Current Law and the Growth Investment Tax Plan by Income Level (2006 Law)

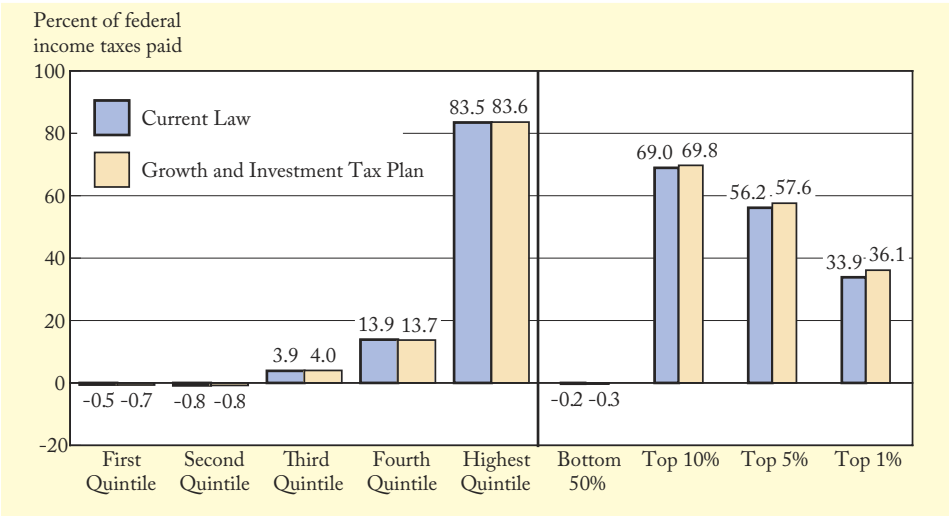


Note: Estimates of 2006 law at 2006 cash income levels.
 Source: Department of the Treasury, Office of Tax Analysis.

To provide additional information about the effect of the Growth and Investment Tax Plan on the distribution of the tax burden, the Panel asked the Treasury Department to provide a distribution of the plan for the tax law that would be in place in 2015, the last year of the budget window, while holding income constant at 2006 levels. This distribution would account for provisions that change over time, such as transition relief for business and individuals and the rapid growth of the AMT under current law.

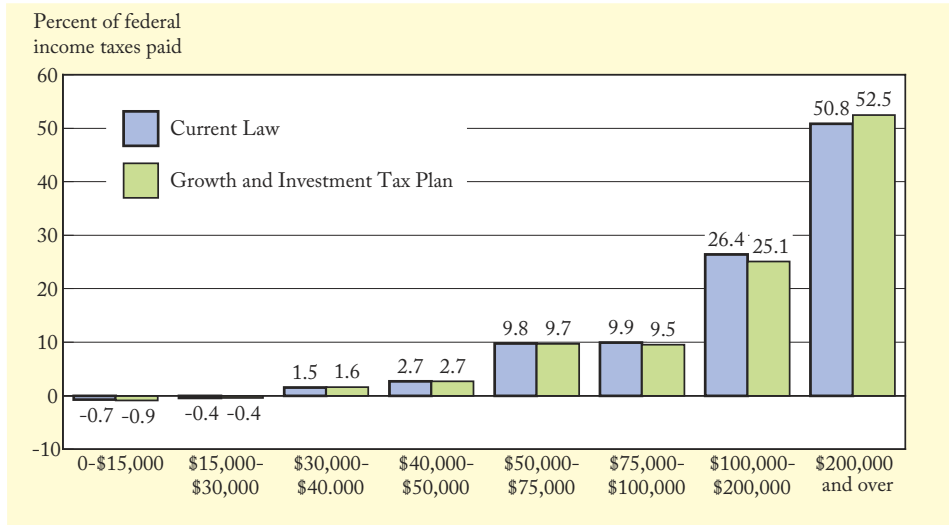
One of the most expensive items in the Panel's proposed reforms is the repeal of the AMT. Covering the \$1.2 trillion cost of this repeal over the ten-year budget window requires changes in other components of the tax code. While taxpayers are aware of the cost of tax changes that may limit some itemized deductions, many taxpayers who are likely to pay the AMT in future years, but who have not yet paid this tax, may not recognize the benefits associated with AMT repeal. Figures 7.6 and 7.7 demonstrate how the distribution of the tax burden under the current income tax system, with the AMT, will evolve over the next ten years, as well as how the Growth and Investment Tax Plan will affect that distribution in 2015.

Figure 7.6. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.
 Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.7. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Level (2015 Law)



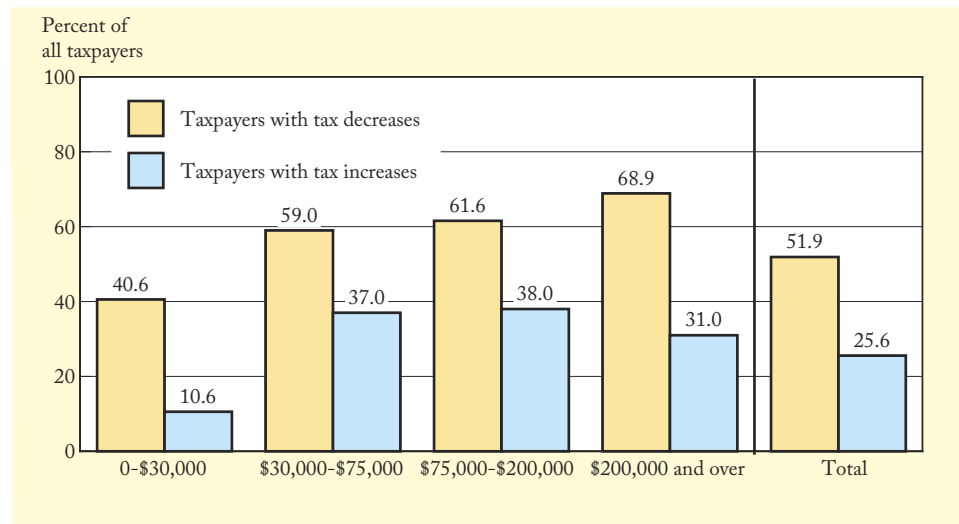
Note: Estimates of 2015 law at 2006 cash income levels.
 Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department also provided two additional sets of distribution tables that are explained and presented in the Appendix. One table demonstrates the tax burden under the Growth and Investment Tax Plan for the entire ten-year budget period. The other shows the tax burden if the corporate income tax is distributed 50 percent to owners of capital and 50 percent to labor, rather than solely to owners of capital income.

Another way to evaluate the distributional effects of a tax reform proposal is to consider the number of taxpayers who would face higher or lower taxes under the proposal. The constraint of revenue neutrality implies that any tax relief provided to one taxpayer must be financed with higher taxes on somebody else. Looked at solely from the perspective of one's tax bill, any revenue neutral tax reform is certain to generate both "winners" and "losers." The Panel recognizes that this comparison is inevitable, but at the same time urges taxpayers to recognize other benefits of tax reform. Greater simplicity in the tax system would allow taxpayers to save time and money, and would inspire confidence that the tax system is straightforward and fair, and not providing hidden loopholes to others. Greater economic growth, which is projected to occur under the Growth and Investment Tax Plan, would also generally benefit all Americans by increasing their incomes.

Figures 7.8 and 7.9 demonstrate that at each income level in both 2006 and 2015, there would be many more taxpayers who would pay less in taxes than those who would pay more in taxes. In total, under the Growth and Investment Tax Plan, there would be more than twice as many taxpayers who would receive a tax cut.

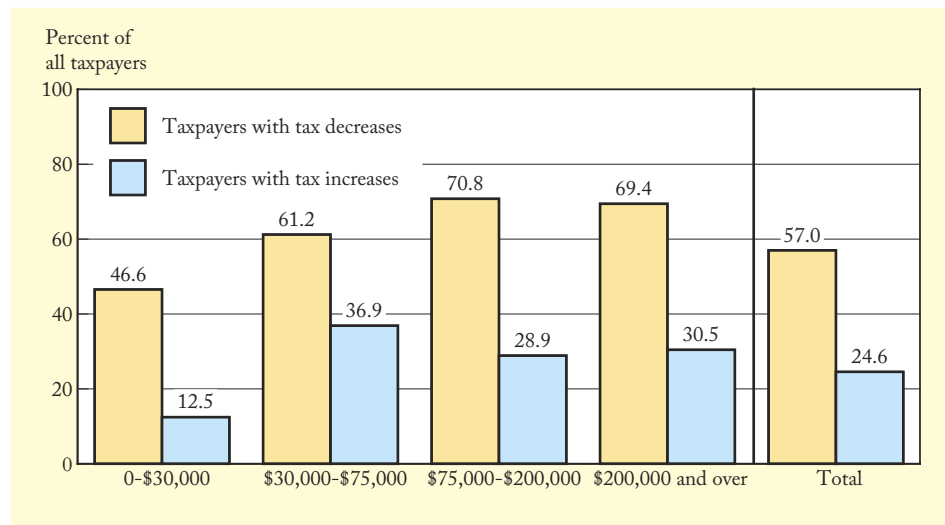
Figure 7.8. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Growth and Investment Tax Plan (2006 Income Levels)



Note: 2006 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.9. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Growth and Investment Tax Plan (2015 Income Levels)



Note: 2006 law at 2015 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.

Source: Department of the Treasury, Office of Tax Analysis.

The preceding figures describe the overall effects on groups of taxpayers. While this is informative, the Panel understands that many taxpayers would like to have a greater level of specificity, and would like to know what would happen to their own tax bill. In order to provide that type of information, the Panel has developed an array of hypothetical taxpayers and calculated their taxes under the Growth and Investment Tax Plan.

The Panel chose these hypothetical taxpayers using a methodology that has already been described in Chapter Six. In short, the Panel asked the IRS to construct a set of stylized taxpayers with different family structures, age, income, and deductions, using data from actual tax returns. These examples reinforce an essential point: looking at elements of the Growth and Investment Tax Plan alone can lead to very misleading conclusions. Just like the Simplified Income Tax Plan, the Growth and Investment Tax Plan has been carefully crafted to achieve substantial improvements in the tax system while minimizing the changes in total tax liabilities experienced by individual taxpayers and the overall distribution of the tax burden. While some elements of the plan, considered in isolation, may increase the taxes paid by some taxpayers, other elements will have offsetting effects. The focus should be on the aggregate changes in tax liability that would result from the Growth and Investment Tax Plan.

Table 7.3 shows how a set of hypothetical taxpayers would be affected in 2006. For example, a stylized married couple under age 65 earning about \$100,000 would expect to pay \$9,340 in taxes in 2006. Under the Growth and Investment Tax Plan, that couple would pay \$9,004, a decrease of 3.6 percent. A stylized married couple under age 65 at the median income level of \$66,200 would expect to pay \$3,307

under current law. Under the Growth and Investment Tax Plan, that couple would pay \$2,349 in taxes, a decrease of 29 percent.

Much like the Simplified Income Tax Plan, a single taxpayer under age 65 at the median income level of about \$24,000 would receive a tax cut of 4 percent. A head of household taxpayer at the median income of about \$23,000 would have his or her tax bill remain roughly the same. Single taxpayers and heads of households who are at the 95th percent of income would face a tax increase under the Growth and Investment Tax Plan.

The Panel also felt that it would be instructive to see how this plan affected taxpayers living in high-tax and low-tax states. Accordingly, the Panel asked the IRS to vary the amount of state and local taxes paid by each of the taxpayer groups under age 65. Using the methodology described in Chapter Six, the Treasury Department then calculated how tax liabilities would change for those taxpayers.

The examples in Table 7.4 show that because of the interaction between the alternative minimum tax and other provisions, there would be no difference in the treatment of the stylized married couple earning about \$100,000 or in the treatment of the married couple earning about \$207,000. In other words, regardless of whether those couples live in high-tax or low-tax states, they would still benefit from a reduced tax bill under the Growth and Investment Tax Plan. The stylized couple earning about \$66,000 living in a low-tax state would receive a tax cut of \$1,081 while the same couple living in a high-tax state would receive a tax cut of \$781. Under the Growth and Investment Tax Plan, these taxpayers would pay the *same* level of tax, regardless of where they live.

For single taxpayers and heads of household who itemize and are not subject to the AMT under current law, there would be a larger tax increase for those who are living in high tax states. This is due to the fact that taxpayers in high tax states currently pay less in tax than taxpayers in low tax states. Under the Growth and Investment Tax Plan, this would no longer be the case – taxpayers with similar income and characteristics would face the same tax bill.

