U.S. TAX REFORM UPDATE

Byrle M. Abbin, Arthur Andersen LLP, Washington, D.C.

PART I — A REPRISE ON 1993: THE MORE THINGS CHANGE, THE MORE THEY STAY THE SAME

I. Background — The U.S. Revenue System is in Trouble

A. Deficits from excess of spending over tax receipts increased public debt by $3 trillion in the 1980's-early 1990's.

B. For all the hoopla over new directions breaking gridlock, etc., the recently enacted Clinton Economic Program at best (since spending cuts are delayed for a number of years) merely slows down the rate of increase so for his first term through 1996 the deficit will grow by $1 trillion.

1. Throughout the five-year span, deficits will continue to be in excess of $200 billion annually.

2. After 1997 the deficits will increase sharply, predicted to rise to over $300 billion a year.

a. Much of this emanates from rapidly escalating health care costs that President Clinton hopes to control in his yet to be completed Health Care Program.

C. The income tax system — the primary source of Federal revenues has proved to be incapable of political adjustment to provide revenues equal to expenditures.

1. The attempts to reduce spending have proved to be both illusory and politically impossible.

2. Fragmented party loyalty and weakened presidency has resulted in multifarious interest groups so lobbying has controlled ability to reform income tax system.

3. Class aspects: rich vs. middle-class vs. poor has created revenue barriers of immense proportions, since real significant revenue can only be derived from the midddle-class — that is where most of the taxpayers are!

4. The U.S. is the ultimate of a consumerist society and its savings rate is pathetic. Most concede the U.S. tax system favors consuming over savings, although some commentators dispute whether this affects savings rate or other factors are the root cause.

5. The individual income tax revenue as a percent of GDP has stayed constant while corporate taxes have dropped significantly as a percent of GDP and total revenue.

6. Flat rate payroll taxes (on a base subject to a ceiling) now equal individual income tax as a percent of GDP.

D. The U.S. operates under a federalist system and national politicians always are careful, if not leery, of the political ramification of challenging state relationships and the fact that in addition to income taxes most states impose sales tax on consumed goods (and some services) at rates up to 8%.

II. In spite of disclaimers by the Administration and health care reform advocates, many conclude that significant change to the current system, including providing for those without health coverage, will require additional revenue sources.

A. Based on 1993 Budget Act problems, it appears unlikely that income tax can be raised sufficiently.

B. Proposed BTU tax was an element of a consumption tax. Removing it as part of 1993 budget compromise package due to pressure from certain U.S. Senators could prove to be a foreboding predictor regarding future consideration of a transaction tax such as a VAT.

C. The 1993 increase in wage base for Medicare tax and proposed wage base taxes for health care reform also are elements of a consumption tax, especially a VAT, since added value from goods and services are the essential elements of a VAT.

1. Increases in payroll tax now appear more acceptable to the administration and Congress since expanded wage base only affects "the rich."

III. Consumption Tax Have Been Considered Before

A. In 1921 a proposal for a consumption tax was publicized.

B. In 1940 a bill establishing a consumption tax was introduced into the U.S. Congress.

C. From 1953 to 1967, the state of Michigan imposed a VAT variation; its successor a single business tax functions like a VAT.

D. In 1966 the research and policy committee of the Committee for Economic Development (CED) proposed replacing the corporate income tax with a VAT.

E. In 1970 a Nixon presidential task force on business taxation considered a VAT as a new revenue source, if required, but not as a substitute for current taxes.

F. Another presidential suggestion by Nixon in the 1970s was to replace local property taxes used for education with a VAT.

G. House Ways & Means considered a VAT in 1979 as a partial replacement for corporate and individual taxes.

1 A bill never resulted and Chakman Al Ullman's subsequent reelection defeat has been cited for two decades as a reason why VAT "won't sell" in the U.S.

H. A VAT and consumed income tax alternatives were discussed in depth by economists, politicians and other tax policy pundits in 1983, proceedings published in Walker and Bloomfield, New Directions in Federal Tax Policy for the 1980's, American Council for Capital Formation.

I. An even more in-depth discussion ensued in 1986 for three days, the Consumption Tax — A Better Alternative, sponsored again by the American Council for Capital Formation. The proceedings edited by Walker and Bloomfield involved politicians from tax writing committees, economists, industrialists, political journalists.

J. U.S. Treasury Department Tax Reform for Fairness, Simplicity and Economic Growth, Vol. 3 — Valued Added Tax (U.S. Govt. Printing Office, Nov. 1984).

K Blueprints for Basic Tax Reform (U.S. Treasury 1977)

IV. The Current Discussion

A. Value added taxes

1. Arthur Andersen, VAT Facts: A Primer on Value-Added Taxes.

2. Joint Committee on Taxation, Factors Affecting the International Competiveness of the United States (1991).

3. Government Accounting Office (GAO) Report to the Joint Committee on Taxation, U.S. Congress: Tax Policy Value Added Taxes (May 1993)

4. Tax Foundation Background #4, Value-Added Taxes and Other Consumption Based -Taxes: An Annotated Bibliography (Bartlett April 1993)

5. Congressmen Sam Gibbons, A Proposal for A New Revenue System for the United States Incorporating a Value-Added Tax (#7 dated June 29, 1993).

6. Tax Executives Institute, Value-Added Taxes — A Comparative Analysis (1992).

B. A VAT variation — The Business Transaction Tax (BTT) or Uniform Business Tax (UBT)

1. Congressman Schulze, The Uniform Business Tax (1991).

C. A generic study

1. A National Consumption Tax — Why, What and When, Staffs of Senators Danforth and Boren (March 1, 1993).

D. The consumption based income tax

1. Center for Strategic and International Studies, the CSIS Strengthening of America Conunission, Senators Nunn and Domenici, co-chairman (1992) — Tax Restructuring Strategy: The Consumption Based Income Tax.

2. Recently, it has reemerged as the Savings Exempt Income Tax (SEIT).

V. Some Analysis and Comparisons

A. The VAT discussion

1. Prior history and positions taken

a. Many acknowledge that Ways and Means Committee Chairman Al Ullman was defeated at least in part because of his support in the 1970's.

b. Conservatives are concerned it is a money machine to expand scope of government spending.

(1) Proposals for legislative limits on tax rate are considered infeasible, unlikely or just not to be believed.

c. Liberals feel it unfairly discriminates against the poor and lower middleclass since they expend all income for taxable consumption.

(1) They propose methods for alleviating regressivity such as exemptions for necessities and tax rebates.

(2) Experience indicates these solutions do not solve the problem nor do they operate effectively.

d. Retired people feel it will be double taxation — they already paid tax on savings so they will be able to consume in retirement.

e. Retailers and distributors feel it will hurt their business due to increased total cost, especially for imported items sold to consumer, thus reducing consumption.

f. Others fear costs of administration by private sector and government flowing from complexity if the European multi-rate and item exemption approach is implemented.

g. States agonize over competing with the Federal government, since a major state revenue source is flat rate retail sales tax — a form of consumption tax.

(1) Revenue sharing is an obvious solution but generates strong political concern at state level.

h. VAT has an inflationary impact.

i. Transition problems emphasize need to rectify complaints of retireds, others who were taxed on savings and old versus start up enterprises.

2. Supporters' contentions

a. Our U.S. income tax system is bankTupt financially and intellectually — it cannot provide sufficient revenues and is getting far too complex.

b. The largest tax on the working class is on payroll and this is too harsh and regressive; a VAT can replace payroll taxes or at least offset them to a large extent.

c. A VAT can replace corporate income tax in whole or part.

d. Since all major trading partners of the U.S. now have a form of VAT in order to be competitive internationally U.S. needs a border relief tax — not all economist agree that a VAT accomplishes this.

e. A Federal VAT can be integrated or rationalized with states and a revenue sharing approach used to mitigate competition.

(1) Yet states have reasons to mistrust the Federal government since recently revenue sharing has been scaled back considerably.

f. Poorer taxpayers can be given relief through tax credits, VAT refundability, etc.

(1) As noted U.S. experience on efficacy of this remedy is poor.

g. A VAT will collect a significant amount of untaxed revenues that now escape through the underground economy.

h. A VAT will not be a government money machine if statutory limits are placed on rates; it is a substitute for payroll and corporate income tax in whole or part.

i. Proponents state that complexity can be mitigated by the BTT concept — a subtraction method similar to an income tax system, instead of the credit invoice approach typical in Europe.

(1) Experience is limited for empirical evidence supporting this conclusion; detractors disagree with its premise.

B. The Business Transfer Tax (BTT) really is a form of VAT using the subtraction method so all the above discussion on VAT essentially applies.

1. Comports to U.S. experience of annual filing.

2. Avoids complex transactional approach and apparent competition with states' sales tax imposition.

3. Overall result and impact considered by most economists not to differ from credit invoice VAT.

C. Consumed income tax (often termed a cash flow tax)

1. The corporate model is very similar if not identical to a BTT — all net receipts including borrowing would be considered receipts and all disbursements including operating costs for inventory, etc., and purchase of assets, loan repayments, etc., would offset receipts to derive the taxable base classified as net business cash flow. Compensation, dividends and interest would be nondeductible.

2. The individual model includes in the tax base all revenue sources such as wages, interest, dividend, borrowings, sales proceeds, less purchase of financial assets, bank account activities and other investments to derive a taxable consumption base.

a. Individual transfer taxes/estate and gift would continue.

b. Some are considering a merger of the two individual systems, so individuals annually would be taxed on all items above (V.c.2.) and inheritances and gifts. This has been described in tax and economic literature as an "accessions tax."

PART II — AN UPDATE SINCE THE 1993 CTS

I. A Modest Proposal—Tear Up the Entire Tax Code and Start From Scratch

A. While this view may sound extreme, it is shared by many Americans.

B. In a new Wall Street Journal/NBC News poll, 37% favor "complete overhaul" of the tax system.

1. That includes 46% of those earning over $50,000 — and 48% of those age 50 to 64.

2. Support for drastically revamping the tax code draws backing from 38% of Democrats, 37% of Republicans and 43% of independents.

C. Overall, 59% think the tax system is "basically unfair," while only 38% think it is "essentially fair."

D. Many experts agree.

1. "I would repeal the entire Internal Revenue Code and start over," says Shirley Peterson, a former IRS commissioner and now a Washington lawyer at Steptoe & Johnson. The system's "inordinate" complexity "contributes mightily to noncompliance."

2. But Phillip Mann of Miller & chevalier in Washington says: "There's not much evidence that if you chuck everything out and start all over again, youll get an improvement."

Source: Tax Report, Wall Street Journal, August 3, 1994 (page 1)

II. Political Aspects — The reinstatement of gridlock in Washington, D.C. — now between President Clinton and a Congress controlled by his party

A. The slap-in-the-face before allowing a vote on the crime bill

B. The death of the original Clinton health care plan

1. Clinton avoided a tax increase by favoring an employer mandate.

C. Off year 1994 Congressional elections could exacerbate that problem and give the opposition party more clout

D. Voting blocs are impeding any positive consensus

III. The most promoted approach appears to be the cash flow tax also called a consumed income tax, a Savings Exempt Income Tax (SEIT)

A. The business prototype

1. Taxpayer — All businesses, whether incorporated or unincorporated, and without regard to size.

2. Accounting method — Cash receipts and disbursements.

3. Rate of tax — Flat rate in the range of 8.5% to 10%.

4. Accounting period — Annual accounting and annual return.

5. Calculation of tax base — Receipts from sales of goods and services less payments for goods and services purchased from other businesses.

a. Excluded from receipts — mere financial receipts such as interest, dividends, proceeds from sales of financial instruments, and the proceeds of borrowing.

b. Excluded from payment — mere financial payments such as interest, dividends, purchases of financial instruments, and repayments of loans.

c. Employee compensation — direct and indirect payments of compensation to employees <u>are not deducted.</u>

d. International transactions

(1) Receipts from export sales are not included.

(2) Receipts from sales outside the U.S. are not included and associated costs outside the U.S. are not deducted — a territorial system.

6. Import tax — A tax is imposed on the importation of goods and services at the same rate as is imposed on domestic-source net business receipts (i.e., the excess of sales over purchases).

a. The cost of imported items is deductible in calculating the base of the business tax.

7. Carryovers of excess deductions — The unrecovered tax basis of depreciableproperty acquired prior to the effective date is amortized over five to ten years, depending generally on the categorization of the property as five-year or ten-year (or longer) property under MACRS.

8. Financial intermediaries — The tax base of a financial intermediary such as a bank is the sum of (i) regular net business receipts and (ii) intermediation income. In general, intermediation income is the excess of financial inflows over financial outflows.

9. Payroll tax credit — At businesses are allowed a tax credit for the amount of employer OASDHI tax they pay.

a. The rate of such tax is now 7.65% of "covered wages."

B. Individual tax prototype

1. Taxpayer — All individuals, all estates and all nonbusiness trusts are included.

2. Accounting method — Cash receipts and disbursements.

3. Rates of tax — Graduated rates based on three to four brackets probably ranging from 10% to 40%

4. Accounting period — Annual accounting and annual return.

5. Basic calculation of tax base — The sum of annual employment receipts and annual financial receipts less allowable deductions.

a. Basic employment receipts — all wages and salaries from whatever source.

b. Basic financial receipts — all (1) interest, (2) dividends (and equivalent withdrawals from unincorporated businesses), (3) pensions, (4) withdrawals from bank accounts, (5) proceeds from sales of financial assets, (6) life insurance proceeds, (7) proceeds of borrowing, and (8) other similar receipts without regard to source.

c. Optional receipts — transfer payments received from governments.

d. Basic allowable deductions — (1) personal exemptions, (2) a standard deduction (both generally the same or greater than present law), (3) the cost of all savings assets purchased during the year, (4) the repayment of a loan the proceeds of which have been included in receipts, and (5) the payment of interest on such a loan.

6. Optional allowable deductions — Several additional deductions are being considered and possible within the approximate tax rates indicated above.

a. Homeowner deduction — probably to include both principal and interest but limited in amount.

b. Contributions to charity.

c. Education and training.

d. Unreimbursed medical expenses — depends in part on outcome of health care legislation.

e. State and local income taxes.

f. Credits in lieu of deduction — all or some of the above could be allowed as credits instead of deductions to create greater progressivity in a graduated rate system.

7. Employee payroll tax credit — A credit (probably refundable up to some income level) would be allowed for the 7.65% employee OASDHI payroll tax on "covered wages."

8. Definition of savings assets

a. This generally would include <u>only</u> the purchase of financial assets such as (i) bank deposits, (ii) stocks and bonds, (iii) life insurance contracts, (iv) annuity contracts, and (v) other similar financial instruments.

b. Contributions to employer/employee plans and contributions to the capital of an unincorporated business would also be included.

9. Worldwide scope — In general, both domestic-source and foreign-source financial receipts by individuals would be included in gross income from individuals.

a. For example, if X Corp received a dividend from Zurich, the dividend would not be included in X Corp's taxable receipts but would be included in Shareholder Y's taxable receipts (without distinction) when distributed by X to Y.

b. If Y invested directly in a Zurich financial asset, Y would deduct the cost of the investment but would include all returns in taxable receipts.

10. Optional treatment of debt — Instead of including loan proceeds in income and allowing a deduction for principal repayment and interest, loan proceeds could be excluded from income and no deduction allowed for repayment.

a. In this case, no deduction would be allowed for a savings asset purchased with debt.

11. Optional transition rule on treatment of basis — When the acquisition of a savings asset (bank deposit, stock, etc.) occurs after the effective date, and a deduction is allowed for the cost, the individual has no cost basis.

a. Therefore, the withdrawal of the deposit is income and the entire proceeds from sale of the stock is income.

b. Where, however, the deposit was made or the stock purchased prior to the effective date, no deduction has been allowed and the individual does have a basis.

(1) If the withdrawal of that old deposit or the proceeds from sale of that old stock is included in income, the result is to again tax accumulated savings that have already been taxed under current law — unless, of course, the individual resaves the deposit or the proceeds.

(2) Unless the policy were to again tax old savings, the optional treatment would be (i) to exclude the withdrawal (or the basis of the old stock) from income and (ii) to reduce by the same amount the individual's otherwise allowable deduction, if any, for savings out of current income.

c. Source — The Center for Strategic Tax Reform popularly described as the Nunn-Domenici proposal

(1) See Exhibits A, B and C for expanded analysis of SEIT and an evaluation of its impact on labor vs. capital at a symposium sponsored by Institute for Research on the Economics of Taxation (IRET) in June 1994

IV. The Business Activities Tax (BAT), Senators Danforth and Boren proposed in S. 2160, 1994

A. Overview — The Comprehensive Tax Restructuring and Simplification Act of 1994 eliminates over $400 billion of business and individual income taxes and payroll taxes.

1. To replace this revenue, the package enacts a Business Activities Tax (BAT).

2. The BAT is a tax on all businesses that sell goods or services in the U.S. economy.

3. For any person engaged in business activities, the bill imposes a tax (the "Business Activities Tax," or "BAT") equal to 14.5% of the taxable amount for the taxable period.

a. The "taxable amount" generally is the amount by which the taxpayer's gross receipts from business activities exceed the taxpayer's business purchases for the taxable period.

b. If the taxpayer's business purchases exceed its gross receipts for the taxable period, the taxpayer generally would be entitled to a refund equal to 14.5% of the excess.

B. Business activity

1. "Business activity" means:

a. The sale of property or services in the United States by any person in connection with a business;

b. The import of property or services into the United States (whether or not in connection with a business);

c. The export of property or services from the United States in connection with a business; the provision of financial intermediation services; and

d. The provision of financial intermediation services;

e. Any activity carried on continuously or regularly, whether or not for profit, that involves or is intended to involve the sale of property or services.

C. Exclusions from being a business activity

1. Services provided by an employee for an employer.

2. Import of articles that are duty free.

D. Definition of gross receipts from business activities

1. All receipts from a business activity.

2. Insurance from business activity losses.

3. Separately levied excise, sales or other federal or state imposed duty.

4. Imported property or services for consumption in U.S. and the transportation thereof.

E. Excluded from gross receipts are exports of property or services for consumption outside the U.S., or the transportation thereof — the destination principle

F. Business purchases

1. This covers any amount paid or incurred to purchase property or services for use in a business activity other than:

a. Any amount paid or incurred as current or deferred compensation to employees, or employee benefits;

b. Interest or insurance premiums (other than premiums for property or casualty insurance); or

c. Other implicit financial intermediation fees; and

d. Amounts the payment of which is unlawful under federal, state, or local law.

2. Business purchases include any excise tax, sales tax, customs duty, or other separately stated levy imposed by the federal, a state, or a local government on property or services purchased for use in a business activity.

3. Under a special rule, business purchases would include certain implicit intermediation services provided by a financial intermediary for which the purchaser receives notice of the amount of these services.

G. Allowable accounting methods is cash or accrual but not the installment method.

H. BAT applies to all forms of business activities, incorporated or not.

1. An entity can elect to be treated as a regular taxable corporation.

I. Special treatment of financial services

1. BAT would be imposed on the provision of financial intermediation services.

a. Special rules would apply to determine the taxable amount derived from financial intermediation services.

b. The business user of financial intermediation services could deduct as business purchases any stated fees for such services and any implicit fees allocated and reported to it by the financial intermediary.

c. This would prevent the cascading of BAT when financial intermediation services are used in connection with a business.

2. The term "property" generally would be defined in the bill to exclude money and financial instruments. Financial instruments would be defined under the bill as:

a. Corporate stock;

b. Ownership interests in certain partnerships and trusts;

c. Notes, bonds, debentures and other evidences of indebtedness;

d. Interest rate, currency and equity notional principal contracts;

e. Evidence of an interest in, or a derivative financial instrument in, any financial instrument described in (a)-(d) above, or any currency, such as options, forward contracts, short positions or similar interests in such a financial instrument or currency; and

f. Any other instrument that is not otherwise defined as a financial instrument, but that is an identified hedge of any of the above.

J. Taxable amount excludes return from (interest dividends) and disposition of financial instruments and outflows related to payment of such amounts

K One-half reduction will be effected in employment taxes and self-employed taxes.

L. A significant increase in the exemptions and standard deductions for lower income individuals will be provided.

M. A special passive investment tax will be imposed on a taxable corporation that has nonbusiness gross income in excess of a set threshold amount for any year.

1. Nonbusiness gross income covers export sales, dividends, interest, capital gains and income from other passive activities.

PART III — SUMMARY AND CONCLUSION

I. The Prognosis

A. Public interest — and political interest — in taxes currently is at a low ebb as a result of activities emanating from the Clinton Economic Program, let alone NAFTA, GATT Health Care, Welfare and Crime Control initiatives

B. Yet, the 1993 Budget Act does not solve the U.S. Deficit Crisis — in four years another $1 trillion will be added to public debt.

C. Health care needs and other government activities such as GATT likely will add to the revenue need.

1. It is doubtful that the income tax system can accommodate this.

D. Extremism by liberals and conservatives in their concern about a consumption tax's impact seem to be diminishing.

E. There is more interest expressed in means to develop a tax system that encourage savings and discourage consumption.

F. With a global economy, the perceived detriment of being the only major trading company without a border relief tax is gaining strength and currency.

G. Each 1% consumption tax rate provides $30-$40 billion per year in revenues — a source that is most enticing.

1. This assumes nothing and no one is exempt from coverage.

2. Respecting the needs of lower income consumers could reduce this to $20-$25 billion annually.

H. Passage of some for of a consumption tax soon is most unlikely, but reflecting all factors discussed above, it is possible to envision a form of it being enacted before 2000.

1. Without doubt, the U.S. Congress will give this serious consideration in the foreseeable future.

2. Based on the problems he faced recently with a BTU tax proposal, it is doubtful the Clinton Administration will encourage it.

a. Whomever the president, a consumption tax will not be enacted without active backing of the Administration.

I. If some type of consumption tax is enacted based on prior experience of U.S. legislation:

1. It will not be an ideal VAT.

2. A number of exceptions will be set forth.

a. Zero rating

b. Special rates on select items

3. It is unlikely to be a complete replacement for an income tax; rather it will be an add on.

4. European version — credit invoice — is unlikely; an annual accounting is more probable

J. There are appealing features to a two-faceted, business and individual consumed income tax.

1. It avoids visibility and demands for new system of collectibility and enforcement of a VAT.

2. It can be progressive without problems and complexities of a multi-rate system that also features exemptions (a zero rate).

3. Annual filings are part of U.S. experience — it is nothing new.

4. Capital type enterprises are enthusiastic.

5. <u>But</u>

a. It emphasizes taxation on labor — the fastest growing segment of U.S. commerce are high-tech companies, entrepreneurial enterprises and service businesses and professionals, all of whom are labor intensive and utilize relatively little capital investment.

K. The political probabilities

1 . U.S. Congress (as in the Health Care debate) exhibits a strong desire for incrementalism, not radical restructuring.

2. The SEIT as a complete replacement for corporate and individual income tax and as an offset for employment taxes has theoretical purity, but past experience shows that the political process in the U.S. remolds extensively any proposal, and portions of it may be adopted as part of a more hybrid income tax system that has greater consumption tax attributes, i.e., expanded tax deductible savings (called IRAs in U.S.), etc.

a. Other features of SEIT that has strong detractors.

(1) Territoriality concept

(2) Complete expensing of capital investments

(3) Impact on certain activities if current deduction is removed: e.g., charitable giving, home ownership.

3. A basic political and class premise exists that an income tax system is a means to redistribute wealth, cut down high income earners "to size."

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THE SAVINGS-EXEMPT INCOME TAX

>by Murray Weidenbaum **fn***

Introduction

The United States would benefit greatly by reforming the national system of taxation to encourage more saving and investment — and thus help to achieve faster economic growth, higher levels of employment, improved standards of living, and smaller budget deficits. Specifically, a savings-exempt income tax on individuals and families and a companion cash-flow tax on business should replace the existing federal income taxes.

The Basic Idea

This proposal deals with the missing link in the budget debate. Until now, most proposals to reduce the deficit have focused either on cutting spending or raising taxes. There is a third alternative — improving the way that the tax system functions. The twin proposals made here — the savings-exempt income tax and the business cash-flow tax — would initially raise the same amount of revenue as the existing tax system with far less damage to the economy. This means that, over the years, the nation would achieve a faster growing economy. The direct benefits will be threefold: (1) more people at work, (2) lower federal outlays for unemployment payments, etc., and (3) more income to the Treasury from a growing tax base with no future change in tax rates.

All this cannot be attained by tinkering with the details of the Internal Revenue Code. Instead, the present federal income tax must be overhauled so that it exempts saving and investment, which constitute the seedcorn for economic expansion. This is not an argument for a new tax, such as a value-added tax (VAT), but a sea change in the existing income tax structure.

Going beyond the present array of detailed proposals that would modify the income tax in a piecemeal fashion, let us consider a fundamental change in the government's revenue system: abandon the whole idea of taxing income and shift to a consumption-based tax as the primary federal revenue source. Because so many people jump to the conclusion that all consumption taxes are unfair and regressive, the idea needs to be examined carefully.

There are several basic arguments that economists have offered over the years for shifting the primary base of taxation from income to consumption in an effort to achieve greater equity as well as economic efficiency. Consumption-based taxes put the fiscal burden on what people take from society — the goods and services they consume — rather than on what they contribute by working and saving, as do income taxes. Thus, under a consumption-based tax system, saving — and long-term investment — is encouraged at the expense of current consumption. Of course, over a period of time, the society is likely to achieve higher levels of saving and consumption because the added investment, by generating a faster growing economy, will lead to a bigger income "pie" to be divided among the various participants in economic activity.

Among the major industrialized nations there is a clear and positive correlation between the share of CDP going to investment and the pace of economic growth.

A constant theme voiced by tax reformers is the need for increased incentives for saving, capital formation, and economic growth. It is common knowledge that the United States saves and invests far less than other industrialized countries. In 1990, the U.S. net savings rate as a percentage of GDP was only 2.2 percent, the lowest of any Organization for Economic Cooperation and Development (OECD) member country; the OECD average net savings rate was 8.3 percent. Standing alone, this fact might not appear terribly harmful. However, among the major industrialized nations, there is a clear and positive correlation between the share of GDP going to investment and the pace of economic growth. This is not a transitory or fleeting relationship. The close fit between investment and growth shows up in the data for the past three decades (see Figure 1).

In that light, this report examines the many ramifications of consumption-based taxation and also analyzes the major alternative approaches to structuring a new consumption-based tax.

Figure 1 — Relationship of Investment to Economic Growth

Source: International Monetary Fund, *International Financial Statistics Yearbook*, 1993. The trend was obtained by performing an ordinary least squares regression of gross domestic product on investment. The slope coefficient of 0.14 is significant at the 5 percent level.

Promoting Investment and Economic Growth

Under a consumption-based tax, the basic way to cut taxes — legally — is for individuals and families to save more and for companies to invest more. In contrast, to minimize tax liability under the existing tax structure, taxpayers have to earn less. This fundamental fact reduces the incentives for taxpayers to work, save, and invest. By increasing the amount that we save and invest, the proposed tax system would augment the forces that create the formation of capital.

The United States has much lower rates of saving and business investment than our economic competitors.

To many citizens, any discussion of capital formation immediately brings to mind visions of greedy bankers, wealthy coupon clippers, and — to use what is to many a pejorative word — capitalists. Nevertheless, capital plays a pivotal role in providing the basis for the future standard of living of any society. Capital is essential for increasing productivity and thus providing the basis for rising real incomes. Increased capital formation also enhances our competitiveness in an increasingly global marketplace.

A rising stock of capital is necessary for a growing society. It is really a basic matter of how much we want to eat, drink, and be merry today, and how much we want to set aside for tomorrow. Boiled down to its fundamentals, assuring an adequate flow of saving and investment is little more than demonstrating a proper concern for the future.

A slow pace of capital formation in the United States is especially troublesome at a time of heightened global competition, when modern, state-of-the-art machinery and equipment are necessary to match foreign firms with low-wage structures. The increasingly international nature of business competition requires updating the American tax system to face up to these global realities. Unfortunately, the United States has much lower rates of saving and business investment than our economic competitors.

The reason for this shortcoming is clear: the current U.S. tax code is biased in favor of current consumption and against saving. Any doubt about this fact can be resolved quickly with a very simple example. Consider three workers, A, B, and C, each of the same age, with the same work experience and size of family, and with the same compensation. Mr. A regularly spends what he earns, no more and no less. Mrs. B, a saver, deposits a portion of her paycheck into a savings account each week. Mr. C not only spends everything he earns but also borrows to the hilt, having bought as expensive a house as he could obtain financing for.

It is interesting to compare the differential tax burden of these three workers. Clearly, Mrs. B, the saver, will have the highest tax bill, for she pays taxes on her wages as well as on the interest that she earns on her savings account. Mr. C winds up with the lowest tax bill, as he receives a tax deduction for the interest he pays on his large mortgage. Actual practice includes many variations in the tax treatment of specific financial transactions. Yet, for the average citizen, the existing personal income tax structure favors consumption over saving. In effect, the current system taxes saving twice, once when the income is earned and second when the saving generates interest, dividends, etc.

