REPLACING THE FEDERAL INCOME TAX

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JUNE 6, 7, AND 8, 1995

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REPLACING THE FEDERAL INCOME TAX

TUESDAY, JUNE 6, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The Committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearings follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
May 11, 1995
FC-7

CONTACT: (202) 225-1721

Archer Announces Hearing on Replacing the Federal Income Tax

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold three days of hearings on replacing the Federal income tax. **The hearings will take place on Tuesday, June 6, Wednesday, June 7, and Thursday, June 8, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m. each day. The Committee will receive testimony from invited witnesses.**

BACKGROUND:

The first Federal income tax was enacted as part of the Revenue Act of 1862 to finance the Civil War. However, the modern income tax was enacted as part of the Revenue Act of 1913, following the ratification of the 16th Amendment. The income tax had a maximum rate of 7% (for taxable incomes over $500,000).

Since 1913, the Federal income tax has steadily expanded, as has public dissatisfaction with it. Major revisions to the Internal Revenue Code occurred in 1938, 1954, and 1986, but significant revisions occur on nearly an annual basis, and minor amendments to the Internal Code are generally made several times a year. This torrent of tax legislation has been followed by a flood of tax regulations, tax forms, and tax litigation.

The cost of complying with the Federal income tax has grown with the complexity of the tax. The cost of complying with Federal taxes is generally considered to be well in excess of $100 billion annually. This compliance burden is particularly brutal for small businesses.

Frustration with the current Federal tax system is widespread. The current Federal income, estate, and gift taxes treat savings and investment too harshly. Many aspects of the current tax code place American workers and businesses at a competitive disadvantage. All the various rules in the tax code have not stopped widespread tax avoidance by the underground economy.

In announcing the hearings, Chairman Archer stated, "I am committed to tearing the income tax out by its roots. If we don't tear it out by the roots, I am afraid it will grow back just as tangled as it is now. Therefore, I intend to have the Committee on Ways and Means carefully examine alternative tax systems that would replace completely the current income, estate, and gift tax system. However, alternative tax systems must not be measured simply against the current tax system. That's too easy. Instead, all of the proposed tax systems considered by the Committee should be measured against four goals: (1) Is it easy to comply with and does it reduce the role of the Federal Government in our lives; (2) Does it encourage greater savings and investment; (3) Does it improve the international competitiveness of American workers and businesses; and (4) Does it pick up revenue from the underground economy and others who currently do not comply with the tax laws? I believe that a broad-based tax on consumption best meets these goals, and every proponent of a new tax system should be prepared to explain how that tax system meets these four goals."

FOCUS:

This hearing will review the problems with the current Federal income, estate, and gift taxes and examine various alternative tax systems, including consumption taxes, a flat tax, and the Unlimited Savings Account tax proposal.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Thursday, June 22, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least two hours before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

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Chairman ARCHER. The Committee will come to order.

We ask our guests and staff to take seats.

I think most Americans would agree that today could be perhaps one of the most important hearing days in the history of this Committee, because we are undertaking a very ambitious challenge, and that is to look at ways to replace the current Income Tax Code.

Today begins the first of 3 days of hearings. Many of you know that I have spoken out very strongly about this and I have reached the conclusion that after many, many efforts to reform the current system, it is unfixable, if that is a correct English word; that it is certainly too broken to be fixed. And I believe we should look at options to replace it.

It is clear to me as I talk to my colleagues who have returned from two major recesses in their districts that this is a major topic of interest on the parts of their constituents, and it is further clear to me that a large majority of the American people, regardless of party, are willing to support the complete and total elimination of the current Income Tax Code. In its place, I believe that we, the Members of Ways and Means, can design a new Code that will allow our Nation and our people to soar to unparalleled prosperity in the next century.

Today's hearing will focus on the problems that exist in our current complicated and counterproductive Income Tax Code. Tomorrow and Thursday we will hear testimony from various witnesses about their recommendations for replacements of the current Code.

In my opinion, our challenge is to do no less than pull the current Income Tax Code out by its roots and throw it away so that it can never grow back. When we abolish the income tax from the books as an insurance policy, I would not mind seeing the repeal of the 16th amendment to make doubly sure that the income tax won't rise from the dead and ever again haunt the American people. As for what replaces it, I believe the answer is a broad-based consumption tax designed to make America the economic juggernaut or behemoth of the 21st century in the world marketplace.

The new tax would be based on two principles: Freedom and prosperity; freedom from the IRS, the total elimination of the IRS from the individual lives of every single American citizen; and prosperity for all Americans.

As we begin this important search for the best Tax Code for our Nation, we should be guided, I believe, by four objectives. One, the Code, as I said, must get the IRS completely out of our individual lives. The American people should never again have to keep records for the IRS to audit, proving to the government that they are indeed honest people. The people should never again have to fill out a tax form. Withholding taxes from people's paychecks should stop. The government should not have first dibs on the money that people earn. If you make it, you should be able to have the discretion to spend it, all of it, in the way that you see fit.

Two, the new Code should encourage savings. Economists of all persuasions who have appeared before this Committee agree that we need to increase our savings rate in the United States. Our current system of taxing savings, interest, dividends, capital gains during life, and assets at death is harmful to long-term economic

growth. The new Code must encourage savings where savings are found.

Three, the new Code must be able to stop the crimes of tax cheaters and avoiders in the underground economy. Honest Americans who play by the rules and faithfully pay their taxes are forced to pay between 10 and 15 percent more in taxes to make up for those who don't and won't report any of their income. Only a consumption tax can catch the drug dealers and the others who don't report their incomes when they buy their cars and other expensive items. If the police can't put all the bad guys behind bars, then at least the Tax Code should hit them in their wallets.

Four, the new Code should be able to be waived at the border in a GATT-legal manner. That is, remove the cost of government, remove from the price of our products when they are exported, GATT-legal, and, to keep the playingfield level, it should be able to be imposed on foreign products when they enter this country so that they bear a fair share of the cost of our government, again, GATT-legal, without starting a very disastrous trade war around the world.

I have no doubt that if we are able to fashion a new Code in a manner that meets these four criteria, the American people will be greeted by a period of unparalleled economic prosperity the likes of which we have not seen for a long, long time in this country. We will become the economic juggernaut of the world, a sponge for savings, with a fair advantage for our products in competition with foreign products in the global marketplace.

Before I turn to the distinguished Ranking Minority Member, Sam Gibbons, I would like to praise Sam for the bipartisan manner in which he joins this issue. I don't think much of what I have said he will disagree with.

Mr. RANGEL. I assume that allows me to have some time, Mr. Chairman.

Chairman ARCHER. Congressman Gibbons has been a powerful voice over the years in changing the current Code, and I believe that he shares my passion for this issue, and I am delighted to turn my attention to his thoughts.

Sam.

Mr. GIBBONS. Thank you, Chairman Archer.

First, I commend you for holding these hearings. They have been long needed, and I am glad we are on the road to correcting the current tax system.

Second, you are correct; I do not disagree with what you have said. We have talked about this together on many occasions, and you and I are in very broad general agreement.

Third, I want to hear the witnesses so I am not going to speak long, and I appreciate you giving me the opportunity to present what I think is a system that we can both perhaps embrace.

I think we ought to define the objectives that should control our thought process. First of all, I hope this will not degenerate into a debate about the size or the cost of government. We are here to talk about a revenue collection system. There is a time and a place to talk about the size and the cost of government, but this is not the time, so I hope we can control our debate and look at the system.

Too, I think we have to practice in broad terms all the rules of fairness and equity that we have cherished so much. If you look at individual tax distribution burdens over a long period of time, they have been fairly well fixed. I don't think that we want to open a big debate about changing the tax burden here. I think our objective should be that.

Obviously, as you pointed out, we need a system that is a great deal simpler than the present very complex system that requires so many hours of personal attention to just paying the correct taxes. So simplicity both from the individual's point of view and from the business point of view is important.

I believe, like you do, that the current tax system is a heavy impediment upon economy and efficiency in our government and in our whole economic system. We are spending perhaps as little as $300 billion, maybe as much as $600 billion just in administering the current tax system, and that we must get away from.

As you pointed out, we must have a system that suits the international business climate, the business practices that we must comply with, including the World Trade Organization agreements. In 1947, we generally defined what the GATT rules were as far as taxation was concerned, but the United States has not, like the rest of the world, taken advantage of the fact that other nations adjust their taxes at the border and we do not. And this has made us quite a bit uncompetitive in the international economic and trade situation.

So let's try to keep the debate on those subjects short, look for a better and a simpler system, and I commend you for holding these hearings and look forward to participating in them with you.

Chairman ARCHER. Thank you, Mr. Chairman—Mr. Gibbons.

Mr. RANGEL. Mr. Chairman, may I be heard briefly?

Chairman ARCHER. If the gentleman from Florida would like to yield to you. Otherwise, all Members will, by unanimous consent, without objection, have the opportunity to insert any statements in the record.

Mr. GIBBONS. I will be happy to yield.

Mr. RANGEL. Mr. Chairman, first let me thank you for so clearly defining the issues and I don't think that we have to be partisan to state a different philosophy in how we perceive our government should be. Clearly, the voters thought it should be different than it is now and I don't take issue with that.

As we move forward to determine what type of tax system we have, I think that you and the House leadership have truly been consistent with their Contract With America, and it relates to services and soon we will see as relates to taxes. And the reason I thank you is because you are clearly defining the differences and that is what America is all about. That is what elections are all about, and you are not moving to any great area in order to see what one party stands for and what the other stands for.

So far, this Committee, joining with other House Committees, have made it abundantly clear that the Federal Government should not be involved in what has been called entitlements. I think the leadership has said being poor, being old, being sick, does not entitle you on the Federal level, and local and State govern-

ments, of course, being closer to the problem, should be able to find better answers to these problems.

For those reasons, entitlements are over and now we have shifted that responsibility to local and State governments with the understanding that even if they cannot properly deal with the problem, the problem should be dealt with by charitable organizations, churches, synagogues, mosques, and those people who have taken different types of oaths to deal with the sick and the poor.

Having said that, we see ourselves facing whether or not they should enjoy tax exemption, but that is further down along the line. What makes this day important is to see whether or not, after we have shifted the responsibilities, there is no need for us to continue to take this much money from the taxpayers. And so we have a tax bill that would dramatically reduce the revenues.

By reducing the revenues, it makes it clear, driven toward a balanced budget, that we won't be able to revisit these programs, so once they are gone, they are gone. This is the last, not nail in the coffin, but I would say this is the last thing we have to do to tighten up that difference of opinion. We are saying now that income is not a factor, that we just want a broad-based tax. That if we want to throw in progressive lumps in the tax system with deductions, taking into consideration poverty and ability to pay, that we are getting right back involved in a complicated tax system which we don't want.

What we are saying is, rich and poor, working and nonworking, everyone find his common level and do the best we can because, after all, our government would only be to protect the national interest and only to collect enough taxes to do that.

So, Mr. Chairman, let me thank you. No one should have to go back home on any of these issues and be asked, Which side are you on? The way these hearings are going we will never have to worry about the Roosevelts, the Kennedys, and the Johnsons; their time is gone, and I think the voters will have to soon decide whether they want them to return.

Thank you, Mr. Chairman.

Mr. GIBBONS. I didn't realize that we were all going to make long opening statements. I hope we can get to the witnesses.

Mr. Rangel, I hope you will be here tomorrow to hear my presentation because Mr. Archer and I generally agree, and I don't see that this should be a big partisan issue. Maybe I am wrong, but we need a better tax system. That is not a debate about the size of government or the role of government as far as I am concerned. This is simply a debate about which is the best way for the American people to pay the dues that they have to pay and I hope we can focus the debate on that.

There is an appropriate and proper time for us to debate the size of government and the role of government, but this debate is just about the way you finance the government. We want to stress fairness and similar issues in all of this.