Table 7.4. Examples of Taxpayers Under the Growth and Investment Tax Plan in 2006

Model Taxpayer Percentile	Income	Salaries and Wages	Taxable Interest, Dividends, & Capital Gains	Itemized Deductions				Income Tax under 2006 Law at 2006 Levels			
				State and Local Taxes	Mortgage Interest	Charitable Contributions	Misc (before 2% floor)	Current Law	Growth and Investment Tax Plan	Percentage Change in Tax Liability	
Single Taxpayers Younger Than 65											
1	Bottom 25th	12,300	12,300				369		385	158	-59.0%
2	50th	24,300	24,300				729		2,003	1,922	-4.0%
3	Top 25th	41,000	40,700	300			1,230		4,758	4,447	-6.5%
4	Top 5th	82,800	80,500	2,300	4,000	6,400	2,000	2,200	13,541	14,523	7.3%
Heads of Household Younger Than 65											
(bottom 25th and 50th percentile households have two child dependents; top 25th and top 5th household has one child dependent)											
5	Bottom 25th	14,000	14,000				420		-4,941	-5,488	-19.5%
6	50th	23,100	23,100				693		-4,225	-4,242	-2.4%
7	Top 25th	37,200	36,700	500			1,116		1,960	1,238	-9.5%
8	Top 5th	71,800	71,300	500	2,900	8,300	2,400	2,500	7,042	8,005	5.4%
Married Filing Jointly Younger Than 65											
(bottom 25th and 50th percentile households have two child dependents; top 25th and top 5th household has one child dependent)											
9	Bottom 25th	39,300	38,600	700			1,179		-282	-783	-178.2%
10	50th	66,200	65,300	900	2,300	8,200	2,400	2,100	3,307	2,349	-29.0%
11	Top 25th	99,600	97,800	1,800	4,100	9,400	2,700	2,200	9,340	9,004	-3.6%
12	Top 5th	207,300	196,200	11,100	10,000	14,400	5,400	2,800	40,417	37,959	-6.1%
Single Taxpayers (and Surviving Spouses) Age 65 and Over											
13	50th	24,800	0	4,900			555		1,919	2,338	21.8%
14	Top 25th	42,800	0	7,400			1,130		5,731	6,529	13.9%
Married Filing Jointly Age 65 and Over											
15	50th	51,000	0	4,800			1,125		2,772	2,723	-1.8%
16	Top 25th	77,500	0	10,000			2,230		9,635	9,750	1.2%

Note: * The 50th percentile taxpayer has gross social security benefits of \$6,300 and taxable pensions, annuities, and IRA distributions equal to \$13,600. The top 25th percentile taxpayer has gross Social Security benefits of \$12,000 and taxable pensions, annuities, and IRA distributions equal to \$23,400. ** The 50th percentile taxpayer has gross social security benefits of \$18,400 and taxable pensions, annuities, and IRA distributions equal to \$27,800. The top 25th percentile taxpayer has gross Social Security benefits of \$21,000 and taxable pensions, annuities, and IRA distributions equal to \$46,500. See text for further explanation of sample taxpayers.

Source: Department of the Treasury

Table 7.5. Examples of Taxpayers with “High” and “Low” State and Local Tax Deductions under the Growth and Investment Tax Plan in 2006

Taxpayer Characteristics and Placement in Income Distribution	Adjusted Gross Income	State and Local Taxes Deduction	Income Tax under 2006 Law at 2006 Levels		
			Current Law	Progressive Consumption Tax Plan	Growth and Investment Tax Plan
Single Taxpayers Younger Than 65					
Top 5% in “low-tax” state	82,800	3,500	13,666	16,244	14,523
Top 5% in “high-tax” state	82,800	6,400	12,941	16,244	14,523
Heads of Household Younger Than 65					
Top 5% in “low-tax” state	71,800	2,400	7,167	9,154	8,005
Top 5% in “high-tax” state	71,800	4,800	6,567	9,154	8,005
Married Filing Jointly Younger Than 65					
50th in “low-tax” state	66,200	1,900	3,307	2,727	2,349
50th in “high-tax” state	66,200	3,900	3,307	2,727	2,349
Top 25th in “low-tax” state	99,600	3,600	9,340	9,599	9,004
Top 25th in “high-tax” state	99,600	6,900	9,340	9,599	9,004
Top 5% in “low-tax” state	207,300	8,300	40,417	42,868	37,959
Top 5% in “high-tax” state	207,300	16,300	40,417	42,868	37,959

Notes: Taxpayers have same characteristics as those in Table 7.4 with the exception of state and local taxes. See text for further explanation of sample taxpayers.
 Source: Department of the Treasury

Beyond the Growth and Investment Tax Plan: The Progressive Consumption Tax Plan

The foregoing discussion emphasizes that the Growth and Investment Tax Plan is not a true consumption tax because it imposes a 15 percent tax on the interest, dividends, and capital gains received by individuals. This feature affects the distribution of the tax burden by raising the tax burden on those with substantial income flowing from their financial assets. It also raises the tax on saving and capital investment. In addition, just like the Simplified Income Tax, this provision preserves important components of the income tax system, and thus retains some of its compliance and administrative costs. For example, individuals would be required to keep track of their tax basis in financial and real assets. Many of the complex rules in the current income tax system, such as those that govern wash sales, hedges, and straddles, would be required under the Growth and Investment Tax Plan. It would also require firms to track earnings and

profits in a way that makes it possible to distinguish dividend payments from returns of capital.

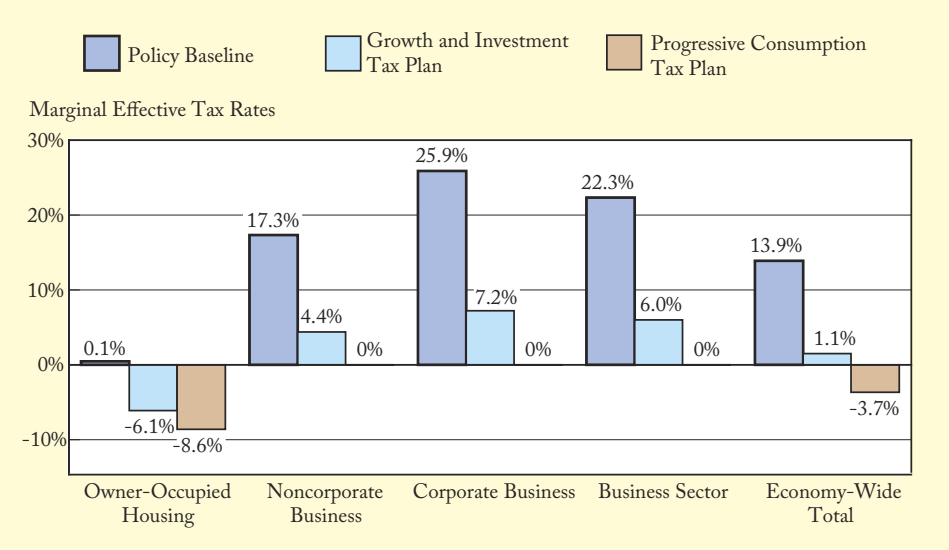
The Panel developed a consensus in support of the Growth and Investment Tax Plan, but many members supported an even more fundamental change in the tax structure, such as adopting the Progressive Consumption Tax Plan. Even some members who did not support the Progressive Consumption Tax Plan agreed that the structure described below is the most attractive way to implement consumption tax in the United States, should the political branches decide to pursue such a shift in the tax base. Such a tax would closely resemble the Growth and Investment Tax Plan, but there would be several important changes. First, there would be no taxation of capital income at the household level. Second, because there would be no taxation of capital, there would be no need for special saving accounts, like the Save for Retirement and Save for Family accounts, that would exempt certain savings from taxation. All saving would be tax-exempt. This would eliminate the complex record-keeping associated with various types of tax-preferred investment accounts. While record-keeping would be much less onerous under the Growth and Investment Tax Plan or the Simplified Income Tax Plan than under the current system, such record-keeping would be eliminated with the Progressive Consumption Tax Plan. Third, in order to achieve revenue neutrality, the deduction and exclusion for employee-provide health insurance coverage would be lowered by approximately 25 percent and both the top individual tax rate and the tax rate on business cash flow would rise to 35 percent. Table 7.6 summarizes the tax rate structure under the Progressive Consumption Tax Plan.

Table 7.6. Tax Rates under the Progressive Consumption Tax Plan

Tax Rate	Married	Unmarried
15%	Up to \$80,000	Up to \$40,000
25%	\$80,001 - \$115,000	\$40,001 - \$57,500
35%	\$115,001 or more	\$57,501 or more

The principal advantages of the Progressive Consumption Tax Plan relative to the Growth and Investment Tax Plan would be its more favorable treatment of saving and investment, and its greater simplicity and transparency. As summarized in Figure 7.10, the effective tax rate on new investment projects that are expected to just break even, the “marginal project” that economists consider in defining the investment incentives under different tax codes, would be zero under the Progressive Consumption Tax Plan. Moving from the low tax rate on capital under the Growth and Investment Tax Plan to the zero tax rate of the Progressive Consumption Tax Plan would provide additional stimulus to economic growth. The simplicity benefits

Figure 7.10. Comparison of Effective Tax Rates on Different Types of Investments



Note: The tax rates for the policy baseline assume, among other things, that the 2001 and 2003 tax cuts would be permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a \$5,000 limit) would be enacted.
 Source: Department of the Treasury, Office of Tax Analysis.

of the Progressive Consumption Tax Plan would derive from eliminating the need for the record keeping and filing associated with capital income taxation of individuals.

Although the conceptual difference between the Progressive Consumption Tax Plan and the Growth and Investment Tax Plan is substantial, with the latter a hybrid tax system combining income tax and consumption tax elements, it is important to point out that for most households, the effect of the two taxes would be virtually identical. Because the Growth and Investment Tax Plan includes a variety of provisions to provide tax-exempt saving opportunities, most individuals would find that the bulk, if not all, of their returns to capital would not be taxed under either the Progressive Consumption Tax Plan or the Growth and Investment Tax Plan. Save for Family and Save for Retirement accounts, in particular, would mean that most individuals could earn the full before-tax return on their investments. Since business investment would be fully expensed under both plans, the only tax provisions that would discourage investment in new, marginal investment projects would be the 15 percent tax on dividends, interest, and capital gains under the Growth and Investment Tax Plan. The Growth and Investment Tax Plan would move our system a long way toward the Progressive Consumption Tax Plan, and would capture most of the associated efficiency benefits, while still preserving some elements of the progressive taxation of capital income.

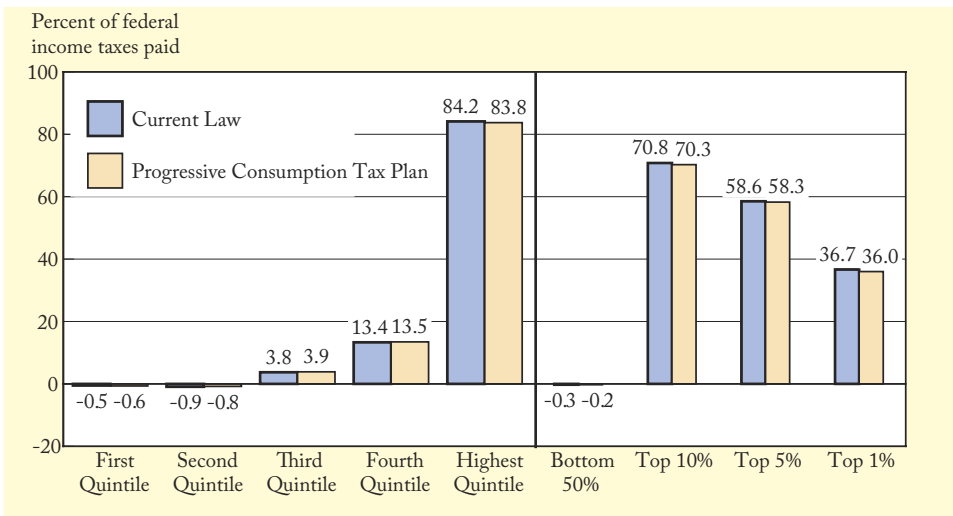
The principal objection to the Progressive Consumption Tax Plan was that it would result in a less progressive distribution of tax burdens. While there would certainly be households that would not need to write any checks for taxes under this tax system, it is important to point out that they would still pay taxes. The Progressive

Consumption Tax Plan collects taxes from firms on supernormal returns to businesses investment, rather than from households. Thus, an individual who receives a dividend payment receives the distribution after the firm has already paid taxes. This tax burden on the business reduces the amount that the firm is able to pay in dividends to shareholders, but the shareholder does not write a check to the government and so does not *appear* to make a tax payment. Distinguishing between the economic burden of taxes and the point of collection of taxes is essential in analyzing the differences between various tax structures.

Distribution of the Progressive Consumption Tax Plan

The Treasury Department computed the distribution of tax burdens under the Progressive Consumption Tax Plan, as under the Growth and Investment Tax Plan, and compared those burdens with the distribution under the current tax system. Figures 7.11 and 7.12 show the estimates for 2006.

Figure 7.11. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentiles (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.

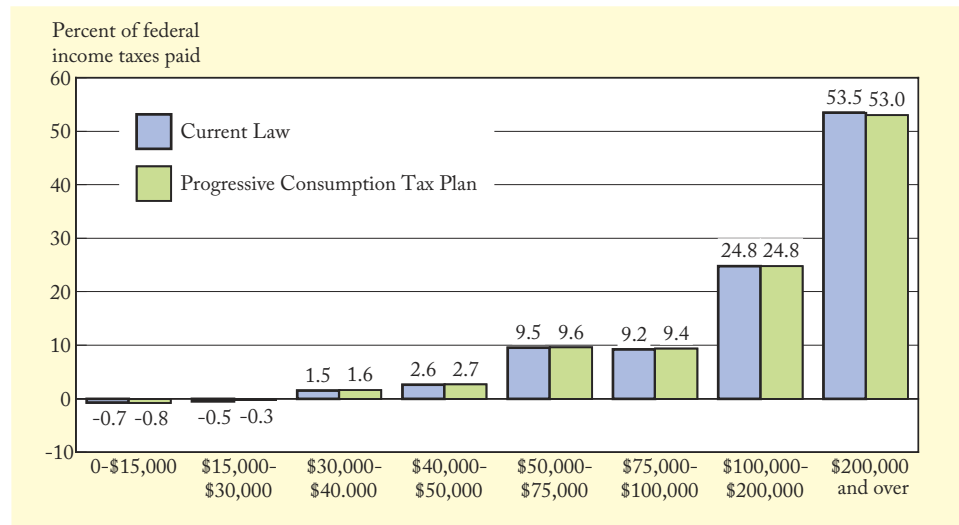
Source: Department of the Treasury, Office of Tax Analysis.

Just like for the Simplified Income Tax Plan and the Growth and Investment Tax Plan, the Treasury Department also produced an analysis of the Progressive Consumption Tax Plan for 2015, using 2006 income levels. Figures 7.13 and 7.14 show those estimates.