In addition, many of the government spending programs — such as welfare and food stamps — operate with a similar effect. Let us assume that A, B, and C all get laid off at the same time and that none of them obtains a new job. Mr. C, the big spender, and Mr. A, the pay-as-you-go man, will quickly be eligible to receive welfare, food stamps, and related benefits. The last to qualify for federal assistance will be Mrs. B, the big saver. Unlike the good Lord, the feds do not help those who help themselves. Clearly, the economy would benefit from the adoption of the principle that all income should be taxed only once.

Changing the Tax Structure

The United States uses consumption taxes to a far lesser degree than most other developed Western nations. In 1991, the 24 members of the OECD obtained an average 30 percent of their revenue from taxes on consumption. For the United States, the ratio was 17 percent.

The U.S. Treasury proposed a "spending tax" in 1942 as a temporary wartime measure to curb inflation. The proposal was quickly rejected by Congress. A major argument against such a tax — then and now — is that the exemption of saving would favor the rich, since they are better able to save large portions of their incomes. Some believe that this would lead to greater concentrations of wealth in the hands of a few. As we will see, proponents of a consumption tax respond that some versions can be made as progressive as desired.

The "savings-exempt income tax" is based on the current income tax, but exempts all savings.

Another objection to consumption-based taxation is that such a system would favor the miser over the spendthrift, even when both have similar spending power or ability to pay. The response offered to this argument is that consumption uses up the resources available to the nation, while saving adds to these resources. Thus, people should be taxed on what they take out of the society's pool of resources, not on what they put into it.

Tax experts have devised, and criticized, a variety of specific consumption-based taxes. No consensus has yet been reached on the details. It is likely that three interrelated clusters of issues will receive increased public attention in the 1990s: (1) the general desirability of a tax on consumption, (2) the specific form that it should take ("top-down" or "bottom-up"), and (3) whether it should replace or augment an existing tax.

There are two ma or types of consumption-based taxes. One is a "bottom-up" tax on individual purchases of goods and services. The United States provides many examples in the form of general sales taxes. In Western Europe and other industrialized areas, a variation known as a value-added tax (VAT) is customary. Like general sales taxes, a VAT is comprehensive. Essentially, valueadded is the difference between a business's sales and its purchases from other companies. The VAT is paid by each enterprise in the chain of production - manufacturer, wholesaler, and retailer. Duplication is avoided by taxing only the added value that the firm contributes to the goods or services it produces.

The second approach to consumption taxation is a "top-down" variation. This proposal, over the years, has been called an expenditure tax and a consumed-income tax. The current nomenclature is a "savings-exempt income tax." This tax is based on the current income tax, but exempts all savings. This revision would, in effect, change the income tax into a consumption-based tax. As will be shown, this form of taxation avoids many of the negatives associated with the VAT, while capturing most of the benefits. Conceptually, the base of the two types of consumptionbased taxes is the same (the value of goods and services purchased) and the yields from these taxes could be very similar.

The Value-Added Tax

A value-added tax (VAT) represents a very different way of collecting a general tax than most Americans are familiar with: It focuses on the sales of goods and services to consumers by individual companies. It is, in effect, a sophisticated and comprehensive sales tax which avoids the double counting other-wise inevitable when the same item moves from manufacturer to wholesaler to retailer. In total, a VAT should be equivalent in yield to a single-stage sales tax levied at the retail level.

Essentially, a firm's "value-added" is the difference between its sales and its purchases from other firms. Value-added can also be estimated by adding labor and capital inputs supplied by the firm itself — represented by wages and salaries, rent and interest payments, and profit.

Reasons for Favoring a VAT

Proponents of the VAT contend that it is economically neutral, because ideally it would be levied at a uniform rate on all items of consumption. It would not distort choices among products or methods of production. In that regard, the VAT is superior to the existing array of selective excise taxes.

Advocates of the value-added tax also point out that, in contrast to an income tax, there is no penalty for efficiency — profits are taxed equally as wages — and no subsidy for waste (a dollar of expense saved becomes a dollar of profits and is taxed equally). Moreover, the VAT is neutral between incorporated and unincorporated businesses and, theoretically, also between public and private enterprises. By focusing on consumption, it avoids a double tax burden on the returns from capital. This tax starts off with no exclusions or exemptions and thus, at least initially, provides a broader and fairer tax base, one that the underground economy will have more difficulty evading. Consumption taxes such as the VAT are levied on the returns to labor (wages and salaries) equally with the returns on capital (rent, interest, and profits). Thus, shifting to a more capital-intensive and perhaps more profitable method of production would not influence a firm's tax burden.

Another argument in favor of a value-added tax is that many other nations have adopted this form of taxation. It therefore fits in better than conventional taxes with the growing international character of production. The VAT has become one of the revenue workhorses of the world. Virtually every industrialized economy in Europe imposes the tax and it has spread throughout the Third World. The members of the European Union have used VAT taxation since the late 1960s or early 1970s. In 1989, Japan imposed a broad-based 3 percent sales tax.

However, unlike recent attempts to overhaul the United States tax code, the adoption of a tax on value-added was true reform in Western Europe. The VAT typically replaced an extremely inefficient form of consumption tax that was already in place, a cascading sales or turnover revenue system. Those latter taxes apply to the total amount of a firm's sales rather than only to its valueadded. Sales taxes, thus, would be paid over and over again on the same items as they moved from firm to firm in the various stages of the production and distribution process. Such cascadetype taxes favored integrated firms (that could legally avoid one or more stages of the tax), but they severely discriminated against independent companies that operate at only one phase of the production process.

An added, widely cited reason for adopting a VAT is the anticipated foreign trade benefits. Unlike an income tax, a sales-based tax can be imposed on goods entering the country and rebated on items leaving — supposedly encouraging exports and discouraging imports. Thus, at first blush, a VAT would seem to help reduce this nation's presently large deficit. However, most economists believe that fluctuations in exchange rates would largely offset these initial effects and result in little change in the balance of trade.

Reasons for Opposing a VAT

Opponents of a value-added tax offer an extensive list of shortcomings. They contend that a VAT is inherently regressive — those least able to pay face the highest rates because, on average, the higher your income the smaller proportion you spend on current consumption. That regressivity can be softened by exempting food and medicine or by refunds to low-income taxpayers, but such variations make the collection of the tax much more complicated. They also provide opportunity for people in the underground economy to avoid paying taxes.

Because the VAT is included in the price of purchases, it registers in the various price indices and, hence, exerts an. inflationary force on the economy. The counterargument to this charge is that any price increases would be only a one-time effect, occurring when the tax is enacted or increased. However, there would be secondary inflation effects resulting from the operation of automatic escalators in wage and price agreements. That inflationary impact could in turn be offset by appropriate changes in monetary policy, albeit at times with an adverse effect on the levels of production and employment.

Imposition of a value-added tax in the United States would require establishing a new tax-collection system by the federal government and additional recordkeeping on the part of business taxpayers.

Opponents also charge that a VAT would invade the area of sales taxation, traditionally reserved for state and local governments. However, most states and some localities have come to rely on income taxes despite heavy use of the same tax base by the federal government.

Turning to the administrative aspects, imposition of a VAT in the United States would require establishing a new tax-collection system by the federal government and additional recordkeeping on the part of business taxpayers. This would be a vast and expensive undertaking. The Treasury Department, based on European experience, believes it would need 18 months after enactment to begin administering a VAT.

A variety of approaches has been suggested for collecting a new VAT. The simplest is the credit method (see Table 1). Under this approach, the tax is computed initially on a company's total sales and the firm is given credit for the VAT paid by its suppliers. To a substantial degree, such a VAT would be self-enforced. Each company would have a powerful incentive to ensure that its suppliers paid their full share of the tax, because any underpayment would have to be made up by the next firm in the chain of production and distribution.

Table 1

Computing the VAT Using the Credit Method

	Raw Materials Producer	Manufacturer	Wholesaler	Retailer
Sales of output	$100	$500	$800	$1,000
Less:				
purchases	0	100	500	800
Equals:				
Value-added	$100	$400	$300	$200
Tax on total sales	$10	$50	$80	$100
Credit on				

purchases	--	10	50	80
Equals:				
Tax liability	$10	$40	$30	$20

Note: Assumes a 10 percent VAT calculated on a consumption basis.

In practice, the collection of the VAT may not be as simple as shown here. That would be the case if certain transactions were exempted (such as food) and if nonprofit institutions and government enterprises were treated differently from business firms. Exemptions are no minor matter in terms of the administrative complexity that they generate. In France, a long and extensive debate occurred over whether or not Head and Shoulders antidandruff shampoo was a tax-exempt medicine or a cosmetic subject to the full VAT.

The Savings-Exempt Income Tax

A new approach to a consumption-based tax has been proposed by Senators Pete Domenici (R-N. Mex.) and Sam Nunn (D-Ga.) in the form of a savings-exempt income tax.

Taxes on Individuals and Families

As we have seen, the VAT suffers from a number of possible complications, such as inflation, regressivity, and administrative burden. In contrast, a savings-exempt income tax would be collected much as income taxes currently are. It would be levied directly on the taxpayer. The annual taxpayer return would continue to comprise the heart of the collection system, containing exemptions and deductions, as at present. However, one fundamental change would be instituted: the portion of income that is saved would be exempt from taxation.

A savings-exempt income tax is essentially the equivalent of a universal but simplified IRA, using an amended rate table.

This type of tax has been known by a variety of names, a fact that can unnecessarily complicate policy debates. Many prefer to call it a consumption tax, for the intent is to tax what people spend, not what they save. Another frequent name is expenditure tax. The most recent congressional label attached to this proposal (and the name that this report uses) is the savings-exempt income tax.

Figure 2 illustrates a hypothetical example of a "short form" version of a savings-exempt income tax return. It shows how the difficult bookkeeping requirement to tally all consumption outlays could be structured. The illustrative tax form is based on the notion that income equals consumption plus saving. Thus, consumption can be readily estimated, indirectly but accurately, merely by deducting saving from income — and taxpayers are used to developing estimates of their incomes. That new schedule of saving during the year would include changes in bank balances and in holdings of bonds, stocks, and similar investment assets.

To a typical taxpayer, a savings-exempt income tax is essentially the equivalent of a universal but simplified IRA, using an amended rate table. Each of us would decide how much to save and in what form. Many benefits would result. Take the current tax treatment of housing: a bigger down payment, and thus lower interest payments, gives one a smaller tax break. But why should tax policy discourage investing in a home? Under a savingsexempt income tax, down payments and payments of principal would be fully deductible (as would a limited amount of interest on the mortgage). After all, building equity — in a home or business — is a form of saving and investment. Home equity loans that tap into this investment would not be rewarded with tax deductions, as they are under current tax law.

Figure 2

Savings-Exempt Income Tax Illustrative Tax Return

Income and Other Receipts		Amounts
1.	Wages, salaries, tips, etc.	____
2.	Dividends	____
3.	Interest	____
4.	Rents and royalties	____
5.	Pensions and annuities	____
6.	Net receipts of sole proprietorships	____

7.	Withdrawals from partnerships	____
8.	Receipts from:	
	a. sales of financial assets	____
	b. gifts and bequests	____
	c. insurance	____
9.	Net decrease (if any) in bank accounts	____
10.	Total (add lines 1 through 9)	____

Saving

11.	Purchases of financial assets	____
12.	Capital contributed to partnerships	____
13.	Net increase (if any) in bank accounts	____
14.	Other investments (equity in a home)	____
15.	Total (add lines 11 through 14)	____
16.	*Net Income* (subtract line 15 from line 10)	____

Deductions

17.	A. Itemized deductions	____
	or	
	B. Standard deduction	____
18.	Exemptions	____
19.	Total deductions (add lines 17 and 18)	____

Tax Base

20.	Taxable Income (subtract line 19 from line 16)	____
21.	Tax from rate table	____

The first reaction by many people to a savings-exempt income tax is that it is unfair because it must be regressive. If this were true, poorer people would pay a larger share of their income in taxes than would wealthier Americans. However, the savings-exempt income tax need not be regressive at all. Like the existing income tax, each taxpayer would face a rate table that could be made as progressive as desired. Under the revenue-neutral shift from the traditional income tax contemplated here, the average taxpayer experiences no change in tax burden. However, at each income level, above-average savers would pay less than they do now and below-average savers would pay more.

The basic idea is that the new tax structure would raise as much federal revenue as the existing system (that is known as being "revenue neutral"). In the longer run, the savings-exempt income tax could generate more revenue — or permit rate reductions — to the extent that the added savings stimulate economic growth which, in turn, increases the tax base while it reduces the demand for unemployment benefits and other government spending.

Most importantly, the savings-exempt income tax is not a new or an added tax: it is a simple change in the existing IRS tax collection system. Current restrictions on IRAs, Keogh accounts, and other specialized forms of investment would be eliminated. All savings would be exempt from taxes. Thus, the savingsexempt income tax does not suffer from the administrative burden associated with a VAT, which would require setting up a new taxcollection system and new recordkeeping, causing overhead costs to rise in both the public and private sectors. From the viewpoint of the taxpayer, the current bookkeeping and administrative requirements would actually be reduced under a savings-exempt income tax system.

For example, the Nunn-Domenici version of the savings-exempt income tax does not differentiate among different income sources: wages, salaries, interest income, capital gains, and dividends are all treated equally. We may never again achieve the level of simplicity offered by the original 1913 income tax: its 1040 form was three pages long, accompanied by one page of instruction, and filed by only one percent of the population. However, the savings-exempt income tax is still a drastic simplification of the current individual tax code that is estimated to cost taxpayers $50 billion in compliance costs annually.

Because the savings-exempt income tax is not a new tax, it will not generate an added source of income for the U.S. Treasury. Thus, its enactment would not encourage the further expansion of the public sector. A VAT, by contrast, is a new tax that would be an addition to the current array of taxes levied by the federal government.

For a while, the United States was moving toward a form of savings-exempt income tax, albeit indirectly and in modest steps. The establishment of individual retirement accounts (IRAs) enabled many federal taxpayers to defer paying taxes on amounts saved and invested in an IRA (up to $2,000 a year). Also, the first $100 of dividends per taxpayer was exempt from income taxation. The 1986 tax law, however, sharply cut back on IRAs and eliminated the dividend credit.

The Business Cash-Flow Tax

Tax incentives to promote saving do not suffice in responding to the desire for more rapid economic growth. A larger amount of new investment is also necessary. To accomplish this, a business counterpart to the savings-exempt income tax should replace the current corporate income tax and provide greater stimulus to investment. Two current congressional proposals would replace the corporate income tax with a cash-flow tax: the Boren-Danforth Business Activities Tax (BAT) and the Business Tax in the Nunn-Domenici plan.

The Business Tax proposed by Senators Nunn and Domenici would levy a flat 10 percent tax on the cash flow (total sales minus purchases) of most businesses: very small businesses — a group that files the majority of business tax returns, but pays only a small fraction of the total tax collected — will probably be exempted from the cash-flow tax altogether, as will most nonprofit organizations. The earnings of unincorporated businesses are not taxed until the money is withdrawn for personal use. Export sales are excluded from the tax base and a tax equal to the Business Tax rate is levied on imports entering the country. This tax treatment is designed to provide a "level playing field" for products sold within the United States.

One important feature of the Nunn-Domenici proposal is its treatment of the current employer payroll tax. All firms are required to pay a 10 percent tax on their cash flow, including the amounts paid to employees as salaries and wages. However, firms are given a full credit for their payment of the 7.65 percent employer payroll tax for social security. This reduction of their payroll tax liability is designed to help offset the new tax on labor inputs and other cash flow.

In computing the cash-flow tax, each firm would add up all its sales during the year, and then deduct the cost of any purchases it makes from other businesses during the year (i.e., plant and equipment, outside services, parts). The remaining cash flow is the tax base, which would then be taxed at the designated rate (see Figure 3 for a hypothetical computation of the Nunn-Domenici cash-flow tax). Remaining after-tax cash is available for payments of wages and salaries, dividends, interest, or otherwise reinvested in the business.

A cash-flow tax would drastically simplify the current business tax structure, allowing firms to devote fewer resources to complying with tax regulations and more resources to productivity-increasing investment.

The key characteristics of the Nunn-Domenici cash-flow tax are:

1. The cash-flow tax applies to all businesses, regardless of their legal form: corporations, partnerships, individual proprietorships, etc. Unincorporated firms currently taxed under the individual collection system will, instead, pay the business cashflow tax. This eliminates the incentives for companies to structure themselves in ways that are less productive just to take advantage of tax differentials.

2. Because it is a tax on cash flow, capital purchases are treated in the same way as other expenditures: they are deducted in full at the time of purchase (i.e., "expensed"). Because of this, firms have strong incentives to invest in productivity-enhancing capital equipment. Furthermore, there are no onerous accounting requirements for depreciation, estimates of an asset's useful life, or the other arcane complications required by the current tax system.

3. The current tax advantage afforded to borrowed capital compared to equity — because interest payments are now tax deductible but dividend payments are not — is eliminated.

Figure 3

Hypothetical Computation of Cash-Flow Tax

Total Sales	____
Deduct: Exports	____
Equals: Domestic Sales	____
Deduct:	
Purchases from other firms	____
Capital outlays	____

Equals:	Cash flow	____

Calculation of cash-flow tax:

	Cash flow times the tax rate	____
Equals:	Gross tax	____
Deduct:	Employer paid social security tax	____
Equals:	Cash-flow tax liability	____

Note: Cash flow covers employee compensation, dividend and interest payments, and retained funds.

This type of cash-flow tax is superficially similar to a VAT: both taxes use the same tax base of sales minus purchases. However, the cash-flow tax differs from the VAT in several important respects. First, the cash-flow tax is intended as a replacement to the corporate income tax, not as an additional sales tax. Second, the cash-flow tax lacks the administrative complexities of a VAT, which requires firms to track on an invoice-to-invoice basis the amount of tax attributable to each transaction.

Indeed, a cash-flow tax would drastically simplify the current business tax structure, allowing firms to devote fewer resources to complying with tax regulations (and on devising creative methods to minimize their tax burden), and more resources to productivityincreasing investment. For example, the cash-flow tax would eliminate bizarre, complicated tax provisions such as the "amortization of intangible expenditures," a procedure that depreciates purchases of patents, licenses, and other intangibles. Such complicated law contributes to the high costs of tax compliance: the Tax Foundation estimated that business tax compliance costs in 1990 totaled $112 billion, a sum nearly equal to 75 percent of federal corporate income tax collections. The simplifications offered by a cash-flow tax would particularly aid small business.

The second congressional proposal to replace the corporate income tax — the Boren-Danforth Business Activities Tax (BAT) — is similar to the Nunn-Domenici cash-flow tax, but with important differences. Under the BAT, firms would be taxed at a flat rate of 14.5 percent on the sum of:

- Labor services (wages, salaries, benefits)
- Capital services (interest to creditors, profits to owners)

Small businesses (those with less than $100,000 in gross yearly sales) would be exempt from the tax. Like the NunnDomenici plan, certain non-profit businesses (schools, charities, medical institutions) are exempted from the BAT, as are most governmental agencies except enterprise-type activities. Unincorporated businesses (such as partnerships and sole proprietorships) would pay taxes only on income distributed to owners, and not on income retained within the business.

Miscellaneous Provisions

The BAT attempts to deal with the concern over regressivity by using some of its proceeds to triple the individual standard deduction and to expand the earned income credit (both are provisions used mainly by low income taxpayers). Under the BAT, social security taxes paid by employers and employees are cut in half. The Nunn-Domenici approach provides a full tax credit for the employer contribution. In addition, lower-income families (perhaps those with combined earnings less than $25,000) would also receive a tax credit for some portion of their contributed payroll taxes. This credit would be phased out for mid-income families (earnings of $25,001-$50,000), while high-income families (those earning more than $50,000) would receive no payroll tax credit.

The Nunn-Domenici plan also expands the earned income tax credit by about 30 percent and exempts households with low incomes from the savings-exempt income tax altogether. For example, a family of four might not pay any federal taxes on their first $25,000 of consumption. A graduated rate schedule provides further assurance that the savings-exempt income tax is a progressive tax.

The Boren-Danforth proposal excludes exports from a firm's taxable receipts. Moreover, deductions are allowed for the purchases of inputs that produce these exports. Therefore, firms that primarily export their products or services would typically receive tax refunds, as their purchases exceed their taxable gross receipts. While acknowledging the desire to promote exports from the United States, rewarding exporters with cash refunds from the government is, in essence, a disguised federal subsidy.

The short-run complications caused by these major changes in the tax system are likely to be far more than offset by the long-run advantages.

Both the Boren-Danforth and Nunn-Domenici proposals are designed to be revenue neutral. They do not initially provide the federal government with additional funds. Thus, they are not new taxes, but are instead designed to be more efficient replacements for the current corporate tax. As with any major change in the tax system, in the period of transition from the old to the new, a variety of short-term adjustments will be necessary. The shortrun complications are likely to be far more than offset by the longrun advantages.

Conclusion

A "top-down" savings-exempt income tax would achieve many of the same budgetary and economic benefits associated with a VAT while avoiding its many shortcomings. Converting the current income tax to a savings-exempt income tax — unlike adopting a new tax on value-added — does not require setting up an additional collection system. Nor is it regressive or inflationary. In contrast, a value-added tax becomes extremely complicated if an effort is made to soften its inherent regressivity by exempting certain categories of expenditures or taxing them at lower rates (e.g., food and medicine). Unlike a VAT, a savings-exempt income tax does not provide the federal government with a new revenue source. Therefore, the public sector has no special temptation to grow more rapidly.

It is not surprising that politicians in many countries favor sales-type taxation on the assumption that, politically, the best tax is a hidden tax. "Bottom-up" sales taxes such as a VAT are rarely identified separately, as the purchaser merely pays a combined product-plus-tax price. Therefore, that type of tax forces business firms to act as the middlemen (or women) between government and the consumer. Many companies marketing consumer products fear that the higher prices resulting from the imposition of a VAT would reduce their sales and earnings. Conversely, companies selling capital equipment and business services tend to take a more sympathetic attitude toward this form of government revenue, which would lighten the tax burden on their customers and, hence, tend to-expand their markets.

The impact of the comprehensive savings-exempt income tax, in contrast, would not be shielded from the knowledge of the taxpayer and would not be likely to generate the differential reactions that flow from the VAT. In any event, a shift in emphasis in U.S. taxation from income-based to consumption-based should on balance generate positive results, especially in helping to move the economy to a more rapid expansion path and, thus, enable the American people to enjoy a higher living standard while reducing the federal budget deficit.

The combination of a savings-exempt personal income tax and a companion business cash-flow tax would initially be revenue neutral compared to the income tax system that it displaces. However, over the years, it would generate more revenue for the U.S. Treasury. This is likely because such a tax system encourages more saving to finance additional investments in a growing economy. The tax reform proposed in this report is one of the few pain-free ways of reducing the federal budget deficit.

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ARTICLE

THE UNAMERICAN SPIRIT OF THE FEDERAL INCOME TAX

>SENATOR PETE V. DOMENICI **fn***

In this Article, Senator Domenici makes a powerful case against the "anti-saving, anti-growth" aspects of the current federal income tax and proposes replacing it with a progressive consumption tax, or "savings-exempt" income tax. Along with Senator Sam Nunn, Senator Domenici has developed a proposed consumption tax, which he discusses in detail in this Article, explaining the policy reasons behind the proposal and candidly highlighting unresolved issues. Senator Nunn and Senator Domenici have not reached final agreement on all topics discussed in this paper; this Article represents Senator Domenici's current thoughts on these unresolved issues. Senators Nunn and Domenici plan to hold a series of seminars and hearings about their proposal.

In 1984, with the publication of Treasury I, the movementfor tax reform began in earnest. Today, Senator Domenici's Article illustrates continued Congressional pressure for tax reform and may provide a preview of the road ahead.

The American entrepreneurial spirit of risk-taking and investing in the future has been shackled by the American tax code. The tax code has become more a mechanism for redistributing wealth than an engine and incentive for creating wealth.

In 1986, Congress attempted to restore the entrepreneurial values of simplicity, fairness, and economic growth to the tax code. For those who supported the 1986 reform, our proposal completes the unfinished agenda of 1986. For those who thought the 1986 reform went astray, *this* is our opportunity to correct its fatal flaws. And for those who believe that the 1993 rate increases repudiated the 1986 tax reform covenant of lower rates in exchange for a broader base, we propose to begin the reform movement again. We propose to abolish the entire income tax system and replace it with a system that taxes only income that is consumed.

The way a country taxes its people deeply influences its potential for economic growth: therefore. reform is no small matter. Long ago, the Supreme Court recognized the power to tax as the power to destroy.[1] As the federal income tax has grown from affecting slightly less than one percent of the population to affecting practically everyone and every productive endeavor, its destructive power has become unamerican in spirit and wrong in principle. As its top marginal tax rate has risen from the initial one percent (with a surcharge of up to six percent) to today's top rate of 39.6%,[2] it has become an impediment to entrepreneurship, industriousness, and thrift.

As Supreme Court Justice Potter Stewart noted nearly twenty years ago, "our economy is 'tax relevant' in almost every detail."[3] Today, taxes have become an increasingly important factor in investment decisions as other barriers to international capital flows have disappeared. As governments make unilateral, bilateral, and multilateral trade policy decisions to reduce investment restrictions and foreign exchange controls, differences in the way countries tax capital income generally, and corporate profits in particular, are among the few remaining barriers to efficient international allocation of capital. Therefore, each country's tax system is playing an increasingly prominent role in companies' decisions about where to invest and where and whether to finance investment with debt, new equity, or retained earnings.

The world economy has evolved, and in so doing, has changed our domestic economy. While other countries provide substantial tax deductions for savers, and even require citizens to save,[4] our tax code penalizes savers. Though the national savings rate is extremely important, most Americans do not understand the multifaceted role national savings plays in our economy or the damage done by our low national savings rate. Most observers agree that if we could increase our savings rate we would benefit from hio,her investment, higher productivity growth, and a higher future standard of living. Unfortunately, our federal income tax system has not kept up with the increasing integration of the global economy or with the practices of our competitors.

Instead of changing to meet the global challenge, our tax code has become weighted down with outdated jargon and legal fictions. Left unchanged, it threatens our long-term economic growth and prosperity. The tax code is as close as this country comes to an enacted industrial policy, but most of our tax incentives encourage the wrong activities. The details of the federal income taxation system currently on the statute books are anti-growth, anti-savings, anti-investment, and anti-job.

I. WHERE DID IT ALL BEGIN?

Prior to the enactment of the federal income tax in 1913, the United States relied on a series of high tariffs and excise taxes at the federal level and property taxes at the state and local levels. By the end of the nineteenth century, this system had drawn fire from several quarters. Citizens from agrarian states felt they were paying more than their fair share of taxes in the form of high commodity prices generated by protectionism. These "invisible taxes" added their weight of misery to the plight of the poor. Because the tariffs and excise taxes were regressive, a poor man with a large family could pay more taxes than a rich man with a small family. Representatives from western and southem states called for a new income tax to mitigate that burden and lower the cost of living for the working class. Furthermore, during the 1880s, popular resentment of the swollen fortunes of the Vanderbilts, Whitneys, Morgans, and Rockefellers helped to stimulate egalitarian calls to "tax the rich." Finally, many believed that local property taxation was being evaded on a grand scale.[5]

Based on these concerns, a growing number of constituencies supported an income tax. The Taft Administration supported a constitutional amendment to allow an income tax because it wanted a secure revenue source adequate to finance a major war should the need arise. Populists wanted to end the special privileges of the giant industries and to punish corporations and the wealthy. The Progressives wanted government to do more, and businessmen wanted predictability.[6]

After the Supreme Court's decision in *Pollock v. Farmers Loan and Trust Company*[7] foiled early attempts to enact a federal income tax, ratification of the Sixteenth Amendment to the Constitution on February 25, 1913, permitted the federal government to tax income and removed the barriers to a federal income tax on individuals.

On October 13, 1913, President Woodrow Wilson sicned the Underwood-Simmons tariff bill, enacting the first income tax under the authority of the Sixteenth Amendment. Slightly more than one percent of the population had incomes large enough to be subject to the new tax. Since the average American worker in 1913 made less than $1,000, and tax liability did not accrue until taxable income reached $3,000, the *New York Herald* predicted that many new taxpayers would proudly display their income tax receipt as evidence of their "value and standing in the commercial world."[8] In the beginning, it was a modest tax, with a rate of one percent on incomes between $3,000 and $20,000, less deductions and exemptions, and graduated surtaxes of up to six percent on higher incomes.[9]

The 1913 version of the 1040 form was four pages long, including one pacre of instruction. Unmarried individuals were allowed a deduction of $3,000 while married couples could deduct $4,000. Other authorized deductions included personal interest paid, business losses, losses from "fires, storms, or shipwreck" not compensated by insurance, all other taxes paid, bad debts, and "reasonable" depreciation of business property.

According to the Treasury Historical Association, when the first income tax was due throngs of newly initiated taxpayers crowded Internal Revenue Service offices to pay, and some of them were glad to be there.[10] At that time, Representative Cornell

Hull, then chairman of the Ways and Means Committee, labeled the income tax "the fairest, most equitable system of taxation that has yet been devised."[11] "[A]mazingly ... most Americans actually welcomed the tax." [12]

Perhaps those statements were true in 1913, but in 1994, they no loncer reflect reality.