So, Mr. Chairman, I yield back the balance of my time.

Mr. RANGEL. Since you referred to me, could I briefly respond?

I had always thought, Mr. Gibbons, that when the Chair allowed the Minority to speak that somehow it would be interpreted as representing "the Minority," and since you made it abundantly clear

that these are your personal views, I am sorry that I went into this long exchange.

Mr. GIBBONS. That is all right, Charlie. We know each other and will get along fine.

Chairman ARCHER. Without objection, any opening statements may be submitted in writing in the record.

[The opening statements follow:]

BENJAMIN L. CARDIN
3D DISTRICT, MARYLAND

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON HEALTH
SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON STANDARDS OF
OFFICIAL CONDUCT

Congress of the United States
House of Representatives
Washington, DC 20515–2003

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STATEMENT OF THE HON. BENJAMIN CARDIN
AT COMPREHENSIVE TAX REFORM HEARINGS
OF THE COMMITTEE ON WAYS AND MEANS
JUNE 6, 1995

Mr. Chairman, these hearings could mark the beginning of an historic effort to bring genuine and comprehensive reform to the way the federal government raises revenues.

Most of our tax debates in this committee skirt the fringes of tax policy. We concentrate on narrow aspects of the tax code, seeking to encourage some activities and discourage others, responding to concerns raised by various segments of the economy. Or we debate fiscal policy, trying to determine the macroeconomic effects of the different levels of federal taxation.

The hearings you have scheduled this week, which, I trust, will be only the first round of what will be an extended and ambitious project, go to a more basic question. For eight decades now, we have built a federal tax system on the premise that a progressive tax on personal and corporate incomes, mixed with an evolving number of tax preference items, is the best means of raising the revenues needed to fund the essential services of government.

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Today we begin a reexamination of that basic premise. We will start, appropriately, with consideration of the degree to which the current system meets our expectations. The unfortunate fact is that repeated, strenuous efforts to simplify and reform the Internal Revenue Code have failed. Small businesses, pension plan sponsors, partnerships, issuers of tax exempt bonds, and investors in real estate are only a few of the categories of taxpayers for whom the Code remains a labyrinth to enter only at their own risk and considerable expense.

The debate has already begun on the question of alternatives to our current tax system. Most of the attention thus far has focused on two proposals -- a flat rate tax, or a broad based consumption tax, such as a value added tax.

I begin this process with a favorable view of value added taxes. Most of our international competitors collect most of their revenues through a value added tax. By implementing a VAT here, we can avail ourselves of some of the advantages it offers.

In addition to broadening the base of economic activity covered by the tax system, a VAT will help achieve three major objectives. By taxing consumption instead of income, it will help spur savings. All of us who are concerned about the dramatic difference between savings rates here and in Asia and Europe must give careful thought to developing a tax regime that rewards savings.

Another advantage of a value added tax is that it will help U.S. exporters. A border-adjustable VAT will put U.S. companies on an even playing field with their international competitors. A

value added tax would certainly be far more simple to administer and enforce than our current foreign income tax structure.

As we consider these issues, we must consider a number of caveats that arise. State governments, which depend heavily on revenues from sales taxes, have always viewed the imposition of a broad-based federal consumption tax with great concern.

It is the same taxpayer who pays all levels of taxes. We should look to better coordinating federal and state taxes and expenditures. For example, to avoid a needless and counterproductive competition between states and the federal government over consumption-based revenues, the committee should look for appropriate trade-offs.

One such trade-off could be based on the states willingness to repeal their sales taxes, in exchange for having the federal government assume complete responsibility for Medicaid. While sales tax revenues currently exceed state Medicaid expenditures, the gap has recently narrowed as health care costs have risen much more rapidly than sales tax revenues. Before acting on any such proposal, we must have full and open public hearings, including close consultation with our nation's governors.

The other significant objection to a value added tax has been concern about its regressive nature. Since low- and middle-income families must devote a much higher percentage of their incomes to consumption than upper-income families, a consumption tax, like a sales tax, can make the tax system regressive. These effects can be neutralized through a number of means, such as a low and moderate income credit, and/or retaining

income-based taxes for high income taxpayers.

Thus far, this debate has been characterized as pitting flat tax proponents against those who favor a VAT. We may find that the effort to ease any potential regressive effect of a VAT would be to marry the two notions. By joining a VAT with a flat individual income tax that applied only to relatively high income Americans, we could achieve the goals of revenue neutrality and distributional progressivity that, in my view, must be part of comprehensive tax reform.

I believe a well-structured VAT will make our federal tax system more fair, more simple, and more sensible, and I look forward to working with the chairman and the members of the committee in this historic effort.

JON CHRISTENSEN
2D DISTRICT, NEBRASKA

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OPENING STATEMENT
BY
REP. JON CHRISTENSEN

On
Replacing the Federal Income Tax

Before the Committee on Ways and Means
June 6, 1995

I enthusiastically applaud Chairman Bill Archer for commencing this historic set of hearings on what is wrong with our federal tax code and how we can fix it.

President Jimmy Carter was right on target when he called the income tax "a disgrace to the human race." Few will argue that our current tax code is simple and easy to understand. We have gone from just 14 pages of federal income tax law in 1914 to over 9,000 pages today. This complexity is extremely costly to all Americans and wastes scarce resources that could best be spent elsewhere. A 1985 IRS-commissioned study found that the economic cost of preparing and filing tax returns for businesses and individuals was $159 billion annually. Economist Walter Williams has estimated that more hours were spent computing taxes and filing tax returns than were used to build every car, van and truck in the United States last year.

Enough is enough.

Today we begin the important task of reexamining the wisdom of our current tax system. We will examine its complexity and inefficiency. We will examine ways to address these inefficiencies and complexities. And we will examine alternative systems of taxation, including a pure flat tax, modified flat tax, national sales tax and value-added tax. I look forward to rolling up my sleeves and working with my colleagues as so that we may get to a federal tax system that is clear, simple, and fair--a system that encourages savings and investment rather than punishing those who plan for the future.

Thank you.

STATEMENT OF CONGRESSMAN JIM MCDERMOTT
SUBMITTED FOR THE RECORD
COMMITTEE ON WAYS AND MEANS
JUNE 6, 1995

Today's hearing will no doubt be the first of many hearings that the Committee will hold to review our current tax system and lay the groundwork for possible reform of the tax code. I think that it is vitally important that this Committee does not rush to eliminate our current tax code for short-term political gain and create long-term economic chaos.

I agree that our tax code is complicated. But when we legislate there is always a trade off between simplicity, fairness and complexity. All of the reform proposals the Committee will be hearing about this week are appealing on a superficial level - who wouldn't want to fill out a postcard length tax form? However, appearances can be deceiving and simplicity should not be a trade-off for fairness and progressivity in our tax code.

If this Committee is serious about tax reform, any new tax system must include (1) distributional equity, and (2) revenue neutrality when compared with our current tax system. In the Tax Reform Act of 1986, this Committee in a bipartisan manner eliminated most of the major corporate and individual tax loopholes, and in exchange lowered tax rates. Furthermore, I find it hypocritical that this Committee is holding hearings on tax reform when the tax cut package which was part of the Contract With America contains numerous, complicated tax proposals that are perfect examples of the types of complexity tax reform is meant to eliminate.

Instead of expanding tax entitlements for corporations and well-off individuals and lowering their rates, this Committee should seek real tax reform. In my opinion, that would include curtailing existing loopholes, simplifying tax laws and maintaining graduated rates, distributional equality and revenue neutrality. I have a list of existing corporate subsidies that I would like to see curtailed, and I would like to work with Chairman Archer and this Committee on real tax reform.p

Chairman ARCHER. The Chair is ready to recognize the witnesses before us today. First I would like to recognize Sharon Beard, president of Hurricane Fence Co., Springfield, Ill., and a delegate to the White House Conference on Small Business.

Ms. Beard, you may proceed. We would like to ask all of you to limit your statements to 5 minutes. If your written statement is longer, without objection, it will be in its entirety inserted in the record.

STATEMENT OF SHARON R. BEARD, PRESIDENT, HURRICANE FENCE CO., AND ELECTED DELEGATE, NATIONAL WHITE HOUSE CONFERENCE ON SMALL BUSINESS

Ms. BEARD. I would like to thank you for holding these hearings today and taking on this issue. One thing I have learned since I have been in the process for the White House Conference on Small Business is that taxation is a big issue. There has been a lot of debate, and a lot of discussion. I hope your schedule gives you an opportunity to listen to it during the conference.

An accountant in Springfield recently completed a study of a small business client and when I told him I was coming here today, he said, I have interesting figures for you I just figured up last week. When asked to rank their most important concerns from one to five, with one being the most important——

Chairman ARCHER. Would you mind shifting the mike a little bit so that you are speaking right into it?

Ms. BEARD [continuing]. Almost 44 percent rank taxation as their number one key issue and almost 19 percent ranked it number two. So that is a big concern for small business.

I don't want my title of president of Hurricane Fence Co. to fool you; we are a very small business. I handle a wide variety of tasks as president, including the various administrative advertising, quotations and sales, and also dusting, cleaning the office, and occasionally cutting pipe.

We did not purchase the fence company because we were financially secure and wanted to own a business. In all honesty, we traded our unemployment checks for a mountain of debt and a dream.

As complicated as our current tax system is, it seems that the corrections that have been taking place over the years add more complexity to the reporting requirements. When I look at my business tax return, I get lost in all the various schedules and sections. Like many small business owners, we sign our return hoping that our tax preparer did everything right because it is beyond our comprehension.

Our current income tax system, in my view—and I have worked a lot on the health care debate over the last year—has led to the problems that we have faced with health care. It treats big businesses so much better than small businesses and individuals with the way that it has been handled. Many of us feel that as you make changes in the tax system, the health care crisis could be drastically improved.

In my written testimony, I have a specific point regarding an employee who is only paying $8.33 a week for his health care coverage. He didn't want to pay that anymore. Within a matter of 1

month, he is off work with a major chronic disease, facing surgery, and it is going to be probably paid for by taxpayer dollars.

Our tax policy used to permit deductions and such for personal interest, but yet we have always treated health care differently. It has to reach 7.5 percent of your gross income. Frankly, there are a lot of people that will pay more for interest on a credit card than what they are willing to pay for health care and that has been largely created by past tax policy; the spending habits still exist. Look at home mortgage rates, and the interest paid by the average person. I think it is a tremendous irony there.

Current tax law makes benefits deductible by many businesses as it relates to doing business but S corporations and self-employed don't get the same breaks, resulting in tax inequities. I hope that you will consider some major changes in this area and feel that expenses are expenses; benefits are benefits. We are dealing with hidden taxes any time business incurs taxes as a cost of doing business, the costs are included in the calculation of the cost of goods sold, and are part of the basis used for markup and profit margins.

Through the White House conference we have had a lot of people discuss the collection of taxes. They were upset with having to do the collection as servitude when we are handling various withholdings and filling out the forms, if it is wrong, you get penalized, you get fined if it is late; yet time is money and it is costing us to do that. I don't have the funds to hire a tax attorney, tax accountant, and all these special people just to handle my taxes, and it is quite complex.

One thing that really bothered us was the way that purchase on real estate for commercial and banking, what it did was we looked at buying a building. Purchased at $110,000 we would pay it in 5 years. Then we would have to carry the depreciation 39 years, which would cause a negative cash flow under the current system.

I have got quite a bit more here in my written testimony. I hope you review it. I think there are some real changes that would help generate the economy and if you allow to where proceeds can be used without taxing, some of the recommendations that, our various ones, don't tax what is being used for capital improvements. You can get that money turning.

There are some concerns about some of the proposals even that you have proposed. The consumption tax—I am sure there would be exemptions that would be allowed. But there is a major concern for paperwork.