As shown in the above figures, a combination of tax credits for low- and middle-income households combined with the broadening of the tax base and the progressive tax rate schedule makes it possible to generate very similar distribution of the tax burden under the Progressive Consumption Tax Plan and the current system. This finding is important: Many previous analysts have dismissed structures like the Progressive Consumption Tax Plan as inevitably shifting the burden of taxes toward

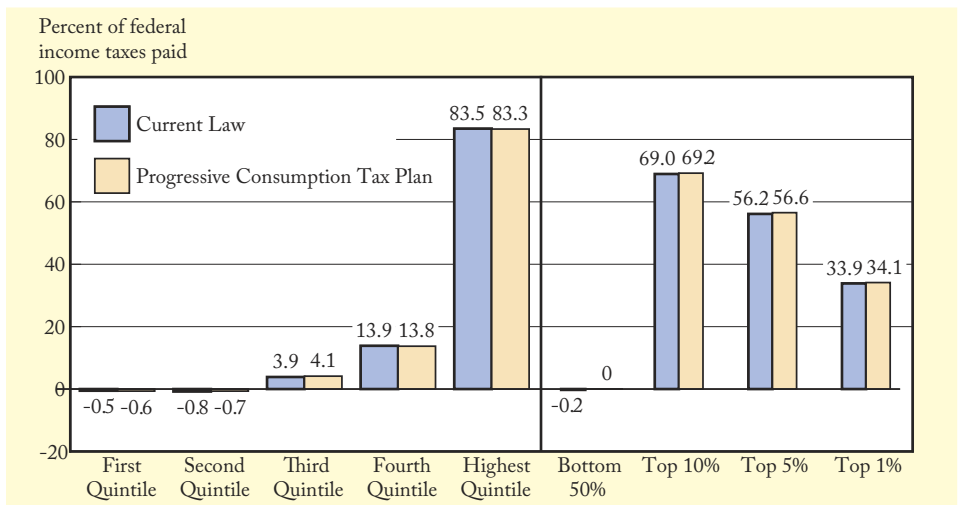
lower-income households, on the grounds that such households spend a greater share of their income than their higher-income counterparts. Figures 7.11 through 7.14 suggest it is possible to implement a consumption tax without this distributional effect.

Figure 7.12. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
 Source: Department of the Treasury, Office of Tax Analysis.

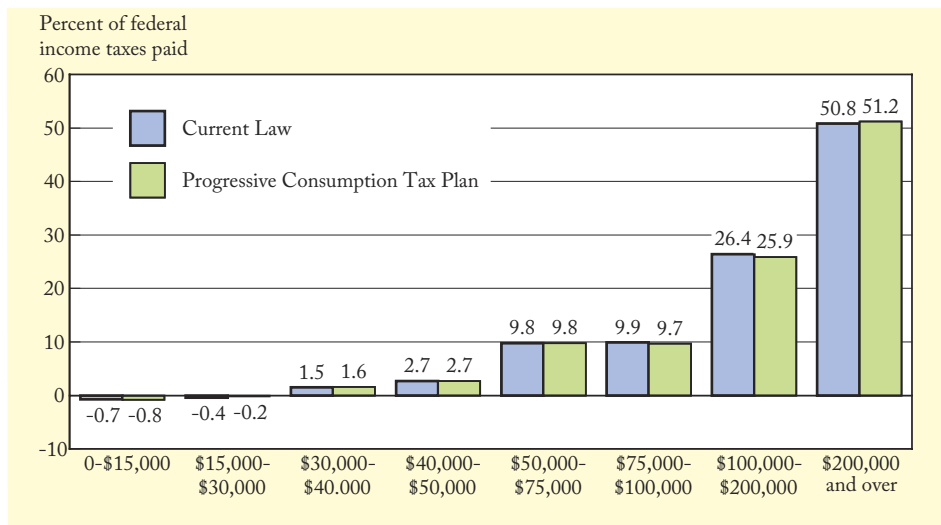
Figure 7.13. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.14. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Level (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury.

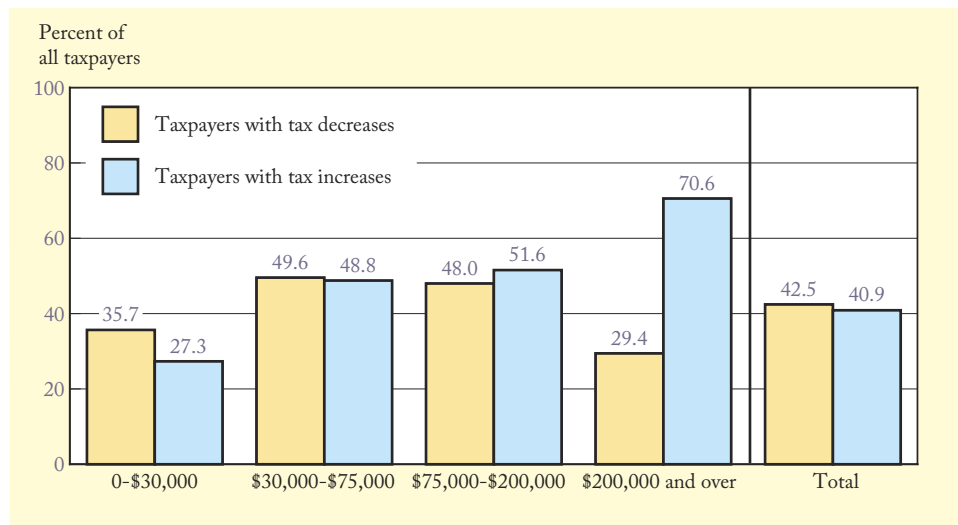
Furthermore, the Treasury Department calculated the number of taxpayers who have tax decreases and tax increases under the Progressive Consumption Tax Plan. Figures 7.15 and 7.16 show those estimates for 2006 and 2015. In both years, there are more taxpayers who have a tax decrease than who have a tax increase. However, there are more taxpayers with incomes of more than \$200,000 who would have a tax increase. It is unclear why this occurs, but it is likely that the benefit of removing the tax on capital income was not enough to offset the effect of higher tax rates, which were increased to make this plan revenue neutral.

Using the same methodology as the other plans, the Treasury Department provided examples of hypothetical taxpayers for 2006. These examples are shown in Table 7.7. Examples of hypothetical taxpayers in high-tax and low-tax states are shown in Table 7.5.

Revenue Neutrality

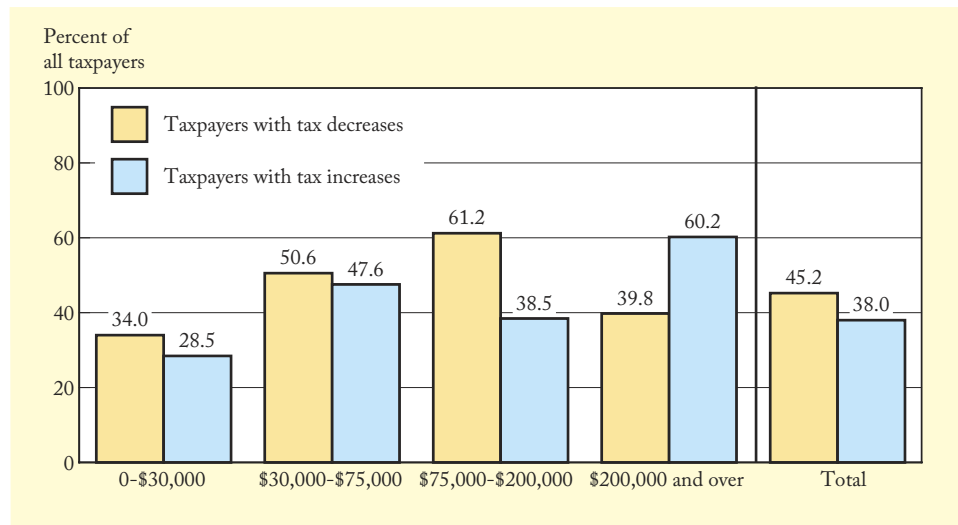
The Treasury Department estimated that both the Growth and Investment Tax Plan and the Progressive Consumption Tax Plan would be revenue neutral. It is worth noting that the plans are balanced without using any revenues from the shift to a destination based tax system through border adjustments. The amount of revenue gained from border adjustments during the budget window would be approximately \$775 billion under the Growth and Investment Tax Plan and approximately \$900

Figure 7.15. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Progressive Consumption Tax Plan (2006 Income Levels)



Note: 2006 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
 Source: Department of the Treasury.

Figure 7.16. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Progressive Consumption Tax Plan (2015 Income Levels)



Note: 2006 law at 2015 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
 Source: Department of the Treasury.

billion under the Progressive Consumption Tax Plan. If policymakers were to propose either of these plans and decide to use the revenues from border adjustments, the additional revenue could be used to further reduce tax rates or make other adjustments to the plans. Both plans also provide transition relief, which has been

Table 7.7. Examples of Taxpayers Under the Progressive Consumption Tax in 2006

Model Taxpayer Percentile	Income	Salaries and Wages	Taxable Interest, Dividends, & Capital Gains	Itemized Deductions				Income Tax under 2006 Law at 2006 Levels			
				State and Local Taxes	Mortgage Interest	Charitable Contributions	Misc (before 2% floor)	Current Law	Progressive Consumption Tax	Percentage Change in Tax Liability	
Single Taxpayers Younger Than 65											
1	Bottom 25th	12,300	12,300				369		385	270	-29.9%
2	50th	24,300	24,300				729		2,003	2,034	1.5%
3	Top 25th	41,000	40,700	300			1,230		4,758	4,590	-3.5%
4	Top 5th	82,800	80,500	2,300	4,000	6,400	2,000	2,200	13,541	16,244	20.0%
Heads of Household Younger Than 65											
(bottom 25th and 50th percentile households have two child dependents; top 25th and top 5th household has one child dependent)											
5	Bottom 25th	14,000	14,000				420		-4,941	-5,600	-13.3%
6	50th	23,100	23,100				693		-4,225	-3,433	18.7%
7	Top 25th	37,200	36,700	500			1,116		1,960	1,177	-40.0%
8	Top 5th	71,800	71,300	500	2,900	8,300	2,400	2,500	7,042	9,154	30.0%
Married Filing Jointly Younger Than 65 (all have two child dependents)											
9	Bottom 25th	39,300	38,600	700			1,179		-282	-94	66.6%
10	50th	66,200	65,300	900	2,300	8,200	2,400	2,100	3,307	2,727	-17.5%
11	Top 25th	99,600	97,800	1,800	4,100	9,400	2,700	2,200	9,340	9,599	2.8%
12	Top 5th	207,300	196,200	11,100	10,000	14,400	5,400	2,800	40,417	42,868	6.1%
Single Taxpayers (and Surviving Spouses) Age 65 and Over											
13	50th	24,800	0	4,900			555		1,919	1,673	-12.8%
14	Top 25th	42,800	0	7,400			1,130		5,731	5,287	-7.8%
Married Filing Jointly Age 65 and Over											
15	50th	51,000	0	4,800			1,125		2,772	1,853	-33.1%
16	Top 25th	77,500	0	10,000			2,230		9,635	7,973	-17.2%

Note: * The 50th percentile taxpayer has gross Social Security benefits of \$6,300 and taxable pensions, annuities, and IRA distributions equal to \$13,600. The top 25th percentile taxpayer has gross Social Security benefits of \$12,000 and taxable pensions, annuities, and IRA distributions equal to \$23,400. ** The 50th percentile taxpayer has gross Social Security benefits of \$18,400 and taxable pensions, annuities, and IRA distributions equal to \$27,800. The top 25th percentile taxpayer has gross Social Security benefits of \$21,000 and taxable pensions, annuities, and IRA distributions equal to \$46,500.

See text for further explanation of sample taxpayers.

Source: Department of the Treasury

described earlier in the chapter. The cost of transition relief in both plans is about \$400 billion.

Moreover, as noted in Chapter Six, some members of the Panel believe that it is likely that lawmakers will extend a current-law provision, referred to as the “patch,” to ease the effects of the AMT on millions of unsuspecting taxpayers. If the Panel did not need to account for the cost of the patch, estimated to be about \$866 billion, tax rates could be reduced further in both plans. For example, the tax rates in the Growth and Investment Tax Plan could be reduced across the board by 5.6 percent, so the top rate could be lowered from 30 percent to 28.3 percent. Similarly, the rates in the Progressive Consumption Tax Plan could be reduced by 5.3 percent, so the top rate could be lowered from 35 percent to 33 percent.

Pro-Growth Tax Plans

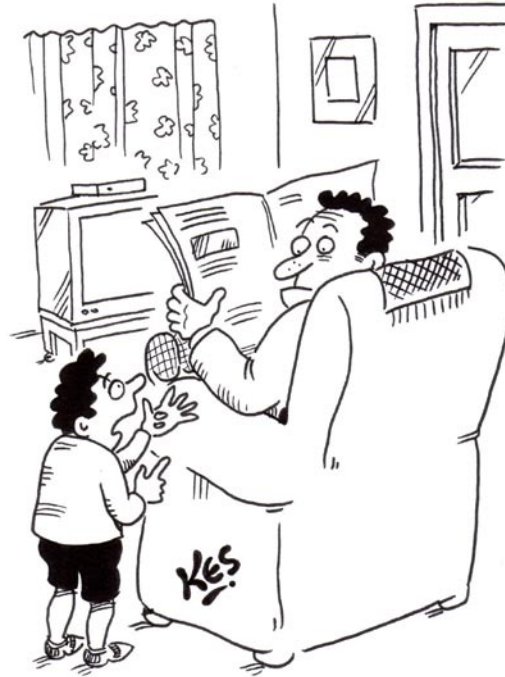
The Growth and Investment Tax Plan retains a tax burden on capital income, while the Progressive Consumption Tax Plan eliminates this burden. Both plans would encourage economic growth, but the effects would be larger under the Progressive Consumption Tax Plan. The Treasury Department has evaluated the growth effects of both plans using a range of economic models.