II. WHERE DID IT ALL GO WRONG? AN INDICTMENT OF THE CURRENT TAX CODE

The federal income tax code is unamerican in spirit and wrong in principle. Because it levies a double tax on dividends and taxes savings, it discourages risk-taking, entrepreneurship and the creation of jobs. It is hostile to savings and investment and tilted toward consumption. Savers are penalized and consumers are not—the tax favors debt financing over equity and hampers international competitiveness. Finally, it encourages corporate management to neglect long-term investment in favor of focusing on short term profits.

This lack of saving leads to a shortage of investment, which, in turn, leads to insufficient growth, stagnating incomes, and the loss of high-wage jobs. And the increased costs of capital created by the current tax system often affect the initial decision to invest, the decision to modernize, and the development of new products. [13]

A. The Current Code Unfairly Increases the Cost of Capital

Our current tax code adds to the cost of capital. Professor John B. Shoven of Stanford University estimates that taxes account for up to one-third of U.S. capital Costs. [14] When other countries have lower costs of capital, investments can be made there that would not be profitable in the United States. In 1990, it was estimated that U.S. capital costs were approximately twice those of Japan, 60% higher than those of the United Kingdom, and 30% higher than those of the former West Germany. For a typical piece of equipment financed with equity and with an assumed five-year life, the cost of capital was 10.4% in the United States in 1988 compared with 4.1% in Japan-the cost of capital is 153% higher in the United States.[15]

The Tax Reform Act of 1986,[16] (TRA), was aimed at "leveling the playing field" on which alternative investments compete for capital. However, only part of the playing field was actually leveled by TRA. According to one prominent economist, "Eliminating the Investment Tax Credit (ITC) and lengthening the depreciation period actually widened the distortion between investments in tangible business capital and other forms of spending, thereby favoring spending on advertising, temporary price competition to enlarge market shares, and household spending on first and second homes and major consumer durables."[17] Indeed, some estimates indicate that repeal of the investment tax credit, longer depreciation periods, the comparatively high capital gains tax, and the stiff alternative minimum tax (AMT) make capital acquired in the United States the most expensive in the world.[18]

To make matters even worse, in 1986 Congress enacted a second system of corporate taxation, the AMT.[19] Under this new system, taxpayers are required to pay the higher of the regular tax or the AMT. The AMT is particularly harmful to companies that do the "right stuff"—namely, investing for the long-term, investing to modernize, and investing to compete. The more a company invests in productivity-enhancing equipment and new plants, the more likely it will get caught in the AMT tax trap.[20]

Experience proves that the AMT is a perverse tax on capital that gets progressively more punitive the longer the taxpayer falls under it. Moreover, the AMT is most punitive when balance sheets are weakest. For example, the AMT burden gets heavier during recessionary periods, because as profits drop it is more likely that previously made investments or investments in new productive assets will trigger the AMT.

> Investments in new productive assets increase the total difference between regular depreciation (MACRS) and depreciation allowed under the AMT, thereby creating or aggravating the AMT liability. To relieve this situation and allow full utilization of accumulating Minimum Tax Credits (MTCs) corporations may have no choice but to reduce their level of investment.[21]

The ramifications of such a perverse investment policy for our world competitiveness are obvious and widespread. An estimated 40 to 60% of the largest U.S. corporations are paying tax under the AMT.[22] This tax-driven pressure to reduce the level of investment means that our economic recoveries will not be as strong as they would be absent the AMT.

B. The Current Code Makes American Exports Less Competitive

While the current tax system discriminates among various investment types and between regular and AMT-paying competitors, it also hampers the ability of U.S. companies to sell abroad. Many of our international competitors understand that most consumption taxes are superior to income taxes for enhancing export competitiveness. For example, former Japanese Prime Minister Morihiro Hosokawa recently proposed reducing Japan's income tax and raising its consumption tax from 3% to 7%. [23]

Japan is neither alone nor ahead in this trend toward a greater reliance on consumption taxes. As we decide whether to change our tax system, we should bear in mind our competitors' increasing use of consumption taxes and, conversely, our greater reliance on income taxes. For example, in 1993 Germany obtained about 23% of its total revenues from consumption taxes. The comparable figures are 28% for France, 31% for the United Kingdom, and 17% for Japan. Only about 4% of our federal government's revenue comes from consumption taxes in the United States, mainly in the form of selective excise taxes and tariffs. [24]

Unlike our current income tax system, a greater reliance on consumption taxes would enhance our export competitiveness by allowing a border adjustment for goods we export. Under the General Agreement on Tariffs and Trade (GATT), a purchasing country that levies consumption taxes may make border adjustments so that the country where the product is purchased and used taxes it. Likewise, the country producing the product is allowed to make a border adjustment (usually in the form of a tax rebate) relieving the exported goods of the producing country's tax burden. Most of our competitors have border-adj u stable tax systems. We do not. Such systems allow them to sell their products in the global market unburdened by domestic tax costs, while American exporters must pay domestic taxes before shipping their products abroad, and they get no rebate.

C. The Current Code Penalizes Savings

Another disturbing result of our federal income tax system is that our net domestic savings rate compares poorly with that of our competitors. In international comparisons, a country's net domestic savings rate correlates very strongly with that country's economic growth. Many of the economies that demonstrate high rates of net domestic savings have achieved higher rates of investment than those economies with low rates of domestic savings.[25]

Singapore has a domestic savings rate of over 42% of GDP; Malaysia's is almost 30%.[26] The World Bank has cited these countries as the "East Asian Economic Miracles" recognizing their extraordinary rates of economic growth.[27] The experience of these countries contrasts sharply with that of the United States, which, in 1992, manaoed a rate of net household savinas as a percentage of disposable household income of 5%[28] and a modest economic growth rate of only 2.6%.[29] Even the more mature economies of Japan, Germany, Canada, and France have better savings rates than the United States.[30]

"Productivity isn't everything, but in the long run it is almost everythine."[31] Therefore, we must increase our savino's or suffer the consequences of low productivity growth.[32] Our low savinas rate contributes to our relatively high cost of capital and our low level of investment. In turn, this dearth of capital investment dampens growth in productivity, incomes, and our standard of living.

As a matter of personal finance, most Americans are out of the savinas habit and do not realize how financially "out of shape" they are. In particular, most Americans do not know how much they should be saving for their own retirement. A 1992 study commissioned by Merrill Lynch and prepared by Dr. B. Douglas Bernheim of Princeton University concluded that the oldest baby boomers — those born between 1946 and 1956 — are saving barely one-third of what they need to maintain their pre-retirement lifestyle after they retire at age sixty-five.[33]

Although many observers concur with Bernheim's view,[34] the Congressional Budget Office (CBO) paints a different picture.

> [B]aby boomers in general will have higher real retirement incomes than older people today for a variety of reasons. First, as long as real wage growth is positive on average during the next 20 to 40 years, boomers will have higher real preretirement earnings than today's older people had in their working years. With current law, this growth will increase the level of boomers' Social Security benefits. Pension benefits will be higher as well, and higher earnings now will enable boomers to save more for retirement. Second, increases in women's participation in the labor force imply that more boomers will have acquired additional years of work experiences before retirement . . . . Third, boomers will be more likely to receive income from pensions as a result of recent changes in the pension system. Finally, baby boomers may inherit substantial wealth from their parents.[35]

While CBO forecasts a potentially bright future for the well educated, it also forecasts a "distinctly gloomy" picture for those without many marketable skills.[36]

To most of our citizenry, economic growth sounds like an abstraction. But enhancing long-term economic growth is the key to ensuring America's future, and increasing the saving rate *is* the fundamental building block for achieving that growth.

> Our highest priority must be to address the low level of saving in America and improve the allocation of that saving to its most productive uses. Until we do that, talk of [industrial policy] or even wider reforms is simply a waste of time for the same reason that you don't worry about tacking in a new direction if your sails are full of holes and the water is over the gunwales. First things must always be first. [37]

D. The Current Code Imposes a Double Tax on Corporate Earnings

Over the past twenty-five years, most of our trading partners have integrated their corporate and shareholder taxes to mitigate the impact of imposing two levels of tax on corporate profits distributed as dividends. Most typically, this has been accomplished by providing the shareholder-taxpayer with a full or partial credit for taxes paid at the corporate level.[38] Unlike our competitors, we continue the dividend double taxation habit.

Moreover, we seem unable to muster the political will to provide a meaningful capital gains differential which would enhance new investment by freeing up $1 trillion in currently locked-in investment. Although we have created a "back-door" capital gains differential by raising the top personal income tax rate to 39.6%, that differential is still subpar when compared to our competitors.

To understand why the U.S. treatment of capital gains is inadequate when compared to that of our competitors, consider their policies. Three of the ten foreign industrialized countries — Belgium, Italy, and the Netherlands — do not tax capital gains at all. In addition, Germany does not tax capital gains on assets held longer than six months. Canada, France, Japan, and Sweden tax capital gains at rates ranging from 16 to 20%. Hong Kong and four Pacific Basin countries — Malaysia, Singapore, South Korea, and Taiwan — do not tax capital gains. Given these policies, some economists suggest that the most efficient capital gains tax rate for the United States would be about 18%. [39]

E. The Current Code Suffers from Mind-Boggling Complexity Yet Still Fails to Collect $127 Billion Each Year in Owed Taxes

Some observers have predicted that our tax system may die of its own complexity. Section 61 of the code defines the tax base, and answers the fundamental question: "What is income?"[40] Hundreds of sections set forth the exceptions and preferences. In 1953, Albert Einstein commented that "the hardest thing in the world to understand is the income tax."[41] Imagine how Einstein would have reacted to the enactment of the increasingly complex tax bills of the 1960s, 1970s, 1980s, and early 1990s.

The tax code's complexity costs Americans over $50 billion annually in compliance costs.[42] This is more than the GDPs of Iceland and Ireland *combined*.[43] And it appears that compliance costs are growing. For individual filers, "[flhe average real expenditure on fees to advisors rose by 47 percent between 1982 and 1989."[44]

Despite the tax code's complexity and far-reaching nature, the Internal Revenue Service calculates that up to $127 billion in owed taxes goes uncollected each year.[45] This growing tax gap is another count in the indictment acainst our current tax code.

F. Summary of Indictment

If we are to perform well in the competition among nations, we need to address our federal tax system's shortcomings. In 1913, when America adopted an income tax system, we followed the lead of fifty-two of our most significant competitors. However, our competitors have long since abandoned their heavy reliance on income taxes in favor of consumption taxes.

Before we enact another round of taxes to pay for health care reform, cobbling new taxes onto the old, anti-saving, loophole-encrusted system, Congress should engage in a little intellectual introspection to address the basic problems inherent in the income tax. Senator Nunn and I encaaed in such an exercise when we acyreed to co-chair the Strengthening of America Commission.[46] The Commission undertook a three-year assignment under the auspices of the Center for Strateggic and International Studies (CSIS) to determine the right steps to put our fiscal house in order. Our commissioners, and the experts we consulted, were asked to put aside their individual agendas and act as statesmen, so that the Commission would adopt bipartisan recommendations that best serve the nation's long-term economic interest.

Commissions are not usually the forum for bold or unequivocating statements. However, one of the Commission's key recommendations was to "[a]bolish the current income tax system in favor of a new system that would stimulate greater savings, investment and jobs . . . [and create a] consumption-based in come tax system that will gear the economy for growth and be both progressive and fair in its impact."[47] In reaching our recornmendation to abolish the current income tax system we recognized that it must be replaced with something better; in doing so, we parted company with those who would repeal the federal income tax without replacing it.[48]

Over the years we have learned that the method of taxation is as important as the rate of taxation. As Henry George once observed, "As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be impoverished and their power of producing wealth destroyed by taxation, which if levied another way, could be borne with ease."[49]

Over the last eighty years, our tax system has become that "burden badly placed," diminishing, if not yet destroying, our power to produce wealth. It has evolved into everything an efficient tax system should not be. It is complicated, laden with excessive recordkeeping, internationally anti-competitive, and generally misguided.

Senator Nunn and I have a better idea. We believe taxing income that is consumed rather than income that is earned would produce a better-placed tax burden.

III. THE NUNN-DOMENICI PROPOSAL FOR A "SAVINGS-EXEMPT" TAX SYSTEM

We believe that it is more efficient and more equitable to tax income that is consumed than it is to tax income simply because it is earned. Consumed income is a good index of a citizen's ability to pay taxes as measured by what a person withdraws from society. What a citizen consumes provides prima facie evidence of well-being; in contrast, what is received as income ignores the citizen's contribution to society through his or her labor and investment choices. A person's ability to consume is a sophisticated and multi-faceted indication of his or her ability to pay taxes because it is determined by income, net worth, and prospects for the future, depending on whether earnings are expected to remain constant and secure or irregular and uncertain. At best, income provides only circumstantial evidence of wellbeing. Income is a one-dimensional, rough measure of what a person contributes to society through work and investment choices. Using that contribution as the tax base penalizes hard work and is wrong in principle.

In reasserting the equities of taxing consumption rather than income, we dispute traditional thinking that income is the best measure of a citizen's ability to pay taxes. Our assertion revives the consumption tax theory that first developed in the seventeenth century writings of Thomas Hobbes.[50]

Senator Nunn and I want a tax code that encourages the creation of greater wealth, not just the redistribution of existing wealth. Under the current income tax code, the most straightforward approach to tax minimization is simply to "consume leisure" rather than earned income. Non-economists might recognize this phenomenon as "slacking off." We think this is unamerican in spirit, yet it is the only audit-proof escape route from the basic philosophy of "ability to pay" based on what is earned. Our current system reduces the incentives to work, save, and invest. It is difficult to explain why we keep it on the books. Under the Nunn-Domenici proposal, the Congressionally blessed and IRS-approved method to minimize tax liability would be to save and invest more. Our proposal recognizes that savings and investment are at least as productive and useful to our society as paying taxes to the federal government.

The guiding principle behind our reform is that all income should be taxed once and only once. Under this proposal, no income would escape taxation permanently. To achieve this goal, the tax system could either tax the capitalized value of an income stream (seed capital) without taxing the income stream itself, or not tax the initial investment but tax all subsequent earnings and returns of capital. The former corresponds to what is sometimes called an "unlimited back-ended Individual Retirement Account (IRA)," while the latter corresponds to the frontloaded IRA available to some taxpayers under current law.[51] Regardless of the path taken, we want to create a tax code that is neutral and does not favor consumption over investment. Our goal is to eliminate all of the biases contained in the current Federal income tax law.

Senator Nunn and I could achieve our fundamental objective of taxing all income once by exempting savings and repealing either the individual or the corporate income tax. But we believe it would be difficult politically to raise all the revenue at the individual level and impossible to place the entire tax burden at the corporate level. The current corporate income tax raises only $100 billion per year, one-fifth of the revenues generated by the individual income tax. Putting the entire tax burden on corporations would be too radical a shift. Moreover, without two tiers, individuals could accumulate income in corporations in a virtually tax-free fashion for indefinite periods of time.

Since under the Nunn-Domenici proposal the tax system will continue to collect taxes in two tiers, the spotlight should be kept on our guiding principle — all income is always taxed once and no income escapes taxation. The business portion of our tax can be characterized as prepayment of individual income tax. Our proposal would abolish the current federal income tax code, which has long floundered in inefficiency and complexity. In its place, the Nunn-Domenici proposal would enact a progressive consumption-based income tax for individuals to replace the current personal income tax and alternative minimum tax (AMT), and a cash-flow tax for businesses to replace the current corporate tax, the corporate AMT, and the foreign tax code provisions.[52]

Our proposal is designed to maintain the distribution of the tax burden as currently shared between businesses and individuals, with individuals shouldering $5.50 for every dollar paid by corporations. It would maintain the progressivity of the current code, as measured by the distribution of tax burden among income quintiles. Some people within a quintile would pay more and some would pay less than they would under current law, but as a group, the quintile would pay the same amount under the current code and the proposal. Finally, it would be revenue-neutral, as compared to the current system.

A. Features of the New "Savings-Exempt" Income Tax for Individuals

The new system would have some familiar key concepts: gross income, adjustments to gross income, adjusted gross income, deductions, and a few tax credits, including the earned income tax credit. With respect to these durable features, the Nunn-Domenici proposal resembles the traditional income tax system. However, the proposed tax system is actually based on an individual's income that is consumed rather than on that which is merely earned.[53] Accordingly, the proposal would also have several new key concepts: net new savings deduction, family living allowance deduction, employer and employee payroll tax credits, financial income, previously acquired financial asset adjustment, compensation income, and college tuition allowance.

The following sections provide more detail about key features of the Nunn-Domenici progressive consumption tax for individuals.

1. The Tax Base

The tax base is Gross Domestic Product (GDP) excluding savings and investment and adjusted for net exports. Economists define our tax base as all factor income. Tax lawyers define it as all income, regardless of its source. On the surface, the tax base definition resembles that in the current tax code; however, there are significant differences. There are no permanent exclusions, no double taxation, no phantom income, no capital gains differentials, no depreciation, and no uniform capitalization rules.

The Nunn-Domenici proposal does not differentiate among income sources. Wages and salaries are treated the same as interest income, capital gains, and dividends. Each is taxed if and when the income is consumed. The income stream is taxed only once, and nothing escapes taxation.

The definition of a taxable event also distinguishes the Nunn-Domenici tax base from the current tax base. Both the individual and the business tax would be based on cash-flow principles.[54] Under the Nunn-Domenici proposal, businesses would not pay income taxes on their financial receipts.[55] Having been excluded from the business cash-flow tax base,[56] financial receipts such as interest and dividends would be included in gross income under the individual tax. However, if such receipts are saved or reinvested, they would be deductible under the proposal's new net savings deduction.

2. An Unlimited Deduction for Savings and Investment

For individuals the hallmark of the plan would be an unlimited deduction for savings and investment. This is most easily understood as an expanded, unlimited, unrestricted, and simplified IRA. The proceeds could eventually be spent for any or all purposes without incurring the current tax penalty for early withdrawal.

The Nunn-Domenici system would recognize that the act of saving defers personal use of the taxpayer's resources, making it available as investment capital. Because additional investment capital leads to expanded opportunities for economic growth, the nation benefits from this decision to increase savings and investment. Eventually, the Federal government shares in the return on that investment in the form of higher revenues. The proposal compensates individual taxpayers for their act of saving through tax-favored interest and dividends because "it is better to tax on the basis of what we take out of the common pool and not on the basis of what we as citizens put into it."[57]

To put this policy into practice, the Nunn-Domenici proposal allows taxpayers a "net new savings deduction" for net additions to savings accounts, investments in stocks, bonds, mutual funds, life insurance, and other savings assets. Income generated on these investments would not be taxed as earned or received so long as they continued to be reinvested and saved. The same tax treatment would apply to interest, dividends, and capital gains if they were saved or invested.

3. Major Purchases

Advocates of pure tax simplification would not distinguish between big-ticket purchases and any other spending for consumption. These purists would collect the tax in a single, upfront tax payment made in the year of the purchase. They would argue against any special rules for automobiles or any other major purchase, regardless of its business or pleasure purpose or whether it is essential to the taxpayer's life or business. The rules would be the same for the purchase of a refrigerator, a drive-about lawn mower, deluxe Soloflex exercise equipment, a computer for personal use, or a boat. To avoid endless "what about this or that" discussions, the purist would have no special rules-consumption is consumption. And all income spent on consumption would be taxed in the same manner.

Under a progressive tax rate structure, a big purchase might push an otherwise thrifty taxpayer into a higher tax bracket in the year he or she makes a major purchase.[58] The absence of special rules or averaging could result in taxpayers with identical incomes and savings patterns paying different amounts of taxes over their lifetimes. The pure tax simplifier would be unconcerned, preferring the perfect (but perhaps unattainable) system over the attainable, better system.

On the other hand, some economists would argue for a special consumer durables rule. Their analysis leads them to categorize consumer durables as "consumer capital" and conclude that consumer capital should receive the same tax treatment as durable capital facilities used by businesses. Under this approach, the purchase of such consumer assets would be free of tax. However, each year the taxpayer would calculate the value of the consumption services provided by the asset, and that amount would be taxed. For example, the purchase of a car would not be taxed at the time of the purchase, but each year the consumed value of the car (perhaps as measured by the decrease in its resale value) would be taxed. This is probably the most theoretically correct approach, but it poses several complicated questions of administration:[59] Which purchases would qualify for the special rules? How would the value of the consumption services provided be calculated?

Alternatively, a more administrable "rough justice" system could be developed to "average," or spread, the tax on the purchase of major consumer goods over several years. Because some taxpayers might prefer simplicity and a slightly larger tax bill to the recordkeeping requirements of major purchase averaging, averaging could be optional. The basic requirement for major purchase averaging would be that a taxpayer's qualified expenditures for the current year exceed a fixed percentage (120-140%) of his or her average expenditures for the preceding three years by more than a certain dollar figure ($3,000 to $5,000). In effect, major purchase averaging would spread one major purchase or a cluster of expenditures over the current year and several future tax years. Generally, averaging would keep the taxpayer in the same tax bracket he or she would have been in "but for" the major purchase. It also spreads tax liability over several years in much the same way an installment plan would make it easier to purchase the asset in the first place. Prior to 1986, the Internal Revenue Code included a mechanism for income averaging for individuals whose income varied significantly from one year to the next. A similar mechanism could be developed for taxpayers whose annual consumption varies significantly.

Our current solution to the major purchases problem is to propose refining the major purchase averaging approach. This would allow consumers to plan their consumption without fear of inadvertently raising their top marginal tax rate and would avoid the administrative and valuation difficulties inherent in the "purer" approaches. Regardless of the approach we choose, our paramount consideration will be to ensure that a major consumer purchase made with saved income is treated the same as or more favorably than a purchase made with borrowed funds.

4. Home Ownership

Home ownership is the investment of choice for one out of every three dollars of net private investment.[60] This leads many tax policy experts to conclude that America is overinvesting in housing and that the federal income tax preferences for owner-occupied housing are larger than necessary to maintain a high rate of home ownership. For example, the Canadian government grants a capital gains preference for home sales but does not allow deductions for mortage interest, yet Canada and the United States have achieved comparable home ownership statistics. [61]

The United States's high level of home ownership has not come cheaply. The home mortgage deduction is the third-largest tax expenditure in the federal individual income tax code and subsidized home owners in 1993 with $45.1 billion in the form of lower taxes.[62] The current tax code treats homes more favorably than other investments. A taxpayer may deduct interest paid on a mortgage of up to $1 million used to acquire and improve first and second homes, and interest paid on a home equity loan of up to $100,000.[63] The proceeds can be used for any purpose.

Along with other tax expenditures that infest the federal income tax code, the home ownership deduction is often diagnosed by economists as inefficient, inequitable, and overly generous.[64] Economists have criticized the structure of the mortgage deduction both because the amount of the deduction rises with income and because it gives renters no direct benefits.[65] The value of the deduction varies with a person's tax bracket and can be as low as 15% of qualifying expenditures. The maximum subsidy, 39.6% of qualifying mortgage interest payments, is available only to single persons with incomes of more than $115,000 and to jointly filing families of four with taxable incomes of more than $140,000. For example, a married couple in the top marginal bracket filing jointly and paying 7% interest on a $1 million mortgage could save over $22,000 per year, while lower income families who rent their homes would not have their tax bill reduced at all.[66] Studies show that more than half of the subsidies under this deduction accrue to households with incomes of $50,000 per year or more and virtually none to households with incomes of $10,000 per year or less.[67]

Despite these perceived flaws, the home mortgage interest deduction is generally supported by the American people and has a powerful grip on members of Congress. A family residence is both the largest consumer purchase and the main investment for most American taxpayers. While formulating the Nunn-Domenici proposal, we listened carefully to both critics and proponents of the home mortgage deduction. We concluded that home ownership would be considered an investment and a separate deduction would be allowed for principal and interest repayment.[68] While we have not yet made a final decision, we probably will propose capping the mortgage deduction at an amount somewhat lower than the current $1 million.[69] However, no deduction would be allowed for home equity loans and property taxes paid on the home.[70] Our proposal recognizes that home ownership has a significant investment component. However, it does not recognize the consumption element under an economic "imputed rent" calculation. In this case, we decided to sacrifice purity in the name of simplicity.

To ensure parity of treatment between home owners and renters, David Bradford suggests that a homeowner could be charged an amount equal to the value of the financial alternatives he or she foregoes in choosing to buy a home.[71] For example, the tax schedule could direct taxpayers to include in their tax base an amount equal to the current year's interest cost (or some portion of it) on a twenty- or thirty-year bond. Such an amount would roughly equal the market value of the house and provide a conservative estimate of the annual rental cost and consumption component on the family home. This proposal's simplicity and fairness commends its further consideration.

Senator Nunn and I recognize that our tax treatment, without Bradford's proposed calculation, perpetuates the current tax code's discrimination against renters. However, under the Nunn-Domenici proposal, renters would find it easier to purchase homes since families would receive a deduction for saving. That deduction would help them overcome the primary hurdle to home ownership — amassing a down payment.

5. Family Living Allowance

One objective of the Nunn-Domenici proposal is to retain the current distribution of the tax burden among income quintiles. To meet this goal, the proposal includes the family living allowance, an expanded earned income tax credit (EITC), and a credit for payroll taxes.

The family living allowance recognizes that every family's budget includes necessities and that the federal government should not tax the first dollars earned and spent to maintain a minimal standard of living. The proposal provides a tax-free threshold level of consumption upon which families would not be taxed. The family living allowance would vary to accommodate family size and would include personal exemptions and components similar to the familiar standard deduction. It would also include an amount sufficient to cover average expenditures for essentials.[72] In developing the family living allowance, we have taken special care to ensure equitable treatment of larger families, who typically spend more and save less than smaller families with the same incomes. We estimate a family living allowance of $25,160 for a family of four.[73] This allowance would rise each year with the cost of living.

Converting the current personal exemption and standard deduction into our family living allowance is necessary to reflect the shift in the tax base from income to consumption. It should not be interpreted as a commentary or policy judgment on what families should spend or save but rather as one of several mechanisms in the proposal designed to retain the progressivity of the current tax code.

6. A Tax Credit for Employee Payroll Taxes Paid

The payroll tax on employment finances the Social Security and Medicare programs.[74] For the great majority of workers, the combined employee and employer payroll tax exceeds their liability for federal income taxes.[75] Because of its flat rate structure, the payroll tax is often criticized for its regressivity.

Under the Nunn-Domenici proposal, every employee-taxpayer would be given a credit on his or her individual tax bill for some of the payroll taxes he or she pays. Under our current system, no deduction is allowed. The credit would be refunded to any taxpayer whose payroll tax exceeds his or her income tax liability. The payroll tax credit would be gradually reduced as taxable income exceeds the family living allowance: it would start to phase out dollar-for-dollar at $25,001 of income and phase out completely at $50,001.

This credit furthers our guiding principle that income should be taxed only once. In addition, it facilitates our goal of retaining the progressivity of the current income tax and helps neutralize the regressive nature of the current payroll tax while maintaining the financial integrity of the Social Security trust fund.

7. Continuing, the Earned Income Tax Credit

The Nunn-Domenici tax proposal currently envisions a tax provision that would accomplish the same objectives as the current EITC. [76] While every family would receive a family living allowance, the families at the lowest end of the income distribution would also be eligible to claim the EITC. To retain the progressivity of the current tax code, the Nunn-Domenici plan would increase the EITC by approximately 30%. [77]

8. Pruning, Some Itemized Deductions — Reforming Others

Our proposal may retain some itemized deductions from the current law. Those that are not expressly retained would be incorporated in the family living allowance. Generally, retaining itemized deductions leaves us facing a form of Hobson's choice: the more itemized deductions we keep, the higher rates must be to accommodate a smaller tax base and still meet a revenue goal. The tax rates in our proposal assume the continuation of certain itemized preferences.[78] For illustrative purposes, the Congressional Budget Office (CBO) assumed when calculating the tax brackets of the Nunn-Domenici proposal that the deductions for state and local income taxes, charitable contributions, and medical expenses above the 7.5% floor would be retained and that the EITC would be expanded. CBO included this illustrative "basket" of deductions with a total revenue loss of $50 billion per year because we have not reached final decisions on deductions.[79] The basket sets aside a revenue-loss budget to include some worthwhile deductions in our proposal. These deductions could include those assumed in the CBO prototype or others that could be modified, reformed, targeted better, or transformed from deductions into credits.

As a matter of tax equity, itemized deductions are unfair. They provide the greatest tax relief to taxpayers in the highest tax brackets and negligible relief to people who claim the standard deduction. The higher a person's tax bracket, the bigger his or her tax savings from claiming deductions. To achieve greater fairness to all taxpayers, most current deductions that are retained in the Nunn-Domenici proposal could be transformed into tax credits. For example, the current deduction for charitable giving could be transformed into a credit based on the maximum marginal tax rate. Some argue that it is inequitable for the federal income tax system to provide greater encouragement for charitable giving to higher bracket taxpayers than it provides to low-bracket taxpayers.[80] A credit would provide all taxpayers with the same tax benefit.