And in closing, we always hear if it is not broke, don't fix it; if it is beyond repair, get rid of it. I think it is safe to say our current system is broken and beyond repair so we are counting on you to apply the KISS—keep it simple, stupid—principle to whatever you do.

[The prepared statement follows:]

Testimony by Sharon R. Beard
Hurricane Fence Company
Before House Committee on Ways and Means

First I would like to thank Chairman Bill Archer and the Ways and Means Committee for inviting me to come and speak today. I find this to be a particular honor because later this week I will also be representing Small Business as an elected Delegate to the National White House Conference on small business. Tax Reform and Tax Simplification will be the topic of much debate, as it has been throughout the conference process. As you begin looking at alternatives please consider the broad impact of your options. Sometimes initial impressions and views don't take the total ripple effect of the solution into account. Unfortunately those ripple effects can have consequences worse than any of the benefits realized.

White House Conference on Small Business

I hope you are capable of taking some time from your busy schedule and sit in on some of the debate that will take place in the taxation issue area. The taxation issue area is one of the largest issue areas at the conference. There are aiso tax related issues in other areas such as capital formation, community development, human capital, technology, and the open forum. The timeliness of your hearings in conjunction with the conference should be helpful to you. Throughout the process there has been a strong cry for tax simplification and major changes in what is considered TAXABLE income. Tax simplification is a major issue for most if not all small business groups represented at the conference. I hope you will also help simplify the taxing Independent Contractor issue. The problems are based on tax issues. An accountant in Springfield recently completed a study of his small business clients. When asked to rank their concerns from 1-5 with 1 being most important 43.75 percent ranked taxes as #1 and 18.75 percent ranked it #2.

My Background

Don't let my title of "President" fool you. Like most small business owners, my job description covers a wide array of tasks and functions within the company. I handle the wide assortment of administrative tasks, answer phones, prepare sales quotas, deal with inventory, purchasing, advertising, and many other functions including dusting and cleaning the office. Hardly the typical CEO who testifies before you. We did not purchase a fence company because we were financially secure and wanted to own a business. We traded our unemployment checks for a mountain of debt and a dream. Like a growing number of small business owners we did it for survival and because we didn't have many other options.

We fit the typical educational background of many small business owners who have completed high school and possibly some college. Owning our small business however, is a never ending educational experience.

Simplification

As complicated as our current system is, it seems that some corrections of apparent deficiencies can add more complexity to the reporting requitements. When I look at my business tax return, I get lost with all the various schedules and sections. Like many business owners I sign a return my accountant has prepared and pray that he didn't goof it up. All the schedules are beyond my comprehension.

Current Tax Policy & Health Care

Our current income tax system is also responsible for much of our present health care problems. It treats big business so much better than small business and individuals that many including myself feel that a fix here could be a major step forward in dealing with the health care problems of our nation.

Case and point: I have an employee who was only paying $8.33 per week for his medical coverage, while the total cost of his health care was approximately $192.00 per month. In April he canceled his insurance because he no longer wanted to pay the $8.33 per week. His coverage ended on May 1st. Currently he is off work and facing surgery for a medical condition called Diverticulitis. He has applied for medical assistance, and Medicaid will likely cover the costs.

When our tax policy permitted individual deductions for interest payments, individuals were willing to pay far more in interest on their plastic than the average worker would ever consider spending for health care related expenses. I see a tremendous irony when you look at the returns on investment and our health care crises.

Current Inequities

Current tax laws make benefits deductible by the business as it relates to doing business. S-Corporations and the self-employed can only deduct a small portion of what they pay for their benefits as a business expense (even though the insurance is the same), and employees can't deduct anything. I hope you would consider a major change in this area and make all employee benefits deductible by the employer and the self-employed and taxable for the recipient, just the same as wages are treated with deductions allowed for their out of pocket insurance and medical costs. In doing so, employees would have a financial interest in containing cost and would have a financial interest in conducting a cost/value review of their health care packages and other benefits. Benefits are an extension of wages and a benefit to the worker, therefore, paying income taxes on benefits at a lower rate is far better than not having the benefits at all.

Uncompensated Collections

Another complaint with the current tax structure is that the average person likely can't tell you their total tax bill for last year. They plan their weekly living around their net pay, and they can likely tell you what they either had refunded or what they paid on April 15th. Small business has the responsibility for withholding, deducting the proper amount, dealing with earned income credits, and making the deposits. Businesses large and small have paperwork burdens related to the collection of taxes for our government. This is more of a problem for small businesses like myself who lack the designated personnel to deal with that as their only task, unlike large corporations who employ payroll clerks and comptrollers. Many of us still lack technology. All this takes time and in the business world, time is money. I have heard some small business owners refer to it as servitude and are adamantly opposed to the collection of taxes and performance of government tasks without some form of compensation. This is especially true when you consider the penalties and fines that businesses are assessed if the deposit and returns are late or incorrect.

I, like many other small business owners I know, cannot afford a tax accountant or a tax attorney or a bookkeeper to solve my government paperwork problems. Complications, problems and current inequities threaten our very existence.

Current Tax Policy Creates Negative Cash Flow

Our current policy has forced undercapitalized and capitol intensive businesses to borrow. Over the past several years, with the disappearance of community banks, replaced by large national banking chains, and the tightening of the money supply to discourage inflation, we are seeing small businesses afraid of debt. Many like myself have made decisions to operate leaner or to do away with interest expenses being paid to others. We are attempting to get ourselves into a better cash position.

When we purchased our business we leased the property with an option to purchase it later. I sat down and worked with a few numbers. I found that the current tax system adversely affects the ability of small business owners to purchase property. This is especially true with existing property in need of capital improvements. The property I leased was available for me to purchase for $110,000 and the average interest rate over the year in question ran approximately 2-3 percent above prime or 10-11 percent. I would be required to deduct the building and the capital improvements over a 39 year period, even though it was a metal building well into the second half of it's economic life. Bankers explained to me they really prefer five years on commercial property loans but could go as long as ten. Can you imagine the negative cash flow while principle is being paid off so much faster? We would be getting taxed on the principle which cannot be deducted as an expense for another 28 years or so. I decided that current depreciation and tax laws with regard to real estate are terribly unfair to small businesses.

This is a major factor for many small homebased businesses. I moved our offices into our home. Other businesses are coming to the same realization, and avoiding borrowing at all costs.

Net Result on Money Supply and Inflation

Going against the traditional borrowing practices and using profits for capital purchases as opposed to debt is drawing attention. William Dunkelberg of Tempel University has stated that much of the current recovery in small business is a direct result of projects being funded by profits rather than increased debt. Helping small business fund improvements with before tax profits would drastically improve the longevity of recovery without the inflationary pressures caused from interest rates.

Increasing the ability for businesses to use pre-tax dollars for expansions and capital improvements would in effect create wealth by increasing the velocity at which money flows through the economy. This would create jobs and increase wealth.

Regarding Consumption Taxes

While a national sales tax will be debated, myself and others share a concern that it could create even more paperwork for us. Additionally, it would have an effect on the consumer which could jeopardize our businesses. A customer who pays let's say 20 percent sales tax on an installed fence job would be far more likely to do it himself on a weekend. There are also some fears that the complications experienced with current sales taxes regarding tax exempt entities, agencies, and programs would become far more complex under a national system.

Another concern is that it would have the capability of turning into a value added tax and become a paperwork/regulatory nightmare. Various services which are not currently taxed in many states would become taxable, and an underground economy in these service industries would likely result.

I would also be concerned about the impact on lower wage earners who spend a larger percentage of their income and lack the reserves to save any substantial amounts. A National Sales Tax could have a regressive tax effect when you figure that those who make more have the ability to save more, so the percentage of their total earnings paid in taxes could be less.

Regarding Flat Tax

The flat tax being proposed raises concerns as well. I have heard opponents say they want a progressive tax. The notion that flat tax proposals are not progressive is not entirely true, however, because many such proposals retain exemptions and allowances. The allowances and exemptions allowed on a family of four with an income of $45,000 per year, for example, would be far less than the 17-20 percent of total income, and someone who makes $300,000 would pay far closer to the full percentage.

Elimination and Simplification of Paperwork

While opponents may oppose the reduction of the ability to take deductions, others may find that by eliminating a large percentage of the paperwork, major simplification would allow them to complete the return far easier, there would be less chance for error or fraud and we might be able to fully understand the tax documents which we sign. Some concern must be given to the transition process for whatever changes are adopted. A change to a national consumption tax would mean a whole new way of doing business. All new forms and a whole slew of new regulations. Increased consumption taxes paid by businesses in the course of doing business will need to be reflected in prices and costs, and passed onto the consumer. Some business operations will likely become less profitable while others may become unprofitable because of hidden taxes.

Regressive Vs. Progressive Taxes

State sales taxes have been criticized as being regressive because those on the lower portion of the wage scale typically consume a higher percentage of their pay. Those individuals who are more wealthy have the ability to invest and save a larger portion of their earnings. Under a regressive system it is the rich who benefit.

Progressive taxes benefit the lower and middle income. The flat tax could have this progressive effect because of increased exemptions.

FAILURE TO APPLY THE K.I.S.S. PRINCIPLE
COULD RESULT IN A DISASTER FOR SMALL BUSINESS AND THE ECONOMY!
we are counting on you...

Chairman ARCHER. Thank you, Ms. Beard.

Our next witness is Ray Tyler, a small business man in Washington.

STATEMENT OF RAY TYLER, OWNER, TYLER BUSINESS SERVICES, INC., AND MEMBER, SMALL BUSINESS SURVIVAL COMMITTEE

Mr. TYLER. Good morning, Mr. Chairman and Members of the Committee. My name is Ray Tyler, owner of Tyler Business Services, Inc., located in Washington, D.C. I am also a member of the Small Business Survival Committee, a nationwide, nonprofit, nonpartisan, small business advocacy organization that fights against the growing burden of taxes and regulations on our Nation's small businesses and entrepreneurs.

Tyler Business Service is a full-service printing shop which has been operating in the Nation's capital for 35 years.

First, let me thank you, Chairman Archer, for inviting me to speak before the Committee today.

Second, I congratulate you for holding these hearings to address the important issues of overhauling our Nation's tax system. Your leadership in this area is critical to not only today's small businesses and entrepreneurs, but also the well-being of future small business owners who indeed will need this Committee's help to increase their chance of success and survival.

Of course, my time must be factored into these overall costs as well, which takes away from my productive time actually running the business. Let me add that these are just compliance costs, not actual taxes. Today's small business persons almost always have to pay professionals to navigate them through the complicated tax compliance maze. This is a never-ending, changing maze, I might add.

According to the Tax Foundation, over the past 40 years since the passage of the Internal Revenue Act of 1954, which puts the income tax at the center of the Federal tax system, 31 notable tax changes have taken place, on average a major change to the Federal Tax Code every 1.3 years. Not surprisingly, the increase of the size and complexity of the Tax Code has caused an increase in my tax compliance cost.

The uncertainty and instability of the tax system, the number of taxes that I must pay combined with my total tax bill and compliance cost is enough to drive anyone out of business. I am not sure how a person starting his or her own business can quite make it these days. Fortunately, my business has grown and with it I have been able to factor in the cost of taxes and taxing plans in my overall business cost.

I am almost sure that many business failures are the direct result of our Nation's excessive and burdensome tax system. The current system creates disincentives to save, invest and pursue risk-taking entrepreneurial activities. Many, many times in my business I tried to do the right thing for my employees by creating incentives for them to stay with the business and, while with us, to be more productive employees.

When I first created a pension plan for the business, I used to manage it, but because of the complexity of the tax laws I had to

turn it over to the bankers and our lawyers. Now I just sign reams of paperwork for the bank. At the end of each month, if the business turns a profit, I give bonuses to my employees. The government makes even this difficult because I have to renegotiate salaries to comply with the misguided regulations.