The Treasury Department estimates that the Progressive Consumption Tax Plan could increase national income by up to 2.3 percent over the budget window, by up to 4.5 percent over 20 years, and by up to 6.0 percent over the long run. The Treasury Department models also suggest that the Plan could increase the capital stock (the economy's accumulation of wealth), with estimates ranging from 0.7 percent to 5.1 percent over the budget window, from 2.5 percent to 16.7 percent over 20 years, and from 7.6 percent to 27.9 percent over the long run.

For the Growth and Investment Tax Plan, Treasury estimates that the plan could increase national income by up to 1.8 percent over the budget window, by up to 3.6 percent over 20 years, and by up to 4.7 percent over the long run. The Treasury Department models also suggest that the plan could increase the capital stock, with estimates ranging from 0.5 percent to 3.64 percent over the budget window, from 1.7 percent to 11.7 percent over 20 years, and from 5.3 percent to 19.8 percent over the long run.

Chapter Eight

Value-Added Tax



"Thanks for my pocket money Dad. But you forgot to add 17.5% v.a.t."

The Panel developed and analyzed a proposal to adopt a value-added tax (VAT) that would replace a portion of both the individual and corporate income taxes. The VAT is a type of consumption tax that is similar to a retail sales tax but is collected in smaller increments throughout the production process.

The "Partial Replacement VAT" proposal studied by the Panel would combine a VAT and a lower-rate version of the Simplified Income Tax Plan described in Chapter Six. As shown in Table 8.1, a VAT imposed at a 15 percent rate would allow the top individual income tax rate in the Simplified Income Tax Plan to be reduced to 15 percent. The top corporate income tax rate would also be lowered to 15 percent. Both the income tax and VAT rates are presented on a tax-inclusive basis, as is the norm for income tax rates and the way they are presented throughout this report. The tax-exclusive rates would be 17.6 percent. A discussion of the difference between tax-exclusive and tax-inclusive rates is provided in Chapter Nine.

Table* 8.1. Proposed Income Tax Rates for Married and Unmarried Taxpayers

Simplified Income Tax Individual Rates - Modified with a VAT			Simplified Income Tax Individual Rates		
Tax Rate	Married	Unmarried	Tax Rate	Married	Unmarried
5%	Up to \$64,000	Up to \$32,000	15%	Up to \$78,000	Up to \$39,000
15%	Above \$64,000	Above \$32,000	25%	\$78,001 - \$150,000	\$39,001 - \$75,000
			28%	\$150,001 - \$200,000	\$75,001 - \$100,000
			33%	\$200,001 or more	\$100,001 or more

Panel members recognized that lower income tax rates made possible by VAT revenues could create a tax system that is more efficient and could reduce the economic distortions and disincentives created by our income tax. However, the Panel could not reach a consensus on whether to recommend a VAT option.

Some Panelists who supported introducing a consumption tax in general expressed concern about the compliance and administrative burdens that would be imposed by operating a VAT without eliminating the income tax or another major tax. Some Panelists were also concerned that introducing a VAT would lead to higher total tax collections over time and facilitate the development of a larger federal government – in other words, that the VAT would be a “money machine.” Other Panelists suggested that studies of the international experience and domestic political realities did not support the “money machine” argument. Some Panelists argued that adopting a VAT, whether to reduce income taxes or payroll taxes, would make it more likely that higher taxes would be used to solve the nation’s long-term fiscal challenges, especially unfunded obligations for the Social Security, Medicare, and Medicaid programs. Other Panelists expressed the opposite view and regarded the VAT as a stable and efficient tool that could be used to reduce income taxes, fund these programs, or serve as a possible replacement for payroll taxes. A proposal to use the VAT to replace payroll taxes was beyond the scope of the panel’s mandate, which focused only on income taxes.

Despite the lack of consensus to recommend a VAT option, the Panel views a Partial Replacement VAT as an option worthy of further discussion. This chapter will highlight issues that policymakers would need to consider in evaluating such a proposal. First, the chapter describes modifications to the Simplified Income Tax Plan that would be made possible by the VAT and the resulting distribution of the overall federal income tax and VAT tax burden. The chapter then discusses how businesses would compute their VAT liability and the advantages and disadvantages of a Partial Replacement VAT from a tax policy perspective. Finally, the chapter addresses

arguments regarding whether the VAT would facilitate the growth of the federal government.

How it Would Work: Adjustments to the Simplified Income Tax

The Partial Replacement VAT proposal studied by the Panel combined a VAT with a low-rate income tax modeled on the Simplified Income Tax Plan. This VAT would collect about 65 percent of the amount of revenue currently collected by our individual and corporate income taxes. As a result, tax rates under the income tax system could be substantially reduced.

The Simplified Income Tax Plan does not materially alter the current distribution of the federal tax burden. By contrast, a VAT absent other modifications would change the current distribution because the VAT is imposed directly on consumption, and therefore would tax all families equally on each dollar they spend on items subject to the VAT. Households with lower incomes generally spend a larger portion of their income than higher-income households, and therefore the VAT would generally impose a larger tax as a percentage of income on lower-income households. In considering the Partial Replacement VAT, the Panel sought to relieve the additional VAT burden through an appropriate income tax rate and credit structure. The Panel's goal was to maintain a distribution of the overall federal VAT and income tax burden that would be approximately distributionally neutral relative to current law.

In response to the Panel's request, the Treasury Department modified the Family and Work Credits described in Chapter Five to alleviate the additional burden of the VAT on lower-income families. This approach would be more effective than exempting food and other necessities from taxation because it could be targeted to lower and middle-income families alone, rather than all taxpayers.

The base credit amount of the Family Credit would be increased by \$1,000 for married couples and \$500 for all other taxpayers except dependent taxpayers. The additional Family Credit amount based on the number of children and other dependents would be increased by \$500 for each child or other dependent. Like the Family Credit in the Panel's recommended options, this Family Credit would not phase-out; it would be available to all taxpayers.

The Work Credit would also be increased, so that the maximum credit amount in the first year would be: \$1,832 for workers with no children, \$6,820 for one child, and \$9,750 for two children. The Work Credit would increase as the amount of work income increases, be refundable, and phase-out gradually above certain income levels. Further details regarding the modifications to the Family and Work Credits made by the Treasury Department in estimating the Partial Replacement VAT can be found in the Appendix.

Box 8.1. Reducing the Number of Individuals Who Pay Income Tax

If the Family Credit and Work Credit were expanded as described in this chapter, 101.1 million taxpayers would have no income tax liability, 51.1 million more than the 47.4 million taxpayers that would have no income tax liability under the Simplified Income Tax Plan. Some Panelists felt that it was inappropriate to increase the number of taxpayers who do not make a direct contribution to the cost of maintaining the federal government through income taxes. Other Panelists took the opposite position, commenting that taking additional lower and middle-income taxpayers off the income tax rolls would make the federal tax system simpler. Those taxpayers would continue to pay taxes, at the cash register through the VAT and through payroll taxes.

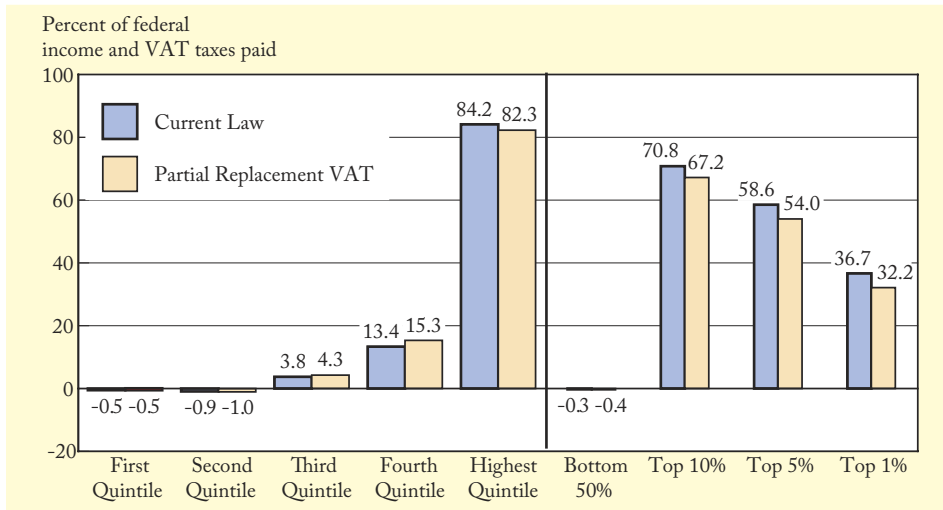
Who Pays the Tax?

As shown in Figures 8.1 through 8.4, the Family and Work Credits as modified by the Treasury Department would ensure that the tax system would be roughly as progressive as current law for families with incomes in the bottom two quintiles of the income distribution. However, for families in the third and fourth quintiles, the modified Work and Family Credits and rate structure presented here do not fully offset the increased burden of the VAT. Families in the highest quintile would bear less of the total tax burden.

The Treasury Department did not develop a modified credit and rate structure that would make the Partial Replacement VAT proposal approximately as progressive as current law. While the Partial Replacement VAT described in this chapter does not entirely alleviate distributional concerns, the Panel believes that with additional work, it would be possible to develop an approximately distributionally neutral tax credit and rate structure. Such a structure might, however, require somewhat higher income tax or VAT rates.

Figures 8.1 and 8.2 show how the distribution of the burden of the individual and corporate income taxes under current law for 2006 would compare to the distribution of the income and VAT taxes under the Partial Replacement VAT proposal.

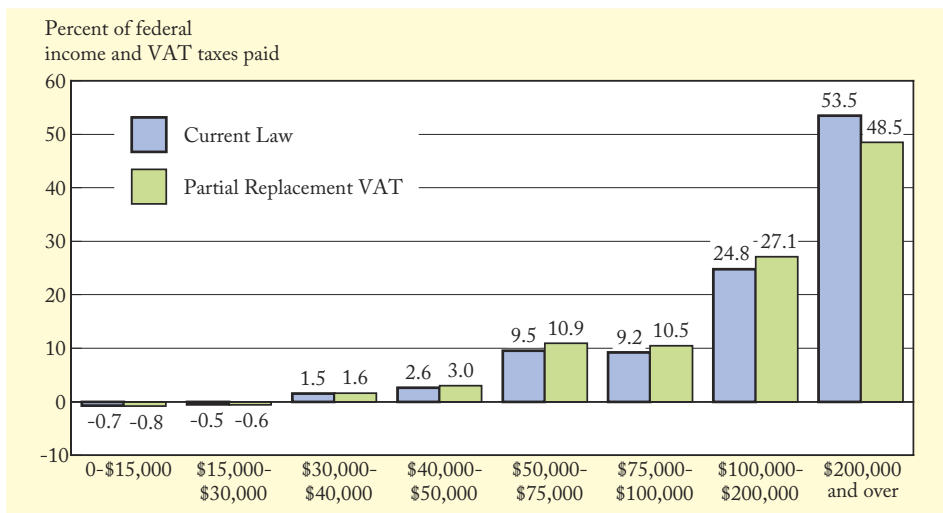
Figure 8.1. Distribution of Federal Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$48,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907. Bottom 50% below \$36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 8.2. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Level (2006 Law)

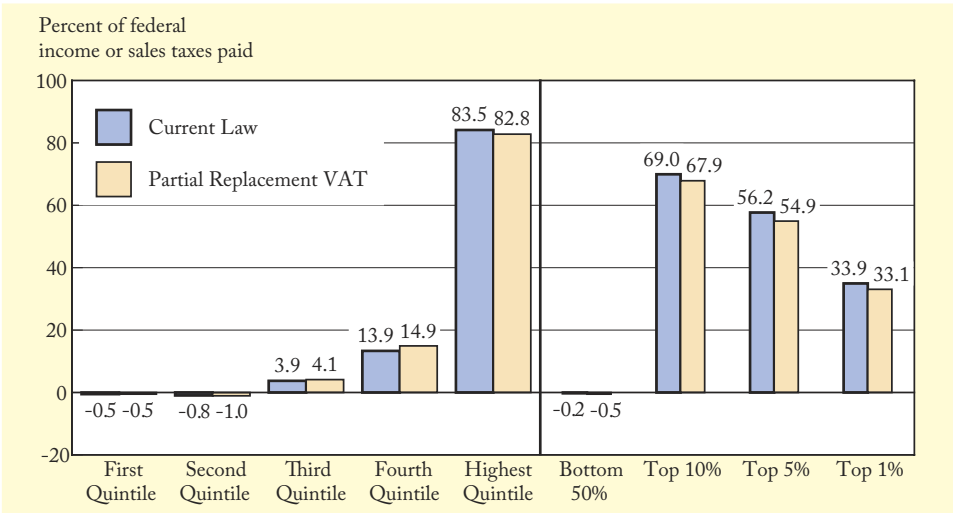


Note: Estimates of 2006 law at 2006 cash income levels.

Source: Department of the Treasury, Office of Tax Analysis.

Figures 8.3 and 8.4 provide distributional estimates for 2015, the last year of the budget window.

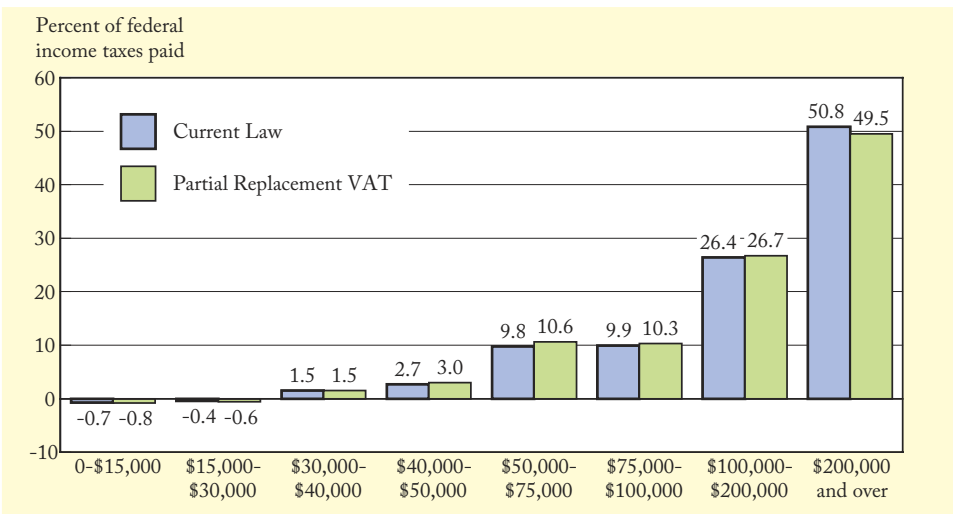
Figure 8.3. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$48,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907. Bottom 50% below \$36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 8.4. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Level (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels.