Some of the current tax preferences the Nunn-Domenici plan could retain but convert into tax credits include:

a. *Charitable giving.* Charitable giving is income for which the taxpayer has permanently renounced ownership. It represents savings on behalf of society and, thus, would be tax-favored under the Nunn-Domenici proposal.

b. *Pension and profit-sharing plans.* These would continue to be excluded from the individuals' consumed-income tax at the time the employer makes its contributions toward benefits. There would be no taxable event until the benefits are paid out to the retiree taxpayer. Once pension benefits are received by the taxpayer, they would be included in his or her tax base. This income, like any other income, would be partially offset by the tax-free family living allowance. Also, the taxpayer could save or invest the paid-out benefits and avoid tax until those benefits are consumed.

c. *Tax-exempt bonds.* We believe that a tax-favored treatment of municipal and state bonds has become intrinsic to federalism and states' rights. Bonds issued by state and local governments would continue to receive favored treatment. Since all types of bonds, when purchased, would enjoy a deduction as part of the net new savings deduction, our new system would allow the interest earned from taxexempt bonds to be spent without being taxed.

d. *College tuition.* The cost of higher education is an investment because the greater future earnings generated by attending college eventually would be taxed. Income spent on education'also can be characterized as an investment in human capital. If expenditures on post-secondary education are characterized as investments, they should be deductible.[81] Under this approach, loans to finance higher education would be taxable receipts and repayments of principal and interest would be deductible.

Our current plan is to design a special deduction for tuition, books, and fees, capped at a reasonable amount, perhaps $7,500 per year with a lifetime ceiling of $25,000 per student.[82] It is also important to consider that under the new system, the savings would be deducted as part of the net savings deduction and the accumulation of interest and other gains would not be taxed until the funds are spent. Because of this tax deferral, a person who wished to save for a child's college education eighteen years in the future and who could invest at ten percent, would have to earn and set aside considerably less under the Nunn-Domenici proposal than under the current income tax code.

9. Treatment of Previously Acquired Financial Assets

Americans own almost $5.6 trillion in financial assets, including $260 billion in savings accounts, $580 billion in money market accounts, $1.9 trillion in stocks and bonds, $1.2 trillion in retirement accounts, $600 billion in CD's, and $900 billion in other financial assets. Additionally, Americans own $2.4 trillion in net investment real estate.[83] A portion of these assets represents the accumulation of past after-tax savings. Also, any dividends, interest, or rents generated by these investments have already been taxed. These taxpayers have foregone the instant,gratification of spending their income as it was earned in order to acquire investment assets that provide security and income in the future, especially during retirement.

If Congress were to change the tax base from income to consumption tomorrow, individuals would be subject to multiple taxation for the $5.6 trillion they had saved under the rules of an income tax system but consumed after implementation of the Nunn-Domenici proposal. Any new tax system has to recognize that tax ayers' current savings and the earnings on that savings have already been subject to the income tax. It would be unfair if the new system simply triggered tax liability all over again when investment proceeds are used to buy consumption goods.

Our proposal will strive for equitable treatment of those investments acquired with after-tax dollar assets, or "old savings," to make sure that people who saved under the current tax code with after-tax dollars are not taxed a second time when they spend their old savings. This problem is particularly important for people who have been saving for their retirement and would start to consume that retirement nest egg sometime after the enactment of the Nunn-Domenici tax system.

There are four possible approaches to the problem of retaxing old savings. First, a "hardline" approach would tax individuals on any withdrawal for expenditure, including any savings account withdrawal or the proceeds from the sale of any asset acquired before the enactment of Nunn-Domenici, and provide no deduction since the proceeds were used for consumption. Under this approach, it is irrelevant whether the saving was done before the enactment of our proposal or whether the consumption was financed with previously taxed savings — consumption is consumption and consumption is taxed. While revenue raisers might like this approach, it would be both unfair and inconsistent with the overall policy objectives of the new tax system. Because this approach would penalize people who saved and invested, behavior the new system is designed to encourage, I categorically reject this approach.

Second, at the other extreme, a blanket grandfather rule would exempt previous net savings from the consumption tax. Although potentially desirable as part of the policy of encouraging savings and investment, this approach could cause a massive revenue hemorrhage, particularly if the new tax system were to allow these old savings to be rolled over completely tax-free through the purchase of new tax-deductible assets.

Basis adjustment, a third approach, would require the taxpayer to determine the basis (usually the acquisition cost) of each previously acquired asset as of the day the consumption-based income tax was enacted. This "date-of-enactment basis" would become the starting point under the new tax system for each previously acquired asset. There would be no tax consequences until a previously acquired asset is sold. When the asset is sold to pay for consumption, the Nunn-Domenici proposal would then allow individuals to exclude from gross income the gain equal to their existin date-of-enactment basis. Only the gain realized above the date-of-enactment basis would be included in gross income when an asset is sold and its proceeds used for consumption. Additionally, any sale or withdrawal of this tax basis in old savings assets used for consumption would be offset against the purchase of any new savings assets in determining an individual's net savings deduction. This procedure would provide consistent tax treatment between investments made under the current tax code and acquisitions made after enactment of our proposal, since only previously untaxed gains or appreciation would be included in the new tax base. It would also recognize that investments made before the enactment of the new tax system were made with income that has already been taxed.

The main problem with the basis adjustment approach is recordkeeping. Proponents of this approach argue that this burden is no greater than the burden under current provisions that require individuals to keep track of their tax basis. However, the basis adjustment approach would require separating assets into those acquired prior to the new system's effective date and those acquired afterward. It would require keeping track of those assets until they are sold, thereby prolonging the transition period indefinitely. For this reason, we did not incorporate this approach into the Nunn-Domenici proposal.

Finally, a transition adjustment approach blends elements of several of these approaches. By adding two percentage points to marginal rates, the proposal would raise revenue to engineer an equitable treatment of previously acquired financial assets. Under this approach, on the date of enactment all taxpayers would determine their total financial assets or old savings acquired before Nunn-Domenici. This one-time calculation would be administratively simpler than the basis adjustment approach and result in a relatively short and fixed transition period. The new system would allow each taxpayer an additional deduction — called a "previously acquired financial asset adjustment deduction" — for each of several years following the enactment of the new system. For example, the taxpayer could be entitled to a deduction equal to twenty percent of his or her total previously acquired financial assets for each of the five years following date of enactment. This would provide full accommodation of old savings. However, revenue constraints may not allow Congress to go that far. Alternatively, the system could allow a deduction of ten percent for each of the three years following date of enactment to achieve a partial adjustment. This approach could be designed to favor the less affluent and the elderly if necessary to maintain current code progressivity.[84] The exact percentage of the deduction and its duration would be determined to fit its costs within the revenue raised by the two percentage point "add on" to marginal rates. The rate add-on would be temporary, and tax rates would fall at the end of the transition period.

Since equity and revenue considerations have to be balanced, we support the transition adjustment approach, recognizing that this adjustment is very important in order to insure that today's elderly, whose consumption during retirement relies heavily on already-taxed savings, shoulder only their share of the tax burden.

10. Inheritance

Estate taxes would remain unchanged under the Nunn-Domenici proposal. While some have advocated major changes in the estate and gift tax in conjunction with a shift to a consumptionbased income tax, we do not believe that an overhaul of the estate and gift tax is necessary. The proposal treats inheritance as income to the recipient and taxes it to the extent that it is consumed rather than saved. If the entire inheritance is saved, inheritance is not a taxable event for either the donor or the beneficiary because the inheritance neither increases the aggregate amount of net taxable income nor diminishes the nation's saving pool.

In order to conform treatment of inheritance to the principles of the Nunn-Domenici plan, we had to resolve one fundamental issue: Is making a bequest rightly considered consumption? For reasons of both fairness and efficiency, we conclude that it is not. A bequest is not consumption because it is not an exchange for goods or services. In fact, it is almost the opposite of consumption. Inheritance is merely a change of ownership and not a taxable event; the consumption comes when that inheritance is spent by the heir for goods and services.

Further, if we were to maintain that leaving an inheritance is consumption, subject to our current inheritance tax, a consumption tax, or any other tax that takes effect merely because of death, then our income tax would not really be savings exempt at all — it would merely be a lifetime income tax. [85]

Working from the conclusion that leavina an inheritance is not consumption, the proposal would treat inheritance like any other income. Treating the event of inheritance as consumption by the donor would provide a disincentive to the rational use of capital. If inheritance were taxed to the donor as consumption, then, in order to tax the assets only once, it would have to be received with taxes prepaid for the donee, making immediate consumption of the inheritance and saving it equally attractive to the donee.[86] If the donee were to save the inheritance, the returns would have to be earmarked so that he or she would not be taxed upon consuming the savings, in order to avoid double taxation. This seems unnecessarily complicated. Moreover, if donors must pay taxes on the amount they bequeath, as if it were consumption, they would have an incentive to spread the bequest out over a number of years in order to minimize the rate of taxation.[87] This would distort economic decisions unnecessarily.

Instead, by treating inheritance as regular income to the recipient not consumed by the donor, the Nunn-Domenici plan maintains all its incentives for saving. Donors do not pay taxes on money they never spend. Thus, they will have no additional incentive to consume their savings before they die and, therefore, will be more likely to make capital available to others. Recipients are treated similarly; they face the standard decision of either consuming and paying tax or saving and avoiding tax. This treatment of inheritance ensures that assets are taxed only once and maintains the incentives to save and invest.

However, this treatment for estates and gifts raises the possibility of "consumption splitting." analogous to attempts at income splitting, which are disfavored by the current code.[88] In order to avoid changing the incentives for taxpayers to make inter vivos gifts and to eliminate the opportunity for high bracket taxpayers to reduce their taxable consumption by making gifts to lower bracket family members, an inter vivos gift could be taxed as consumption to the donor regardless of whether the beneficiary spent or saved the gift. While this tax treatment would close the consumption-splitting loophole, it is not a totally satisfactory answer because it would result in differing treatment of testamentary requests and inter vivos gifts. However, consistency would leave us with a significant loophole. The problem needs to be addressed, but at this time we have not developed a solution or a series of options.

11. Graduated Rates

One prominent feature of the Nunn-Domenici tax system, and of consumed-income tax proposals generally, is its distributive quality. "A consumed income tax permits the sort of flexibility to specify the vertical discrimination among taxpayers that we associate with a graduated income tax."[89] The proposed Nunn-Domenici individual tax includes a graduated rate structure designed to retain the progressivity of the current federal income tax within quintiles. The proposal will include three or four consumed-income brackets.

In setting the tax rates, it is critical to estimate the amount that families save, since all saving would be deductible. In work done at my request, CBO found that existing data yield inconsistent estimates of the amount saved by families with the same incomes.[90] When modeling the tax rate structure of the Nunn-Domenici proposal, CBO used two different definitions of saving and found that inconsistencies in the data led to different rate structures under the two definitions, even though the those definitions are equivalent. Both structures meet the objectives of revenue neutrality and maintaining current code progressivity.

If saving is measured using a residual approach, which defines annual savinc, as the difference between a family's income and expenditures during the year, CBO's preliminary estimates suggest that rates could be 16%, 38%, and 49%.[91]

If saving is measured using a net worth approach, which defines annual saving as the change in a family's net worth during the year, CBO's preliminary estimates suggest that rates could be 14%, 28%, and 36%. [92]

Under the net worth methodology the tax rates might look like this for single taxpayers:

INCOME	CURRENT INCOME TAX	NUNN-DOMENICI PLAN
up to $22,750	15	14
$22,751-$55,100	28	28
$55,101-$115,000	31	36
$115,001-$250-000	36	36
above $250,000	39.6	36

The rates can be based on income, consumption, or an income tax equivalent.[93]

12. The Bottom Line for Individuals — Everyone Is a Winner, but Some People Will Pay More

An individual taxpayer calculating his or her annual tax bill first would add together all types of annual income. Then, he or she would deduct the family living allowance, all "net new savings" and investment made during the taxable year. The tax rate on income that is saved and reinvested income generated by those savings and investments is zero. Next, the taxpayer will calculate taxes on his or her net consumed income at progressive rates. Finally, the taxpayer can take a number of tax credits that roughly correspond to the most defensible of the current tax deductions.

With a larger savings pool encouraged by the tax-exempt status of savings and investment, every American would be a winner. By stimulating saving, the new tax system will reduce the cost of capital investment, leading to increased capital stock and growth in output. The Nunn-Domenici proposal aims to restore an American entrepreneurial spirit to our tax system while maintaining the distributional equities of the current tax code. To achieve that end, the new tax system has been modeled to retain current code progressivity. Taxpayers in each income quintile would continue to shoulder, as a group, the same proportion of the tax burden as they do under the current tax code. However, those who save more than the average within that quintile would pay less in taxes than they do under the current system, and those who save less would probably pay more in the short run.

B. The Nunn-Domenici Business Tax

The corporate income tax was first enacted in 1909 as an excise tax on the privilege of doing business in the corporate form.[94] Despite its continuing presence in our income tax code, considerable controversy surrounds the role of the corporate income tax. Most economists contend that corporations do not pay taxes; only people pay taxes.[95] Furthermore, economists suggest that the corporate income tax system distorts three fundamental economic and financial decisions: business organizational form, financial structure, and dividend policy.[96]

While many theorists would argue for elimination of the corporate tax and total integration, Senator Nunn and I believe that practically all of the economic distortions can be eliminated and the economic benefits retained without eliminating the corporate tax. Moreover, retaining the corporate tax in modified form would protect against the danger that if the corporate income tax were eliminated, owners of corporations would be able to use their businesses to avoid personal consumption taxes by having their corporations buy goods and services for them such as automobiles, life insurance, health care, or legal services.

A common criticism of the current corporate tax system centers on the double taxation of corporate revenues, which typically are taxed once at the corporate level and again when distributed to shareholders. In other circumstances corporate income is taxed only once and, occasionally, not taxed at all. One goal of the Nunn-Domenici proposal is to tax corporate income once, and only once, under all circumstances, even though the tax may be "collected" at more than one point in the flow of income from the corporations that earn the income to the people that ultimately receive it.

To attain this goal of taxing all income once, the Nunn-Domenici plan taxes corporations, partnerships, and proprietorships identically. A partnership interest is treated exactly like a shareholder's ownership in corporate stock. Both assets are financial assets. Our proposal also eliminates the current bias against equity financing.

1. The Business Tax Base: Eliminating Double Taxation

Under current law, the corporate income tax base is net income or profits. Under the Nunn-Domenici proposal, the corporate tax base would be net cash flow. A business cash-flow tax base is equal to the value of goods and services the business produces during the year. The objective of the business cash-flow tax is to tax the total output of the private sector economy as measured by the receipts from goods and services moving through the economy. In maintaining a two-tier system of individual and business taxes, the Nunn-Domenici proposal treats every business as merely the alter ego of its equity holders, bondholders, and employees, who ultimately receive the net cash flow in the form of dividends, interest and compensation.[97]

From this vantage point, a business cash-flow tax levied on any particular factor of the country's tax base could be collected from the individual who ultimately earns it instead of the business that generates the profits to pay the employee or share holder. This holds true whether the returns represent compensation, returns to human capital in the form of training and education, returns to risk taking and entre reneurship, or returns to capital flows in the form of interest, dividends or capital sales.[98] However, under our proposal, we have split the tax collection point for these types of income. The new tax system would collect part of the tax both at the individual and business levels but would collect most of the tax from individuals.

2. Simplified Cost Recovery and Reporting

For all businesses the centerpiece of the Nunn-Domenici proposal would be virtually unlimited expensing — a current year deduction for the amount of all new capital investment. Expensing would replace depreciation, depletion, uniform capitalization rules, and other similarly complicated adjustments for cost recovery. Inventory costs also would be expensed. In addition, the corporate AMT would be repealed. Because our business cash-flow tax would apply only to U.S. source income, the proposal would eliminate the most complicated foreign source tax rules in the current tax code and thereby eliminate the discrimination against U.S. companies as they compete with foreign multinationals.[99] Finally, as a general rule, cash accounting would be used.

3. Expensing for Intangible Assets

Few concepts in the federal income tax have caused more litigation than the "amortization of intangibles."[100] Taxpayers and the IRS litigate over whether a certain expenditure can be expensed or must be amortized, and often a second round of litigation determines the appropriate amortization period. The Nunn-Domenici proposal would eliminate this unnecessary complication and confusion. Income generated by a business selling or licensing patents, trademarks, trade names, mailing lists, etc., would be included in the business's tax base. Amounts paid for intangible assets would be treated as necessary and ordinary business expenses and fully deducted in the year the expenditure is made.[101]

4. Lower Business Tax Rates and a Broader Base

The business tax would be a flat rate in the ten percent range. In work done at my request, CBO estimated that a business tax rate of 7.1% would raise the same amount of revenue as the current federal corporate income tax and the employer share of the payroll tax.[102] Though this rate would not lessen the aggregate tax burden for businesses, a rate reduction from current levels is possible because the tax base would be significantly broader after elimination of many current business deductions. For example, interest paid on borrowing would not be deductible, nor would tax payments, salaries, or wages. However, a credit would be allowed for most current payroll taxes paid by businesses.[103]

5. Treatment of Dividends and Interest Paid by Corporations

Under current law, most corporate income is taxed to the corporation at a marginal rate of 35 %.[104] When corporations use some of that income to pay dividends to shareholders, the dividend income is usually taxed again to the shareholders at their individual marginal tax rates.[105] If the corporation retains earnings, the company's stock price might increase to reflect those retained earnings. When shareholders sell their stock, gains from the sale also are taxed, usually at capital gains rates.[106] The greater the stock price increase, the larger the capital gains tax bill. In short, both income distributed as dividends and retained corporate income often are taxed to both corporations and shareholders. [107]

Unlike dividends, interest generally is deductible by corporations.[108] This dichotomy of treatment distorts financial markets and interferes with the efficient allocation of resources.[109] "Interest income received by domestic lenders is Oenerally taxed at their maroinal tax rates",[110] but interest income received by foreign lenders from U.S. corporations is seldom subject to U.S. tax.[111]

Pension funds and educational, religious, and other not-for-profit organizations supply a sizeable amount of corporate capital to the U. S. economy. While they are not taxed on interest, dividends or capital gains, the corporate level income tax does apply to corporate income attributable to the equity capital they supply. Moreover, "tax-exempt entities may be subject to the unrelated business income tax (UBIT) on earnings from equity investments in partnerships."[112]

Under the Nunn-Domenici proposal, two simple rules replace the myriad current rules governing interest and dividends. First, a business's "financial income," such as interest received by the business, would not be included in gross income. Second, a business's interest payments would not be deducted from gross income. Similarly, dividends received from other businesses would not be included as part of gross income, and dividends paid would not be deducted. Since financial income is excluded from the tax base at the business level, it becomes part of an individual's gross income under the individual income tax. [113]

These proposed rules eliminate a host of complicated rules from current tax law and address two of the fundamental flaws in the current code by neutralizing the tax implications of the business's choice of orcanizational form and eliminating the double taxation of dividends and interest. Under the proposed business cash-flow tax, it is irrelevant for tax purposes whether a business decides to retain earnings or pay shareholders dividends. Thus, the current tax incentive to finance expansion or other capital improvements with debt instead of equity would be eliminated.

Non-profit organizations would not pay the business cash-flow tax unless they were actively engaged in unrelated business activities. If they are engaged in business activities unrelated to their tax exempt status, they would either pay the Nunn-Domenici business cash-flow tax or continue to pay the UBIT.

Although the Nunn-Domenici proposal keeps in place a twotier system with an individual and business tax, the result is a single tax that is the same whether income is created and received by a corporation or an unincorporated business entity. Dividends and interest received are taxed only once.

6. Taxation of Partnerships

Under current law the choice of business form can have substantial tax consequences because a partnership's earnings are taxed directly to the partners at their personal tax rates and not taxed to the business, even if all of these earnings are invested in the business; corporate income, on the other hand, is double taxed because it is subject to the corporate income tax and the individual tax when shareholders receive dividends.[114]

The Nunn-Domenici proposal postpones taxation of a partnership's earnings until the money is withdrawn from the partnership for the partners' personal use, typically in the form of salaries, dividends, and bonuses. This is consistent with the treatment of net savings at the individual level. The proposal treats undistributed income as if it were saved, or reinvested, by the business on behalf of its owners. The cash-flow accounting treatment of retained earnings accomplishes this.

Finally, in this discussion of smaller businesses, one should note that the Nunn-Domenici business cash-flow tax will probably contain an exemption from tax for certain small businesses.

7. Tax Treatment of Employer-Provided Fringe Benefits

If Congress were not engaged in a major health care reform debate, some tax experts would consider treating employer-paid medical insurance, life insurance, and other fringe benefits as nondeductible compensation. However, there are good reasons to retain some tax-favored status for health care fringe benefits, and those reasons will be evaluated in the health care reform debate. Since Congress is in the process of developing health care legislation, we have postponed decisions regarding the appropriate tax treatment awaiting the outcome of this debate.

8. Casualty Insurance

Any premiums paid by the business on business assets for property and casualty insurance are ordinary and necessary business expenses and would retain current tax deductible status.

9. A New Credit for Payroll Taxes Paid

Payroll taxes are the taxes Americans love to hate. They are both expensive and regressive, yet they fund, among other programs, Social Security and Medicare. Moreover, payroll taxes cause several other unintended harms to our economy. GATT discriminates against both our Federal income tax system and our payroll tax system, while providing favorable cross-border treatment to the value-added taxes (VATs) relied upon by most of our international competitors.

While Senator Nunn and I do not favor a VAT, we believe that the United States should strive toward a tax that receives favorable GATT treatment, while maintaining the integrity of the Social Security trust fund and minimizing the burden payroll taxes place on employers and employees. To accomplish this goal, we would replace the current deduction for wages and salaries with a tax credit that would offset part of the existing Social Security or FICA employer payroll tax.

a. *Mechanics of the credit.* Under current law the payroll tax applies only to direct wages and not to indirect compensation such as fringe benefits.[115] In addition, the payroll tax is higher on the first $60,601 of wages paid to each employee. In the case of employees earning less than $60,601, the Nunn-Domenici payroll tax credit for employers would be substantially equivalent to allowing the business to deduct 75% of these wages paid against a 10% business cash-flow tax rate. Currently, employers can deduct between 75% and 100% of the costs of wages from corporate taxes.[116] The Nunn-Domenici plan replaces this income deduction for wages with a tax credit for payroll taxes paid.

Currently, the payroll tax is 7.65% on all wages up to $60,601 and 1.45% on any excess. For example, if an employer paid an employee a wage of $50,000 and were allowed to deduct $50,000 against a 10% business cash-flow tax rate, the tax saving to the employer would be $5,000. Not deducting the $50,000 wage payment but being allowed a payroll tax credit for 7.65% of the $50,000 wacre results in a tax saving of $3,825. In comparing the proposal to the current tax code, it is important to remember that no payroll tax credit is available and that businesses are not always allowed to deduct the entire amount of wages in the year paid; often they must defer the deduction until associated items of capital or inventory can be deducted.[117]

b. *Rationale behind the credit.* Our current federal income tax system, our current payroll tax mechanism, and the differential treatment under GATT of direct and indirect taxes all put U.S. exporters at a competitive disadvantage.[118] Under current law, U. S. exports to Europe bear the burden of both U.S. direct taxes (income taxes) and European indirect taxes (their VAT); while European exports to the United States bear the burden of neither European indirect taxes (the VAT provides a rebate for exports, making it "border-adjustable") nor U.S. direct federal income taxes.

The GATT allows other countries' VAT systems to be border-adjusted for exports and imports but does not allow either our current corporate income tax or our FICA payroll tax to be border-adjusted for exports and imports. That unfavorable result under GATT arises for several reasons, of which the most important is that our present corporate income tax does not include wages paid, as such, in the corporate income tax base even though our separate employer-paid payroll tax has much the same effect as a corporate tax on wages paid (albeit at a rate of 7.65% rather than at the current corporate income tax rate of 35%).

Because GATT prohibits border adjustments, or rebates, for direct taxes like the payroll tax,[119] when a U.S. company exports its U.S.-made products for sale abroad, neither the company nor the purchaser may be given a refund of the payroll taxes associated with those products. However, under GATT it is legal to rebate indirect taxes to exporters and to levy such indirect taxes on importers of like products as a border tax adjustment.[120] Border tax adjustments consist of waiving or rebating consumption taxes on exports while applying those taxes to imports. This procedure allows the country in which consumption occurs to be the one that taxes that consumption. [121]

Because the Nunn-Domenici business cash-flow tax allows no deduction for interest paid and because it allows no direct deduction for wages paid, although a payroll tax credit is allowed, some experts predict that the proposal would qualify for export and import border tax adjustments.

The business payroll tax credit is one of the more innovative features of the new tax system. [122] It resolves the current inequality of treatment the United States suffers, relative to its trading partners under GATT, while protecting the financial integrity of the Social Security trust fund. Payroll taxes will continue to be paid into the Social Security trust fund. However, because the payroll tax credit, unlike the current deduction, is designed to be a border-adj u stable tax, it would help make our exports more competitive.[123]

10. Treatment of Exports and Imports

Under the Nunn-Domenici proposal, income from export sales would be excluded from the business cash-flow tax base. The foreign operations of U.S. companies would not be taxed. This should move the United States toward a more globally competitive tax system. Amounts received from export sales that are distributed to shareholders in the form of dividends or used to pay employees would, however, be included as income for individual tax purposes.

An import tax equal to the business cash-flow tax would be imposed on imports sold in the United States. Under this import tax, any company, regardless of its location, that manufactures goods or provides services to be sold in the U.S. market would be taxed essentially at the same rate as if the factory or service were located in the United States.

11. Territorial Tax System

Most of our competitors have already moved substantially toward a "territorial tax system" that exempts the foreign operations of their multinational corporations from home-country tax. [124]

In light of this development, our current tax on the foreign operations of U.S.-based multinationals creates another competitive disadvantage for U.S. companies.[125] Moreover, foreign-headquartered multinationals that compete head-to-head with U.S multinationals are permitted full deductions by their home countries for their interest, research expenses, and other costs, while U.S. expense allocation rules prevent the benefit of a full deduction for many U.S. federal income tax paying companies. [126]

The Nunn-Domenici proposal eliminates a great deal of complexity in this area as well as many anti-competitive consequences by taxing only U.S. activities.[127]

12. Transition Rule for Unrecovered Cost Basis of Depreciable and Depletable Assets

The recordkeeping required to calculate depreciation under the current tax code, examined by itself, is complicated enough to make a case for reform. Many companies are in the unenviable position of maintaining three different depreciation schedules — one for pre-1980 assets, one for assets acquired between 1980 and 1986, and one for assets acquired after the company became an AMT taxpayer, if it has become one.[128]

If Congress were to enact the Nunn-Domenici proposal, businesses would have a large amount of unrecovered cost basis in assets that were acquired before enactment and only partially depreciated or depleted. There are several methods available to facilitate the transition from the current corporate income tax to a business cash-flow tax. One approach would allow the companies to deduct the remainder of their depreciation in the first year of the new tax. Rates could be adjusted upwards for that first year to accommodate this transition while maintaining a sufficient revenue stream. Some would arcrue that this would needlessly reward taxpayers for investments that they already made with full knowledge that they would be required to take a depreciation allowance over many years. An alternative approach would require the taxpayer to continue along whatever depreciation path his existing assets take him. While this is fair, it would continue the complexity of current law and would add post-Nunn-Domenici property as an additional category in calculating depreciation and expenses.

Regardless of the transition rule chosen, to provide symmetry between the business tax and the individual tax, the Nunn-Domenici proposal would allow these partially depreciated assets to be amortized over the same period that individuals are given for previously acquired assets. [129]

13. The Bottom Line for Businesses

Under the Nunn-Domenici proposal, paying business taxes would be simpler than under current law. A business would add up its total receipts from U.S. sales of goods and services made during the year, excluding export sales of U.S.-made products sold to foreign markets. Next, the business would deduct the costs of purchases from other businesses, including the cost of plant and equipment (equivalent to expensing), parts, components, inventory, and outside services such as accounting, engineering, legal, and transportation services. After deducting purchases attributable to U.S. sales, the business's remainder is "gross profit," or the tax base to which the business tax rate would be applied. Finally, the business would take allowable credits such as the payroll tax credit.

IV. CONCLUSION: THE PERFECT TAX BASE AS HOLY GRAIL

When Senator Nunn and I began our search for a fundamentally more efficient tax system, we knew we did not have all the answers. Our proposal is a work in progress, embodying over 400 years of economic and political thought. The idea of taxing consumption dates back to the 1600s and has been advocated by scholars ever since, seemingly regaining visibility about once every twenty years.