The bottom line to the costly and burdensome tax system is that my employees are hurt through lower wages and my customers are hurt through higher prices. My business is only one example of how the government is depressing our Nation's standards.

Is the time up?

Chairman ARCHER. One minute.

Mr. TYLER. I would say one good thing about all these taxes and all these regulations. Let me say one good thing about it from my standpoint. One good thing from my standpoint, a person who has been in business 35 years, is that it is keeping other people from going into business. It is also keeping other competitors who don't run as well as I do out of business.

So today in the District of Columbia, where practically no printers are left, only small copysetters, I have a wonderful business partially because of what the government has done to my competitors.

Thank you.

[The prepared statement follows:]

TESTIMONY OF RAY TYLER
SMALL BUSINESS SURVIVAL COMMITTEE

Good morning Chairman Archer and members of the committee. My name is Ray Tyler, owner of Tyler Business Services located in Washington, D.C. I am also a member of the Small Business Survival Committee, a nationwide, nonprofit, nonpartisan small business advocacy organization that fights against the growing burden of taxes and regulations on our nation's small businesses and entrepreneurs. Tyler Business Services is a full-service printing shop which has been operating in the nation's capital for 35 years.

First, let me thank you Chairman Archer for inviting me to speak before the Ways and Means Committee today. Secondly, I congratulate you for holding these hearings to address the important issue of overhauling our nation's tax system. Your leadership in this area is critical to not only today's small businesses and entrepreneurs, but also to the well-being of future small business owners who indeed will need this committee's help to increase their chance of success and survival.

I say this Chairman Archer, because I have been a small business owner for over 35 years and have seen the increased tax and regulatory burden placed on my own business. The only way that I have been able to keep the doors of my business open has been through the paid assistance of professionals who specialize in the tax compliance area -- namely a Certified Public Accountant (CPA), a full-time bookkeeper, an attorney and bankers.

Last year my CPA cost the business over $9,000. At least 10 percent of my staff bookkeeper's salary -- about $4,500 -- is dedicated to dealing with lawyers, bankers and IRS issues. The company pension fund, which I used to manage myself as well as pay someone $1,000 to do actuarial work ten years ago, cost me $26,000 last year because of changes in the way the IRS administers the tax fund. My billing department also incurs hefty tax code compliance costs. And, of course, my time must be factored into these overall costs as well which take away from my productive time actually running the business. Let me again add that these are just compliance costs -- not the actual taxes!

Today's small businessperson almost always has to pay professionals to navigate them through the complicated tax compliance maze. And, this is a never-ending changing maze I might add. According to the Tax Foundation, over the past forty years (since the passage of the Internal Revenue Act of 1954 which put the income tax at the center of the federal tax system) thirty-one notable tax changes have taken place -- on average, a major change to the federal tax code every 1.3 years. Not surprisingly, the increase of the size and complexity of the tax code has caused an increase in my tax compliance costs.

The uncertainty and instability of the tax system, the number of taxes that I must pay, combined with my total tax bill, and compliance costs is enough to drive anyone out of business. I'm not quite sure how a person starting his or her own business can quite make it these days. Fortunately my business has grown, and with it have been able to factor in the cost of taxes and tax compliance into my overall business costs. I am almost sure that many business failures are the direct result of our nation's excessive and burdensome tax system. The current system creates disincentives to save, invest and pursue risk-taking, entrepreneurial activity.

Many, many times in my business I try to do the right thing for my employees by creating incentives for them to stay with the business, and while they are with us be more productive employees. When I first created a pension plan for the business (as mentioned above) I used to manage it, but because of the complexity of the tax laws I had to turn it over to the bankers and the lawyers. Now I just sign the reams of paperwork from the bank, and pay a lot to do simply that.

At the end of each month if the business turns a profit, I also give bonuses to my employees. The government even makes this difficult because I have to "renegotiate" salaries to comply with misguided regulations.

The bottom-line to the costly and burdensome tax system is that my employees are hurt through lower wages, and my customers are hurt through higher prices. And my business is only one example of how the government is depressing our nation's standard of living and hurting economic growth and job creation.

I, like many other small business owners, agree that something must be done to make our tax system less-costly, less-burdensome and more efficient. That is why Chairman Archer you, and other leaders in the Congress who are advocating far-reaching proposals to overhaul the tax system have certainly won the hearts of many small business owners. And, although you may have won our hearts, lawmakers have not yet won our minds. Because many small business owners believe that the federal government is incapable of making a tax system fair and less-burdensome. This is only an honest assessment of how many small business owners feel.

However, I remain confident that perhaps this will occur in my lifetime. By the way, I am 75 years-old and would appreciate it if you put these tax overhaul efforts on the fast-track.

While at this point in time I do not advocate one tax system over another, I agree with some basic principles which have been well presented by the Small Business Survival Foundation. Two leading proposals which "score" high against these principles are a flat tax and a consumption tax -- or the national sales tax. The basics of a sound tax system developed by the Small Business Survival Foundation, and based on Adam Smith's maxims of a taxation in 1776, include:

- ***Low Flat Tax Rate to Promote Economic Growth***
- ***No Taxation of Capital***
- ***Inflation Factor***
- ***Clarity***
- ***Simplicity***
- ***Limited Bureaucracy and Intrusiveness***
- ***Minimum Incentives for Tax Avoidance***
- ***No Additional Boost to Government Spending***

I'd like to leave with you Chairman Archer, and I am sure that the Small Business Survival Foundation would make this available to all members of the committee, a copy of a Preliminary Report prepared by the organization's chief economist called *"The Great Tax Debate: Making Sense of Competing Tax Plans."* This report details each of the above principles in greater detail, and how leading proposals score against the basics of a sound tax system.

Once again Chairman Archer I thank you for inviting me to be a part of these important hearings today. While typical Washington observers will say that overhauling the nation's tax system is an impossible task that will never happen, I am just thrilled that we have entered a political environment where this debate is actually occurring.

Most hard-working taxpayers agree that something must be done to make the U.S. tax code more fair, less-costly and less-burdensome. For our nation's small business owners, the current tax code is a mess and totally out-of-control. I am so pleased that you are taking a lead to help reward our nation's risk-takers and job creators which will lead to greater economic opportunity and security for all Americans. I would be more than happy to answer any questions you or committee members may have.

Chairman ARCHER. Thank you, Mr. Tyler.

Our next witness is Constance Skidmore from San Francisco. You are recognized. You may proceed.

STATEMENT OF CONSTANCE E. SKIDMORE, PARTNER, COOPERS & LYBRAND, L.L.P.

Ms. SKIDMORE. Mr. Chairman and Members of the Committee, I am Connie Skidmore, a partner of Coopers & Lybrand, L.L.P., and partner in charge of our firm's tax compliance practice. Coopers & Lybrand, L.L.P., is one of the world's largest accounting and business advisory firms and provides indepth expertise to individuals and business enterprises. In our practice we resolve business tax problems in a wide variety of industries and for individuals of all levels of income categories.

We have been asked today to address the need for reform of our current income tax system, not to address any particular alternatives. I would like to share our perception of the frustrations facing individuals and businesses based on today's system. I will share some examples of both inconsistency that we believe exists in the system as well as the high levels of complexity.

During an individual's life cycle there are many natural changes that cause people to question the fairness and simplicity of the system. For example, our complex rules require that when a child reaches the age of 1 year, he or she must have a Social Security number and if that number is not placed on the tax return, the refund could be delayed and the parents could be assessed a $50 penalty. You can imagine that for a couple that has just had a child, they probably don't have the time to figure out the rules for filing for a Social Security number. To obtain a child care credit the parent must also understand the multiple levels of complexity, defining who is a qualifying person, what are dependent care benefits and what are qualified expenses. Even when one determines the foregoing, there is a six-point test that must be met.

As a child gets his first job he or she is likely to come home and ask, "How many exemptions should I be claiming?," and the correct answer to that question is even a different answer than the rule for a dependent. Finally, the child contemplates marriage and faces the choices of filing jointly, filing separately, or single, or head of household.

As my written testimony explains, life goes on and so does the complexity of interfacing with the tax system. As a person has children, moves, buys and sells a house or other assets, and maybe even gets divorced, the rules must be adhered to. Upon retirement, major decisions must be dealt with concerning taxation of retirement pay, when, how much to receive, how long a period of time to receive it over, whether in lump sum, as a rollover, or as an annuity, and what the contribution recovery rate should be.

As one faces receiving Social Security, an individual has a complicated formula to determine annually how much, if any, is subject to taxation. The calculations are so convoluted as to greatly aid in the misunderstanding of the scope of the provision; and finally, death brings many tax complexities.

The kinds of basic and normal changes in an individual's life also exist in the normal evolution of a business enterprise. I will just

mention three issues. As a business starts up and becomes incorporated, little thought is given to the tax consequences either because of lack of knowledge or advice regarding these complex choices. Every week businessowners show up in our offices owing a double level of tax because they have sold a company and have chosen the wrong form of business. The business should have been organized as a passthrough entity, but there is nothing we can do to retrieve the prior taxes that have been paid unnecessarily. We generally solve this problem going forward by suggesting an S corporation be elected.

Now, there are new rules that have been instigated in certain States allowing limited liability companies, and these same companies are facing the question, "What choice do we make in choosing our business entity"? As a company moves through its operating lifetime, it may also encounter as many as a half a dozen definitions of a given term. For example, the term gross receipts has many different definitions in the tax law.

As a company winds down and comes to the end of its life cycle, we can give a good example of how overly complex the rules are that create confusion by looking at a bankrupt company for which we filed returns.

The company's actual losses were so significant there was probably no possibility it would ever pay taxes under the regular tax system and it was destined for liquidation. Yet, because of the alternative minimum tax system, which is a system that imposes a minimum level of taxes in spite of allowable deductions, the company's alternative minimum tax liability took preference in liquidation over the debts to unsecured creditors. In other words, even though there was no benefit or income for those allowable deductions, the government was paid an income tax while the business' suppliers and other creditors of the business got nothing. The stakeholders obviously were baffled by this complex set of rules.

I hope this perspective of normal everyday events both on the individual and business side gives you a feel for the frustration that taxpayers face. We propose that in your deliberations regarding tax reform that you consider the underlying principles of both simplicity and consistent policymaking.

Thank you for giving me the opportunity to testify. I welcome any questions you may have.

[The prepared statement follows:]

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Statement on "Replacing the Federal Income Tax"

Constance E. Skidmore
National Director of Tax Compliance
Coopers and Lybrand L.L.P
before the House Ways and Means Committee

June 6, 1995

Mr. Chairman and members of the Committee, I am Connie Skidmore, a partner at Coopers & Lybrand, L.L.P., and partner-in-charge of our Firm's Tax Compliance practice.

Coopers & Lybrand, L.L.P., provides expertise in Business Assurance, Tax, Consulting, Human Resources Advisory and Process Management for individuals and business enterprises. We have over 66,000 partners and staff worldwide, with more than 740 offices in 126 countries. Our tax practice serves a wide variety of clients and assists them in complying with U.S. tax laws in a cost effective manner. Since 1898 we have been assisting clients with tax consulting and tax compliance.

A general overview of my 22-year career in taxation includes over three years as an IRS tax auditor, two years practicing estate and trust taxation, and many years in the fields of real estate, individual and general corporate taxation, tax shelter consulting, and high technology and venture capital taxation among others. My experience has exposed me to the difficult and frustrating problems encountered by taxpayers when complying with our current tax laws.

In our practice, we see complexity problems on the corporate side, as well as problems associated with lower and middle income returns of individuals. We do tens of thousands of individual tax returns of business employees as part of our expatriate practice, as well as thousands of returns for our client's children.

We have been asked to address the need for reform of our current income tax, not to address any particular alternatives. I would like to share with you our perception of the real world problems facing individuals and businesses that try to comply with tax rules and provide some examples that demonstrate the importance of the reform effort that this committee is undertaking today.