Source: Department of the Treasury, Office of Tax Analysis.

How it Would Work: Implementing the VAT

The VAT can be thought of as a retail sales tax that is collected in stages, instead of all at once from the final consumer. The tax is collected by all entities providing taxable goods and services and is imposed on sales to all purchasers. A business calculates its VAT liability by taking the total value of its taxable sales and multiplying by the VAT rate. The business is then permitted to offset its VAT liability by the amount of VAT paid for its purchases of goods and services. The simple example first provided in Chapter Three provides an easy way to understand the process.

Imagine that a boot maker makes and sells custom-made cowboy boots. He buys leather and other supplies enough for one pair from a leather shop at a cost of \$200 before taxes. The boot maker sells each pair of boots he makes for \$500 before taxes.

If a 10 percent retail sales tax were in place, the boot maker would add the tax to the cost of the \$500 pair of boots, and the consumer would pay \$550 per pair. In the meantime, the leather shop would not impose a retail sales tax on its sale to the boot maker because such a business-to-business transaction would not be treated as a retail sale.

Under a VAT, the tax calculation works somewhat differently. The VAT, like a sales tax, is separately stated on invoices or receipts. However, because the VAT is charged on all sales of goods and services, and not just sales to consumers, the leather shop would collect a VAT of 10 percent, or \$20 on the \$200 of supplies purchased by the boot maker. The boot maker would pay the leather shop \$220, and the leather shop would send the \$20 to the government. When the boot maker sells the boots, he computes the VAT as \$50, and charges the purchaser \$550 for the boots.

Instead of sending \$50 to the government, the boot maker would subtract the \$20 of VAT already paid to the leather shop and remit \$30 to the government. The government would receive \$50 total — \$20 from the leather shop and \$30 from the boot maker. The \$20 credit that the boot maker applies against his VAT liability is called an “input credit,” and the invoice received from the leather shop showing \$20 of VAT paid serves as proof that the boot maker can take the credit. The government receives the same revenue under a VAT as it would under a retail sales tax, and from the consumer’s perspective the taxes look identical.

Design Assumptions

In studying the proposal, the Panel made certain decisions about the appropriate design for a VAT if it were ever adopted at the federal level.

- The VAT should be imposed on the broadest consumption base consistent with:
 - The structure of our federal system of government, and
 - The need to maintain neutrality between public and private sector provision of goods and services.

- The VAT should use the credit-invoice method.
- The VAT should be border adjusted.
- The VAT should be imposed at a single uniform rate.
- The VAT should be set at a rate that is high enough to raise sufficient revenue to accomplish substantial income tax reform, justify the administrative burden of the VAT on businesses and government, and discourage subsequent rate increases.

Tax Base

The Partial Replacement VAT base considered by the Panel would be broad in order to prevent economic distortions between taxed and non-taxed goods and services. The proposed VAT base would include all domestic consumption except for non-commercial government services, primary and secondary education, existing residential housing, and charitable and religious services. Special rules would apply to financial services and certain other goods and services that are difficult to tax. A more detailed discussion regarding the proposed VAT base and the mechanics of VAT exemptions are provided in the Appendix.

Government Services

Noncommercial services provided by federal, state, or local government would be outside the VAT base. However, commercial activities conducted by the government, such as electricity supplied by a government-owned power plant, would be taxed like any private sector business. The rationale for this treatment is to prevent federal, state, or local government from having an advantage over the private sector in areas where the two might compete to supply similar products. Rules would be necessary to distinguish between commercial and non-commercial government services. Further discussion of these issues appears in the Appendix.

Box 8.2. State and Local Government Services

Taxing the imputed value of noncommercial state and local government services would be technically feasible. New Zealand, for instance, does this by requiring local governments to pay a VAT on the total value of the salaries they disburse to their employees. However, if the federal government assessed a VAT on state and local government services in this way, those governments would need to raise taxes to pay the VAT on their purchases and on the imputed value of their services. The Panel concluded that it may be inappropriate for the federal government to directly assess an excise tax of this sort on state and local governments in the context of our federal system. Instead, state and local governments would pay a VAT on their purchases, but would receive refunds from the federal government for VAT paid.

Border Adjustments

Because the VAT is intended to tax domestic consumption, exports are outside the VAT tax base. However, because the VAT is assessed at every level of production and distribution, a “border adjustment” is necessary to exclude exports from the VAT. These adjustments are made by allowing businesses to claim input credits on exports while exempting their sales from the VAT. All of America’s major trading partners remove the VAT from their exports in this way, and the World Trade Organization specifically defines a VAT as border-adjustable tax. Border adjustments are discussed in greater detail in Chapter Seven.

Small Business

Because the compliance costs associated with a VAT may be low overall but require a significant investment for some small businesses, it would be important to consider how to treat such businesses under a VAT. One advantage of the VAT is that it is possible to exempt many small businesses from collecting the tax without significant revenue loss. There are two reasons for this result. First, because the VAT is collected at every stage of production (rather than once at the retail level like a retail sales tax), and many small businesses buy many of their inputs from larger businesses, exempted small businesses would still pay tax on their inputs. As a result, much of the tax on any final good sold by a small business would still be collected. Second, exempted small businesses would be allowed to voluntarily register to collect the VAT. Some exempted businesses that sell primarily to other businesses would choose to collect VAT voluntarily in order for them and their customers to be able to claim input tax credits on their purchases.

The Partial Replacement VAT designed by the Panel would not require businesses with less than \$100,000 in taxable annual gross receipts to collect the VAT. The Government Accountability Office estimated in 1993 that a VAT collection threshold at this level would reduce the number of businesses filing VAT returns from about 24 million to about 9 million. They further estimated that approximately 19 percent of small businesses qualifying for the exemption would nonetheless voluntarily collect the VAT. Preliminary estimates for 2003 suggest that only 1.8 percent of gross receipts are collected by businesses with less than \$100,000 in annual gross receipts. Thus, a VAT collection threshold at this level likely would not lose significant revenue, particularly when voluntary collection is taken into account. Whether a higher VAT collection threshold would be feasible could be the subject of future study.

Tax Policy Considerations — Advantages and Disadvantages of Adopting a VAT

Economic Growth

A Partial Replacement VAT could achieve many of the advantages of moving to a consumption-based tax system discussed in Chapter Seven. Economic research shows that consumption taxes have a positive effect on economic growth compared with an income tax.

A broad-based VAT applied at a single rate is economically efficient because it generally does not distort consumers' choices among goods and services and does not discourage savings or distort the allocation of capital. Economists agree that a well-designed VAT imposes a lower excess burden than most other taxes for any given amount of revenue raised. Reducing the excess burden of taxation on the economy is an important way that the tax system can encourage economic growth.

The Partial Replacement VAT also would make it possible to substantially reduce income tax rates for all individual and corporate taxpayers. Lower marginal income tax rates on individuals and businesses would strengthen incentives to save, invest, work, and innovate while making our tax system more efficient.

U.S. Competitiveness

Reducing the corporate income tax rate should improve incentives for investment of capital in the United States by both U.S. residents and foreigners. U.S.-based multinational corporations and multinationals based in countries with territorial tax systems would have incentives to shift investment and operations to the United States to take advantage of the lower income tax rates relative to other countries. These incentives would be similar to those discussed in Chapter Seven, although the incentives would not be as strong as those discussed with respect to the Progressive Consumption Tax Plan because an income tax would be retained, albeit at lower rates.

The Partial Replacement VAT also would be compatible with existing bilateral tax agreements with our major trading partners because it would retain a corporate income tax. These agreements facilitate cross-border investment and ensure that U.S. multinationals operating in foreign markets receive tax treatment comparable to the tax treatment of companies based in the country in which the U.S. multinational is operating.

Box 8.3. Border Adjustments and Competitiveness

Border adjustability has been a longstanding priority for many American businesses with substantial export sales. All our major trading partners border adjust their VATs, and exporters of goods and services imported into the United States receive VAT rebates.

American businesses sometimes argue that the lack of border adjustability of the U.S. income tax system puts U.S. exports at a competitive disadvantage in global markets. However, economists generally believe that exchange rate adjustments or other price level changes offset border tax adjustments in the long term and eliminate any advantage or disadvantage border adjustments might otherwise create. Regardless, a border-adjustable VAT that reduces corporate income tax rates could positively affect the competitiveness of U.S. goods and services in the global marketplace. Further discussion of border adjustments and the advantages of destination-based taxes appears in Chapter Seven.

Benefiting from International Administrative Experience

In implementing the VAT, the United States would be able to take advantage of the wealth of worldwide experience in administering and complying with the tax. The VAT has been adopted by every major developed economy except the United States. Thus, the Treasury Department and IRS could study and apply best practices from around the world. Moreover, U.S. multinational corporations already have extensive experience in complying with the VAT, as they currently collect and remit VAT taxes in most countries in which they operate outside the United States.

Compliance and Administration Costs

One significant benefit of the Simplified Income Tax Plan is that it would reduce administration and compliance costs for the government and taxpayers. In contrast, having to collect and pay both VAT and a business income tax might increase total compliance costs for businesses. It would also create an additional set of administrative responsibilities and costs for the IRS.

On the other hand, the Panel heard testimony that taxpayers' compliance costs for the current income tax amount to approximately 13 cents per dollar of tax receipts, whereas compliance costs for European VATs ranges from 3 to 5 cents per dollar of tax receipts. Further, compliance costs per dollar of income tax revenue could fall as a result of reduced incentives for income tax evasion due to the lower income tax rates accompanying the introduction of a VAT. Thus, it is not clear whether the overall compliance and administration cost savings from introducing a Partial Replacement VAT and lowering income tax rates would be larger or smaller than the cost to businesses of complying with the VAT.

Noncompliance

Some evasion is inevitable in any tax system. For 2001, the IRS estimates that the evasion rate for the income tax was between 18 and 20 percent of taxes due. Some analysts suggest that evasion rates for a Partial Replacement VAT could be somewhat lower. One reason is that invoices used to claim input credits under a VAT create a paper trail based on third-party information reporting that facilitates audits and may induce businesses to comply more fully with both the VAT and the corporate income tax. Under the current income tax, compliance rates are highest where there is third-party information reporting or withholding.

Further, business-level tax evasion is often concentrated in smaller businesses, and the VAT exempts many of these businesses from the collection process. To the extent that tax avoidance and evasion are motivated by high income tax rates, lowering income tax rates with a Partial Replacement VAT might also reduce incentives to avoid or evade the remaining income tax.

However, the VAT would not put an end to tax evasion. Evasion in a VAT can range from simple non-filing and non-payment of tax by businesses to complex schemes in which goods pass through a series of transactions designed to generate counterfeit input tax refunds. The Organization for Economic Cooperation and Development (OECD) reports noncompliance rates of 4 percent to 17.5 percent in major developed economies with VAT systems. United Kingdom Revenue and Customs, which employs one of the most sophisticated approaches to estimating VAT evasion, found VAT evasion of 12.9 percent in the U.K. as of April 2004. One should note, however, that the U.K. VAT base is substantially narrower than the Partial Replacement VAT base studied by the Panel and includes more than one VAT rate. VATs are more prone to evasion when they exclude more categories of goods and services and utilize multiple rates. In its revenue estimates, the Treasury Department assumed a noncompliance rate of 15 percent for the VAT.

Coordination of State Sales Taxes and the VAT

Coordinating between states' retail sales taxes and the VAT would be a major challenge. States likely would view a VAT as an intrusion on their traditional sales tax base. Differing federal and state consumption tax bases, with different forms and administrative requirements, would be complex for business. In states that continued to apply their pre-existing sales taxes, the weighted average combined tax-exclusive state and federal tax rate would be approximately 24 percent.

If states were to bring their sales tax bases into conformity with the broad federal base and coordinate their sales tax collection systems with the federal regime, the economic efficiency of state sales taxes would be improved. Compliance burdens for multistate businesses and administrative costs for states could be reduced. Even greater gains in terms of simplicity and lower compliance burdens might be achieved if the states moved to impose state level VATs.



However, the result of a similar harmonization effort in Canada is not encouraging. Canada considered adopting a unified federal and provincial VAT base in 1987, but intergovernmental discussions failed to produce an agreement to standardize the existing provincial sales tax bases with the base for Canada's federal goods and services tax. The United States has many more sales tax jurisdictions than does Canada, and so it is quite likely that the U.S. experience could be fraught with even greater difficulties.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a VAT. Although there may be some such consequences, those considerations were secondary in the Panel's decision not to recommend the Partial Replacement VAT. Any consequences associated with price level adjustments under a Partial Replacement VAT would be less severe than those under a full replacement retail sales tax or a full replacement VAT, because the tax rate would be lower and therefore any required adjustments would be less extensive.