In 1651, Thomas Hobbes asked:

> For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idly, getteth little, and spendeth all he gets; seeing the one hath no more protection from the Commonwealth, than the other?[130]

Those who agreed with Hobbes argued that a person should be taxed on what he or she uses and not on the fruits of labor which are saved and thereby made available for use by others. In the 1800s, John Stuart Mill accused the income tax of being unfair to savers, asserting that "[n]o income tax is really just from which savings are not exempted. . . ."[131]

Alfred Marshall, a giant in the world of economics in this century, also believed that, despite its practical problems, a tax on consumer expenditures would be superior to a tax on incomes.[132]

The prominent American economist Irving Fisher sought to establish that a consumption tax is not only superior to an income tax but also feasible. He used accounting principles to illustrate how a consumed-income tax could be put into operation, proving that such a tax was not merely a theoretical curiosity. [133]

In Great Britain after the mid-1950s, interest in this type of consumption tax increased substantially. Nicholas Kaldor advocated replacing the British income tax with an expenditure tax.[134] In 1978, the Meade Commission issued a report confirming the feasibility of a consumed income tax system. [135]

In 1977, the U.S. Treasury conducted a study entitled *Blue Prints for Basic Tax Reform* and specified in great detail how a comprehensive consumption tax would work. One of the chief architects of the study believed that a consumption tax would reduce our reliance on the existing unsatisfactory system and that "if consistently implemented, should provide major advantages in fairness, simplicity, and economic efficiency." [136]

Senator Nunn and I will introduce legislation calling for a comprehensive examination of a consumed-income tax. We need hearings to evaluate the proposal and determine how the system should be structured. We have three sets of goals for the hearings. First, we will call upon Congress to evaluate the macroeconomic effects of a consumed-income tax, or savings-exempt income tax. These effects include potential changes in the growth rate of the Gross Domestic Product, the costs of capital and labor, productivity, and the national savings rate. Second, the hearings should evaluate the proposal's effects on generating revenues, increasing fairness, and simplifying the tax system. Finally, we hope that the hearings will refine or suggest solutions for several key elements of the proposal, including the following: (a) the family living allowance, (b) the treatment of tax expenditures to reflect the investment and consumption components of such subsidies, (c) an appropriate treatment of gifts and estates to achieve generational equity, and (d) unresolved transitional issues.

There are many issues to be resolved, but we need to start on the path toward a savings-exempt income tax now. Income taxes are distorting our economic decisions by favoring consumption and penalizing savings. Greater reliance on consumption taxes rather than income taxes will enhance the nation's competitive position; people will save more, financing investment for future growth.

At one time, most tax policy experts preferred income taxes to consumption taxes and the highly regressive, stifling tariffs that income taxes replaced. But there is a better way. Today we have the opportunity to replace our current tax system, flawed at its inception and made worse with each passing year, with a tax system that encourages investment. It is a progressive tax system that distinguishes between those who spend and those who save, making capital available to build our future. The savings-exempt income tax will simplify and eliminate many of the economic distortions inherent in the current code. It will unshackle our productive power, encouraging international trade and economic growth that will benefit all Americans.

ROUND TABLE ON THE NUNN-DOMENICI SAVING EXEMPT INCOME TAX (SEIT)

>Norman B. Ture

To: Participants in IRET's June 16, 1994 Round Table on the Nunn-Domenici Saving Exempt Income Tax (SEIT)

From: Norman B. Ture

Subject: Would SEIT shift tax burden from capital to labor?

One of the principal issues raised during the June 16 round table concerned the effect of replacing the present individual and corporate income taxes by the SEIT on the allocation of the tax burden between returns to capital and those to labor. There are several dimensions in the answer to this question.

Presumably, the replacement would be revenue neutral in static terms, that is, before taking account of changes in business and household behavior induced by the changes in the tax structure. Since the SEIT, by assumption, corrects the over taxation of saving and capital while raising the same revenue as the present income taxes, it is evident that initially the tax load on labor must increase by the same amount as that on capital decreases.

This shift in tax liabilities is illustrated in Table 1. The income magnitudes are taken from the national income and product accounts for the year 1990, produced by the Bureau of Economic Analysis in the Department of Commerce. The present law tax amounts are derived from the BEA estimates of the revenues from the various tax sources, measured on an income and product account basis.

The second dimension of the issue is whether Nunn-Domenici would differentially burden labor compared with capital. Would Nunn-Domenici impose a higher effective rate of tax on labor income than on capital income? The answer is that it would, because in the case of capital, only the excess of the gross returns over the outlays for the capital is included in the tax base, whereas no equivalent offset for the cost of producing labor income is provided. In essence, the gross amount of labor compensation is subject to N-D tax.

Most labor compensation represents the returns on human capital. The present income tax allows no deduction for the costs of acquiring that capital, nor does Nunn-Domenici. Because it does allow a deduction for the outlays for other capital, N-D tilts the tax burden toward labor.**[1]**

Table 1. INCREASE IN TAX ON LABOR IN SHIFT FROM INCOME TAX TO N-D

Economic magnitudes in 1990

GNP	$5,540
Less: capital consumption	600
National product	4,940
Less: indirect business taxes, business transfer payments, etc.	470
National income	4,470
Employee compensation	3,300
Gross capital income **1**	1,770
Less: gross private domestic investment	800
Net capital income 2	1,170
Average federal income tax rate on labor income	10.0%
Average payroll tax rate	13.5%
Average total tax rate on labor income	23.5%

Present law income and payroll taxes:

	Tax Base	Tax Revenue
Employee compensation	3,300	
Income tax		330
Payroll tax 3		445
Net capital income	1,170	270
	4,470	1,045

Nunn-Domenici with uniform 9.64% tax rate:4

	Tax Base	Tax Revenue
Employee compensation		
SEIT 5	6,600	636
Payroll tax, employee only		222
Capital income		
Gross capital income	3,540	
Less: gross private		

domestic investment	1,600	187
	1,940	1,045
Average total tax rate on labor income	26.0%	

Another dimension of the issue is whether the deduction of income that is saved and the expensing of capital outlays, while taxing the gross returns produced by the capital, eliminates the tax on capital, leaving in place the tax on the returns for labor. The standard analysis holds that immediate deduction of saving and investment does indeed eliminate the tax on capital, if the present value of the gross returns generated by the capital just equals the amount paid for it. In this view, only the excess, if any, of the present value of the gross returns over the outlay for the capital bears tax.

Overlooked in this view is that in the absence of expensing (and ignoring depreciation) the amount of income one needs to purchase a given amount of capital is greater than the capital outlay because one must pay tax on that income. If a person is subject to a, say, 25 per cent tax rate on his or her income and wants to buy a piece of equipment for $1,000, a pre-tax income of $1,333.33 is required. Expensing eliminates the need for this grossing up, but it doesn't eliminate the tax; it merely eliminates the doubling up of the tax.

The following example clarifies this proposition.

Assume a person receives an incremental $2,000. Absent taxes and assuming that the appropriate discount rate and the rate of return on investment is 10 per cent, investing the $2,000 produces an income equal in present value terms to $2,000. Now assume alternative taxes: an income tax without expensing (or, for ease of exposition, depreciation) and Nunn-Domenici. Assume also a 50 per cent tax rate in both taxes.

	Income tax	Nunn-Domenici
Income	2,000	2,000
Deductible investment	------	2,000
Tax	1,000	------
Amount invested	1,000	2,000
Annual gross returns	100	200
Present value of gross returns	1,000	2,000
Annual tax on gross returns	50	100
Present value of tax on gross returns	500	1,000
Annual net returns	50	100
Present value of net returns	500	1,000
Annual gross rate of return on income needed for investment	.05	.10
Annual net rate of return on income needed for investment	.025	.05

The following is a simple mathematical proof of the proposition. In a no-tax world, the optimal allocation of a given marginal amount of income between current consumption and investment uses is such that

(1) $S = Y^*$, where

S = the purchase price of a capital facility (also, by assumption the amount of current consumption forgone to purchase the facility), and

Y^* = the present value of the gross returns produced by the facility.

Now assume an income tax of the basic configuration but with neither expensing nor depreciation. To have an amount of income = S to purchase the facility, one needs S/(l-t) in pre-tax income, where t =

the applicable tax rate. The returns on the asset are also taxed so that the present value of the net return is Y* (1-t). Then

$$(2) \quad S/(1-t) = Y^* (1-t) \text{ or}$$

$$(2') \quad S = Y^* (1-t)^2$$

Now allow expensing. Then with the outlay for the facility deductible, tax is reduced by tS; so, too, is the amount of pre-tax income that is needed for the purchase. Equation (2) becomes

$$(3) \quad (S-tS)/(1-t) = S(1-t)/((1-t) = Y^* (1-t) \text{ or}$$

$$(3') \quad S = Y^* (1-t)$$

The effective rate of tax is the percent reduction in the present value of the net returns that may be obtained from a given amount of income. In the case of the income tax (per equation (2')), the net return obtainable from a marginal amount of income, S, is $Y^* (1-t)^2$. Then the effective income tax rate, t', is

$$(4) \quad t' = \frac{Y^* - Y^* (1-t)^2}{Y^*} = 1 - (1-t)^2$$

In the Nunn-Domenici tax, the net return is Y*(1-t), and the effective tax rate, t'', is

$$(5) \quad t'' = \frac{Y^* - Y^* (1-t)}{Y^*} = t.$$

ROUND TABLE ON THE NUNN-DOMENICI TAX RESTRUCTURING PROPOSAL

SUMMARY

In opening the proceedings, IRET president Norman Ture noted the tax policy community's growing interest in basic restructuring of the existing federal tax system. The growing number of Congressional tax restructuring initiatives reflect a growing persuasion that the existing system is seriously deficient in important respects, particularly because of its adverse effects on saving and investment, hence on economic progress. Dr. Ture observed that since its founding, IRET has taken the lead in identifying the anti-saving, anti-investment bias exerted by the income tax and in identifying the attributes of a tax system that would better perform the essential function of taxation, while conforming more closely to the criteria of neutrality, uniformity, and simplicity.

Ture stated that one of the most thorough going of the tax restructuring initiatives aimed at eliminating the anti-saving, anti-investment bias of the income tax is that of Senators Nunn and Domenici, the so-called Saving Exempt Income Tax. Because the SEIT calls for so substantial a change in the federal tax system, it raises a large number of issues that need to be resolved.

The purpose of the round table, Ture stated, was to give the participants the opportunity to identify the issues they perceived, particularly with respect to their companies and industries with which the participants are associated. The Round Table participants were not being called upon either to endorse or reject the SEIT, but instead to explore its advantages and disadvantages from their respective perspectives.

Ture then called upon Dr. Barry Rogstad, president of the American Business Conference, and Ernest Christian, Esq., of Patton, Boggs, and Blow, the principal developers of the SEIT proposal, to present a brief description of the proposed tax structure, and to explain its objectives. Both noted that the details of the proposed SEIT had not yet been developed. In essence, however, the SEIT is a two-tier tax, one tier in the form of a subtraction-method, border-adjusted VAT and the other a personal income tax with an unlimited, universally available, deductible IRA, without penalties for early withdrawal or restriction on use of withdrawn funds.

Following these presentations, each of the Round Table participants stated his or her concerns and posed questions concerning the mechanics and operation of the proposed SEIT. A very wide range of major substantive issues, summarized following, were identified in these statements.

An initial issue concerned the definitions of consumption and of saving f or purposes of the SEIT. As an example, would the purchase of a residence for the owner's use be treated as consumption or as saving-investment? What would be the treatment of mortgage lending and borrowing and the service of mortgage indebtedness? By virtue of the fact that a large proportion of personal dissaving and saving is entailed by incurring and by servicing mortgage indebtedness, the resolution of this issue in the SEIT poses a major issue.

A corollary issue is the likely impact of replacing the present income taxes with the SEIT on consumption outlays and, therefore, on consumer-products businesses. one concern focused on the possible effects of the proposed tax restructuring on consumer durables and on instalment sales.

A concern of broader scope was whether the SEIT would permanently depress the level and rate of growth of consumption. On the one hand, it seems obvious that a revenue-neutral shift from personal and corporate income taxation, with its heavy bias against saving, to the SEIT, which presumably would be free of this bias, would necessarily depress consumption uses of income as it increased saving. On the other hand, if the substitution resulted in a greater proportion of income being saved and invested, the result presumably would be a higher level of income in the future than would be realized under the present income taxes; at this higher level of income, consumption outlays might well be greater than otherwise. Moreover, the increase in the share of income that is saved induced by the tax restructuring would probably be transitory; the saving:income ratio would revert to the long-term trend as the adjustments to the tax change were completed.

It was stressed by several of the participants that the proposed tax restructuring would necessarily entail major disturbances in the way in which businesses are operated and major dislocations in response to the tax-induced changes in the tax costs that businesses in differing situations would confront. An important case in point concerns the impact of the proposed tax change on labor-intensive compared with capital intensive businesses. It was pointed out that if the proposed restructuring were to be revenue neutral while allowing the expensing of capital outlays, hence imposing a reduced tax load on the returns for the use of capital, the tax burden on labor necessarily would have to be greater than under the present income taxes. This would increase labor costs, hence disadvantage labor-intensive relative to capital-intensive businesses. It would, therefore, increase costs for businesses in the service and trade, while reducing costs for-goods-producing businesses.

An associated concern was that the tax substitution would lead to displacement of people by machines, hence intensification of unemployment and of the problems of retraining and relocating employees. The fear was expressed that the tax restructuring would be particularly costly with respect to the use of highly-skilled, high-tech personnel and might lead to relocation abroad of the operations relying on such personnel. A prime example is afforded by research and development activities. On the other hand, it was observed, if the tax restructuring achieved its growth objectives, job opportunities would expand as labor's productivity was enhanced by the increases in the amount and quality of the capital with which labor is employed. A basic question, accordingly, is whether the tax restructuring would in fact have the growth-generating effects sought by its proponents.

It was pointed out that the proposed restructuring, to a far greater extent than the Tax Reform Act of 1986, would necessarily entail a wide array of dislocations and changes in the conduct of business. Because of the border tax adjustments that are a major feature of the Nunn-Domenici business tax, American businesses that are heavily dependent on imports for inventory, raw materials, energy supplies, etc., would suffer substantial cost increases compared to businesses relying on domestic sources of supply.

The territoriality feature of the SEIT was both endorsed as a major advance toward tax neutrality and identified as the source of a range of problems. This feature, it was pointed out, would enhance the attractiveness of foreign tax haven jurisdictions and would lead to exporting U.S. saving, investment, business operations, and jobs. It would also shift the presumably unchanged tax burden from multinationals to domestic businesses. It would intensify the thorny problems of determining the Section 482 allocation of income among related businesses operating in foreign and domestic jurisdictions. A related question concerned the treatment of domestic saving invested abroad and the returns to that saving. Similarly, would the existing Subpart F rules pertaining to "passive" income be repealed or remain in force?

Problems of compliance associated with the transition from income taxation to the SEIT loomed very large in the Round Table discussion. Of particular concern was the treatment of the returns for saving undertaken and of capital acquired prior to the SEIT's enactment. Also troublesome was the question of how tax assets, such as net operating loss carryovers, unused foreign tax credit, alternative minimum tax credits, etc., would be treated during the possibly long-extended transition period. Concerns were also expressed about the problems in shifting from accrual accounting, required under the business income tax, to cash accounting, an essential feature of the SEIT. In this connection, the growing disparity between tax and book accounts that would orcur under SEIT was identified as intensifying the serious problem of reconciling these accounts.

The revenue productivity of the business tax and the fact that the tax would be very largely hidden from the public was identified as offering a strong temptation to public policy makers for increasing the tax rate. This was seen as posing the danger of underwriting a more rapidly expanding public sector than under the present tax regime. On the other hand, it was also observed that the explosion of existing entitlement spending requires an increase in government revenues that can only be provided, realistically, by a shift to the VAT proposed as the business tax component of Nunn-Domenici.

Increases in the SEIT's rates would impair the neutrality of the tax because saving and investment would be expensed at lower tax rates than those to which the returns would be subject. This problem would be particularly severe if the relatively high and graduated rates of the individual tax component rather than the flat rate of the business component were raised.

Questions were raised about how the SEIT would apply in the case of partnership businesses. A similar question arises with respect to the effect of the disparity between the business and business tax rates on the form of business organization.

The relatively high and graduated personal tax rates, combined with the unlimited deductibility of saving, was seen as posing a fairness issue. Presumably, this would create a stronger incentive for high-income than for lower-income individuals to save; higherincome people, moreover, would have greater capacity than lowerincome people for taking advantage of the saving incentive. A similar concern arose with regard to capital intensive companies whose large capital outlays might permit them, at least in some years, to "zero out" of the business tax.

Such concerns intensify the issues concerning the tax treatment to be provided under SEIT for property, i.e., accumulated savings, transferred by gift or at death. More generally, these concerns raise a question about the lack of explicit integration of the proposed business and personal taxes and why a two-tier tax is called for.

THE 'BUSINESS ACTIVITIES TAX' — A PRIMER

>by Cliff Massa III

Cliff Massa III is a partner with the Washington law firm of Patton Boggs, L.L.P.

This article explains, both conceptually and structurally, the "business activities tax" or "BAT" proposed by Senators Danforth and Boren, with a moderate level of technical discussion. The author argues that understanding the BAT requires setting aside the now deeply ingrained income/profits tax concepts and then focusing on the components of economic value added that are used by all businesses. He explains that the BAT applies tolhe value that each business adds to the goods and services sold in the. United States, which value is determined by computing the company's gross receipts from its sales of goods and services and then subtracting the costs of its purchases of goods and services from other businesses. Massa then gives extensive attention to the BAT's treatment of financial intermediation services and to the border adjustment features for imports and exports. The author credits the sponsors with taking a major step forward in converting consumption tax theory into a workable American-style tax system applicable to all businesses.

I. Introduction

Concepts of "income" and "profits" have dominated U.S. business taxation for so long that it's difficult to analyze tax proposals from any other perspective. Even the major tax reform debates in 1981 and 1985-86 tended to focus on ways to compute income or profits, rather than on whether such amounts are the best possible tax bases.

But all of the income tax wisdom and technical expertise accumulated over the past 80 years will be of little use in analyzing the "Business Activities Tax" or "BAT" that Senator Danforth and Senator Boren have proposed in S. 2160. This replacement for the corporate income tax, for the individual income tax on undistributed profits of "pass through" entities, and for one-half of the Social Security tax has nothing to do with income or profits. In fact, the more familiar one is with business income tax concepts and rules, the greater the likelihood that the BAT and similar proposals will appear strange or even unintelligible.

Familiarity with "value added taxes" or "VATs" is more relevant, but not necessarily helpful. These terms have almost become proper nouns, connoting tax structures used in other countries that apply multiple tax rates to sales of different goods and services using a series of invoices and receipts that list the tax attributable to each sale. The BAT is not such a system. So if the BAT is not an income/profits tax and is not a traditional VAT, what is it and how is it computed?

A. What Is It?

In the most generic economic sense, the BAT is a tax on the value that each business adds to the property and services that it sells in the United States. It will apply a flat 14.5 percent rate of tax to the amount, if any, by which a company's gross receipts from the sales of property or services in the United States exceed the cost of the company's purchases of property or services. This simple subtraction process yields the value that that company has added to the total value of property and services consumed in this country.

The more familiar one is witb business income tax conceptsand rules, the greater the likelihood that the BAT rand similar proposals will appear strange or even unintelligible.

The general rule is augmented by two "border adjustment" features for imports and exports. By taxing the amount paid for imports, the BAT assures that the value created by foreign businesses that send property and services into the United States is taxable equally with value created here. By excluding export sales, the BAT removes its domestic tax burden from property and services produced in the United States but sold for use abroad. These additional rules assure that the BAT is applied solely to U.S. consumption and not to foreign consumption. This approach is usually called the "destination principle" because the tax burden is levied in the country where property and services are consumed rather than in the country of origin. (This also may be called a "territorial principle" because it confines the tax to the value that is consumed within the United States.)

B. Why Is It Important?

The BAT makes three significant substantive contributions to converting the theory for a tax on economic value added into a workable set of rules, no matter what a particular system is called.

(1) The BAT imposes one flat rate of tax on all businesses without preferential rates and exclusions for certain sectors or activities.

(2) The BAT is the first comprehensive writtenfrom-scratch *subtraction method* tax on value added introduced in the Congress — and probably in any country.

(3) The BAT offers a workable structure for taxing the value of financial intermediation services — a feature that has not been implemented by our major trading partners.

By itself, each of these is an important contribution to the coming debate. Putting all three together, the BAT offers a fresh, simplified, but comprehensive structure for implementing a tax on value added by businesses.

C. Reviewing the Mechanics

This is a "what it is and how it works" commentary. The BAT concept is sufficiently different from — and simpler than — the U.S. income tax and foreign VATs to need an explanation and commentary on the structure and rules and how they are tied together.

Given this context, the reader is asked to focus on the *mechanical* fact that the BAT is levied on businesses and is remitted by businesses, without regard to how its economic burden may be distributed among customers, employees, and/or owners of the business. (The BAT's economic incidence is an interesting topic, but it is the subject for later articles.) The concept and the rules are relatively easy to understand when studied from the following two perspectives.

- A company's BAT base is computed by determining the value of what it sells to its customers and then subtracting the value of what it purchases from other businesses. This assures that all value is taxable once — and only once — during the period.
- A company's BAT base also equals the payments it makes for the use of capital services (interest on debt and profits on equity) and the payments it makes for the use of labor services (all compensation including wages, salaries, and benefits) to convert what it purchases from other companies into the more valuable goods and services that it sells to customers.

The BAT's general rules are easy to state. As a result, its general statutory structure also is simple and should be easy to understand (once income tax concepts are set aside). However, there is a host of more complex business transactions in the U.S. and international economies. Such transactions require a more detailed statutory structure. The BAT is much simpler than the current income tax, but its simplicity is relative and should not be oversold.

The following commentary is an initial topical discussion of the principal BAT concepts and rules as they relate to one another, rather than a section-by-section analysis. For convenience in finding the appropriate language in Title III of S. 2160, references are to proposed Internal Revenue Code sections 10001 through 10065 in a new Subtitle K/Chapter 100 of the code. This article does not attempt to analyze every nuance of the current BAT draft or identify every subject that needs more attention. There will be ample time for that.

The BAT is much simaler than the current income tax, but its simplicity is relative and should not be oversold.

By way of disclosure, note that this commentary is based on approximately two years of work with the consumption tax group formed by Senators Danforth and Boren and on additional conversations with the senators' tax counsel. Some of the interpretations and comments expressed here differ from those in the Technical Overview of S. 2160 released by the senators. The interpretations and comments are the author's alone.

II. General Structure of the BAT

Section 10001 creates the general structure of the BAT in one simple sentence:

> "In the case of any person engaged in any *business activity*, there is hereby imposed for each taxable period a tax in an amount equal to 14.5 percent of the *taxable amount."* (Emphasis added.)[1]

The balance of the statutory structure is devoted almost exclusively to definitions of and elaboration and limitations on these two highlighted terms, plus two other terms — "gross receipts" and "business purchases" — that are essential to the definition of "taxable amount."

The computation of "taxable amount" is the ultimate objective, and there will be a tendency to jump directly into that process. But that is not the place to begin.

"Business activity" is the basic concept. If an entity is not engaged in a business activity, then the BAT does not apply at all. Even if a business activity exists, some of a company's receipts and expenses may be attributable to transactions that are not considered business activities for BAT purposes. Therefore, an understanding of the BAT's statutory structure must be built on what is meant by "business activity."

III. Business Activity

"Business activity" is defined in section 10012 to mean three categories of activities — "(1) *the sale of property or services* in the United States by any *person* in connection with a *business*, (2) the import of property or services into the United States [whether for business or nonbusiness purposes], or (3) the export of property or services from the United States in connection with a business." (Emphasis added.)

A. **Sales Activities in the United States**

Clearly, the general sales category covers the vast majority of activities to which the BAT applies. Before determining whether the activity is undertaken in a business, a judgment must be made about the sales activity itself.

Sales activities generally are easy to identify. They are the transferring of ownership of property or the performance of services for consideration. Formal definitions of the important terms are in paragraphs (1), (2), (3), and (11) of section 10051, which is the definitions section.

The distinction between a sale and a lease does not exclude the latter from the BAT. Whether a company is selling property or is selling *the use of property*, the BAT applies. But this *does* highlight the importance of considering what is meant by property and what is meant by services.

1. What is 'property'? The term "property" is defined expansively in section 10051(3) as any tangible or intangible property other than money or financial instruments (which includes stocks, bonds, partnership interests, "swaps," derivatives, and other interests). So the sale of any property except money and financial instruments initially qualifies as a business actiyity.**2**

The exclusion of money and financial instruments from the definition of property assures that a company is not subject to the BAT with respect to investment activities involving such assets or the sale of its own stock or other ownership interest for cash or in-kind capital contributions.**3** But the exclusion of money and financial instruments from the definition of "property" does *not* exclude companies such as brokerage firms and banks from the BAT. In these situations, companies generally are selling a service to their customers — handling the purchase and sale of financial assets for customers, arranging and administering the lending of money between depositors and borrowers, etc. — rather than selling such assets to the customers.

2. What are 'services'? The sale of services is also defined quite expansively in section 10051 (1). Widely understood meanings of "services" include all professional services (legal, accounting, medical, architectural, engineering, consulting, etc.), transportation services, and communications services, to name just a few categories. It also includes financial intermediation services provided by banks, insurance companies, and others. Financial intermediation is sufficiently complex that a separate rule is provided under section 10034. (This important contribution to converting the theory of value added taxation into practice is discussed in more detail later.)

The sale of services also includes the granting of the right to use tangible or intangible property, such as the leasing of buildings, the sale of licenses for trademarks and software, the sale of mineral rights, and anything similar. Also included are the granting of a right to the performance of services in the future or to reimbursement under warranties and similar arrangements.

3. Does the sale occur in a 'business?' The scope of covered sales activities is very broad, and the definitions should not be particularly difficult to implement. Once sales activities are identified, the question is whether they are made in connection with a "business."

Rather than refer to the legend and lore of "trade or business" that has developed within the income tax rules, the BAT starts with a clean and simple definition. "Business" (defined in section 10051(4)) includes any activity carried on continuously or regularly that involves or is intended to involve the sale of property or services, whether or not for profit.**4**

Subjective judgments will be required in some cases, and there may be a need for *de minimis* rules in some others. But this definition is appropriately comprehensive in scope. The start-up company that *intends* to sell property or services is engaged in a business even before its first sale. A writer or inventor is in a business even when there are periods of time between actual sales of books or patents. The continuous or regular activity with an intent to sell is broad enough to apply to such individuals. But the sale of the family's used car to either their neighbors or to a used car dealer does not create a family business. Neither does the sale of one's residence create a business activity. The absence of both a continuous or regular activity and an intention to sell the property will exclude such transactions.

4. Sales 'in the United States.' This first category of business activity is limited to sales "in the United States," a limitation that is essential to making the BAT a destination principle tax. All of the sales activities outside the United States by subsidiaries or branches of U.S. companies are left to other taxing jurisdictions. At the same time, the U.S. sales activities of foreign-based companies — including foreign subsidiaries of U.S. companies — are business activities for BAT purposes.

Sourcing rules in section 10024 govern whether a sale occurs in the United States and, therefore, is made in a business activity. For property, the rule provides that its location at the time of sale determines whether the sale is "in the United States." For services (other than certain international transportation services covered in section 10033), the place from which the services are provided — or the location of the property with respect to which the services are provided — is the determining factor.**5**

5. 'Person.' The BAT applies to the sales activities of any "person." For BAT purposes under section 10051(7), "person" means an individual, trust, estate, partnership, association, company, corporation, or governmental entity. Exempt status under the income tax is not relevant.

B. Imports and Exports

The vast majority of companies are purely domestic in nature. They buy from other U.S. companies, and they sell to U.S. customers. They will not need to move beyond the general sales category to develop an understanding of "business activity." However, it is very likely that the companies with the largest sales activities and the largest BAT liabilities will also have import and export activities. For them, two more categories of business activities will be important.

1. Imports. The second category of business activity is the import of property or services into the United States. This is necessary to implement the destination principle. Imports arrive with a significant amount of value already in them. If the act of importation itself were not a business activity, the general sales category could be misinterpreted to apply only to the business activity that adds value *after the import arrives*. Also, imported property or services may be purchased for nonbusiness uses by businesses or may be purchased directly by consumers. In such cases, the imports would not be covered by the general sales category. For these reasons, the explicit rule is needed to pick up import activities of all kinds — whether for business or nonbusiness purposes — and to include them in the definition of business activity. As the BAT proposal evolves, a definition of "import" or rules for identifying the importer — or both — may be developed. (The mechanics of applying the BAT to imports are discussed later.)

2. Exports. The third category of business activity is the export of property or services from the United States in connection with a business. Goods that are produced in the United States may be sold when they are outside the country. A company may ship its own manufactured goods to an overseas branch for use or sale without "selling" them within the generally understood meaning of a sale. To address these and other possible situations, this category makes clear that exports in connection with a business (whether or not a sale occurs) are business activities that subject the company to the BAT system. This explicit rule is necessary to assure that the "taxable amount" rules discussed below will allow all BAT that has been payable with respect to the production of exports to be eliminated. As with imports, a definition of "export" or a set of rules for identifying the exporter or both may be needed.[6]

C. Particular Situations

Whether or not an activity is considered a "business activity" will be clear in most situations, but others require specific attention in the BAT structure. The treatment of governmental entities and traditionally tax-exempt organizations are two such situations.