Income Tax Complexity and Fairness

The extreme complexity of our current system is a source of frustration that becomes particularly acute for taxpayers when they feel that the complexity has not produced the best result for those in their circumstances.

Our current income tax has many sources of complexity. Some complexity is inherent in the structural components of the tax system. For example, any tax that adjusts for family status or family size must define "married", "head of household", and "dependent". These distinctions are not easy ones and are the source of complexity and hardship for many average taxpayers. Similarly, once adjustments are permitted which attempt to address the tax burden for different family circumstances, additional definitions are required and judgments can be made about when other events imperil the individual's ability to pay. Examples include the definition of "medical" expense, "casualty loss", and

the different AGI tests included in the Code today to determine when these costs are deductible. Additional complexity is added by provisions intended to influence behavior, such as those permitting favorable tax treatment for savings, an itemized deduction for mortgage interest and charitable contributions, and so forth.

Individual -- Life Cycle Complexity and Fairness

For many individual taxpayers, the income tax is relatively straightforward and the form 1040 A or 1040 EZ relatively simple, as long as they have mostly wage income and do not have to dwell on their filing status or the dependency tests. Unfortunately there are significant elements of the population who each year face some sort of complexity. Our normal basic changes in life which give us pleasure or perhaps tension are compounded by tax complexity. Let me give you a few examples that arise with our life cycles:

- When a child reaches the age of 1 year, he or she must have a social security number. If that number is not placed on the parent's 1040 tax return, their potential refund could be delayed and they may be assessed a $50 penalty.

- On special occasions, the child receives gifts. Even when these amounts are relatively small, we as tax practitioners are asked if these gifts are taxable income. Few people understand the delineation between the gift tax and the income tax.

- When the child is growing up, the parents may incur child care expenses. To receive a child care credit, one must understand who is a qualifying person, what are dependent care benefits and what are qualified expenses. Even when one determines the foregoing, a six point test must be met.

- Then the child gets his or her first job. How many of you have had a son or daughter come home or call asking how many dependents they should claim for withholding?

- Finally the child is contemplating marriage but faces the choice of filing jointly, married filing single, single or head of household. We have a secretary in my office who asked her boss to review her 1040 since she incurred an inordinate amount of medical expenses. Her boss looked over the return and mentioned that he did not realize she had been married or had children to claim the head of household filing status. Her honest reply was that "she owned her own home so surely she was head of a household".

- When the married couple have children they now have dependents which may or may not give them an exemption deduction. Clients often ask us whether someone is a dependent. As simple as this question sounds, I must respond with a series of questions to determine 1) relationship, 2) marital status, 3) citizenship, 4) residency, 5) income, and 6) support. These questions take on a whole new complexity if the child was of divorced parents.

- What if a spouse loses a job. What is the tax status of any unemployment benefits. Moreover, in these low income years, there is the possibility of qualifying for the earned income tax credit. We observe, however, that this credit is far too complex for the population it targets.

- Later in life the married couple moves. It's bad enough that the couple must file split year state returns, but they must also face two additional complications on the federal return. The first one is the moving expense deduction. To calculate this deduction, there is a distance and a time test and of course exceptions thereto.

Then all expenses must be broken down into categories to determine whether some, all or none are deductible. The second is reporting the gain on the sale of the personal residence and the replacement property. This calls for the compilations of all the records relating to expenditures of the sold residences. Fortunately, once a person has gone through this exercise, they generally keep better track of their house expenditures thereafter. Still, one of the most frequently asked questions is "How long and what records do I need to keep for income tax purposes?"

- Unfortunately our theoretical couple become separated or divorced which creates a series of difficult and theoretically complex issues such as: gain recognized; sale of residence and reinvestment; alimony; what constitutes child care expenses; who gets the deduction for the children, etc.

- When our theoretical taxpayers become elderly, the tax complications compound along with the normal complications of aging. Upon retirement, major decisions must be made concerning the taxation of retirement pay: when, how much, how long, lump-sum, roll over, annuity, contribution recovery etc. Upon receiving social security, a complicated formula needs to be done annually to determine how much, if any, is subject to tax. The calculations needed to determine the taxable portion of social security benefits are so convoluted as to greatly aid in the misunderstanding of the scope of the provision.

- For the elderly a credit is possible if one meets an age test, a filing test and an income test which takes into account nontaxable income.

- And finally, death brings upon several tax complexities, especially in the estate tax area. Practically no one in the United States really knows how to prepare someone for our estate tax law other than those who practice in this area.

"Main Street" Business Issues -- Life Cycle of a Business

The kinds of basic and normal changes in an individual's life, also exist in the normal changes during the life of a business from its birth (choice of entity) to its death (bankruptcy or liquidation). The current system, which generally requires the taxpayer to understand and to fully comply with tax rules, has procedural and definitional difficulties that many taxpayers must learn by experience - sometimes too late.

- ***Choice of Entity - starting the business***

Basic Business Forms.

All taxpayers are experiencing an undue burden with respect to tax filing requirements. These onerous requirements begin the moment a business starts operations. Choosing the proper business entity from a tax viewpoint can perplex even the most sophisticated entrepreneur. Most decisions are made with little or no knowledge of compliance requirements. And typically, no financial or tax advisors are consulted at the time the decision is made.

Many startup businesses are incorporated with little thought about the tax consequences. Every week, business owners show up in one

of our offices owing two levels of tax as a C corporation when the business should have been organized as an S corporation. The businesses have effectively overpaid (sometimes hundreds of thousands of dollars) because they were not focused on the tax consequences and did not have adequate tax advice from the start. These are resources that could have been reinvested in the company; yet there is nothing we can do to get back the prior tax liability already paid. We can only solve the problem going forward by advising the company to elect S corporation status.

Now that states are adopting new legal entity rules to permit a new kind of pass-through entity, limited liability companies (LLC), some of the same companies are again having difficulty with the federal tax rules. These new entities have all kinds of competitive advantages in the marketplace (*e.g.*, the types of employee fringe benefits and investors that the federal tax law will allow them to have), yet S corporations can generally only convert to this LLC status by paying a very significant federal income tax toll charge.

Selecting A Tax Year.

The change made in the law to require a December 31 year end for businesses that operate as pass-through entities is an example of how a tax procedural rule can run completely afoul of business interests. A retailer who has a huge Christmas season and January clearance sales will use a January 31 year end for solid business reasons, but for tax purposes a December 31 year end must be used (or a complex alternative under Section 444). This has not worn well in practice. It causes difficulty for the taxpayer as well as workload compression for tax practitioners which translates into workload compression for the IRS.

Elections Generally: do they communicate fairness to the taxpayer?

Our current tax code and regulations are filled with complicated elections that must be made with the first return filed to which the election could apply. This causes tax directors of major companies many sleepless nights. They worry that they have missed a possible election that would benefit their company. They worry that they made the wrong election because they had so little time to make it that they had to guess. It gives tax professionals an uncomfortable feeling that the tax code has a Las Vegas mentality -- heads I win, tails you lose. This sort of burden is hard to quantify but adds much angst to the system. Why couldn't an election be made or changed anytime before the statute of limitations has tolled? Is it really in the government's interest to make taxpayers feel tricked when they are trying to comply while paying the least amount of tax legally owed?

- ***Net Operating Losses -- early year operations***

A usual scenario for the entrepreneurial company includes operating losses in the early years. When the entrepreneurial venture shows some signs of real success, the company frequently needs an infusion of additional investors to compete successfully enough to assure that the any of those benefits will materialize. Enough new investors can mean triggering the change of ownership rules in Sec.

382. The lengthy and complex rules requiring reporting under Sec. 382 (even for years prior to utilization of the net operating losses), assume the resource-constrained young company can accumulate and analyze the appropriate records to comply. We hear many justified complaints from taxpayers about the wasted resources spent on Sec. 382. In many cases, companies with limited resources will not pay to have a proper analysis performed, or provide data for adequate information reporting, and noncompliance may result.

- ***Depreciation and AMT -- building a manufacturing business***

During the growth cycles of companies, they quickly are confronted with significant compliance for fixed asset reporting. These same problems affect mature companies that are capital intensive. For my California clients, they must sometimes track 7 depreciation methods, one for financial statement purposes and 6 under federal and state tax law. This usually creates such a burden that to comply with the tax law requires a full-time employee just to work on fixed assets. Maintaining ongoing records for assets owned when each depreciation change is made in the law is an undue burden. Bottom line -- having one set of rules for depreciation for regular tax purposes and another set of rules if you are not profitable enough to pay the regular tax is a compliance nightmare.

The best real world example of how badly the current AMT works involves a bankrupt company for which we filed tax returns. The company's actual losses were so significant that there was no possibility that it would ever pay taxes under the regular income tax system, and it was clear that the company was destined for liquidation. Yet, because of AMT preferences, the company owed alternative minimum taxes. The AMT tax liability took preference in liquidation over the debts to unsecured creditors. There was no income and no benefit from the so called "tax preferences", yet the IRS got paid an "income tax" while the business suppliers and other creditors of the business got almost nothing.

As soon as the company becomes profitable, the myriad of estimated tax payment rules must be dealt with. It is not out of the ordinary that these rules require the financial books be "closed" within a matter of days in order to make the calculations (usually more than one calculation including AMT analyses) and arrange for payment by the 15th day of the following month. This assumes the availability of accounting personnel as well as hardware and sophisticated accounting software.

- ***Employee Benefits -- adding and attracting employees as the business grows.***

There are a myriad of reasons why the addition of employees to any business increases the compliance burden and potential problems with the IRS. We cannot hope to do justice to the entire topic today. This Committee is well aware of the problems of classification of workers as independent contractors or employees. It is one of long standing and difficult to resolve. It will persist in any tax system that involves distinctions between these classes in terms of deductibility of compensation paid or in the treatment of benefits provided. However, and more importantly, the so-called "qualified plan rules" in the federal tax code have changed an inordinate amount since 1981, causing many to "give up the ghost" and eliminate their retirement plans altogether. The small businessperson today has little other choice given the very complex set of tax criteria faced in setting up a plan and even in determining which employees can participate in a plan. These complexities can extend to other sorts of employee fringe benefits as well.

An employer that offers married employees a choice of benefits can find that instead of improving the lot of their workers as intended, they have created a nightmare. According to the IRS, if an employer gives a married employee a choice between health insurance and improved retirement pay, so that employees who have superior coverage through their spouses can benefit in another way, the company has inadvertently caused the employee who chooses to stick with the health plan to be taxed on that benefit which is a totally counter intuitive result.

- ***Ongoing Complexity -- during a company's operating lifetime.***

The federal tax code is full of rules for which the balance between complexity imposed on the taxpayer and federal revenue benefit is highly questionable. We have a trillion dollar plus per year tax system, with parts of it adding complexity for U.S. business enterprises that are an anathema to the rest of the world.

Uniform Capitalization Rules.

IRC Sec. 263A requires taxpayers that carry inventory, such as manufacturers and retailers, to capitalize a portion of their indirect costs. If you have an off-site storage facility, the costs of that warehouse must be capitalized into inventory. Similarly, the salaries and payroll taxes of the person purchasing the inventory must be capitalized. The inventory accounting system for tax purposes is generally not acceptable under accounting principles, so that taxpayer generally does not even have the option of conforming book accounting to the tax accounting system. Therefore, the taxpayer must maintain both systems. This discrepancy causes major difficulties for small businesses and entrepreneurs.

The best example of this problem is the company that paid their accounting firm $200,000 to perform an analysis of their inventory accounting system which concluded that the uniform capitalization rules required the taxpayer to make an additional one time payment of $50,000. What this means for a company with a constant level of inventory is that the federal government gets a one time revenue pickup and the taxpayer gets an additional accounting system for tax purposes that, legally, must be maintained in perpetuity. Furthermore, the company may have taken a business deduction for the $200,000, in effect costing the government rev. .e.