Political Economy Concerns

The Partial Replacement VAT proposal would add a major new federal tax without eliminating any existing taxes from the federal system. One important factor in the Panel's decision not to recommend the Partial Replacement VAT proposal was several Panel members' concern about how introducing a supplemental VAT might affect the size of the federal government in the medium or long run. These Panel members were concerned that adding a VAT on to the current income tax structure could, over time, lead to growth of federal outlays as a share of GDP — as the tax rate for the Partial Replacement VAT could rise, or corporate and individual income tax rates could return to their present levels. The Panel members who were concerned about this possibility viewed growth in the government's share of the economy as undesirable. Other Panel members were not concerned about this possibility, either because they were more confident that Congress would use the VAT only to offset existing taxes, or because they believed that allowing some growth in tax revenues as a share of GDP would offer a means to finance the growing cost of entitlement programs.

There are relatively few empirical studies on the relationship between the adoption of a VAT and the growth of government spending. None of these studies resolve the fundamental difficulty of determining the direction of causality between the tax structure and the size of government. Simple country comparisons suggest that countries without VATs, like the United States, have a smaller government sector than countries with a VAT. However, more sophisticated statistical studies that control for other factors that may affect the relationship between the size of government and the presence of a VAT yield mixed results. The evidence neither conclusively proves, nor conclusively disproves, the view that supplemental VATs facilitate the growth of government.

Even if the findings were conclusive, studies of VATs in other nations may not provide much guidance on the effect of adopting a VAT in the United States. Most developed countries initially used a VAT to reduce or eliminate other consumption taxes, such as existing sales or excise taxes. The VAT proposal studied by the Panel would replace part of the income tax with a VAT. The United States has no broad-based pre-existing federal consumption tax to replace. Thus, whether adopting a VAT would fuel the growth of U.S. federal spending remains an open question.

Some Panelists who opposed a Partial Replacement VAT suggested that once a VAT was enacted, it would never be repealed. International experience suggests that few countries retreat from a VAT, and that VAT rates generally do not decline. These Panelists were unwilling to support the Partial Replacement VAT proposal given the lack of conclusive empirical evidence on the impact of a VAT on the growth of government. Other Panelists were more confident that voters could be relied upon to understand the amount of tax being paid through a VAT, in part because the proposal studied by the Panel would require the VAT to be separately stated on each sales receipt provided to consumers. These Panelists envisioned that voters would appropriately control growth in the size of the federal government through the electoral process.

Box 8.4. Visibility of the VAT

Some critics of the VAT express concerns about its visibility to taxpayers, because in some countries VAT is included in marked prices and no reference is made to the tax on receipts. However, the Panel assumed the VAT would be separately stated on all sales, so consumers would know the amount of VAT paid with each purchase.

Some Panelists suggested that even a separately stated VAT would be less visible to taxpayers than the burden of the income tax. These Panelists pointed out that taxpayers would not know their total VAT tax liability for any given year unless they kept all their receipts and added together all VAT paid. Other Panelists noted that a similar observation could be made about the income tax, which many taxpayers pay over time through withholding from their compensation, and about payroll taxes, where the employer-paid portion is “invisible” to most workers. These Panelists stated that taxpayers are much more likely to know the amount of the refund check they received as a result of excess tax withholding than the amount of their overall tax liability. Other Panelists responded that if true, these observations were an argument against tax withholding, not an argument for a Partial Replacement VAT.

Box 8.5. Comparing the Enforcement of a VAT and a Retail Sales Tax

Because the VAT is similar to a retail sales tax, one might ask why the Panel chose to study a VAT rather than a retail sales tax as a partial replacement to the income tax. Although they are similar taxes, there are four principal reasons for concluding that a VAT may be more enforceable than a retail sales tax.

First, VAT taxpayers – especially intermediate producers – have an incentive to demand VAT invoices from suppliers because they are needed to claim the VAT credits that reduce the buyer's VAT liability. The invoices used to claim a tax credit create a paper trail that may induce businesses to comply more fully with the law. Most taxable transactions will appear on two tax returns – the buyer's and the seller's – so that tax authorities will have two opportunities to detect evasion. Further, because sellers provide the tax administration a record of their purchases by claiming input credits, tax administrators are more able to estimate what sales and therefore VAT due should be and thereby can detect evasion more easily in a VAT than in a retail sales tax.

Second, the credit-invoice system eliminates the need for business exemption certificates. Under the credit-invoice system, every taxpayer pays tax on its purchases, and then taxpayers show proof to the government that they are entitled to input tax credits, rather than presenting an exemption certificate to a supplier. As described in Chapter Nine, the business exemption system requires retailers to play an enforcement role and is fraught with evasion opportunities.

Third, under the VAT the amount of tax liability at risk in most transactions is only a fraction of the total tax assessed on the sale of the good or service to a consumer. This is because the VAT is collected in smaller pieces at each stage of production, while the entire retail sales tax is collected on a final consumer sale. The lower effective tax rate on each transaction may reduce the incentive to evade the VAT.

Finally, in contrast to a VAT, the proper administration of a retail sales tax would require all small retailers to collect tax. With a tax collected solely at the retail level, a small business exemption would be unworkable from enforcement, efficiency, and revenue perspectives. Because the compliance costs associated with a retail sales tax or a VAT may be low overall, but significant for small retailers, the need to require small retailers to act as collecting agents in a retail sales tax is a significant disadvantage.

The VAT's advantages over the retail sales tax in minimizing evasion should not be overstated. Because large firms are less likely to cheat, evasion problems in either system are likely concentrated in smaller firms. When those firms are retailers, the incentive to cheat at the margin under the VAT and the retail sales tax is roughly equal, assuming the same tax rate applies.

Further, more transactions are subject to a VAT than to a retail sales tax, creating additional opportunities for evasion. Under a VAT, firms could fabricate invoices to claim input credits, even if such purchases were never made. Claiming excess input credits in a VAT also can produce a tax refund for a business. This temptation does not exist under the retail sales tax.

Chapter Nine

National Retail Sales Tax



The Panel considered a number of proposals to reform the income tax, including replacing the entire income tax system with a broad-based national retail sales tax. A retail sales tax is perhaps the most obvious form of consumption tax because it is imposed on the final sales of goods and services to consumers. Like other consumption taxes, the retail sales tax does not tax normal returns to saving and investment and thus may lead to greater economic growth than our current tax system.

After careful evaluation, the Panel decided to reject a complete replacement of the federal income tax system with a retail sales tax for a number of reasons. Two considerations were particularly important to the Panel's decision:

- Replacing the income tax with a retail sales tax, absent a way to ease the burden of the retail sales tax on lower and middle income Americans, would not meet the requirement in the Executive Order that the Panel's options be appropriately progressive.

- Although a program could be designed to reduce the burden of a retail sales tax on lower-income and middle-income taxpayers by providing cash grants, such cash grants would represent a new entitlement program – by far the largest in American history. Adjusting the distribution of the burden of the retail sales tax through a cash grant program would cost approximately \$600 billion to \$780 billion per year and make most American families dependent on monthly checks from the federal government for a substantial portion of their incomes. The Panel concluded that such a cash grant program would inappropriately increase the size and scope of government.

The Panel also had additional concerns with replacing the current tax system with a retail sales tax:

- Even with favorable assumptions, a retail sales tax on a broad base with a cash grant program would require a tax rate of at least 34 percent, and likely higher over time if the base erodes, creating incentives for significant tax evasion. A discussion of the range of potential estimates of the tax rate is provided later in this chapter.
- The federal administrative burden for a retail sales tax may be similar to the burden under the current system. A federal agency, such as the IRS, would be required to administer the tax in order to ensure adequate collection of federal revenues and uniform enforcement of the rules and regulations underlying the tax. Indeed, two types of administrations would be required – one to collect the tax and another to keep track of the personal information that would be necessary to determine the size of the taxpayer's cash grant.
- Taxpayers likely would continue to file state income tax returns, which would limit the potential simplification gains from replacing the federal income tax system with a retail sales tax.

Box 9.1. Comparing “Tax-Exclusive” and “Tax-Inclusive” Rates

The 34 percent tax rate mentioned in the introduction to this chapter is a tax-exclusive rate. Sales tax rates are typically quoted on a tax-exclusive basis, while income tax rates typically are quoted on a tax-inclusive basis. If a good costs \$100 and bears an additional \$34 sales tax, the tax-exclusive sales tax rate is 34 percent. The tax-inclusive rate is 25 percent – \$34 (the tax paid) divided by \$134 (the total amount the consumer paid). An individual who earns \$134 and pays \$34 in income taxes would think of themselves as paying approximately 25 percent ($\$34/\$134 = 0.254$) of their income in taxes.

Although tax-exclusive and tax-inclusive rates are both valid ways of thinking about tax rates, the easiest way to compare the retail sales tax rate to the state sales taxes paid by most Americans is to consider the tax-exclusive rate. On the other hand, it is appropriate to compare the retail sales tax rate with current income tax rates by utilizing the tax-inclusive rate. For ease of understanding, this chapter uses tax-exclusive rates unless otherwise specified in the text. Tax-inclusive rates are provided in the Appendix.

As explained in Chapter Three, the retail sales tax and the VAT represent similar ways to tax consumption of goods and services. A VAT and a retail sales tax that share the same tax base, tax rate, and compliance rates would generate the same amount of tax revenue. The Panel, therefore, analyzed a full replacement VAT at the same time it considered a full replacement retail sales tax. Although the Panel concluded that the full replacement VAT might mitigate some of the compliance challenges encountered with a retail sales tax, the Panel's primary objections to a retail sales tax applied equally to a full replacement VAT. As a result, the Panel does not recommend the full replacement VAT as a tax reform option.

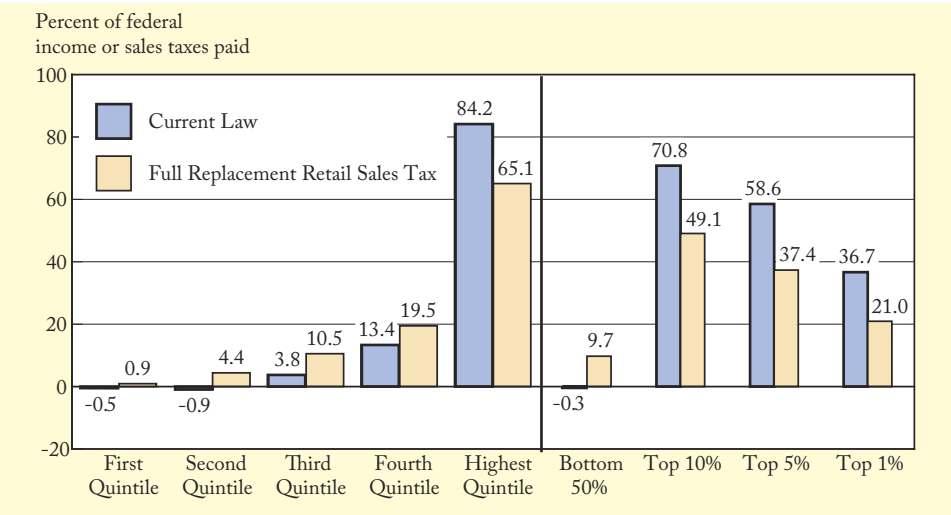
Retail Sales Tax with No Cash Grant

Forty-five states and the District of Columbia currently have retail sales taxes. Many states use multiple sales tax rates and exempt many goods and services from tax. The Panel, however, considered a single-rate tax that would be imposed on a broad tax base because such a tax would be simpler to administer and create fewer economic distortions. The Panel's broad tax base would apply to sales of goods and services to consumers, but, to prevent multiple taxation or "cascading," it would not apply to purchases of goods or services by businesses that are used to produce other goods or services for sale to households.

The Panel initially evaluated the federal retail sales tax using the broad tax base described by advocates of the "FairTax" retail sales tax proposal. That tax base (the "Extended Base") would exempt only educational services, expenditures abroad by U.S. residents, food produced and consumed on farms, and existing housing (or what economists refer to as the imputed rent on owner-occupied and farm housing). The long-term likelihood of maintaining this broad tax base is addressed later in this chapter.

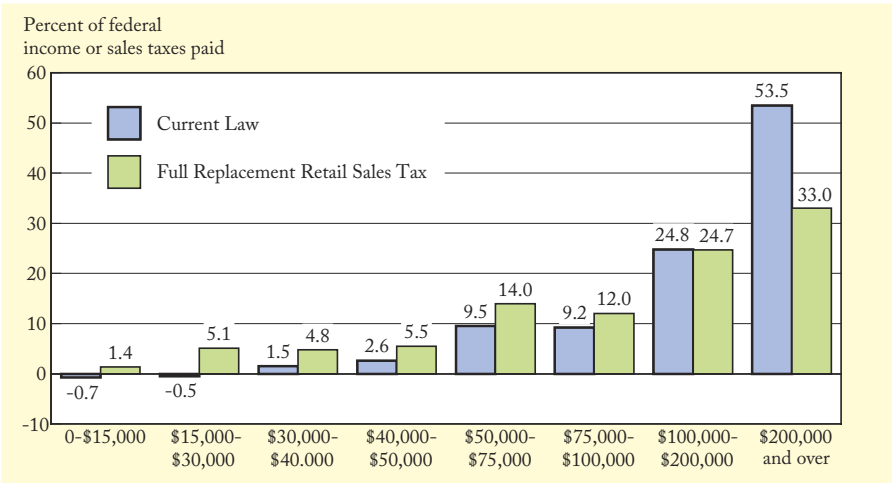
Using the Extended Base and assuming low rates of evasion, the Treasury Department calculated that the tax rate required to replace the federal income tax with a retail sales tax would be 22 percent on a tax-exclusive basis. This tax rate, however, does not include a program designed to ease the burden of the tax on lower-income Americans. Moreover, unless the states repealed their existing sales taxes, most consumers would pay both federal and state sales tax on many goods. The weighted average state and local sales tax rate is approximately 6.5 percent on a tax-exclusive basis. Thus, for sales subject to both federal retail sales tax and state and local sales taxes, the weighted average combined tax-exclusive sales tax rate would be approximately 28.5 percent.