1. Governmental entities. Governments provide numerous services that are funded by taxes. But many governmental entities also sell property and services for consideration just as private entities do. Specifically treated as business activities under section 10022(a) are public utility services, mass transit services, and postal services of all federal, state, local, D.C., commonwealth, or territorial governments and agencies or instrumentalities thereof, plus "[a]ny activity not involving the exercise of any essential governmental function (within the meaning of section 115)." This rule treats governments the same as businesses when their activities are competitive. Only if such governmental services are subject to the BAT should the system allow business customers to take "business purchase" deductions (as described below) for the cost of such services. Otherwise, the customer is deducting an amount of value that has not been taxable by the BAT.

2. Exempt organizations. Under section 10022(b), the BAT applies to the business activities of the entire range of organizations that are exempt from the federal income tax. The BAT is as appropriate a replacement tax for the payroll taxes and corporate taxes (on unrelated business taxable income) for these organizations as it is for the general business community under the Danforth-Boren package. Moreover, to the extent such organizations compete with other businesses, they should be treated the same by the BAT system. And like the governmental entity situation, businesses that pay dues, fees, or other amounts to purchase goods and services from exempt organizations need to have such organizations in the BAT system to offset the business purchase deductions discussed below. The sponsors are maintaining the long-standing social policy of exempting educational and charitable functions from most taxation. As a result, the BAT exempts all activities of current section 501(c)(3) organizations except those activities that produce unrelated business taxable income (as currently defined).

D. 'Not a Business Activity'

To avoid confusion and to provide relief in one area, two activities are explicitly classified by section 10013 as *not being business* activities — (1) providing services as an employee and (2) importing certain duty-free items (primarily as an administrative convenience for modest amounts of foreign goods being brought home by returning tourists). The explicit exclusion of employees' services from the definition of business activities confirms a fundamental concept of value added taxation. This is discussed further in Section IV.E below.

E. A Comment on 'Business Activity'

One of the principal contributions that the BAT makes to converting tax theory into practice is the scope of its definition of "business activity." With relatively minor exceptions for certain section 501(c)(3) activities and *very* small businesses (discussed below), the BAT applies to all business sectors in the U.S. economy. It does not attempt to address regressivity issues as most VATs do by either excluding sales of food, medical care, housing, or other "necessities" from the tax base, or applying a lower tax rate.

The sponsors have made clear their intention to provide relief to adversely affected households by using targeted tax benefits *outside* the BAT system, rather than wasting revenues through preferential treatment of necessities sold to middle- and upper-income households. This approach has several economic and political merits. It treats all business sectors the same and, therefore, does not distort investment decisions among various sectors. It allows the BAT rate to be significantly lower than would be the case if the tax base were cut by one-third (or more) when sales of necessities are excluded. It avoids the enormous complexities and costs that result from multiple rates and preferential exclusions that, regrettably, are common in VATs around the world.[7] A steadily growing trend in other countries to adopt universally applied VATs suggests that policyrnakers; are catching up with what economists have long understood.[8]

IV. **'Taxable Amount'**

For those who find that they are engaged in a business activity, computation of the "taxable amount" is the next step. The general rule in section 10011 is that "taxable amount" equals the excess of "gross receipts" from business activities over "business purchases."

The sponsors have made clear their intention to provide relief to adversely affected households by using targeted tax benefits outside the BAT system.

The general definitions and rules for gross receipts and business purchases will cover the vast majority of companies and activities. Separate rules for computing the "taxable amount" for imports and for handling exports and international transportation services are discussed after the general rules. Keep in mind that the computation of taxable amount is made for each "taxable period," which is defined in section 10062(b) as a calendar quarter rather than a year.

A. 'Gross Receipts' in General

"Gross receipts" for BAT purposes are defined generally in section 10014(a) as all receipts from a business activity. Gross receipts from the vast majority of business activities will be easy to identify because they are the receipts from routine sales of property or services to customers. Also included are sales of property that is considered a capital asset for income tax purposes such as used machinery, old buildings, excess raw materials, or components and other noninventory items, all of which generate gross receipts equal to the amounts received (without regard to "gain" or "loss"). This produces the correct result because such items will have been taken as business purchases (described later) in an earlier period.[9]

Any receipts that are *not* from a business activity are not taken into gross receipts for BAT purposes. The explicit rule in section 10016 reaffirms that transactions involving ownership interests are in this category. The "applicable nontaxable transactions" under that section include reorganizations under section 368, subsidiary liquidations under section 332, transfers to controlled corporations under section 351, and contributions of property to acquire partnership interests under section 721, except for "boot" received in such transactions.

For most businesses, this will be all (or almost all) that they need to know about BAT gross receipts.

B. 'Business Purchases' in General

The general definition of "business purchase" in section 10015 is "any amount paid or incurred to purchase property or services for use in a business activity. . . ." Because such amounts are includible in the gross receipts of the seller, they must be removed from the buyer's BAT base to compute the buyer's own value adaed. Otherwise, the seller's value added will be taxable a second time.

Critically important is the requirement that the purchase be made for use in a business activity. No business purchase is allowed for expenses incurred with respect to a nonbusiness activity such as charitable contributions, overseas purchases of property and services (unless they are imported into the United States), and purchases of investment assets.

There are explicit exceptions to the definition of business purchases in section 10015(a) — illegal payments (this is a public policy principle, not an economic one), interest and other implicit intermediation fees (other than those discussed below), and insurance premiums (other than for property and casualty policies on business property).[10]

Two possible areas of "leakage" due to business purchase deductions of amounts that are not BAT receipts for the sellers appear to be minimal at most. One such situation will arise when larger businesses purchase goods and services from very small businesses that are exempt under the $100,000 gross receipts rule (discussed below). The small seller will not be taxable on its own value added, but the purchaser can deduct the cost of the goods and services bought from that seller. Estimates suggest that less than 3 percent of the BAT base will be lost under this exemption, while perhaps 60 percent of all business entities will be removed from the system if all eligible entities remain exempt.[11] A second situation — the BAT exemption for section 501(c)(3) organizations — is not likely to add to leakage since their educational or charitable services generally are not sold to businesses. Even if businesses pay tuftion for employees' educational services, such expenses should be regarded as compensation and, therefore, not treated as business purchases anyway (see Section IV.E. below).

A potentially confusing situation is the purchase of used consumer goods, such as a used car by a used-car dealer. Even though the consumer/seller is not engaged in a business activity and is not taxable on the sale, the dealer/ purchaser will be allowed a business purchase deduction for the amount paid. The value of the car was fully taxable as it was produced and sold initially. If the car returns to the marketplace through a dealer who resells it, some value will be taxable twice unless the dealer takes a business purchase deduction for the amount paid to the original owner. The same procedure will apply to any used property (e.g., furniture, collectibles, books, appliances, etc.) purchased from consumers by those who are engaged in a business activity of selling such items.[12]

C. A Comment on the Computation Method

Another principal contribution of the BAT is its use of the subtraction method for computing the tax liability. The tax rate is applied to the taxable amount that is produced by subtracting business purchases from gross receipts. With the possible exception of the Japanese system (about which there is some debate), VATs around the world require the tax rate to be applied to each sale and recorded on the invoice. A company then (1) aggregates the tax amounts on its sales invoices/ receipts and on its purchase invoices /receipts, (2) credits the aggregate purchase taxes against the aggregate sales taxes, and (3) remits the difference.

The BAT's sponsors have taken a very significant step by starting with a clean sheet of paper and crafting a comprehensive system.

Previous proposals by Sen. William Roth, R-Del., and by former Rep. Richard Schulze, R-Pa., utilized a subtraction method, but each was tied in various ways to income tax concepts and/or to payroll tax liabilities. The BAT's sponsors have taken a very significant step by starting with a clean sheet of paper and crafting a comprehensive system that utilizes the subtraction methodology without being intertwined with income tax concepts or payroll taxes. The BAT also does not depend on mechanisms or terms lifted from VAT structures. This approach also will allow companies to make maximum use of financial data to comply with the BAT, as discussed later.

D. **Particular Situations**

A number of situations require particular attention where the general rules for gross receipts and business purchases either are not clearly applicable or need some elaboration. The principal ones — financial intermediation services, exports, imports, international transportation services, employee compensation, and taxes — are discussed below. Four others with explicit rules are:

(1) exchange or barter transactions — the fair market value of goods and services transferred plus any money received (paid) will be treated as gross receipts (business purchases) (sections 10014(b) and 10015(e));

(2) property and casualty insurance — with respect to business property or services, insurance proceeds are included in gross receipts as substitutes for lost sales (section 10014(d)) and premiums for such policies are business purchases (section 10015(a)(2)(B));[13]

(3) owner/employee transfers and discounts, etc. — where property or services are transferred to employees, owners, or their family members or sold to such persons at a discount, gross receipts will equal the fair market value of the property or services (section 10014(f)); and

(4) gambling — except for illegal payments, business purchases include amounts paid to winners from gambling, lotteries, etc. (section 10015(g)).[14]

E. Compensation

Employees' labor services are a significant component of the value that a company adds to the "inputs" it buys to produce the "outputs" it sells. Therefore, one critically important feature of the BAT is that *no form of compensation for employees' or owners' labor services is treated as a business purchase*. Wages and salaries clearly are covered by this rule. But the same treatment will apply to any amount paid or incurred as compensation to employees, no matter what form the compensation takes. Contributions to retirement plans, health insurance and health care payments, life insurance policies, educational assistance programs, disability insurance, deferred compensation arrangements, and any other benefits are substitutes for direct cash payments that the employees could use to purchase the benefits directly. In these situations, the company is consuming such services just as if it were making a collective consumption purchase for its employees from their own (higher) wages and salaries.

This essential feature of the BAT also assures that the importance of the distinction between independent contractors and employees will not be eliminated. Purchasing services from another business will allow a company to treat such costs as a business purchase for BAT purposes. The company will not be able to obtain a similar result from paying its own employees to perform the same services. Economically, the results are identical because the business purchase becomes gross receipts for the independent contractor. But the rewards for abuse may be as tempting here as the income and payroll tax withholding benefits of abuses are under current law (until you play audit roulette once too often).

F. Interest and Dividends

The capital services provided by a company's owners (use of their equity) and lenders (use of their debt) are combined with the employees' labor services to enable the company to add value to its inputs so that customers will buy its outputs. Just like wages, salaries, and benefits are compensation for employees' labor services, dividends and interest are compensation for capital services. For the same reason, they are not business purchases. Instead, they comprise a sizable portion of the BAT base (along with undistributed profits). Because interest and dividends are taxable to the company that pays them, they are not taken into gross receipts by companies that receive them (except financial intermediaries, as discussed below).

G. International Transactions

With the destination principle as a context, the general rules for both gross receipts and business purchases need modifications when applied to exports, imports, and related international transportation services.

1. Exports - Section 10031. An exporting business is engaged in a business activity for BAT purposes, even if the sales of property or services do not occur in the United States. This assures that such companies are in the system. Once in the system, a company's export sales are excluded from gross receipts for BAT purposes to allow the destination principle to be applied. For a company that sells exclusively for export, gross receipts from business activities will always be zero.

All purchases of property or services by an exporter for use in producing its exports are business purchases even though its export sales are excluded from gross receipts. For all pure exporters and for many substantial exporters, business purchases will exceed gross receipts for domestic sales, thereby creating a negative taxable amount. This will produce a refund of BAT from the government equal to 14.5 percent of the negative amount. For moderate exporters, their domestic gross receipts will be partially or substantially eliminated. This completes the implementation of the destination principle by allowing the exporter to eliminate the full amount of BAT attributable to the goods and services that it purchased as inputs for purposes of producing its exports.

2. Imports — Section 10032. Imports are subjected to the BAT so that the destination principle can be implemented. To assure that the value that is added to imports by businesses in other countries is treated the same as value that is added to domestic goods and services, imported property and services are subjected to the BAT by computing their full "taxable amount." The taxable amount is the total amount that the importer pays for the property or services. In the case of property, the taxable amount includes any separate fees for transporting the property to the United States. The importer is then liable for BAT equal to the 14.5-percent rate applied to the taxable amount. For companies that export property for repairs or for further assembly and then reimport them, a special rule applies the BAT only to the net cost of the non-U.S. activity.

By imposing the BAT on the full taxable amount for imports, the system equalizes the treatment of domestic- and foreign-produced property and services. The appropriate amount of BAT will be added to the importing company's BAT for domestic activities. But this equalizing process then requires that the taxable amount be allowed as a business purchase for the importer. Otherwise, the value of imports would be subject to taxation again in the importer's domestic BAT base. The BAT attributable to the imports — i.e., 14.5 percent times the taxable amount — is also a business purchase under section 10032(c)(1)(B). This equalizes the treatment of domestic and imported goods and services without regard to theoretical arguments about whether some or all of the BAT is passed forward in prices.[15]

The method for collecting BAT on imported property remains open. Options include (i) actual payments at the border, (ii) inclusion of the tax on the importer's BAT return for the taxable period, and (iii) for those who are substantial and routine importers, a periodic payment to Treasury of accumulated BAT liability on imports. For services with no "border crossing point," the second option seems to be the choice.

One area of potential "leakage" from the BAT system is the purchase by consumers of services from a foreign service provider. This is likely to involve financial and other services that can be provided largely by telecommunications, mail, or courier to U.S. consumers by offshore professionals. If such services relate to property in the United States (which is highly likely), the seller arguably will be subject to the BAT under the sourcing rule for services in section 10024(b)(1), if that can be sufficient nexus for U.S. jurisdiction.[16] This is a subject for further attention.

3. Transfer Pricing. The BAT's treatment of imports and exports produces one significant administrative simplification when compared to the current income/profits tax computations — *there is no transfer pricing problem*. Export sales are excluded from gross receipts without regard to whether a U.S. company attempts to undervalue or overvalue such sales to a foreign affiliate. Imports are taxable on the full amounts paid for the property or services. If the importer understates the amount it pays to its foreign affiliate for the import to lessen the BAT's border tax, the importer's overall BAT liability increases because its business purchase deduction for the import is also understated. The understatements should occur in the same taxable period (which is a three-month period), so there will not be even a time-value-of-money incentive for trying to play such games.

The BAT*s *treatment of imports and exports produces one significant administrative simplification when compared to the current income/profits tax computations — there is no transfer pricing problem.

Cheating with regard to the sourcing of imports and exports is another matter, as discussed below. But for honest taxpayers, the legitimate — though strongly held — differences of opinions with the IRS about transfer prices will be irrelevant.

4. International Transportation Services — Section 10033. Fees and fares for domestic transportation are readily includible in gross receipts. But special rules are needed for *international* transportation activities to assure that the destination principle is applied without double counting or double deducting the fees and fares involved.

a. Property. Fees received for transportation of imported property are excluded from the transportation company's gross receipts because they are included in the importer's taxable amount for property, as noted above. Once the BAT is computed on the importer's taxable amount, these fees are treated as business purchases for the importer.

Fees received for transportation of exported property are excluded from gross receipts because, like the property itself, the service is being exported. To avoid a double exclusion of fees for such outbound services, the exporter is denied a business purchase deduction.

b. Passengers. Fares received for transportation of passengers out of the United States are excluded from gross receipts as an export of services. Because such services are not taxable to the provider, the purchaser cannot deduct the fares as a business purchase. Fares received for inbound transportation of passengers are included in the company's gross receipts as an imported service. Purchasers of inbound transportation may deduct fares as business purchases.

Fares for transportation between two points in the United States are — or should be — domestic sales, even if the passenger travels through or over another country or international waters for a substantial portion of the trip. Likewise, transportation services between

Mexico and Canada that involve flying over or moving through the United States should not be a business activity. The definition of services or the sourcing rules may need refinement or elaboration in this area.

While transter pricing should not be a BAT issue, sourcing will be.

It is likely that international transportation services will require more attention in the context of VATs in other countries. The objective should be to assure that such services are taxable *somewhere* rather than subject to permanent exclusions *everywhere*.

5. Sourcing Rules. While transfer pricing should not be a BAT issue, sourcing will be. Because the BAT's border adjustments are triggered for imports and exports, proper sourcing of sales of property and services will be important. Excluding sales of exports from gross receipts places particular importance on assuring that such receipts are *in fact* from sales of exports. Imposing the BAT on all imports requires equal attention. The Customs Service may be helpful with respect to goods moving into or out of the country. Also, identifying the *correct* exporter will be an important audit item. Two companies at the end of the U.S. distribution chain could seek to exclude the sale of the same goods moving out of the country.

Transportation of tangible property is likely to be easier to deal with than transportation/ transmission services for information and professional services generally. The statute will need to give more attention to these situations to assure that the value of such services is included in the BAT base of either the purchaser (which is the general rule for imported services) or the service provider (which is not the general rule).

H. Financial Intermediation Services

Most services are sold for explicit fees or other identifiable amounts that are readily includible in gross receipts. But many companies receive implicit fees for their services as financial intermediaries when they provide lending services, insurance services, market-maker/dealer services, or other financial intermediation services.

One of the BAT's most important contributions to the consumption tax policy debate is its inclusion of such services. VATs generally exempt such services. This means that the intermediary is not taxable, but it cannot take a VAT credit for purchases of goods and services that are used in providing the exempt services. The size and visibility of the U.S. financial services sector probably assure that it cannot be exempt from the BAT either economically or politically.[17]

The challenge is to compute an appropriate taxable amount when the fee is not separately stated. The two principal examples of financial intermediaries — (1) banks and other lenders and (2) insurance companies — generally do not list a specific fee for their principal services. Instead, that fee is implicit in the "spreads" or other amounts that are retained from the massive flows of money that they move between depositors and borrowers or among the insureds.

There appear to be two general approaches for applying the BAT to financial intermediaries. One is to compute implicit fees, include them in gross receipts, and then apply the general gross receipts and business purchases rules. The other is to craft rules for computing the taxable amount without separately computing the implicit fee. The BAT uses the latter.

1. Computing the intermediary's taxable amount. Financial intermediation services certainly are services in the BAT context. But to avoid any possible confusion (particularly in the case of market makers and dealers), financial intermediation services are explicitly described as a business activity under section 10034(a)(1). Then, paragraph (2) states that the BAT is to be applied by deducting "adjusted business purchases" from "financial receipts." "Financial receipts" means all receipts from such intermediation services other than capital contributions. This will include deposits received, interest received, principal repayments, insurance premiums, dividends, discount premiums, and other financial flows to the intermediary that include the implicit fees. "Adjusted business purchases" will then add to the general definition of business purchases all principal or interest payments allocable to the intermediation service, the cost of and payments under financial instruments used in the intermediation activity (excluding stock/ownership interests in the intermediary), and insurance claims and cash surrender values paid by insurers.

2. Notice to customers. Intermediaries will be required by section 10034(d) to notify customers of the amount of implicit intermediation fees reasonably allocated to those customers. A business customer then treats such fees as a business purchase under section 10015(d)(1). However, section 10034 does not provide for a computation of the amount of the intermediary's implicit fees that can be provided in the required notice to customers. Instead, it computes the intermediary's total taxable amount by combining explicit fees with other "financial receipts" and then deducting "adjusted business purchases."

This is not the amount that customers can be told is a fee for business purchase purposes. First, it may include explicit fees that customers will treat as business purchases anyway. But even if there are no explicit fees included, it *understates* the actual fee that a customer pays for the service. Using this amount would allow business purchase deductions only for the seller's value added rather than the entire fee for services. In that case, the portion of an intermediary's implicit fee representing suppliers' value added would be taxable again as it cascades into the business customer's BAT base.

The Technical Overview of S. 2160 contemplates a separate computation of the allocable implicit fees by returning to both financial receipts and adjusted business purchases and then removing from each the imounts that would otherwise have been taken into account by the BAT's general rules for gross receipts and business purchase rules. Thus, "adjusted" adjusted business purchases would be deducted from "adjusted" financial receipts to produce the implicit fees that are to be allocated among customers. This process is one of the two methods noted above as options for handling intermediation services generally. Perhaps further discussion and analysis will suggest that this process for computing implicit fees can be used as the general rule in section 10034 as well as in the notification provision.

I. Taxes

The BAT generally treats taxes, duties, and other levies received by the seller from the purchaser as gross receipts and business purchases even when they are separately stated in the sales transaction (sections 10014(e) and 10015(f)).[18] The purpose is to take into account the total amount received/paid for property or services without regard to how part of the total has been itemized. While amounts identified as taxes and paid by the purchaser to the seller are business purchases, taxes paid by a company to any government are not business purchases.

This is the correct economic result. Governments at all levels impose a wide range of taxes on all or various parts of a value added base. The fact that several tax systems are dipping into that base does not change the additional fact that the base remains gross receipts minus business purchases. If the BAT granted certain types of taxes (e.g., sales taxes versus income taxes) a "first-call" status to dip into the BAT base, that would encourage the erosion of the BAT base as governments were pressured to convert to such systems.

The BAT currently excludes from gross receipts a series of federal excise taxes (including the gasoline tax, alcohol taxes, and tobacco taxes), which has the effect of removing these amounts from the BAT base. This rule is not explained.

V. **Accounting Rules**

A. Accounting Data

The subtraction method by which the BAT is computed is one of its principal features. This, coupled with the single rate applied to all business activities, will enable a company to use its basic financial accounting data on sales and purchases when computing its taxable amount. Far fewer adjustments and computations will be necessary for BAT purposes than are required either for the income tax or for financial statements under GAAP rules. There will be no reserves for future price adjustments or bad debts. There will be no depreciation or amortization of "capital assets." There will be no inventory capitalization. The principal decision will be when to treat sales and purchases as having occurred.

B. Accounting Methods

For BAT purposes, the allowable accounting methods are cash, accrual, and any other that the Secretary approves. Long-term contracts will require a hybrid using the percentage-of-completion method for sellers and cash for purchasers.

C. Sale vs. Lease

The sale versus lease distinction does not lead to an exclusion of one activity versus the other because both are covered. Instead, the distinction will be important primarily to assure that buyer and seller or lessee and lessor both treat the transaction properly when computing their "taxable amounts." For both lessors and lessees, the entire rental payment needs to be taken into account for gross receipts and business purchase purposes. The lessor may have borrowed money to acquire its assets, but that fact is relevant only with respect to its interest costs. All of its rental receipts are gross receipts because they are fees for services, which entitles the lessee to treat the entire payment as a business purchase.

D. Price Adjustments

Many transactions involve price adjustments — rebates, volume discounts, returns, and refunds — in a taxable period after the sale. Each of these is treated under section 10023 as a decrease in gross receipts in the period in which the adjustment occurs. Business customers who receive rebates or refunds must decrease their business purchases in the same period. No reserves are established for such adjustments.

Bad debts from sales are treated the same way. Gross receipts are not adjusted until the seller treats a debt as wholly or partially uncollectible and notifies the purchaser of that treatment. The purchaser must reduce its business purchases in the period in which it receives notice from the seller.

Price *increases* are also likely in certain situations, such as under a late charge plan when customers are charged a fee if payment is not received on a timely basis (e.g., 30 days). Volume discounts may also be revoked if purchase quantities or other criteria are not met. In these situations, a rule that is the reverse of the refund/rebate rule will be appropriate.

VI. **Administrative Matters**

A. Taxable Period

BAT computations are to be made for each "taxable period." As defined in section 10062(b), this is a three-month calendar quarter. Another year, such as a fiscal year or the 52/53 week schedule, can be used if it is used for income tax purposes, and the taxable period will be determined accordingly. A return is to be filed and BAT payments are to be made within 45 days of the end of each period.

B. Related Businesses

Affiliated groups and companies under common control must file as one taxpayer under section 10063. Controlled groups may elect to do so. Purchases and sales between members of such single taxpayer groups are ignored for BAT purposes. For BAT purposes, the definition of affiliated group is expanded to include insurance companies, section 936 election companies, and DISCs. Foreign subsidiaries continue to be excluded from such groups. If they have business activities, they must file separately.

C. Refunds

Taxpayers who have business purchases in excess of gross receipts for any period are entitled to a refund under section 10041 equal to the 14.5-percent BAT rate multiplied by the excess. The Treasury Department has 45 days after receipt of the quarterly return to do a quick review and then provide the refund.

D. Small Business Exemption

Small businesses that have aggregate gross receipts from business activities of $100,000 or less during the current and three immediately preceding taxable periods will be exempt from the system under section 10042 (unless they elect to be included). As a result, the exempt business will not be taking any business purchases into account. Once a business loses its exempt status through election or an increase in gross receipts, it cannot regain that status.

E. Administration and Audits

The BAT should be relatively simple to administer, from an Internal Revenue Service audit perspective. The BAT should pose no greater audit burden than the more familiar invoice-credit VAT, which requires the listing of a gross tax amount on each invoice or sales receipt. Suggestions that invoices with tax amounts on them provide a better cross-checking audit trail than invoices without tax amounts may appear to be correct, but in practice this is unlikely. Correct sales prices are the critical items of information under both systems. Listing a tax amount in addition to the sales price is not likely to deter fraud; understated or overstated prices can be used under either method. In addition, cross-checking *several hundred thousand* invoices for one company for a given year is extremely unlikely.

The IRS is more likely to focus audit work on testing the company's *accounting procedures* and doing some sampling of paper invoices (and of electronic purchase orders and invoices, which are used increasingly). Either the BAT or invoice-credit VAT can be audited in this manner.

The absence of various adjustments to gross receipts for reserve accounts and to business purchases for depreciation, amortization, and capitalization purposes will limit the number of areas which agents must review. Treatment of export sales and import purchases probably will require the most audit attention.

VII. **Conclusion**

For many years, broad-based "consumption taxes" of various kinds have been the subject of largely academic debates because the prospects for enactment were seen as remote. That seems to be changing. Proponents are turning to the list of consumption taxes to fund policy options ranging from complete replacements of existing federal taxes to paying for new spending to reducing the federal debt.

All who have an interest in developing an efficient and economically neutral system of business taxation are encouraged to get familiar with the BAT and to help provide answers to the questions that will arise.

Senators Danforth and Boren have introduced a bill that is on the tax reduction and replacement end of the spectrum. Perhaps that sentiment will drive the coming debate.

But their principal contribution to that debate is the crafting of a distinctly new, broad-based, uniform, and simplified business tax structure based on value added. They have asked for suggestions and commentaries on a number of issues, and a long list of details will need attention. All who have an interest in developing an efficient and economically neutral system of business taxation are encouraged to get familiar with the BAT and to help provide answers to the questions that will arise.

REVISITING THE INCOME TAX VS. CONSUMPTION TAX DEBATE

>by Michael J. Graetz

Michael J. Graetz is Justus S. Hotchkiss Professor of Law at Yale Law School. Heformerly was Assistant to the Secretary and Special Counsel at the Department of Treasury. This article is an edited version of comments made at the fall 1992 symposium of the Center for Economic Policy Studies, Princeton University.

In this article, Graetz notes the near consensus among economists that long-term growth would be less hampered ky additional taxes if theyfell on consumption rather than on income. He cautions against a broad-based tax on consumption. Instead, he advocates a tax on energy consumption. His proposal is broader than carbon orgasoline taxes, although healso believes that an increase in the latter could be combined with his energy tax. He also believes that higher taxes on both alcohol and tobacco could be easily justified and suggests some more tax measures that would burden consumption rather than savings or investments.

Recently, a prestigious bipartisan commission on budgetary policy — headed by Senators Sam Nunn, D-Ga., and Pete V. Domenici, R-N.M. — has called for replacing the income tax with a progressive rate individualized tax on consumption.[1] This has brought a broad-based consumption tax back into the center of public debate although it is an idea with a long history.

Indeed, in 1921, when the income tax was only eight years old, and a fraction of its current size, Chester Jordan, a public accountant from Portland, Maine, told the Senate Finance Committee that he could reduce the size of his accounting firm from eight to three members, if Congress only would substitute a tax on "spendings" for the income tax.[2] That proposal was strongly seconded by Ogden Mills, then a congressman from New York, who later was to serve as Herbert Hoover's Secretary of the Treasury.[3] After Congress refused to go along with his suggestion, Chester Jordan changed his name to Price-Waterhouse and the rest is history. (That last part is apocryphal, of course, but it should have happened that way.)

September 3 of this year also marked the Golden Anniversary of Treasury Secretary Henry Morgenthou's call for a progressive, graduated rate tax on spendings.[4] Once again, the Senate Finance Committee rejected the proposal for a consumption tax, and, instead, the Revenue Act of 1942 began the conversion of the income tax into a tax on the masses. Had this piece of history turned out differently, the income tax might have remained a narrow tax on high-income people and a consumption tax might have entered our fiscal system as the broad-based mainstay revenue raiser that the income tax became.

Again, little more than two decades ago, President Richard Nixon studied — and came very close to proposing — the substitution of a value-added tax for some combination of corporate income and payroll taxes.[5] A few years thereafter, Ways and Means Chairman Al Ulman did propose a value-added tax — an act by which many people explain the unprecedented failure of this committee chairman to win re-election.

The Tax Reform Act of 1986 is probably most important for reflecting the recent political decision by both Republicans and Democrats to retain and strengthen the income tax.

Indeed, despite other claims about its successes and failures, the Tax Reform Act of 1986 is probably most important for reflecting the recent political decision by both Republicans and Democrats to retain and strengthen the income tax, rather than to heed the calls of economists and some politicians to replace it with a consumption tax. Notwithstanding this recent clarity of direction, however, proposals for consumption taxes of a variety of forms are being advanced once again with vigor.