Larger and more sophisticated businesses can reach an acceptable compliance level after working with complex rules for a number of years, as long as those rules do not change. But new businesses and large existing companies that must face complicated new rules struggle and spend inordinate amounts of time and money to implement such rules. A timely example is the interest capitalization component of the Sec 263A rules that are newly effective 1/1/95. The IRS, eight years later after enactment of the provision, has finalized rules for capitalizing interest that depart dramatically from current practice and will require much adjustment by many taxpayers in different industries. Real estate developers will be required to keep detailed records of construction costs incurred as of certain "measurement dates" in order to decide how much interest must be capitalized. This data would not be kept for any other purposes. Additionally, in some cases, entities without construction activities

must capitalize interest because of construction activities of related companies.

Basic Definitional Issues.

Whenever definitions are a key component of a tax rule, problems and complexity result and sometimes these are out of balance with the benefits to the system. A recent example is the excessive difficulty, time and money taxpayers have spent to determine their non-deductible "lobbying" expenses and to allocate the proper costs thereto. Definitional issues arise in many parts of the Code. Today we see problems even in the definition of those activities that everyone agrees should be most promoted, such as basic and experimental research.

A recent meeting I had with a seasoned, highly qualified CEO of a high technology firm which is developing state-of-the-art technology in a field historically dominated by Japanese companies, is illustrative of this problem. In order for him to be comfortable with our tax advice on the company's research and development, he spent 20 hours understanding the tax regulations on the issue. He was most disconcerted that our tax system is so complex that he must re-allocate his time to this effort instead of adding real value in his field of engineering. Not only was his time not well spent, but he also lost the training and coaching time he would have spent with either his engineering or marketing teams.

"Passive Activity."

These rules are complex, some would say impenetrable. And the rules affect anyone who has a piece of rental real estate or a limited partnership interest, no matter how small. It is virtually impossible to calculate without a computer program. This source of complexity affects all types of taxpayers. A great many middle and lower income retirees, in an effort to maximize the rate of return on their savings, have brokers and investment advisors that have invested them in a small interest in a limited partnership, typically $5-10,000. An experienced tax advisor can easily spend 20 hours performing the calculations that can have little impact on ultimate tax liability. We run the calculations on powerful computers, and even then the time it takes to input the data seems ridiculous. This breeds non-compliance often involuntarily.

Fundamental procedural complexity.

Procedural rules should be measured against a common sense standard. The best example of a procedural rule that communicates the wrong message to a taxpayer when discovered is perhaps the rule for the due date of tax deposits. Taxpayers who must make multiple deposits of taxes during the month frequently send a messenger to the bank to make sure the payment is there on time. Few taxpayers understand that the payment is treated as if made at a bank and recorded when the bank closes its books, not when it closes its doors.

For example, the company that dutifully sends a messenger to the local bank before it closes at 3:00 PM is one day late if the bank has closed its books at 2:00 PM. Worse yet, if the company sends its payment directly to a Federal Reserve bank at 2:00 PM and the Federal Reserve bank closes its books at noon, the taxpayer is one day late even though its check is in the system faster than if the company deposited on time in the local branch office. Imagine the reaction of extremely compliant taxpayers when the IRS assesses large penalties and interest on all the taxpayers' past tax deposits due to the taxpayers' misunderstanding of the system.

- ***Multinational Businesses -- growing into foreign markets.***

The income tax system is currently inordinately complex and burdensome for U.S. companies trying to do business abroad and we urge the Congress to assess the nonproductive costs it is placing on these companies. Even within the constraint of our current system, significant improvement can be made to the workability of the rules, reducing the areas of uncertainty and excess burden.

For U.S. multinationals, the present rules make it very hard to get foreign earned dollars back to the US efficiently. Frequently, rather than repatriating cash earned by foreign operating subsidiaries, and thus making this cash available for U.S. investment and job creation, companies are investing this cash abroad in active businesses so as to avoid other tax costs that would be incurred if the cash were repatriated.

For example: Many U.S. parent companies experiencing U.S. net operating losses often choose to let their foreign operating subsidiaries invest their earnings offshore rather than paying dividends into the U.S. Payment of a dividend very likely would result in the permanent forfeiture of the ability to utilize foreign tax credits properly associated with the dividends. Repatriating the earnings to the U.S. would result in double taxation and a significant waste of the companies' investment resources.

In a number of ways, the current system presents obstacles to US companies trying to penetrate foreign markets. First, the foreign tax credit rules require companies to deal with the tax implications of any international investment and the result is that many investments can not meet the company's so-called "hurdle" rate of return because of the tax costs involved. In this regard, the rules for allocating expenses, including interest, to foreign source income tend to overallocate these expenses to such income. This has the effect of unfairly and inappropriately reducing foreign source income to the point where foreign tax credits associated with this income are rendered unusable. The expense allocation and other FTC rules do not have to be as complicated or harsh to serve the tax policy purpose for which they were conceived.

International joint ventures in particular are frequently further discouraged because of the effect of the rules under the Code's "toll charge" rules. All too frequently, the transfer of technology to an international joint venture cannot be done without incurring "deal breaking" tax costs. In essence the global exploitation of US created technology is greatly undermined because of our tax rules. These rules simply have not kept up with the developments in the world and the need to enhance the position of US companies, products, and technologies abroad.

Summary

The current tax system has grown over the years with layers of sometimes conflicting policy, most of which were designed to raise revenue within the constraints of whatever political compromise could be reached at the time. That layering of policy creates a compliance nightmare and breeds both voluntary and involuntary non-compliance. The additional burden affects U.S. taxpayers on at least two fronts: unnecessary compliance burdens drain business and family resources from more productive endeavors; taxpayers often must compete on price with someone whose tax situation is less complex, or who is less compliant, or in the case of multinational companies, with a foreign firm which bears less tax burden.

We suggest that your Committee adhere to two principles regardless of whether you decide to replace the current system or merely reform it:

- Make clear consistent policy choices - conflicting policy goals create complexity and unnecessary burden.

- Strive for simplicity in every aspect of your policy decisions. Tax complexity, when it competes with the time individuals have for work and family or the time that business executives and others have to compete in an ever more complex global economy, reduces GNP and breeds significant voluntary and involuntary non-compliance.

It is with great respect for the process ahead of you that I must observe that completely replacing the current tax system is a legislative initiative that no Congress has attempted. It will require the best economic and policy analysis plus your base of experience with constituents. Fundamentally, it will require you to shape a tax system that comports well with the American ethos.

Thank you for the opportunity to testify and I would be pleased to respond to any questions.

Chairman ARCHER. Thank you.

Our next witness is William Dakin, senior tax counsel for Mobil, Fairfax, Va.

You may proceed.

STATEMENT OF WILLIAM G. DAKIN, SENIOR TAX COUNSEL, MOBIL CORP.

Mr. DAKIN. Mr. Chairman, distinguished Members, it takes 57 man-years at a cost of $10 million to prepare Mobil's Federal income tax return.

Each year we study the changes that Congress has made to the Internal Revenue Code—five major tax bills since 1986—the new regulations and rulings published by Treasury and the IRS, and the court decisions. At yearend, we send revised instructions and forms to 260 U.S. incorporated companies and 475 foreign incorporated companies. It takes 250 pages of instructions and forms just to collect the information we need to prepare the return from each of our U.S. incorporated companies doing business in the United States. It takes 330 pages of instructions and forms to collect the information we need from our U.S. incorporated companies operating outside the United States because the foreign provisions of the Code are so complex. And it takes 200 pages of different instructions and forms to collect the information we need to file on behalf of each of our controlled foreign corporations.

We keep our books according to generally accepted accounting principles. As soon as our books are closed in March, accountants throughout the world spend the next 2 to 3 months adjusting our financial accounting to the special accounting that the tax law requires and sending the results to our tax group in Dallas. This tax data is collected, analyzed and reported solely for the IRS. It is of no use to our creditors, our investors, any foreign government or the people who run our business.

From May through September, 40 tax return preparers—they are over there in that photograph—verify the data received from the field locations and do the tax calculations. Each of our companies' taxes has to be calculated twice, once for the regular tax and again for the alternative minimum tax.

[The following was subsequently received:]

On September 15, 1994, the tax return for 1993 that you see before you was delivered to the IRS offices in Dallas and Austin. It consists of 9 volumes; it totals 6,300 pages and it weighs 76 pounds. That is this, also in the picture.

The return itself, however, is just the tip of the iceberg. It could not be prepared without doing the work to connect it to Mobil's books and records. This stack consists of the workpapers for just 1 of our 745 companies. The total workpapers for the 1993 return consists of 146,000 documents. This is a 27-percent increase over 1986, the last year before the Tax Reform Act of 1986 took effect. I might say that our return was two-thirds of this size prior to 1987.

However, to the costs of filing the return must be added the costs of conducting the audit. Mobil maintains 16 full-time employees in Dallas, assisted by 17 full-time equivalents in other locations to work on the audit. Our total costs of conducting the audits run about $5 million per year, and this figure does not include litigation costs or outside counsel fees.

Due to the complexity of the tax rules in our last audit cycle, 1987 through 1988, we received requests for information on 8,000 different items. Each request required Mobil to produce one or more documents from various locations around the world and to prepare written responses to the questions asked.

In our current audit cycle, 1989 through 1991, requests are running about 30 percent ahead of where we were at this point in the last cycle, which would give us something over 10,000 items being looked at.

We are currently working with the IRS to finalize unresolved issues which date to 1974.

Mr. Chairman, Mobil's experience in complying with the tax law since 1986 is that it has become far more complex than it needs to be to protect the revenue. This complexity creates serious problems for both taxpayers and the IRS.

We look forward to working with you and your Committee in making the tax law less complex and reducing the heavy compliance costs that U.S. taxpayers now bear.

Chairman ARCHER. Mr. Dakin, thank you for your presentation.

Our final witness will be introduced by our colleague, Congressman Nethercutt.

Mr. NETHERCUTT. Thank you, Mr. Chairman and Members of the Committee.

It is my pleasure today to have the opportunity to introduce to you and the Committee, Wayne Williams of Liberty Lake, Wash. Mr. Williams is here to testify about the economic impact of Federal estate taxes on closely held family businesses.

Mr. Williams is not only an inventor and an entrepreneur and a community leader, but he is also the president of a company called Telect, which is a company very heavily involved in the telecommunications industry, and he is uniquely qualified, I believe, to testify about the effect of Federal and State taxes on family held businesses. It is my honor and pleasure to introduce Wayne Williams today.

Chairman ARCHER. Mr. Williams, you may proceed.

STATEMENT OF WAYNE E. WILLIAMS, PRESIDENT, TELECT CO., LIBERTY LAKE, WASH.

Mr. WILLIAMS. Thank you, Mr. Nethercutt.

I commend Chairman Archer for initiating this hearing. I come before the Committee today representing my family and the nearly 13.5 million other family businesses in the United States. I am also here on behalf of my employees, who represent a few of the nearly 20 million family business private-sector jobs that were created during the eighties. Telect is a closely held S corporation. With the exception of one outside family member, all of the members of the corporation are family. We have grown from 3 employees 12½ years ago to nearly 600 employees today. We compete on a national and international basis. Our 1994 sales were over $41 million. We are a company that offers good jobs and good benefits. This has happened solely with the dedication, planning, and efforts by my parents and me as well as the efforts of our number one asset: Our employees. We may appear to be a large business to some, but we are a mere tadpole amongst killer whales in the emerging telecommunications and videocommunications industry.

When my father decided to start Telect in 1982, he was concerned about where his kids would work and what opportunities would be available to them. On September 13, 1982, he started a family business. My mom, a housewife of 20 years, entered the workplace and collected no salary for nearly 2 years. I was directly out of high school and went to work on the first day.