Figure 9.1. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907. Bottom 50% below \$36,738.
 Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.2. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
 Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.1 and 9.2 compare the current distribution of federal taxes paid with the distribution that would exist under a “stand-alone” retail sales tax at a 22 percent tax rate. Adopting this retail sales tax would impose a larger tax burden on lower-income households than the current system because a retail sales tax is imposed directly on

consumption and does not provide deductions, exemptions, or credits to reduce the tax burden on lower-income Americans. Replacing the current income tax with a stand-alone retail sales tax would increase the tax burden on the lower 80 percent of American families, as ranked by cash income, by approximately \$250 billion per year. Such families would pay 34.9 percent of all federal retail sales taxes, more than double the 15.8 percent of federal income taxes they pay today. The top 20 percent of American taxpayers would see their tax burden fall by approximately \$250 billion per year. Such families would pay 65.1 percent of all federal retail sales taxes, compared to the 84.2 percent of federal income taxes they pay today.

Lower- and middle-income families would be especially hard hit by a stand alone retail sales tax. For example, the Treasury Department estimates that a hypothetical single mother with one child making \$20,000 per year currently pays \$723 in total federal taxes (including both the employee and employer shares of the Social Security and Medicare taxes). Under the stand-alone retail sales tax, her tax bill would go up to \$6,186 – a tax increase of over 750 percent. A hypothetical married couple with two children making \$40,000 per year would pay an additional \$6,553 in taxes, an increase of more than 110 percent of total federal tax liability. In contrast, a hypothetical married couple with two children and \$300,000 of income currently pays about \$89,000 in total federal taxes. Under the stand-alone retail sales tax, this hypothetical family would pay about \$72,000, a tax cut of 19 percent. Further discussion of the Treasury Department’s hypothetical taxpayer analysis appears in the Appendix.

The Panel concluded that the distribution of the tax burden under a stand-alone retail sales tax would not meet the requirement in the Executive Order that the Panel’s tax reform options be appropriately progressive.

Retail Sales Tax with a Cash Grant Program

Universal Cash Grant Program

Retail sales tax proposals generally recognize the distributional effects of a stand-alone retail sales tax. For this reason, such proposals usually include a cash grant program to relieve the burden of the retail sales tax on lower and middle-income families.

The Panel considered the cash grant program advocated by proponents of the FairTax. This program (sometimes called a “Prebate”) would provide a monthly monetary grant to all U.S. citizens and residents. The goal of the program would be to provide families with cash sufficient to pay retail sales tax on all their spending up to the poverty level. The program would not be income based so there would be no need to have a federal agency to keep track of personal income. Nevertheless, it would require a federal agency to keep track of family characteristics, such as family size, on which the cash grant would be based.

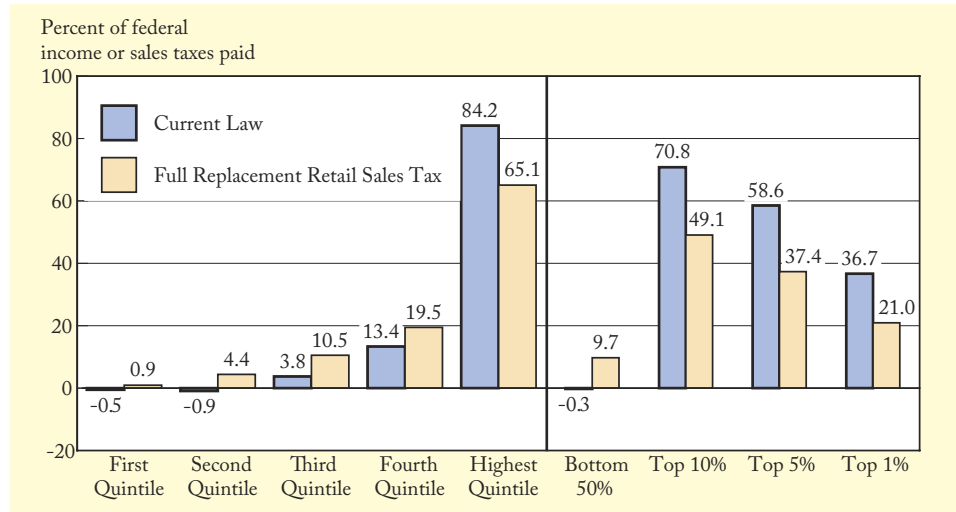
This cash grant program would be expensive, and would require raising the retail sales tax rate. To pay for the cash grant program and remain revenue-neutral, the required

tax rate, assuming evasion rates somewhat lower than those under the income tax, would be 34 percent. Using a higher evasion rate assumption, discussed further below, the tax rate would be 49 percent. If a narrower tax base were used instead of the Extended Base, the tax rate would be even higher.

How would the cash grant program work? The federal government would be required to send monthly checks to every family in America, regardless of their income level. If the tax rate was 34 percent and the before-tax poverty level for an individual was \$10,000, all single individuals would receive \$3,400 a year from the government. The cash grant would also be adjusted for marital status and family size. For married couples with two children, the cash grant amount in 2006 would be \$6,694 per year.

The Prebate-type program would cost approximately \$600 billion in 2006 alone. This amount is equivalent to 23 percent of projected total federal government spending and 42 percent of projected total federal entitlement program spending, exceeding the size of Social Security, Medicare, and Medicaid. The Prebate program would cost more than all budgeted spending in 2006 on the Departments of Agriculture, Commerce, Defense, Education, Energy, Homeland Security, Housing and Urban Development, and Interior combined.

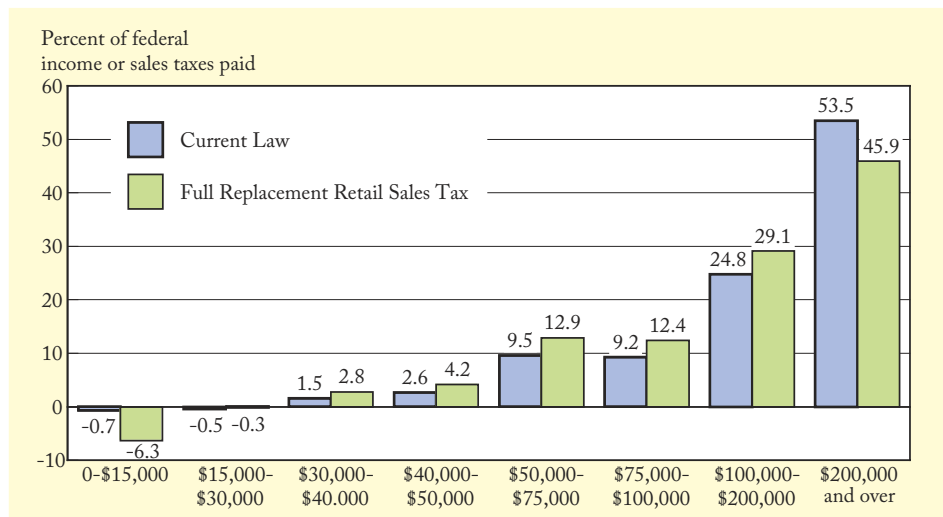
Figure 9.3. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461 Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.4. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.

Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.3 and 9.4 show that low-income and high-income Americans would benefit from the retail sales tax with a Prebate, while middle-income Americans would pay a larger share of the federal tax burden. Separate figures with distributional estimates for 2015 law are not provided because the distribution of the retail sales tax burden in these estimates was identical to the distribution shown in Figures 9.3 and 9.4. American families with the lowest 20 percent of cash incomes currently pay negative 0.5 percent of total federal income taxes because the tax credits they claim exceed their total positive tax liability. Under the retail sales tax with a Prebate, this group would pay negative 5.6 percent of the federal sales tax burden because the amount they would receive in monthly checks from the government would exceed what they would pay in retail sales tax at the cash register. In total, the bottom quintile would bear 5.1 percentage points less of the tax burden. Families with the top 10 percent of cash incomes would also benefit substantially from the retail sales tax. Their share of the tax burden would fall by 5.3 percentage points – from 70.8 percent to 65.5 percent.

Middle-income Americans, however, would bear more of the federal tax burden under the retail sales tax with a Prebate. The Treasury Department's analysis of hypothetical taxpayers shows that married couples at the bottom 25th percentile, 50th percentile, and 75th percentile of the income distribution for married taxpayers would see substantial tax increases under a full replacement retail sales tax. A typical married couple at the bottom 25th percentile of the income distribution earns \$39,300 per year and would pay \$5,625 dollars in federal taxes in 2006. Under the retail sales tax with a Prebate, the same family would pay \$7,997 in net federal taxes after subtracting the Prebate of \$6,694, resulting in a tax increase of \$2,372, or 42 percent. A typical married couple at the 50th percentile of the income distribution making \$66,200

would pay an additional \$4,791, a tax increase of 36 percent, and a typical married couple in the 75th percentile, making \$99,600 would pay an additional \$6,789, a 29 percent tax increase. A typical single mother at the bottom 25th percentile of the income distribution for head of household taxpayers has \$23,100 of income per year and, compared to current law, would pay \$5,866 more under the retail sales tax with a Prebate.

Targeted Cash Grant Program

The Panel requested that the Treasury Department develop a more targeted cash subsidy program to alleviate the burden of a retail sales tax on lower- and middle-income American families. The resulting program required a cash grant of up to \$7,068 to married couples, plus \$2,570 per dependent per year, with a phase-in and a phase-out. Further details regarding the program are provided in the Appendix, as well as a brief discussion of an alternative targeted subsidy program.

The Treasury Department's proposed targeted cash grant program would cost \$780 billion in 2006. It would represent 30 percent of total federal government spending, and would dwarf all other federal entitlement programs and exceed the combined size of Social Security and Medicaid. To implement the program, the government would need to collect 34 percent more revenue and redistribute an additional 6 percent of GDP. The Panel concluded that this substantial increase in the amount of revenue collected from taxpayers and redistributed by the federal government was undesirable. Some Panelists were also concerned that the precedent set by the large cash grant program could set the stage for further growth in the size and scope of the federal government. To pay for the targeted cash grant program and remain otherwise revenue-neutral, the tax rate would need to increase to at least 37 percent, assuming low evasion and using the Extended Base.

Administration of a Cash Grant Program Would be Complex

The proposed cash grant programs would require all eligible American families to file paperwork with the IRS or another federal government agency in order to claim their benefits under this new entitlement program. A federal agency would need to manage the program, verify individuals' marital status and number of eligible children, and write checks to every family in the United States. Eligibility rules would be necessary, for example, to ensure that a child claimed as a dependent could not also file for his or her own separate cash grant.

Substantial additional complexity would be imposed by a targeted cash grant program because determining eligibility would require additional information. For example, a program based on annual income would require the IRS or another federal government agency to make many of the same determinations now made under the current income tax.

Evasion, the Tax Base, and the Required Tax Rate Revisited

The tax rate necessary to replace the revenues from the current individual and corporate income taxes is one key consideration in evaluating a retail sales tax. The two major factors that determine the tax rate are the size of the tax base and the level of evasion. The tax rates and rebate program cost estimates presented thus far have been based on relatively optimistic assumptions about the breadth of the tax base and the evasion rate. As explained above, even under these optimistic assumptions, the Panel does not recommend a full replacement sales tax at the resulting 34 percent tax rate.

The Panel also had substantial concerns that a base as broad as assumed above would not be viable and that evasion rates could be higher than under the present income tax. The Panel believed that in evaluating the retail sales tax it was important to consider the tax rate required under less favorable assumptions regarding the tax base and evasion. Accordingly, the Panel requested that the Treasury Department estimate the required retail sales tax rate using the same tax base as the Partial Replacement VAT described in Chapter Eight and using a base equal to the average state sales tax base.

The Partial Replacement VAT base described in Chapter Eight is slightly narrower than the Extended Base – primarily because it excludes the value of state and local government services. The Extended Base would require state and local governments not only to pay retail sales tax on their purchases from businesses, but also to pay tax at the retail sales tax rate to the federal government on the total value of the salaries that state and local governments pay their employees – this would be equivalent to the value of services provided by state and local governments to their citizens. The Panel concluded that it may be inappropriate for the federal government to directly assess a tax of this sort on state and local government in our federal system. For this reason, the Panel excluded state and local government services from the Partial Replacement VAT base discussed in Chapter Eight.

Existing state sales tax bases are substantially narrower than either of the broad bases studied by the Panel. Most states exempt a variety of specific products and many services from their sales taxes. For example, every state sales tax exempts prescription drugs, most states do not tax health care, approximately 30 states exempt food for home consumption or tax it at a preferential rate, and many states exempt clothing. These exemptions are often justified as a means to ease the burden of a sales tax on basic necessities, but are not well targeted because they often decrease the tax burden on higher-income taxpayers as much or more than they decrease the tax burden on lower or middle-income taxpayers. To illustrate the impact of extensive base erosion on a retail sales tax, the Panel requested that the Treasury Department estimate the tax rate using the average state sales tax base. The Panel acknowledges there are structural differences between state tax systems and a federal tax system that would rely on a retail sales tax instead of an individual and corporate income tax, and that these differences would affect the nature of any base erosion. Nevertheless, the Panel believes that estimating the tax rate using a base equal to the average state sales tax base is illustrative of the impact of base erosion on the tax rate.

Table 9.1. shows the Treasury Department's estimates of the tax-exclusive retail sales tax rates required to replace the federal income tax using the alternative assumptions regarding evasion rates and the breadth of the tax base. The Extended Base and Partial Replacement VAT Base estimates include the Prebate-type universal cash grant program (calculated to provide all families with cash sufficient to pay a 34 percent retail sales tax on a poverty level amount of spending). The average state sales tax base estimate includes no cash grant program, because exclusions from the base are assumed to fulfill the burden-easing function of the cash grant. These tax rates should be compared both to each other and to the overall burden an individual faces under both the corporate and individual income tax today. Tax-inclusive rates are provided in the Appendix.