There are, I think, four good reasons for this renewed effort. First, the strengthening of the income tax in the 1986 tax act was substantially weaker than its greatest admirers seem willing to admit. In particular, its failure to address the fundamental problem of income taxation in an inflationary economy will no doubt continue to haunt taxpayers and the government alike in future years; and the 1986 act's complexities reflecting many political compromises have failed to abate the accelerating costs of income tax compliance that are so wasteful to our economy. The endeavor of the 1986 act to enhance tax neutrality among different types of investment or savings vehicles also has been under attack from many quarters and is surely unstable. Indeed, re-enactment of some type of investment tax credit for equipment seems imminent.

Second, the stubbornness of the federal deficit, coupled with the continuing refusal of policyrnakers of both political parties in both Houses of Congress to address aggressively federal spending — along with calls for new spending, for example, to extend health insurance to the uninsured or to improve the infrastructure — makes it virtually certain that additional federal revenues will be required.

Third, the globalization of capital markets, with their rapid transfers of capital across borders, along with European unification, has made it more difficult for any country to impose substantial taxes on capital income and also has increased the likelihood that the tax systems of the developed countries will tend to converge. The rush of many of our trading partners to imitate the income tax base-broadenings and rate reductions of the 1986 tax act offer striking evidence of this tendency.

When one compares this nation's tax system to those of our trading partners, the greatest disparity is their greater reliance on consumption taxes. The OECD countries, on average, collect about 30 percent of their tax revenues from consumption taxes, and only the United States, Japan, and Switzerland collect less than one-quarter of their total revenues from such taxes.[6] In the United States, consumption taxes account for only about 17 percent of total federal, state, and local revenues, and the federal government's share of that is quite small.[7] Less than five percent of federal revenues come from excise taxes, and the federal government has no broad-based tax on consumption.

Fourth, the United States rates of savings and investment are low compared to those of our international competitors. The net rate of national savings as a percentage of GDP in the United States is currently below the savings rates of virtually all OECD countries, and our average 3.6-percent net savings rate in the decade of the 1980s compares quite unfavorably with the 10.2-percent rate of West Germany and the 17.8-percent rate of Japan during that same decade.[8] Likewise, the U.S. investment rate has long been lower than that of other countries, and during the past three decades, the Japanese net private investment rate has averaged 2½ times greater than that of the United States, while that of Germany has been two-thirds greater.[9] Moreover, a far greater proportion of our private investment goes into housing relative to the corporate sector, when compared to our international competitors. Indeed, in recent years, the United States has had the lowest corporate investment per dollar of housing investment and the lowest ratio of corporate to noncorporate investment when compared to the United Kingdom, Australia, Germany, and Japan.[10]

Although the empirical evidence of the effect of the choice between consumption and income taxation on national rates of savings and investment remains controversial, much support for consumption taxation is grounded in the view that taxing consumption rather than income would contribute to this country's rates of savings and investment and thereby promote long-term economic growth.

Why then, you must by now be asking, has there been such resistance to consumption taxation in the United States? First, one should not underestimate the resistance of governors and mayors to the idea of the federal government entering what they regard as their exclusive domain of consumption taxation. Secondly, there has long been widespread concern about the fairness of taxing consumption rather than income. A consumption tax fails to take into account a taxpayer's ability to pay taxes that result from the accumulation of capital or of income from capital. Indeed, the popular public recognition that fairness in taxation demands the taxation of both labor and capital income motivated the adoption of the Sixteenth Amendment — which served to give Congress the same taxing power over investment income as it already possessed over labor income and business profits.[11]

Notwithstanding the common use in the economics literature of annual consumption as a proxy for lifetime income and claims that lifetime income is a better measure of a taxpayer's ability to pay taxes than current income, in the political arena, the distribution of the tax burden continues to be measured relative to annual income. Moreover, there is no debate that if the federal income tax were to be replaced with a consumption tax of the most common form — a retail sales tax or a value-added tax — the tax burden on low-and middle-income individuals would increase relative to that of upper-income individuals.

In addition, some have expressed concern that — unlike an income tax, which imposes its greatest burden during the taxpayer's highest earning years, typically the middle years — a consumption tax would impose its greatest burden on the lower-earning, higher-consumption years of youth and old age. Indeed, there seems to be some irony in today's currency of proposals to move from income to consumption taxation, simultaneously with calls for higher tax rates on upper-income taxpayers and concerns about the increasing concentration of wealth among the top one percent of wealth-holders. There are several ways — such as by exemptions for food, clothing, and medical expenses, or through income or payroll tax offsets — to eliminate the regressivity of consumption taxes at the bottom end of the wealth or income distribution. But it is difficult, if not impossible without unrealistic top rates, to achieve progressive taxation at the upper levels of income or wealth by taxing only consumption and not taxing either income or wealth. Of course, any taxes on income or wealth would undermine, at least to some extent, the claimed advantages of exempting investment and savings from taxation.

Consumption tax proponents, therefore, will continue to have to confront the prospect either of retaining some income tax — at reasonably low marginal rates — on high-income individuals; taxing bequests and gifts as consumption of the decedent or the donor — contrary to consumption tax principles; strengthening the estate and gift taxes; or imposing a periodic federal tax on wealth. Any expansion of estate and gift taxation is extremely unpopular with politically powerful farmers and small businesses (although it might be practical to make some changes in these taxes at the margin, such as limiting the annual $10,000 gift exclusion per donee). At the same time, a periodic low-rate federal tax on wealth raises extremely difficult practical issues of valuation and liquidity and, more importantly, would require a constitutional amendment to avoid apportionment to the states, and any such amendment surely is impossible.

As a practical matter, in the current political and fiscal climate of the United States, a move to greater federal taxes on consumption seems far more likely as a supplement to the existing tax system (perhaps while reducing payroll or income taxes), than as a replacement for the income tax — a tax that over a long period of time, has supplied 45 percent or more of federal revenues and does so today with relatively low top marginal rates. Despite the recent call of the commission headed by Senators Nunn and Domenici for replacing the income tax with a progressive consumption tax (a tax which to date has been tried only in India and Sri Lanka and no longer exists in either) seems unlikely. As the Nunn-Domenici commission itself acknowledges: There are many issues that would need to "be ironed out," including the tax treatment of housing, borrowing and lending, inheritances, and charitable contributions, to mention only those that the commission itself explicitly identified.[12]

It seems much more likely that any federal broadbased tax on consumption would take the far more familiar form of retail sales taxes or value-added taxes, of either the credit or subtraction (business transfer tax) type. As has been true throughout the more than two decades that the prospect of value-added taxation has been rising and falling on the national political agenda, its most impressive attribute is its prodigious revenueraising capacity. The Congressional Budget Office, for example, estimates that a five-percent value-added tax could raise anywhere from $70 billion to $140 billion annually by 1996, depending on whether such things as food, housing, and medical expenses were included or excluded from the value-added tax base.[13]

Indeed, conservative arguments against moving to a broad-based federal value-added or retail sales tax have been grounded in fears about the revenue-raising capacity of such taxes — realistic fears that putting into place such a tax at the federal level would allow the collection of enormous sums of revenue simply by increasing rates over time, and therefore could facilitate the unbridled expansion of government spending. On the other hand, substantial deficit reduction seems unlikely to occur without a significant revenue-raising component, and such taxes should be levied in the manner most conducive to long-term economic growth: by taxing consumption rather than increasing the tax burden on savings and investment. The question then becomes: Assuming that we are going to tax consumption, how should we do it?[14]

There are, I think, three major broad-based consumption tax contenders. First, we might adopt a federal retail sales tax. The main disadvantage of this mechanism, of course, is its many points of collection, and therefore, many opportunities for noncompliance and its high costs of enforcement and compliance. A federal retail sales tax, in my view, could overcome this serious disadvantage only if imposition of such a tax were used as an opportunity to coordinate and make uniform the tax bases of state and local retail sales taxes throughout the country. This could potentially reduce the varying tax bases at the state and local level from about 150-to-one. Any variations among the states and localities would then be limited to differences in rates. This change, of course, would require unprecedented (and unlikely) federal-state cooperation, but, if it could be achieved, a uniform base national retail sales tax might then be collected using existing state revenue authorities.

Alternatively, the United States could adopt a federal value-added tax of the credit-invoice method commonly used in Europe. The experience of our trading partners makes clear that such a tax is workable. Border tax adjustments are straightforward and a variety of exemptions and multiple rates are common. In 1984, Treasury estimated that this tax could not be put into effect until 18 months after its enactment. This would mean, of course, that almost an entire congressional term would pass before the politicians who would bear the political costs from adopting such a tax would have available to them any of its revenues for spending. The electoral experience of former Ways and Means Committee Chairman Al Ulman, along with more recent adverse political experiences of valueadded tax advocates, for example, in Japan and Canada, suggest that this may not be an appealing prospect for a politician.

It might well be easier politically to enact a subtraction-method value-added tax — also called a business transfer tax (BTT) — that probably could be implemented in a much shorter period following enactment, since most of the calculations required by such a tax are similar to those now required under the income tax. The principal advantage of a BTT is that it makes exemptions, such as for food or clothing, more difficult to implement, although some will no doubt regard that difficulty as its principal disadvantage. This form of value-added tax also has the virtue (or the vice) of looking very much like a business income tax, and therefore, might produce some political cover by allowing debate whether (or for some politicans perhaps even denial that) a federal consumption tax had been adopted. Recent international studies demonstrate the sizable costs to business of complying with any credit method value-added tax, particularly for small businesses, and compliance costs of a BTT might not be significantly greater than under current law.**15** Because this tax is imposed on a cash flow basis, business information reporting, such as urged by the GAO under the income tax, might serve to make a BTT comparable to a credit-method VAT in terms of overall noncompliance.**16**

In my view, any of these flat rate, broad-based consumption taxes — with the retention of some relatively low-rate (integrated one would hope) corporate income tax and individual income tax at upper-income levels — would be preferable to a progressive, individualized tax on consumption, which would probably require sharply progressive and high top rates to satisfy distribution concerns.

Let me, however, echo here the sentiments expressed by Treasury Secretary Andrew Mellon in the same 1921 hearings that brought us Chester Jordan's testimony. Secretary Mellon then urged Congress not to replace a long list of federal excise taxes with a broad-based sales tax.**17** Even at that time, this position was contrary to the prevailing economic wisdom. Certainly, at least since the Excise Tax Reduction Act of 1965 (until very recently), it has been quite unfashionable to urge selected federal excise taxes, in either the Academy or to Congress.

Current circumstances, however, make this conventional wisdom wrong. In the 1990 budget negotiations, a broad-based tax on energy consumption was examined in detail but ultimately was not adopted. I will not rehearse here the reasons for increasing the price of energy relative to other commodities and for reducing energy consumption, but instead will simply note that an energy tax is supported by concern both for the environment and reducing our dependence on foreign sources of oil.

The base of a broad energy tax is just over one-quarter the size of a likely value-added tax base (one that has exclusions for housing, food, medical expenses, and the like, or provides a similar measure of low-income relief).**18** This means that a 10-percent energy tax, for example, could raise approximately half the revenue of a five-percent value-added tax, although low-income offsets would be required here as well. The narrower base and higher rates create something of a natural ceiling on the potential revenue raising capacity of an energy tax in contrast to a VAT. A broad-based energy tax, either based on heat (BTU) content or on an ad valorem basis, would distribute more neutrally across the regions of the country than either of its two major competitors: increased gasoline taxes or a carbon tax. The most difficult practical obstacle in implementing a broad-based tax on energy is the potential need to make border adjustments that would exempt exports and tax imports of those products where energy is a substantial component of price — chemicals, for example. If more revenue were required, the combination of, say, a 10-percent broad-based energy tax and additional gasoline taxes would be possible. Unlike gasoline tax increases, however, where there is great pressure to finance additional spending for highway construction, broad-based energy taxes could be used for deficit reduction or earmarked to finance extension of health insurance to the uninsured.**19**

There also remains considerable potential for increasing federal taxes on alcohol and tobacco, and well-known good reasons for reducing the consumption of each. For example, the Yale Health Plan recently informed us that cigarette smoking is responsible for 21 percent of all mortality from heart disease and that smoking doubles the incidence of coronary artery disease and increases mortality by about 70 percent.

These taxes are low, both by our own historical standards and in comparison to alcohol and tobacco taxes in Europe or Japan, either as a percentage of revenues or a percentage of price. An additional $5 billion or so a year could be raised by increasing all alcoholic beverage taxes from their current levels to $16 per proof gallon and equalizing the taxes on beer and wine.**20** Such a tax would be about 25 cents per ounce of alcohol, as compared to the current rates of 21 cents per ounce for distilled spirits ($13.50 per proof gallon), 10 cents per ounce for beer, and eight cents per ounce for wine. Notwithstanding the wisdom as a matter of policy of such a change, however, no one who participated in the Andrews Budget Summit of 1990 and swam through the endless tears shed for Joe SixPack, and, at the same time, learned that more than 40 of our states produce some wine and would like to produce as much as California or France, would underestimate the political difficulties of enacting these tax increases.

Likewise, the tobacco tax could readily be doubled, from the 24-cents-per-pack level (which it is scheduled to reach in 1993) to 48 cents per pack, and another $4 billion of revenue a year would be collected.[21] Indexing both of these taxes for inflation (or converting them to an ad valorem basis) would produce another $1 billion to $2 billion annually, for a total of about $10 billion.[22]

There are a variety of other candidates for specific excise taxes if these three prove inadequate in terms of revenue, although the implementation problems of many of the other environmentally motivated excise taxes signal caution. We seem unlikely to readily duplicate the success of the ozone-depleting chemicals tax of the 1989 act. The federal government could probably raise $1 billion to $2 billion a year by taxing newsprint and the lead in automobile batteries, for example, but to take a contrary example, it seems a practical impossibility to tax virgin materials generally to encourage recycling, as some have proposed.

A 10-percent broad-based energy tax, in combination with the suggested increases in the alcohol and tobacco taxes, would produce about $50 billion of additional tax revenues annually. The major distributional complaint about broad-based consumption taxes, however, applies here as well; these taxes fall more heavily on lower- and middle-income taxpayers than on high-income taxpayers.

This context, however, where taxes are being increased on specific items of consumption that the nation wants to reduce, may create an opportunity for Congress to begin looking at tax distributional issues on a new basis. In contrast to a broad-based consumption tax, people could reduce substantially their tax burdens by shifting to less harmful consumption patterns. If we were to regulate, rather than tax, these items to reduce consumption, Congress would demonstrate little concern for distributional burdens. This, for example, distinguishes a tax on sulfur or nitrogen emissions from the regulation and emissions trading mechanisms of the Clean Air Act. At a minimum, Congress here should view the distributional burden over a longer time horizon rather than solely by reference to annual income. Tobacco taxes have been found to be proportional to lifetime income and alcohol taxes slightly progressive. Some low-income offset, however, would clearly be required to ease the burden of a significant broad-based energy tax on low-income taxpayers.

In the more limited context of $50 billion or so of annual excise tax increases, rather than a broad-based value-added tax, it also would be easier to impose consumption-oriented revenue-raising tax increases on high-income taxpayers. This is true notwithstanding the recent failure of luxury taxes on boats, jewelry, and furs to fulfill such a purpose. Limiting interest deductions under the income tax to eliminate the use of home equity loans to finance consumption and perhaps even to restrict generally the income tax benefits of borrowing is one obvious, although admittedly politically difficult, option. To take another example, reducing the deduction for business meals from 85 to 50 percent and disallowing deductions for other business entertainment would raise about $5 billion a year and, regardless of what a distribution table might show, would increase taxes on high-income taxpayers. Other common deficit reduction suggestions, such as taxing high-income elderly people on a greater proportion of Social Security benefits or Medicare subsidies also would distribute progressively and would probably tend to reduce consumption, rather than savings.

Finally, let me close with a word of caution. In thinking about abandoning the income tax in favor of consumption taxes, we should avoid the trap of comparing the real income tax that we now know with an ideal consumption tax that we might imagine. Consumption taxes, just like income taxes, inevitably will be subject to the same kinds of political pressure for favored or punitive treatment of one sort or another. The precise political pressure points will change some, to be sure, but there is no reason to expect them to disappear. The capacity of Congress to deal with major tax legislation has long been lamented. The Tax Reform Act of 1969, for example, prompted the columnist Joseph Kraft to remark: "It is now clear that taxes are too complicated and sensitive a matter to be decided in detail by the Congress.... The Congress in fiscal matters is a dinosaur with a tiny brain."[23] In the intervening two decades, unfortunately, taxes have become both more complicated and more sensitive, and Congress has become more mammoth in size, but no larger of brain.

Footnotes

* Murray Weidenbaum is Mallinckrodt Distinguished University Professor and Director of the Center for the Study of American Business at Washington University in St. Louis. He is indebted to Samuel Hughes, the Frederick Deming Fellow at the Center, for extremely helpful research assistance.

* Senator (R-N.M.). B.A., University of New Mexico; J.D., University of Denver Law School, 1958. Senator Domenici has served in the U.S. Senate since 1973. He serves as ranking member of the following Congressional committees: the Senate Budget Committee; the Select Committee on the Organization of Congress; the Senate Appropriations Subcommittee on Commerce, Justice, State, and the Judiciary; and the Senate Energy and Natural Resources Subcommittee on Energy Research and Development. He is also a member of the Senate Committee on Banking, Housing, and Urban Affairs.

1 McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 431 (1819).

2 *Compare* Pub. L. 16 (1913), 38 Stat. 114, 166, *with* I.R.C. § 1 (West Supp. 1994). in the early 1950s, the top marginal tax rate reached an all-time high of 91%. *See* Pub. L. 83-591, 68A Stat. 5, I.R.C. § 1 (1954). Although the Tax Reform Act of 1986 [hereinafter TRA] cut the top marginal rate to 28%, *see* Pub. L. 99-514, 100 Stat. 2096 (1986), the 1993 Act reversed this trend, raising the top marginal rate (including surtaxes) to 39.6%.

3 United States v. Bisceglia, 420 U.S. 141, 154 (1975) (dissenting).

4 For example, Singapore, Japan, and Malaysia have well-developed mandatory pension plans. Singapore's Central Provident Fund increased aggregate savings by about four percent of gross domestic product (GDP) during the 1970s and 1980s. Japan, Korea, Malaysia, Singapore, and the Republic of China (Taiwan) all have established government-run postal savings systems to attract small savers. These countries grant tax-exempt status to the interest income from these postal savings. *See* THE INTERNATIONAL BANK FOR RECONSTRUCTION AND REDEVELOPMENT, THE EAST ASIAN MIRACLE: ECONOMIC GROWTH AND PUBLIC POLICY 218-19 (1993) [hereinafter EAST ASIAN MIRACLE].

5 *See, e.g.*, 50 CONG. REC. 504 (1913) (statement of Rep. Hull).

6 *See* CAROLYN WEBBER & AARON WILDAVSKY, A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD 419-21 (1986); SIDNEY RATNER, TAXATION AND DEMOCRACY IN AMERICA 302 (1980).

7 157 U.S. 429 (1895). In *Pollock*, the Supreme Court held that taxing income violates the Constitutional requirement of Art. I, § 9, cl. 4 that taxes be uniform and in direct proportion to the census.

8 Nancy Shepherdson, *The First 1040*, AMERICAN HERITAGE, Mar. 1989, at 101.

9 WEBBER & WILDAVSKY, *supra* note 6, at 42 1.

10 *See generally* INTERNAL REVENUE SERVICE, I.R.S. HISTORICAL FACT BOOK: A CHRONOLOGY 1646-1992 8 (for the first 25 years of the income tax, "income tax rates remained at levels that affected only the very wealthy. Essentially, payment of income taxes in the years preceding World War II was a sign of affluence. Some citizens proudly reported that they had paid their taxes as evidence of their financial success.").

11. *Id*. at 81.

12. Shepherdson, *supra* note 8, at 101.

13. The cost of capital includes the costs of borrowing, depreciation expenses, inflation, and taxes. Corporate and individual income taxes raise the cost of capital. This increase in capital costs reduces capital formation in the United States by reducing the number of investment projects that are potentially profitable and encourages investors to invest in overseas markets where the cost of capital is lower.

14. *See* JOHN B. SHOVEN, ALTERNATIVE TAX POLICIES TO LOWER THE U.S. COST OF CAPITAL 13 (1990).

15 *Impact, Effectiveness, and Fairness of the Tax Reform Act of 1986: Hearings Before the Committee on Ways and Means*, 101st Cong., 2d Sess. (1990) (statement of Mark Bloomfield, American Council for Capital Formation).

16 Pub. L. 96-514, 100 Stat. 2096 (1986).

17. *Competitiveness and Long-Term Tax Policy, 1992: Hearings Before the Subcommittee on Taxation of the Senate Committee on Finance*, 102d Cong., 2d Sess. 8 (1992) [hereinafter *1992 Competitiveness Hearings*] (statement of Martin Feldstein, President and CEO, National Bureau of Economic Research).

18 *Alternative Minimum Tax, 1992; Hearings Before the Subcommittee on Taxation of the Senate Committee on Finance*, 102d Cong., 2d Sess. 33 (1992) [hereinafter *AMT Hearing*] (statement of L.C. Heist, President and CEO, Champion International Corp.).

19 I.R.C. § 55 (West Supp. 1994).

20 *See AMT Hearing,* supra note 18, at 12 (statement of Andrew B. Lyon, Assistant Professor of Economics, University of Maryland).

For an example of the punitive effects of the AMT, compare the tax bills of Live for the Day, Inc., and Tortoise Growth Company. Each is a hypothetical firm with annual gross revenues of $10 million and "ordinary" operating expenses of $8 million. Live., for the Day pays its executives large bonuses totaling $1.5 million, pushing, but not exceeding, the bounds of "reasonable compensation." *See I.R.C.* § 162(a)(1) (West Supp. 1994). In contrast, Tortoise Growth reinvests all but $500,000 of its surplus in plant and equipment.

Under the current tax code, Live for the Day has $500,000 in taxable corporate income and cannot be subject to the AMT because its bonuses to corporate officers are not added back to the AMT tax base. It pays $175,000 in corporate income tax. *See* I.R.C. § 11(b) (West Supp. 1994). Tortoise Growth may be less fortunate. If Tortoise Growth's increased depreciation deductions on its new investments reduce its effective tax rate to less than 20%, it will lose some of those deductions under the AMT provisions. *See, e.g.,* I.R.C. § 56(a)(1) and § 56(g)(4)(A) (West Supp. 1994). Thus, after applying the AMT, its total tax bill could be as high as $400,000—more than twice what Live for the Day pays.

21 Stephen R. Corrick & Gerald M. Godshaw, American Council for Capital Formation Center for Policy Research, Monograph Series on Tax and Environmental Policies & U.S. Economic Growth: AMT Depreciation: How Bad is Bad? Economic Effects of the Corporate Alternative Minimum Tax 4 (1991) (on file with the *Harvard Journal on Legislation).*

22 *AMT Hearing, supra* note 18, at 12 (statement of Andrew B. Lyon, Assistant Professor of Economics, University of Maryland at College Park).

23 *Mr Hosakawa's Balancing Act*, FIN. TIMES, Feb. 4, 1994, at 17.

24 INTERNATIONAL MONETARY FUND, GOVERNMENT FINANCE STATISTICS YEARBOOK: VOLUME XVII 42 (1993).

25 *Factors Affecting U.S. International Competitiveness, 1991: Hearings Before the House Committee on Ways and Means*, 102d Cong., 1st Sess. 518 (1991) [hereinafter *1991 Competitiveness Hearings*] (statement of Kenneth Gideon, Dep't of Treasury, Ass't Sec'y for Tax Policy).

26 EAST ASIAN MIRACLE, *supra* note 4, at 210.

27 See *generally id*.

28 Organization for Economic Development and Cooperation, *OECD Economic Outlook*: *December 1993* 146.

29 DEPARTMENT OF COMMERCE, SURVEY OF CURRENT BUSINESS 50 (Sept. 1993).

30 Germany has a rate of net household saving as a percentage of disposable household income of 12.9%. The comparable rates for Canada and France are 10.8% and 12.8% respectively. *Id*.

31 PAUL KRUGMAN, THE AGE OF DIMINISHED EXPECTATION, U.S. ECONOMIC POLICY IN THE 1990s 15 (1990).

32 *1992 Competitiveness Hearings, supra* note 17, at 10 (statement of Martin Feldstein, President and CEO, National Bureau of Economic Research).

33 *Retireinent Income Security: Can the Baby Boomer Generation Afford to Retire?*:

Hearing Before the Subcommittee on Social Security of the House Committee on Ways and Means, 103d Cong. 1st Sess. 41 (1993) (statement of B. Douglas Bernheim, Professor of Economics and Business Policy, Princeton University).

34 *See, e.g., id*. at 126 (statement of Ray Crabtree, Senior Vice President for Pensions, Principal Financial Group, on behalf of the American Council of Life Insurance), 92 (statement of Martha Priddy Patterson, Director, Employee Benefits Policy and Analysis, KPMG Peat Marwick, Washington National Compensation and Benefits Practice).

35 CONGRESSIONAL BUDGET OFFICE, BABY BOOMERS IN RETIREMENT: AN EARLY PERSPECTIVE, xii-xiii (1993). One should note the different standards of comparison used by Bernheim and by CBO. Bernheim's study assumes that the benchmark for retirement savings is maintaining the pre-retirement standard of living. Since most private pension plans and Social Security pay benefits based on a fraction of pre-retirement earnings, future retirees must save a substantial sum to bridge that gap. Bernheim's conclusion that people do not save enough to bridge that gap matches common intuitions. However, CBO's study assumes that the benchmark is the standard of living of today's retirees. With its assumptions of real wage growth and the continuation of the current Social Security benefit formula, CBO's conclusion that future retirees will have a higher standard of living than today's retirees is unsurprising.

Reading the two studies together, one can conclude that while future boomer retirees might be somewhat better off than current retirees, boomers are not saving enough to maintain their pre-retirement standard of living after they retire.

36 *Id*. at xiii.

37 CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, THE CSIS STRENGTHENING OF AMERICA COMMISSION FIRST REPORT 83-84 (1992) [hereinafter COMMISSION REPORT] (quoting Barry Rogstad, President, American Business Conference).

38 DEPARTMENT OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 12 (1992). [hereinafter TREASURY INTEGRATION STUDY]

39 SPICER & OPPENHEIM, INTERNATIONAL TAX COMPARISONS: TAXATION OF CAPITAL GAINS, DIVIDENDS AND INTEREST ON SECURITIES INVESTMENTS ON INDIVIDUALS IN THE UNITED STATES AND SIXTEEN FOREIGN COUNTRIES 6-8 (1989).

40 I.R.C. § 61 (West 1988).

41 THE MACMILLAN BOOK OF BUSINESS AND ECONOMIC QUOTATIONS 195 (Michael Jackman ed., 1984).

42 For descriptions of the size of the tax industry, see JAMES PAINE, COSTLY RETURNS (1993); Marsha Blumenthal & Joel Slemrod, *The Compliance Cost of the U.S. Individual Income Tax System: A Second Look After Tax Reform*, 45 NAT'L TAX J. 185-88 (1992) [hereinafter *Compliance Cost*]; Arthur D. Little, Final Report to the Dep't of Treasury, Development of Methodology for Estimating the Taxpayer Paperwork Burden (June 1988); JOEL SLEMROD & MARSHA BLUMENTHAL, THE TAX FOUNDATION, THE INCOME TAX COMPLIANCE COST OF BIG BUSINESS (1993); TAX EXECUTIVE INSTITUTE, THE STRUCTURE AND SIZE OF THE CORPORATE TAX DEPARTMENT: AN EMPIRICAL ANALYSIS (1993); CHARLES ADAMS, FOR GOOD AND EVIL: THE IMPACT OF TAXES ON THE COURSE OF CIVILIZATION (1993).

"[T]he total bill for merely coping with the U.S. tax code tops $50 billion a year. That's nearly one percent of the nation's total output of goods and services . . . ." Rob Norton, *Our Screwed Up Tax Code*, FORTUNE, Sept. 16, 1993, at 35.

43 Iceland's GDP in 1992 was $4.5 billion. Ireland's was $42.4 billion. CENTRAL INTELLIGENCE AGENCY, THE WORLD FACTBOOK 179, 190 (1993).

44 Blumenthal & Slemrod, *Compliance Cost, supra* note 42, at 188.

45 INTERNAL REVENUE SERVICE, PUB. No. 1415, INCOME TAX COMPLIANCE RESEARCH: NET TAX GAP AND REMITTANCE GAP ESTIMATES 2 (1990).

46 For a summary of the Commission's work, see COMMISSION REPORT, *supra* note 37, at 14.

47 *Id*. at 14.

48 Some income tax critics have proposed repealing the Sixteenth Amendment by passing the "Liberty Amendment" to the Constitution. This proposal would preclude Congress from levying taxes on persons, incomes, estates, or gifts. The Liberty Amendment has been introduced several times over the past forty years. At one point, as many as 32 states had enacted resolutions calling for various versions of such an amendment. *See* JOINT ECONOMIC COMMITTEE, THE PROPOSED 23D AMENDMENT TO THE CONSTITUTION To REPEAL THE 16TH AMENDMENT TO THE CONSTITUTION WHICH PROVIDES THAT CONGRESS SHALL HAVE THE POWER TO COLLECT TAXES ON INCOMES, S. Doc. No. 5, 87th Cong., 1st Sess. 1-9 (1961).