Our philosophy has been to reinvest our profits into new products, employees, and our expanding international opportunities. We pay millions of dollars in taxes every year. The government looks at my family's tax returns and sees millionnaires. We look at our family's tax returns and see over 600 families living productive lives.

In 1986, we began the onerous task of planning the succession in our company. This included leadership and ownership of our family business. The leadership is the part of business that every business should be concerned with. The ownership and death planning efforts of the business are areas that should not have to take up time and money. It has been estimated that compliance costs of the transfer system, including compensation to attorneys and accountants, amount to approximately 65 percent of the revenues received [Payne, Unhappy Returns, 91 TNT 264–57, at 4 (1991)]. We are proud of what our family has accomplished during the last 12½ years. The opportunity for the family business is thriving, but the perpetuation of the business into the future is at jeopardy due to the costly effects of our silent partner, Uncle Sam, waiting to cash out upon the death of my parents.

I am sure that each of you are already aware that with a privately held family business, the majority of family net worth is tied up in the family business. The business offers little, if any, liquidity. Uncle Sam has really done nothing to help our business and has already been for that contribution paid.

I chuckle when the issue of estate taxes comes up and our government says that we have allowed you to pay estate taxes for over 15 years. That doesn't mesh with our philosophy of trying to reduce our debt, rather than to increase it. It appears Uncle Sam wants

business to go into debt rather than to reinvest into economic enhancing and asset building opportunities.

I understand that two countries that the United States competes with on an international scale, Germany and Japan, have made it much easier for their family businesses to thrive from generation to generation. We have made an effort to maximize gifting and are much further along in estate planning than most other family businesses.

My parents have used their maximum life exclusion of $600,000 each which is basically the value inside the business and are using gifting allowances on an annual basis in order to mitigate the estate taxes that would be levied upon their death. In addition, a life insurance trust, costing our company and the employees nearly $250,000 annually, has been set up to allow the heirs to cover potential taxes. The trouble is that as the company grows, soon it will be impossible to buy enough insurance to cover the death tax obligations. At the same time we pay enormous amounts of income tax yearly on the profits of the company and still face a threat to the longevity of the company because of estate taxes.

If you kill the company at the time the owners die, you are losing the golden egg of future taxes that the company would generate plus income taxes of employees. This ultimately affects the government because it is short-term gain but long-term pain by eliminating the company, the jobs, and the annual taxes.

If my parents died today while I am testifying before you, I would have to go back home and prepare a check to Uncle Sam for approximately $6,793,000. That seems ridiculous considering the fact that their estate is mostly made up of nonliquid assets in a business that is thriving. Not only does it seem unreasonable to tax someone for their estate based on business interest, death is the worst time to be trying to pay such exorbitant taxes.

Please eliminate this tax from the estates of closely held family businesses. If the competitiveness of the United States is to increase, please quit thinking that this is taxing the wealthy and realize that it is affecting millions of jobs. And please realize that closely held family businesses are managed not against quarterly results, and many times not for the financial return to the shareholder, but are managed for the greater good of people and products.

Thank you for allowing me this opportunity to speak for family businesses. I realized one thing as I prepared this testimony. I am going back to Spokane, Wash., to work on a new product, a product that would let the founder and family members of closely held family businesses live forever, because if this product was developed, we would never have to worry about this tax.

Chairman ARCHER. Thank you, Mr. Williams.

Mr. Crane will inquire.

Mr. CRANE. Thank you, Mr. Chairman.

I want to salute our witnesses today and express appreciation for their testimony. I was brought up, I think, the way every one of you was as a kid, and I tried to indoctrinate my kids in the same manner: Namely, don't squander the paycheck at the end of the week on instant gratification but put something away for the proverbial rainy day.

I remember when my son was a teenager and he got his first check, and I am counseling him thus, and he said, "That is nuts, daddy." I said, "What do you mean, that is nuts, George?" He said, "If I blow it at the end of the week on instant gratification, they only get at it once." I reflected on that, and then came to the realization that if he invested, say, in Motorola or Mobil when they make a profit, it gets hit a second time, dividend distribution it gets hit a third time, sell your stock, enjoy a capital gain a fourth time, and the ultimate obscenity in the Code is when you have the audacity to die and leave them, they come in and bash your bereaved spouse and loved ones.

Our Tax Code does profound violence to all the values we believe in in this system. And for that reason I am grateful for these hearings. I have promoted a flat tax bill for 25 years and I called it a tithe tax. It was only a 10 percent hit and admittedly that wouldn't have covered revenue losses, but my argument was we are brought up to believe we had an obligation to tithe because the Bible taught us so and that if God asked for only 10 percent Caesar should ask for no more.

But I am willing to listen to the variety of options. And I salute especially our Chairman. I know his reservation about the flat tax concept is you have left the roots in the ground and some future Congress might come back and try to recreate the complexities of our current Code.

So I will happily listen to the input on other proposals such as Sam's proposal for a value-added tax. All of this is, to me, designed to address pulling the IRS out by the roots and the whole crowd cheers as the Chairman was saying.

People have had it up to here with this stupid Tax Code we have. Simplification is part of it. I agree equity is a part of it. But I would argue on the flat tax, if you were only taxing above the poverty line and the poverty line was $10,000, you make $20,000, and under my tithe tax you pay 10 percent, you would owe $1,000. If you made $100,000, you pay $9,000. You are not buying anything more from government by making $100,000 than making $20,000. So there is a distinction made based upon your income level. But on the question of pulling the roots out, I am intrigued by our Chairman's line of argumentation there.

One final question I would like to raise, and I have heard Milton Friedman say it many times, is it not accurate that only individuals pay all of our taxes? Businesses, in my flat tax bill, are not taxed because they don't pay taxes. That is a cost of doing business. You've got to figure out how to pass that load through and get a fair return on investment or you are out of business. That being the case, people need to open their eyes up to the fact that you are either paying for it with your tax hat on or paying for it with your consumer hat on. People also need to focus on the total magnitude of the burden and that is the burden of the waste involved in all the paperwork and all the man-hours invested by a business to be in compliance.

Is there anyone that would find fault with that argument, especially Mr. Dakin?

Mr. DAKIN. Mr. Crane, I think my purpose this morning was to provide the Committee with facts and figures and statistics to con-

vey what the magnitude of the corporate tax compliance burden is on filing returns and conducting audits, particularly for those companies that conduct business overseas. I think I will have to limit my answers to questions along those lines, sir.

Mr. CRANE. Well, let me add one further question. I have heard that two-thirds of the revenues paid by business, two-thirds of that amount above and beyond what is paid in taxes, is the cost of being in compliance with our Code.

Mr. DAKIN. The figures that were in my testimony today were the actual costs of filing our returns and conducting our audits on an annual basis. And I was really focusing on the system by which we collect the revenue and not talking about the—of course, the taxes we pay are much greater than that.

Mr. CRANE. Well, my time has expired, but again, I thank you all for participating today.

And, Mr. Williams, did you have a comment?

Mr. WILLIAMS. Yes, I would like to respond to that. I think that is a competitive issue, even from an international standpoint, that just OBRA 1993, the retroactive tax portion, cost our company an additional $300,000 during that year. That is something that we had not planned for. That was—with the new tax based on—at the individual income level, because we are a sub S corporation—was about a $112,000 increase anyway; but being retroactive, that is nearly—that is a product line for us.

We will spend $200,000 to $300,000, typically, in development of passive product lines. And today, like in 1990, we did that with one particular product. We have about 90 jobs dedicated to that one product line today. So when you take the $300,000 just in the retroactive portion out of it, we had to push off research and development on some products, and it ended up affecting the jobs of 90 people.

Mr. CRANE. Well, what you are suggesting then is there is a potential for big job expansion and all of the people who are tax lawyers and CPAs can find more productive work. Thank you.

Chairman ARCHER. Very briefly, Mr. Dakin, just to be sure the Committee understands. Are the documents, the papers that you have in front of you there, 1 year's tax return for your company?

Mr. DAKIN. These four piles are our tax return.

Chairman ARCHER. Is it possible, without falling, for you to stack them all on top of one another?

Let me be precise in my question: That is the return, that is none of the workpapers and everything else that went into developing the return. That is simply the tax return itself. Is that correct?

Mr. DAKIN. Yes, sir. It is 76 pounds of return. It is nine volumes, each of which is about 5 inches thick. And this is simply the return per se for 1 year. Obviously, we may—it does not include anything else. This is simply the return, strictly defined.

Chairman ARCHER. Well, once, when we were in tax reform hearings back in 1986, our colleague, Andy Jacobs, when they began to talk about all the workpapers that had to be filled out before you could get to filling out your return, commented that by the time you get to the point of filling out your return, it is "Miller time." And I just wonder, the workpapers and everything behind getting

to this point of having this return must be far more voluminous than the return itself.

Mr. DAKIN. Indeed they are. Let me just stop this constant balancing act which I always——

Chairman ARCHER. Yes, sir, I don't want to jeopardize your physical well-being there.

Mr. DAKIN. Mr. Chairman, these are the workpapers for one company, for 1 year. The company is Mobil North Sea, Ltd., which produces crude oil in the UK sector of the North Sea. This is one company for 1 year. We have about 745 companies for which we have to prepare returns. The return—the workpapers are very voluminous.

Chairman ARCHER. Thank you for physically demonstrating the cost of compliance with the current Income Tax Code.

Mr. Gibbons will inquire.

Mr. GIBBONS. Mr. Chairman, I don't have any questions of this panel. I thank them for coming and for the information they have imparted.

Chairman ARCHER. Mrs. Johnson will inquire.

Mrs. JOHNSON OF CONNECTICUT. I appreciate your testimony; it has been very, very vivid and very helpful, and certainly we are keenly aware of the need for simplification. But as we move in this direction—and you don't have to answer this now, but if you will get back to us—what will be the impact of eliminating, for instance, research and development tax credits; and should we really try to wipe out everything, such as the deductibility for health insurance premiums?

Where do we draw the line? What really does affect economic activity? Where is the line between an absolutely simple flat tax, what Mr. Dakin has showed us, and a Tax Code that fosters economic activity, personal security, and strong families? Anyone who wants to respond—Ms. Beard.

Ms. BEARD. We get into all these schedules like when you develop or purchase a capital item, or something, you get these credits, then you have to depreciate your expenses over the income period. If you could take those expenses as the money leaves, because you no longer have the cash, and do it as cash, or on an as you go basis. Get rid of the schedules. I mean research, capital equipment, employee benefits are a cost of doing business—and should be treated as such.

When I buy a vehicle or when I make a capital improvement, the money is gone. We don't have that money, but yet we are paying income tax on that money and we are depreciating, taking it forward and getting benefits years later. Business is on a day-to-day, month-by-month basis, and I think we need to drop the complexity and allow our taxes to reflect that.

Mrs. JOHNSON OF CONNECTICUT. Thank you.

Mr. Williams.

Mr. WILLIAMS. I think in—if the whole Tax Code is completely revitalized and just, as Chairman Archer has brought up, torn out by the roots, I think there are issues that we could deal with, even on research and development tax credits and health insurance credits.

I know it is basically—I think everybody in the United States is so fed up with the system right now that we are willing to look at anything. Our—it is interesting the impact, even at a personal level, because I have got like one of my sisters, she made—she is not with the company right now. She made about $15,000 a year, and just the income from the company that got put on her tax return prevented any charitable deductions for her, prevented any of the normal expenses that somebody else would get at $15,000, because of the income of the company. And she never saw that.

You know, no one sees that. That is the way—so there are so many things that are still impacting us besides this Federal Code, in that we still deal with the State regulation, the State taxes.

In Washington State we have a business and occupation tax which is just crazy. I think that we are willing to look at about anything at this point, and offer any suggestions, too.

Mrs. JOHNSON OF CONNECTICUT. Thank you. We will look forward to your input.