Table 9.1. Retail Sales Tax Rate Estimates – Range of Tax-Exclusive Rates			
Evasion Rate	Extended Base	Partial Replacement VAT Base	Median State Sales Tax Base
Low Evasion (15%)	34%	38%	64 %
Higher Evasion (30%)	49%	59%	89%

Source: Department of the Treasury, Office of Tax Analysis.

Box 9.2. Comparing the Treasury Department's Revenue-Neutral Rate Estimate with Estimates Made by Retail Sales Tax Proponents

In their submission to the Panel, proponents of the FairTax claimed that a 30 percent tax exclusive sales tax rate would be sufficient not only to replace the federal income tax, but also to replace all payroll taxes and estate and gift taxes and fund a universal cash grant. In contrast, the Treasury Department concluded that using the retail sales tax to replace only the income tax and provide a cash grant would require at least a 34 percent tax-exclusive rate.

Some may wonder why the tax rate estimated by FairTax advocates for replacing almost all federal taxes (representing 93 percent of projected federal receipts for fiscal year 2006, or \$2.0 trillion) is so much lower than the retail sales tax rate estimated by the Treasury Department for replacing the income tax alone (representing 54 percent of projected federal receipts for fiscal year 2006, or \$1.2 trillion).

First, it appears that FairTax proponents include federal government spending in the tax base when computing revenues, and assume that the price consumers pay would rise by the full amount of the tax when calculating the amount of revenue the government would obtain from a retail sales tax. However, they neglect to take this assumption into account in computing the amount of revenue required to maintain the government's current level of spending. For example, if a retail sales tax imposed a 30 percent tax on a good required for national defense (for example, transport vehicles) either (1) the government would be required to pay that tax, thereby increasing the cost of maintaining current levels of national defense under the retail sales tax, or (2) if the government was exempt from retail sales tax, the estimate for the amount of revenue raised by the retail sales tax could not include tax on the government's purchases. Failure to properly account for this effect is the most significant factor contributing to the FairTax proponents' relatively low revenue neutral tax rate.

Second, FairTax proponents' rate estimates also appear to assume that there would be absolutely no tax evasion in a retail sales tax. The Panel found the assumption that all taxpayers would be fully compliant with a full replacement retail sales tax to be unreasonable. The Panel instead made assumptions about evasion that it believes to be conservative and analyzed the tax rate using these evasion assumptions.

Evasion

Tax evasion occurs when taxpayers do not pay taxes that are legally due. Analysts agree that some evasion is inevitable in any tax, and that evasion rates for any tax tend to rise as the tax rate rises. At the request of the Panel, the Treasury Department estimated the revenue neutral retail sales tax rate assuming evasion rates of 15 and 30 percent of personal consumption spending. The Treasury Department assumed no evasion by state and local governments. By comparison, for 2001 the IRS estimates that the evasion rate for the individual income tax was between 18 and 20 percent and the evasion rate of the entire U.S. tax system was about 15 percent.

The retail sales tax would rely on retail businesses to collect all federal tax revenue and eliminate federal individual income tax filing. Therefore, the number of federal tax return filers would fall significantly under the retail sales tax. Further, the complexity of filing a business tax return would decline dramatically as compared to corporate income tax returns. Retail sales tax returns would indicate only total sales, exempt

sales (sales to businesses with exemption certificates plus export sales) and tax liability. From an enforcement perspective, both the reduced number of tax return filings and the simple nature of the retail sales tax return represent substantial advantages.

Nevertheless, the Panel concluded that a number of features of the retail sales tax would make it difficult to administer and enforce at the high tax rate necessary to be revenue-neutral. A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide a substantial inducement for evasion at the retail level. Retailers and shoppers could use a number of techniques to evade a retail sales tax. For example, unregistered cash sales to a consumer would allow a transaction to escape taxation. Retailers facing a high retail sales tax might also misapply exemption criteria, whether intentionally or unintentionally, and fail to tax goods that should be taxed. Or, the retailer might collect the tax from customers, but keep the money rather than remit it to the government. At high tax rates, the gain to retailers from evasion is high.

Empirical evidence suggests third-party reporting substantially improves tax compliance, particularly when tax rates are high. For the portion of income from which taxes are not withheld and there is no third-party reporting, income tax evasion rates are estimated to be around 50 percent. There is no third-party reporting in a retail sales tax. Retailers would add their retail sales tax to the pre-tax price for their goods and would remit that amount to the government, but shoppers would not separately report what they bought, and at what price, to the government. The government would rely on retailers alone to report their own taxable and exempt sales.

To obtain exemption from tax, retail purchasers might try to fabricate exemption certificates or otherwise masquerade as tax-free buyers of retail products. For example, individuals might create “paper” businesses solely to obtain business exemption certificates and avoid taxes on purchases for personal use. A related problem involves individuals with legitimate businesses using their business exemptions for personal purchases or for goods or services to give to employees in lieu of cash compensation. Using their business purchase exemption would provide a discount equal to the retail sales tax rate.

With a retail sales tax, retailers would have the responsibility to determine whether the ultimate use of a good or service would be for a business purpose, and therefore would be deserving of the business purchase exemption. Retailers are often ill-equipped to carry out this role. State experience suggests that abuse of exemptions is common, in part because distinguishing between business and individual consumer purchases of so-called “dual use” goods and services – goods and services that are commonly purchased by both businesses and final consumers, such as a plane ticket – can be difficult and costly.

Box 9.3. Dual-Use Goods and the Problem of “Cascading”

The difficulty of identifying whether dual-use goods are used for business or individual purposes is one reason that states typically include a significant number of business-to-business transactions in their sales tax base. For example, states often do not ask retailers to determine whether a buyer will use a computer for entertainment at home (taxable) or to run a business (exempt). Instead, many states treat sales of computers as taxable unless the buyer certifies that they are purchasing the computer for resale. Thus, many businesses pay sales tax when purchasing computers. That tax then “cascades” into the cost of the goods and services the purchasing business sells to consumers. Taxing goods and services bought by businesses to produce other goods and services is economically inefficient because it haphazardly imposes double (or triple or quadruple) taxation on some consumer goods and services.

Cascading taxes create incentives for business to produce fewer goods or services, shift resources into tax-favored activities, or adopt tax-driven business structures. Cascading taxes also may have a negative impact on U.S. competitiveness because they impose some tax liability on exports and result in less tax being assessed on imports relative to competing domestically-produced goods.

Comparison with State Sales Tax Evasion and Administration

Retail sales tax advocates often note that evasion rates with sales taxes are lower than evasion rates with the income tax. However, state sales tax evasion rates are not likely to be representative of the evasion rate of a full replacement retail sales tax for several reasons.

First, state sales tax rates are a fraction of the tax rates required to replace the federal income tax. Among states that impose sales taxes, tax rates range from 3.5 percent in Virginia to 7.0 percent in Mississippi, Rhode Island, and Tennessee. When combined with local sales taxes, the highest sales taxes are found in Alabama (11.0 percent), Arkansas (10.625 percent), Oklahoma (10.5 percent) and Louisiana (10.5 percent).

Higher tax rates provide greater incentives for taxpayer evasion and avoidance. Those incentives also make administration and enforcement more expensive – and any failure to effectively administer the tax requires a higher tax rate to compensate for lost revenue. No state or country has ever levied a retail sales tax at a tax rate that even approaches the 34 percent required to replace the federal income tax system. State tax administrators told the Panel that they would expect significant compliance problems at such rates.

State sales taxes also do not broadly tax service providers, often because they are difficult to tax. For example, all U.S. state sales taxes exempt most financial services. Other dual-use services, such as utilities, transportation, and communication services are also difficult to tax properly and often are exempt from state sales taxes. It is reasonable to assume that trying to tax these services through a retail sales tax likely would result in more extensive evasion and higher compliance and administrative costs than existing state sales taxes. Although it is difficult to know with any measure of certainty what the evasion rate would be under the RST, the Panel believes that it would likely be at least as high as evasion under the current income tax and that a 30 percent rate of evasion would not be an unreasonable assumption.

Other Concerns

Response of the States to a Retail Sales Tax

Although some retail sales tax proposals claim the administration of the retail sales tax could be left to the states and the IRS could be eliminated, such a system would likely be unworkable. Existing state sales tax bases are both narrow and varied and it may be difficult to persuade the states to adopt the federal retail sales tax base.

The experience of Canada, which tried to federalize its provincial sales taxes, may be instructive. Canada considered adopting a unified federal and provincial sales tax base in 1987, but intergovernmental discussions failed to produce an agreement to standardize the existing provincial sales tax bases with the base for Canada's federal goods and services tax.

Variation in local sales tax rates within the United States could further complicate any effort to standardize U.S. sales tax bases and rates. As of 2001, Texas alone had 1,109 separate city tax rates, 119 county tax rates, and 67 other special tax jurisdictions. Texas is not atypical in having numerous local sales tax jurisdictions. While some states might bring their sales taxes into conformity with a federal retail sales tax, it is unlikely that all would do so. States have not adopted identical definitions, standards, and rules in their own income tax regimes as those that exist for the federal income tax, even though there would be many administrative and compliance advantages to such an approach.

Given the tremendous variance in the current taxation of retail sales across the United States, the IRS or another federal agency with substantial personnel and resources would almost certainly have to define, administer, and enforce a federal retail sales tax. For example, detailed rules would be necessary to ensure that exemption certificates were issued uniformly and only provided to legitimate businesses for use in purchasing actual business tools, materials, and other inputs. Further, the IRS or another federal agency would likely need to administer the retail sales tax directly in the five states that do not currently impose a sales tax. The same might be true in those states that do not bring their sales tax bases into conformity with the federal retail sales tax base. Finally, because failure to effectively enforce the sales tax would lower federal revenues, Congress might decide that the IRS should maintain a significant enforcement function as a backup mechanism to state tax administration efforts.

State Income Tax

At the Panel's public meetings, state and local tax officials suggested that a federal retail sales tax would encroach on a tax base that traditionally has been left exclusively to states and localities. Currently sales and gross receipts taxes account for about 37 percent of state general tax collections and about 17 percent of local revenues. However, if a federal retail sales tax were put in place at a rate of 34 percent or more, it could become unattractive for states to add their own rates on top of the federal retail sales tax.

If the federal government were to cease taxing income, states might choose to shift their revenue-raising to the income base from the sales base. State income taxes could rise, while state sales tax rates could fall. In any event, unless states found a substitute source of revenue, they likely would maintain their income taxes. For that reason, it is reasonable to expect that taxpayers would need to continue to keep track of income-related information and file income tax returns, regardless of whether the federal government eliminates the federal income tax. Furthermore, with an income-based cash grant program, tracking income at the federal level would remain a necessity.

Today, 45 states and the District of Columbia have state income taxes. Most states use federal adjusted gross income as the starting point in determining the state individual income tax base. Eliminating the federal income tax would remove the common basis upon which most state income taxes are now structured. State and local income tax returns would likely become much more complex if they could not be based on a pre-existing federal income tax return that includes a calculation of annual income. Greater disparities among state income tax systems and potential distortions would likely develop as state income tax structures diverge from each other over time in the absence of a common federal income tax base as a starting point.

State income tax compliance initiatives currently rely in large measure on information that the states receive from the third-party reporting structure created by the federal income tax – such as W-2 and 1099 forms as well as other standard tax forms that report income. In the absence of the federal third-party reporting system, states would need to impose information reporting requirements on individuals, employers, financial institutions, and others in order to maintain their income tax systems. States might bind together to coordinate enforcement of state income taxes and impose those reporting requirements. But if states chose to impose reporting requirements independently, multi-state businesses could face many different sets of reporting obligations. Simplification of the federal tax system through a retail sales tax might be achieved at the expense of greater overall complexity in the combined system of state and federal taxation.

Compliance Burden on Small Business

A retail sales tax also likely would place a disproportionate burden on small retail businesses. Few statistical studies exist on the compliance costs for retailers of different sizes. However, a well-regarded study conducted by the State of Washington Department of Revenue in 1998 suggests that, although such costs are low overall, they are disproportionately high for small retailers. In Washington, the cost of collecting sales tax for retailers with annual gross retail sales of between \$150,000 and \$400,000 was 6.5 percent of sales tax collected. By comparison, firms with annual gross retail sales greater than \$1.5 million spent less than 1 percent of sales tax collected on compliance.

Small vendors, particularly those operating on a cash basis, account for a significant share of the noncompliance in many state sales taxes as well as our current income tax. A retail sales tax would cover all retailers, including small service providers,

such as dentists, car mechanics, or beauticians, as well as small retail stores. Small service providers would likely find retail sales tax compliance costly and would have noncompliance incentives that would be similar to those for small retail stores.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a retail sales tax. Although there may be some such disruptions, those considerations were secondary in the Panel's decision not to recommend a retail sales tax.

Full Replacement of the Income Tax with a VAT

The Panel considered replacing the income tax with a VAT at the same time it analyzed a replacement retail sales tax because of the similarities between the two taxes. The Panel concluded that fully replacing the income tax with a VAT would be substantially more administrable than fully replacing the income tax with a retail sales tax. The advantages of a VAT over a retail sales tax with respect to enforcement and compliance are described in Chapter Eight. However, the Panel's objections regarding the increased tax burden on the middle class and increased size of government resulting from the full replacement retail sales tax apply equally to a full replacement VAT. Because of these concerns, the Panel did not recommend a full replacement VAT.

Conclusion

Like other consumption taxes, the full replacement retail sales tax has pro-retail growth features. Nevertheless, the Panel does not recommend a full replacement retail sales tax. Without a large cash grant program to ease the burden of the tax, a retail sales tax would not be appropriately progressive. A cash grant program to make the tax appropriately progressive would cost at least \$600 billion per year – which would make it America's largest entitlement program. The Panel concluded that it was inappropriate to recommend a tax reform proposal that required the federal government to collect and redistribute this amount in additional revenue from taxpayers. The Panel also was concerned with administrative and compliance issues associated with a retail sales tax, as well as difficulties involving coordination with existing state sales taxes.