49 1 HENRY GEORGE, THE COMPLETE WORKS OF HENRY GEORGE, PROGRESS AND POVERTY 407 (AMS Press ed. 1973).

50 *See* THOMAS HOBBES, LEVIATHAN OR MATTER, FORME AND POWER OF A COMMONWEALTH ECCLESIASTICAL (Michael Oakeshott ed., 1946).

51 I.R.C. § 219 (West Supp. 1994) allows qualified individuals to invest up to $2,250 each year into an Individual Retirement Account (IRA) and to deduct the amount invested in the IRA from gross income.

52 For a more complete description of the proposed progressive consumption tax for individuals, see part III.A., *infra* notes 53-93. For a complete description of the proposed business tax, see part III.B., *infra* notes 94-129.

53 "Since the income concept generally taken as the starting point for taxation is defined to be the sum of consumption and change in net worth, the term 'consumed income' as descriptive of a tax base is something of a contradiction in terms. The term has been popularized by Henry Aaron and Harvey Galper (1985)." David F. Bradford, Discussion Paper No. 20, An Uncluttered Income Tax: The Next Reform Agenda? 3 n.1 (July 1988) (on file with the *Harvard Journal on Legislation*).

54 *See generally* Ernest S. Christian, Jr., Description of a Prototype Business Tax (Oct. 5, 1993) (explaining the cash flow interaction between the individual and business taxes) (on file with author).

55 Financial receipts are generated from holding or selling financial assets. Financial receipts include the proceeds from the sale of stocks and bonds and receipts of interest and dividends.

56 For a more complete discussion of the business cash flow tax base, see part III.B.1, *infra* notes 97-98 and accompanying text.

57 Barry Rogstad, Tax Proposal Outline I (Feb. 26, 1994) (on file with the *Harvard Journal on Legislation*).

58 Consider two taxpayers, Mr. A and Ms. B. Mr. A makes his major purchases during periodic shopping sprees resulting in clustered spending patterns. Ms. B makes her purchases in a more steady and predictable manner. If Mr. A buys a car and a pleasure boat in the same tax year, his aggregate consumption might put him into a higher tax bracket for that tax year and a lower tax bracket in subsequent years. If, in contrast, Ms. B purchases her car in one year and a boat the next year, her consumption in any one tax year may never reach the level at which a higher marginal tax rate applies. Thus, although by the end of the second tax year both Mr. A and Ms. B have consumed the same amount, Mr. A has paid a higher marginal tax rate than has Ms. B on a portion of that consumption.

59 For a good discussion of possible ways to treat consumer durables, see MICHAEL A. SCHUYLER, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, CONSUMPTION TAXES: PROMISES AND PROBLEMS 69 (1984).

60 CONGRESSIONAL BUDGET OFFICE, REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS: A REPORT TO THE SENATE AND HOUSE COMMITTEES ON THE BUDGET 290 (1994).

61 *Id*.

62 U.S. BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1993 334 (113th ed. 1993).

63 I.R.C. § 163 (1993).

64 *See, e.g.*, HENRY J. AARON & HARVEY GALPER, ASSESSING TAX REFORM 18 (1985).

65 *Id*.

66 Under the limitations on itemized deductions, an individual with an adjusted gross income above $108,450 is allowed to deduct no more than 80% of otherwise allowable deductions. *See* I.R.C. § 68 (1993). Therefore, a married couple filing jointly could deduct 80% of the interest payments on a house worth up to $1,000,000. At a 7% annual percentage rate, the couple could deduct 80% of $70,000 or $56,000. If taxed at the top marginal tax rate of 39.6%, this equals a savings of $22,176 per year.

67 *See, e.g.*, AARON & GALPER, *supra* note 64, at 17.

68 But *cf.* DAVID F. BRADFORD, DEPARTMENT OF TREASURY, BLUEPRINT FOR BASIC TAX REFORM 85-89 (1977). Bradford's analysis includes an excellent discussion of the imputed rent concept, in which taxpayers would not be taxed on their initial purchase of their home but would be taxed on the rental value of the housing services they consume each year by living in their homes. While this is probably the most intellectually honest approach to the treatment of housing, we rejected this approach as unduly complicated from both a compliance and administration standpoint.

69 For possible ways to cap the mortgage deduction, see CONGRESSIONAL BUDGET OFFICE, *supra* note 60, at 290-94.

70 Bradford agrees that no deduction for property taxes should be allowed as long as imputed rent from the primary residence is excluded from taxable income. *See* BRADFORD, *supra* note 68, at 93.

71 *Id*. at 85-86.

72 This amount is calculated based on the poverty guidelines established by the Department of Health and Human Services. For an explanation of how these guidelines developed, see Gordon Fisher, *The Development and History of the Poverty Thresholds*, 55 SOCIAL SECURITY BULLETIN 3-4 (winter 1992).

73 The family living allowance is calculated at 170% of the federal poverty guideline for a family of a given size. Other examples of family living allowances for families of varying sizes include: single individual, $12,512; family of two, $16,728; family of five, $29,376; family of eight, $42,024. Each individual family member after eight would result in an increase of $4,216 in the family living allowance. Although federal poverty guidelines are not codified, they may be found at 59 Fed. Reg. 6277 (1994).

74 I.R.C. § 3102 (West Supp. 1994).

75 Almost 73% of families who pay some taxes pay larger social security taxes (employer and employee share) than income taxes. *See* COMMITTEE ON WAYS AND MEANS, OVERVIEW OF ENTITLEMENT PROGRAMS: 1993 GREEN BOOK 1544.

76 I.R.C. § 32 (West Supp. 1994).

77 Congressional Budget Office Memorandum, Estimates for a Prototype Savings Exempt Income Tax, 23 (Mar. 1994) [hereinafter CBO Estimates] (on file with the *Harvard Journal on Legislation*).

78 For a further discussion of the tax rates imposed under the Nunn-Domenici proposal, see part III.A.11, *infra* notes 89-93 and accompanying text.

79 The basket's size corresponds roughly to the sum of the projected revenue losses attributable to the itemized deductions for non-business state and local taxes other than on owner-occupied homes ($25.6 billion), charitable contributions ($19.3 billion), and medical expenses ($3.6 billion). BUDGET OF THE UNITED STATES: ANALYTICAL PERSPECTIVES 77 (1994) (table entitled, "Major Tax Expenditures in the Income Tax, Ranked by Total 1995 Revenue Loss").

80 AARON & GALPER, *supra* note 64, at 71 (generally supporting conversion of any retained itemized deductions into credits, giving special mention to charitable giving and home ownership), 18 (criticizing these deductions as often being poorly designed, and resulting in inefficient, inequitable, and even bizarre patterns of assistance).

81 Aaron and Galper provide an interesting commentary concluding that it is impractical to permit parents a deduction for income they spend to support the schooling of their children, "because most of the cost of such education is borne by others." *Id*. at 93 n.25.

82 In 1993, the national annual average tuition, books and board was estimated at $4,209 per year for four-year public institutions of higher education and $12,756 for private universities. NATIONAL CENTER FOR EDUCATION STATISTICS, U.S. DEPARTMENT OF EDUCATION, DIGEST OF EDUCATION STATISTICS 308-09 (1993).

83 Figures are for 1989 and are based on FEDERAL RESERVE, FEDERAL RESERVE BULLETIN: CHANGES IN FAMILY FINANCES FROM 1983 TO 1989 5-15 (Jan. 1992).

84 Rudolph G. Penner, *Outline of Discussion of Individual SEIT,* BACKGROUND MATERIALS, A NEW PARADIGM FOR TAX REFORM: THE SAVING EXEMPT INCOME TAX: A SYMPOSIUM ON THE NUNN/DOMENICI PROPOSAL 5 (Oct. 1993) (on file with the *Harvard Journal on Legislation*).

85 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ALTERNATIVES TO THE PRESENT TAX SYSTEM FOR INCREASING SAVING AND INVESTMENT 22 (1985) [hereinafter AICPA STUDY].

86 Even if a bequest is not treated as consumption, a double taxation problem arises with any transferred assets that were not qualified as savings when owned by the donor because these assets were taxed once as consumption but were not fully consumed. If not treated as tax pre-paid for the recipient, these funds themselves are subject to double taxation when spent by the recipient. The three alternatives in dealing with these assets are to (1) segregate these funds so that the recipient is not taxed for consuming them or for consuming the returns on them if they are invested; (2) provide a refund to the donor of taxes paid, *see* AICPA STUDY, *supra* note 85, at 22; and (3) allow this degree of double taxation as a replacement for the onerous estate tax. The first option is the most administratively burdensome. The third is the most random and unfair and may also be the least progressive to the extent lower income individuals would die with a smaller percentage of their assets in non-qualified accounts. It also violates the principle of single taxation. The second option seems the least burdensome and allocates the costs of consumption to the entire estate, rather than concentrating them on particular assets.

87 MICHAEL A. SCHUYLER, CONSUMPTION TAXES: PROMISES AND PROBLEMS 59-60 (1984).

88 *See*, *e.g.*, Lucas v. Earl, 281 U.S. 111, 114-15 (1930) (holding that a husband cannot reduce his liability for income tax by entering into an arrangement assigning part of his income to his wife); I.R.C. § 1(g) (West Supp. 1994) (taxing unearned income of children at their parents' marginal rate to avoid income shifting to lower bracket taxpayers).

89 DAVID F. BRADFORD, UNCLUTTERED INCOME TAX: THE NEXT AGENDA? 4 (1988) (on file with the *Harvard Journal on Legislation*).

90 CBO Estimates, *supra* note 77, at 18.

91 *Id*. at 3, 23.

92 *Id*. For this example, CBO assumed that the burden of the existing corporate tax falls equally on capital and labor.

93 An empirical analysis performed by Rudolph G. Penner, former Director of the Congressional Budget Office, now at KPMG Peat Marwick, suggests that the rates could be in the 16%, 35%, and 46% range if taxpayers are categorized by income. For individuals with taxable incomes between 0 and $5,000, the tax rate would be 0%; $5,000 to $45,000, the tax rate would be 16%; $45,000 to $85,000, the tax rate would be 35%; more than $85,000, the tax rate would be 46%.

The following tax rates would apply to married couples filing jointly: Taxable incomes between $0 and $8,400, 0%; $8,400 to $75,600, 16%; $75,600 to $142,800, 35%; more than $142,800, 46%. These calculations were done prior to the enactment of the 1993 tax act. *See* Penner, *supra* note 84, at 6.

94 TREASURY INTEGRATION STUDY, *supra* note 38, at 153.

95 In some circumstances, corporations can "forward shift" the incidence of corporate taxes by increasing the prices they charge consumers. In other cases, corporations can "backward shift" the incidence of corporate taxes by reducing the wages they pay to laborers. Even if the corporation cannot shift the tax, some people bear its effects; because the corporation is an artificial entity composed of shareholders, taxes "borne by the corporation" actually are borne by individual shareholders in the form of reduced dividend payments or dampened capital gains. *See generally* JOSEPH A. PECHMAN, FEDERAL TAX POLICY 141-48 (5th ed. 1987).

96 TREASURY INTEGRATION STUDY, *supra* note 38, at 3.

97 *See* Ernest S. Christian, Jr., The Center for Strategic Tax Reform, The Cashflow Tax Approach 5 (Oct. 16, 1992) (on file with the *Harvard Journal on Legislation*).

98 *Id*.

99 The foreian tax aspects of the Nunn-Domenici proposal are discussed in more detail part III.B.10-11, *infra* notes 124-27 and accompanying text.

100 For the most recent attempt to solve this problem, see I.R.C. § 197 (West Supp. 1994) (creating a common 15-year amortization period for a wide variety of intangibles).

101 For a discussion of this proposed method of taxing intangibles, see Ernest S. Christian, Jr., Memorandum to Barry Rogstad, Rudolph Penner, and Lin Smith 2 (May 12, 1993) (on file with the *Harvard Journal on Legislation*).

102 CBO Estimates, *supra* note 77, at 20.

103 For a more complete discussion of the payroll tax credit, see part III.B.9, *infra* notes 115-23 and accompanying text.

104 I.R.C. § 11 (b) (West Supp. 1994). For a general discussion of the double taxation phenomenon and proposals to integrate the individual and corporate tax, *see generally* TREASURY INTEGRATION STUDY, *supra* note 38.

105 I.R.C. § 61 (a)(7) (West Supp. 1994) (dividends are income). This general rule has two major exceptions. First, corporate taxpayers can take a "dividends received" deduction, which varies with the level of control of the shareholding corporation over the dividend-paying corporation. I.R.C. § 343 (West Supp. 1994). Second, foreign shareholders' capital gains are exempt from U.S. federal income tax. I.R.C. § 871-79 (individual); 881-85 (corporate) (West Supp. 1994).

106 *See* I.R.C. §§ 1(h), 1001, 1221, 1222 (West Supp. 1994).

107 TREASURY INTEGRATION STUDY, *supra* note 38, at 2.

108 I.R.C. § 163 (West Supp. 1994).

109 TREASURY INTEGRATION REPORT, *supra* note 38, at 1.

110 *Id*. at 2. *See* also I.R.C. § 61(a)(4) (West Supp. 1994) (interest is income).

111 *Id. See also* I.R.C. § 871 (f) (individual exemption for annuities); 871 (h) (excluding portfolio debt interest); 871(i) (excluding interest and dividends received by individuals); 881(c) (corporate exemption for portfolio debt interest); 881(d) (exclusion for interest and dividends received by corporations) (West Supp. 1994).

112 *Id*. *See also* I.R.C. § 501(b) (West Supp. 1994) (codifying the unrelated business income doctrine).

113 *See supra* part III.A.1, notes 54-56 and accompanying text.

114 Compare I.R.C. §§ 701-761 (West Supp. 1994) (taxation of partnerships) *with* I.R.C. §§ 61(a)(7) (dividends are income); 161-195 (West Supp. 1994) (enumerating deductions for certain "business expenses" but not enumerating one for dividends paid).

115 *See* I.R.C. §§ 132 (fringe benefits generally); 104(a)(3) (health insurance benefits); 3101 (imposing FICA) (West Supp. 1994).

116 In many instances, corporations must defer deductions for the cost of wages paid until associated items of capital or inventory can be deducted. This deferral can be virtually indefinite, resulting in an effective deduction for wages paid of perhaps as little as

75% of total wages paid. *See* Memorandum from Ernest S. Christian, Jr., Center for Tax Reform 2 (Nov. 16, 1993) (on file with the *Harvard Journal on Legislation*).

117 Currently, wages are up to 100% deductible. The proposed business cash-flow tax rate is 10%. Thus, a full deduction at a tax rate of 10% is equivalent to a 10% credit. *See generally id*.

118 Direct taxes are "taxes on wages, profits, interest, rents, royalties and all other forms of income and taxes on the ownership of real property." Indirect taxes are "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges" General Agreement on Tariffs and Trade, Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, 31 U.S.T. 513, T.I.A.S. No. 9619, Illustrative List of Export Subsidies (1979).

119 *Id*. at Art. III:2.

120 *Id*.

121 *See 1991 Competitiveness Hearings, supra* note 25, at 596 (statement of Judith H. Bello, former General Counsel to the U.S. Trade Representative).

122 Credit for the ingenuity behind this mechanism belongs to Ernest S. Christian, Senior Tax Partner, Patton, Boggs & Blow, who developed the border-adjustable payroll tax credit. *See* Ernest S. Christian, Jr., Description of Prototype Business Tax 5 (Oct. 5, 1993) (on file with the *Harvard Journal on Legislation*).

123 Several sectors of the economy, including the retail and service sectors, may be concerned about the tax treatment of wages and salaries under the Nunn-Domenici proposal. Our objectives are to be fair and to encourage U.S. businesses to be competitive internationally. Therefore, the staff of the Senate Budget Committee has been instructed to explore the process for changing the GATT rules to allow a GATT-legal border adjustment for a tax system similar to the Nunn-Domenici proposal but with a modification to allow a deduction for wages. If the GATT rules could be changed, I would prefer to allow a deduction for wages paid and increase the business tax rate to maintain the same aggregate level of receipts from the tax.

124 *See* TREASURY INTEGRATION STUDY, *supra* note 38, at 216 n.l.

125 *See generally Factors Affecting the international Competitiveness of the United States, Schedule for Hearings Before the Committee on Ways and Means* 89 (1993) (comparing U.S. taxes on domestic operations of foreign corporations with foreign operations of domestic corporations).

126 *See* U.S. INTERNATIONAL TAX POLICY FOR A GLOBAL ECONOMY E-5 (Robert A. Ragland ed., 1991).

127 As a testament to the complexity of current law in this area, consider that the comprehensive Joint Committee on Taxation pamphlet issued in conjunction with the 1991 Ways and Means hearings on international competitiveness needed 150 pages just to explain pertinent rules. *See* STAFF OF THE JOINT COMM. ON TAXATION, 102D CONG., 1ST SESS., FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES 88-231 (Comm. Print 1991).

For a concise critique of the foreign tax provisions of the current federal income tax code, see *Comparative Tax Systems: Hearings Before the Senate Committee on Finance*, 102d Cong., 2d Sess. 149-62 (1992) (statement of Anthony Saggese, general tax attorney, Texaco).

Under the Nunn-Domenici proposal, the United States would eliminate the following features of the current code: (1) an immediate tax on foreign affiliates of U.S. companies involved in cross-border sales and service activities; (2) a minimum tax on foreign income when foreign income is a high percentage of total income, which often has resulted in double taxation; (3) the foreign tax credit; (4) the U.S. rules for interest and other expense allocations; (5) the deemed paid foreign tax credit rules; and (6) the separate foreign tax credit limitation for dividends for non-controlled foreign corporations.

The current foreign tax credit places U.S. businesses at a competitive disadvantage because the U.S. credit is not as generous as other countries' foreign tax credits. The current U.S. foreign tax credit fragments into different lines of business income, keeping U.S. companies from applying unused tax credits on one line of business to other areas. In contrast, other countries either exempt broad categories of foreign business income or permit a simpler foreign tax credit allocation.

We plan to add additional details on the foreign tax aspects of the Nunn-Domenici proposal following Congressional hearings on the subject.

128 I.R.C. § 56 (West Supp. 1994).

129 For other approaches to this problem of unrecovered cost basis see Ernest S.Christian, Jr., *supra* note 101, at 14.

130 HOBBES, *supra* note 50, at 226.

131 JOHN S. MILL, PRINCIPLES OF POLITICAL ECONOMY WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY 814 (William J. Ashley ed., 1929).

132 *See* Alfred Marshall, *The Equitable Distribution of Taxation* (1917), *reprinted in* MEMORIALS OF ALFRED MARSHALL 347, 350-52 (A.C. Pigou ed., 1925).

133 *See* IRVING FISHER & HERBERT W. FISHER, CONSTRUCTIVE INCOME TAXATION: A PROPOSAL FOR REFORM (1942).

134 NICHOLAS KALDOR, AN EXPENDITURE TAX 15 (1955). *See generally id*. at 11-17 (summary of earlier statements in support of expenditure taxation).

135 THE INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE & REFORM OF DIRECT TAXATION 150-215 (1978) (The Meade Report). Although its general conclusions indicate that a consumed-income tax is feasible, the Meade Commission's report recognizes some troubling transition issues and leaves a large number of questions about converting to a consumed-income tax unaddressed.

136 DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINT FOR BASIC TAX REFORM 3 (2d ed. 1984).

[1] This differential treatment is not unique to N-D. The cost recovery provisions for depreciable property in the present income tax provide a partial offset of the outlays for such property against income. To be sure, the income tax offsets for capital outlays are inadequate, because the present value of capital recovery allowances for any capital facility falls short of the amount of the outlays to obtain the facility. On the other hand, there is no generally applicable income tax provision for recovering the cost of accumulating human capital as an offset against compensation an employee receives.

1 GNP Less indirect business taxes, etc., Less employee compensation.

2 Gross capital income Less capital consumption.

3 Combined employer and employee payroll taxes.

4 Rate applied to compensation and capital income in the personal and business Nunn-Domenici taxes. Note that the proposed personal tax in Nunn-Domenici is steeply graduated, contrary to the flat rate assumed for this example. Existing Law payroll tax rate would apply only to employee's payroll tax.

5 Compensation of employees and gross returns to capital Less gross private domestic investment included in both the personal and business tax bases.

5 Compensation of employees and gross returns to capital Less gross private domestic investment included in both the personal and business tax bases.

1 The 14.5-percent rate is included solely for revenue neutrality purposes in the Danforth-Boren package. The rate would be higher if additional tax reductions are proposed and lower if fewer reductions are proposed.

2 Some elaboration or qualification may be needed to assure that "money" in the form of collectible coins, bullion, and similar items is treated as property so that coin dealers, jewelers, and others are not exempt from the BAT.

3 Many such transactions are also covered explicitly in section 10016, as discussed below.

4 This is an intentionally broad definition, but its use of the word "includes" rather than "means" could enable a further widening by regulations. For purposes of this commentary, the definition is presumed to cover everything that is coverable.

5 The latter reference to the location of property with respect to which services are rendered will be important when considering imported professional services used by consumers, discussed below.

6 Section 10031(b) takes one step in this direction by designating as the exporter a seller to a governmental agency or exempt organization when the latter entities export the property in a nonbusiness activity.

7 For an excellent discussion, see Sijbren Cnossen's "Administrative Compliance Costs of the VAT: A Review of the Evidence," *Tax Notes*, June 20, 1994, p.1609.

8 Consider New Zealand's system (1986), Singapore's system (1993), the recent Canadian House of Commons Finance Committee proposal to revamp their system, and European Community moves in this direction.

9 If property is acquired before the BAT becomes effective, its subsequent sale need not be included in gross receipts to offset an earlier business purchase. But this is a transition rule issue, not a conceptual one.

10 Other than property and casualty insurance that replaces lost gross receipts as discussed below, businesses usually purchase insurance policies (life, health, and disability) as forms of compensation for employees. Therefore, premiums cannot be treated as business purchases. But life insurance or disability insurance on key employees where the company is the beneficiary may be analogous to property and casualty insurance. If a company seeks to offset lost sales due to the death or absence of an employee, perhaps the related premiums should be business purchases and any proceeds received should be gross receipts.

11 The greater problem is the possibility that the $100,000 level is increased. Under the Danforth-Boren package, the dramatic reduction in payroll taxes and in the taxation of undistributed earnings should more than offset the tendency by some to assume that small businesses should not be taxable.

12 Sales to dealers of used consumer items that were purchased before the BAT becomes effective raise a transition issue, not a substantive problem.

13 This principle also should apply to awards from litigation, arbitration, and other settlements so that payments received for lost sales, diminished asset values, destroyed property, etc. are included as gross receipts. Payments made in such situations should also be business purchases. Punitive damages/penalty payments, etc. should be ignored for BAT purposes since they are not related to sales or purchases of property or services.

14 Some might argue that casino gaming, lotteries, and similar activities aren't business activities because the entity is really selling money or, possibly, the rights to money. The better analysis is that an entertainment service is being sold. The BAT should settle any dispute with the rule in section 10015(g), which treats payments to winners as business purchases, which presumably requires a business activity.

15 This is the process to be followed when imported goods and services are used in a business activity. If imports are not used in a business activity, sections 10015(a) and 10032(c)(2) deny business purchase deductions for them.

16 For this purpose, the term "property" in section 10024(b)(1) will need to be used in a way that includes money and financial instruments, unlike the general definition of "property" in section 10051(3).

17 A primary reason that VATs in other countries do not apply to financial intermediation services is their inability to identify an amount of tax on each loan payment, insurance premium, etc. The subtraction method for computing BAT liability during a taxable period avoids the transaction-by-transaction notification problem that is inherent in VATs.

18 Section 10015(f) may require the addition of language identifying amounts "paid to the seller" as business purchases. The current text could be read to allow business purchase treatment for taxes paid to a government by the seller who received such amounts from the purchaser.

1 See, 92 TNT 208-154, Center for Strategic and International Studies, The Strengthening of America Commission, First Report (1992).

2 Bernard D. Reams, Jr. (ed.), *United States Revenue Acts: 1909-1950*, *The Laws, Legislative Histories and Administrative Documents*. Vol. 1 (1979). "Internal Revenue Hearings Before the Committee on Finance of the U.S. Senate," 67th Congress, First Session on the Proposed Revenue Act of 1921, May 9- 27, 1921, Testimony of Chester A. Jordan, Public Accountant of Portland, Maine, p. 487:

Before the law came into effect I had three or four men in my employ. Since being obliged to undertake all of these problems for my clients I am obliged to employ seven or eight men and two and three women. Those men are college graduates and they are employed about six months of the year on tax work. I believe that if the tax law were simplified as it should be I might not be obliged to employ more than half that number.

3 Bernard D. Reams, Jr. (ed.), United States Revenue Acts: 1909-1950, The Laws, Legislative Histories and Administrative Documents, Vol. 1 (1979), "Internal Revenue Hearings Before the Committee on Ways and Means of the U.S. House of Representatives," July 26-29, 1921, pp. 144, 153.

4 Report of the Secretary of the Treasury, 1992, pp. 92-95; 408-421.

5 Frank V. Folkes, "Administration Leans to Value-Added Tax to Help Solve National Fiscal Crisis," 6 *National Journal* 210 (1972).

6 Committee on Fiscal Affairs, Directorate for Financial, Fiscal and Enterprise Affairs, Organization for Economic Cooperation and Development, "The Taxation of Profits in a Global Economy: An Overview of the Main Issues," p. 34 (1992). *See also* Joint Committee on Taxation, Committee on Ways and Means, U.S. House of Representatives, "Factors Affecting the International Competitiveness of the United States," May 30, 1992, p. 321.

7 Joint Committee on Taxation, Committee on Ways and Means, U.S. House of Representatives, "Factors Affecting the International Competitiveness of the United States," May 30, 1991, p. 321.

8 Joint Committee on Taxation, Committee on Ways and Means, U.S. House of Representatives, "Factors Affecting the International Competitiveness of the United States," May 30, 1992, p. 50.

9 Joint Committee on Taxation, Committee on Ways and Means, U.S. House of Representatives, "Factors Affecting the International Competitiveness of the United States," May 10, 1991, p. 32.

10 U.S. Treasury Department, "Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Incomes Once," p. 5 (1992).

11 The Supreme Court held in *Pollock v. Farmer's Loan & Trust Co*., 157 U.S. 429 (1895), that an earlier income tax was unconstitutional to the extent that it taxed income derived from real estate and municipal bonds. On rehearing, the Court found the entire income tax to be unconstitutional because it consisted in too large part of a direct tax on property income that was not apportioned among the states in conformity with the Constitution. *Pollock v. Farmer's Loan & Trust Co*., 158 U.S. 601 (1895). As Boris Bittker has observed:

The *Pollock* case is often described as a "judicial veto" preventing Congress from taxing income until the Sixteenth Amendment was adopted in 1913. In point of fact, however, the decision intimated that a tax on salaries, wages, and business profits would not be a "direct tax" and hence would not have to be apportioned, thus leaving Congress free to tax income from these sources if it was willing to exempt unearned income.

1 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, para. 1.2.2 1981).

12 See also Graetz, "Implementing a Progressive Consumption Tax, "92 *Harvard Law Review*, 1575 (1979).

13 Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* 335-337 (1992). (Hereinafter cited as *CBO Options*).

14 I am assuming here that this longer-term revenue question occurs subsequent to (or simultaneously with) President-elect Clinton's fulfillment of his campaign promise to raise the top marginal income tax rate on upper-income individuals.

15 *See*, e.g., Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (1992). (Compliance costs of a single-rate broad-base credit invoice method value-added tax.)

16 An important issue is whether a business transfer tax would replace or supplement the corporate income tax. In the context I am currently discussing, where some individual income tax would be retained — at least for upper-income individuals — some corporate income tax (preferably with a tax rate similar to the top individual rate) would be necessary to preclude sheltering of capital income. If the individual-level tax were a cash-flow type progressive consumption tax or a wage tax, a BTT could replace the corporate income tax.

17 Bernard D. Reams, Jr. (ed.), *United States Revenue Acts: 1909-1950, The Laws, Legislative Histories & Administrative Documents*, Vol. 1 (1979), "Internal Revenue Hearings Before the Committee on Finance of the U.S. Senate," 67th Congress, First Session on the Proposed Revenue Act of 1921. (Page 11, "Letter of the Secretary of the Treasury (Andrew W. Mellon) Relative to the Internal Revenue Laws" to the Chairman, Joseph W. Fordney, dated April 30, 1921.)

18 *CBO Options* at 340-42.

19 Congressional Budget Office, U.S. Congress, "Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels," p. 13 (June 1990).

20 *CBO Options* at 338-39. *See also*, Congressional Budget Office, U.S. Congress, "Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels," p. 13 (June 1990).

21 *CBO Options* at 338-39. Merely indexing the cigarette tax for inflation from its 1951 level of eight cents per pack would produce about a 40-cents-per-pack rate today.

22 *Id*. These tax increases might be part of a package of proposals to finance greater access to health insurance and health care, if not used for deficit reduction.

23 Joseph Kraft, "Power to Destroy," *The Washington Post*, December 7, 1969.

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