Mr. CRANE [presiding]. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

This is a question for anyone on the panel who wishes to answer. If we just took the Tax Code, both the corporate and the individual Tax Code, and started from scratch—and that is what I think that the Chairman has in mind—what would be the first thing that you would suggest?

Ms. BEARD. To keep it simple.

Mr. BUNNING. Right. Well, flat tax does that very well, but whether it is fair or not is a question for individuals. I am not sure how we handle the corporation end of it.

Ms. BEARD. There has not been a whole lot of detailed information on the flat tax. When I was at the airport, I started picking up magazines and getting more information on the way here. There is a lot more information coming out this week, regarding both national sales and flat tax proposals. But I think that as I look at the national sales tax, we have a State sales tax in Illinois on retail. It is not all that simple. You have all these different groups that are tax exempt. So as I do business, if I put in a fence for a school district, church, State or city government, they are tax exempt. When I buy a product, I don't say, oh, this is going for a tax-exempt job or this isn't. I usually order all materials into stock with tax paid at source, because we are in construction.

Mr. BUNNING. That includes your local and State taxes also?

Ms. BEARD. Yes.

Mr. BUNNING. So there would have to be some kind of coordination?

Ms. BEARD. But then trying to get the deduction back or get the credits back once it is paid. It would have to be simple and timely. For example: On a $20,000 project, a 17 percent sales tax would be $3,400 that I would lose use of and for small business this could create big problems.

Mr. BUNNING. It takes longer to get it back than to pay it.

Ms. BEARD. We don't get it back from them. I mean, it is a complex hassle.

Mr. BUNNING. Mr. Dakin, in the tax bill that we recently passed, we phased out the alternative minimum tax over a period of time.

How much would that phaseout of the AMT affect your corporation?

Mr. DAKIN. The AMT is one of the two major sources of complexity in the Code, the other being the foreign provisions of the Code. So that phasing out the AMT and eliminating the need to calculate each tax twice would be a major reduction in workload.

Let me ask—let me ask my prompter here if I can get a better estimate for you.

Mr. BUNNING. Certainly.

Mr. DAKIN. It should cut our workload by about 30 percent.

Mr. BUNNING. Thirty percent?

Ms. Skidmore, in the alternatives that we have been discussing back and forth, like flat tax, consumption tax, VAT tax and other things, is there one that would make life simpler for the accounting group and/or tax lawyers and/or anyone else that has to worry about compliance—correct compliance, anyway?

Ms. SKIDMORE. As all these alternatives are in the formative stage, we are analyzing details of each one. And certainly the peculiarities of these systems will be analyzed for our clients. At that point, we will be able to determine if one provision under one system versus another will have a dramatic impact on complexity and what the economic impact would be on certain of our clients' industries.

Mr. BUNNING. Let me ask the whole panel, what percentage of your employees pay more in FICA tax than they do in Federal income tax?

Ms. BEARD. All of them, including my husband and myself.

Mr. BUNNING. What about you, Mr. Williams?

Mr. WILLIAMS. I would say it is a significant amount in our case. The same, I don't have the exact figures on that, but that would be an interesting——

Mr. BUNNING. The reason I ask that is that when we get into looking at the overall tax burden of an individual across this country, we find that more people pay more money in FICA tax than they do in income tax. And I just wondered how it was with the businesses that you are involved with.

Mr. DAKIN. If you are referring to the employee share of FICA, we would estimate that few of our employees would pay more FICA than——

Mr. BUNNING. I am looking at both ends, the employee and the employer, since you match.

Mr. WILLIAMS. That is right.

Mr. DAKIN. If you combine the two, the number would be even smaller. Not many.

Mr. BUNNING. Ms. Skidmore, since you do the taxes, how do you find that? Are more of your clients paying more in Federal income tax than they do in FICA?

Ms. SKIDMORE. I don't have any of those statistics available, unfortunately.

Mr. BUNNING. I thank the panel for their input.

Mr. CRANE. Thank you.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. I assume that if we were able to pull this system out by the roots, we would have to get back to some type of system.

I will assume that all of you would support a system that will remove the investments that you are making in the business and the salaries you pay for employees and that that should be allowed to be deducted as relates to the income. There are no objections to that, all right?

And further, if indeed we are trying to discourage consumption and encourage savings and investment in plant and equipment, that if we manipulate the Code so that it would cost you less in taxes to do it, no one would object to that, since the whole idea is investment. My question then would be to Mr. Dakin and anyone else, if you take advantage of all of the things that we would try to do in order to encourage investment, at some point you would have no tax liability, it is possible, under many of the scenarios we have today; and that is the reason why we say that, well, there should be at least a minimum tax, because if a business takes advantage of all the incentives, you know, it could be the government owes them money.

Would you consider having an alternative minimum tax under those scenarios?

Mr. DAKIN. I would suggest, sir, with respect, that it might—it might be better to try to get it right the first time in the regular tax so that you don't need a minimum tax. If you——

Mr. RANGEL. But what I am saying is, one way to do that is not to give the deductions for certain of the expenses or investments that we do now. Would you suggest that we look at that and perhaps avoid a particular taxpayer from having no liability at all?

Mr. DAKIN. I think you have to take a look at the totality of the special provisions which Congress has written into the Code over the years.

Mr. RANGEL. Forget that, because we are pulling that up by the roots. So it won't be there.

Let me just ask this question: When we pull the darned thing up, what sounds closer to you as being the most fair way to go, recognizing that any system is going to have its problems, but if the options were flat tax, sales tax, consumption tax, value-added tax? And since I know that you have given some thought to the replacement, could each of you just say what comes the closest, assuming we still would have to make adjustment as to what the replacement would be for the existing system?

Ms. Beard.

Ms. BEARD. I think—a flat tax is what I see, and part of my reason for that is, if you keep it simple enough, those that are not high-wage earners, your middle-income, family households and such would not have the ability to reduce taxes through savings. They don't have the money that they can save at such a high percentage.

People who make the most would have the ability to save the most, therefore reducing their tax burden the most.

Mr. RANGEL. With this flat tax, would it take into consideration the number of employees, wage earners in a family? Or the size of the family, would you want that to be considered?

Ms. BEARD. You would take the family income and then allow exemption, you know, for head of household, single, married and so forth, and dependents.

Mr. RANGEL. You would have exemptions. Would you have deductions?

Ms. BEARD. There would be the deduction for so many people, and then what remained in excess would be taxed at a flat rate.

Mr. RANGEL. How about when you get a new home, first home, young and just getting married, do you think the interest for that home should be deducted?

Ms. BEARD. Well, what you pay for rent is not deducted at all. When you buy a home, you have something in the end to—where you won't be paying rent forever. I mean, there is a decision that is made——

Mr. RANGEL. No, I just asked—so the answer is no?

Ms. BEARD. Personally, I am not opposed to doing away with the mortgage. I know a lot of people would be. There would be a dramatic impact on the housing, real estate, and banking industry if abolished.

Mr. RANGEL. How about the Social Security deduction, should we continue that?

Ms. BEARD. I think Social Security should go through a major transformation.

Mr. RANGEL. How about the health care for the aged that is deducted, should that be eliminated?

Ms. BEARD. I think health care deductions are for the benefit of all. With the crisis that it is, we need to encourage individual responsibility. If health care is not deducted, it is too often going to be paid for by someone else, including tax-financed programs.

Mr. RANGEL. And regardless of the income, you believe that even though wealthy people have more disposable income and spend a lesser percentage actually on things like food and clothing, that it should be just one rate fits all incomes?

Ms. BEARD. On consumption, in Illinois, sales tax has been viewed as a regressive tax, because an extremely low-income family would pay more for clothing and different essentials that they need, while not having any ability to save.

Mr. RANGEL. You would make adjustments based on——

Ms. BEARD. Well, if you start making adjustments, "in fairness," you are going to complicate the system to where, as a storeowner, it would become a bookkeeping, administrative nightmare. You say, this guy only makes so much money, therefore I can only charge him x amount of sales tax. Then the documentation in reporting could prove to be far worse than our current system.

Mr. RANGEL. Would you not want to make adjustments based on fairness?

Ms. BEARD. Well, then you get a paperwork nightmare for the small business owner and the shopowner that has got to say——

Mr. RANGEL. You want to avoid the nightmare and still be fair?

Ms. BEARD. Yes.

Mr. RANGEL. You would like to be fair?

Ms. BEARD. I think it ought to be fair.

Mr. RANGEL. Everyone believes the tax system should be fair? I mean, there is no objection to being fair and equitable?

Mr. WILLIAMS. Mr. Rangel, I would like to comment, too.

I think, in place—in talking about the wealthy Americans, in a subchapter S corporation, because of that, I think it gets—it is a picture that is not true with the income tax on the corporation.

I think, in proposing something like the flat tax, I think we need to get to the point where the States collect the taxes, and we give this body here a proportionate share of the services that we are gaining from the Federal Government; and that we have to look at—the businesses and individuals need to be looked at separately, but they are both benefiting, the jobs. And I mean, we are looking at this with the advent of GATT, with the World Trade Organization, with lots of discussion going on.

We have to look at our corporate competitiveness. I even question why Mobil has 750 corporations and, in many cases, why all these companies have to be set up because of the Tax Code to do that.

Mr. RANGEL. What function do you believe the Federal Government should actually——

Chairman ARCHER. The gentleman's time is about to expire.

Mr. RANGEL. Son of a gun. I will get another chance, I think.

Thank you, Mr. Williams. I thought you were thinking the same way I was.

Chairman ARCHER. Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Dakin, you are aware of the fact that you are not under oath in this hearing. If you were under oath, would you be willing to swear that that tax return is absolutely 100 percent in compliance with all the tax laws?

Mr. DAKIN. I am delighted that you asked that question, because the person who signed that return is sitting right behind me, Mr. Book, of our Dallas accounting office. And I am—I am happy to say that it is Mr. Book who signs the return, rather than me.

We do the very best we can. We comply to the limits of our ability. Is there a number wrong in these 6,300 pages? No doubt there is.

Mr. HANCOCK. You think maybe the depreciation schedule might be off just a little bit, you missed a month or two someplace?

Mr. DAKIN. But we do take the obligation to comply very, very seriously, and Mr. Book particularly, because he is the one who signs it under oath.

Mr. HANCOCK. Ms. Skidmore, do you think it is even possible to fill out or to complete an income tax return that is, you know, just a little small one like 85 or 90 pages; do you think it is possible to complete that and absolutely say, this is 100 percent in compliance with the law?

Ms. SKIDMORE. At this point, the complexity of interpretations of the law are such that one person's idea of what one interpretation is versus another is not clear.

Mr. HANCOCK. Well, has anybody on the panel ever just gotten a notice from Internal Revenue saying the penalty for noncompliance, $4,500 or what have you, you don't have the vaguest idea what they are talking about?

Ms. BEARD. My accountant, when he gave me those figures from his survey, one problem that he has run across is a lot of times when they send out those penalties or those notices, they are incor-

rect. But when you send back your reply, it is difficult to get a timely response. Currently, what has been happening, is they have really sped up collection. Instead of five notices before they start nailing you, they have dropped to three. And you cannot get a response back from the IRS in that timeframe.

Mr. HANCOCK. I have a background in small business. I have been in Congress a little over 6 years. And frankly, Mr. Chairman, I have been looking at this thing since I got into business. I never dreamed in my lifetime there would ever be a hearing like this in the Ways and Means Committee in the U.S. Congress; and I think—I hope the public realizes the historical impact of what is happening here.

A few years ago, 15, about 25 years ago, I started a small leasing company. You are in the telephone business, and anybody that is in business understands that when you are leasing, it is capital intensive. Normally it takes 5 years before you get your volume up to where you could even possibly have profits.

I wonder how many tax returns are completed, thousands of dollars spent, to prove to the government you don't owe them any money.

I tried to make a deal with Internal Revenue. I said, look, you know, rather than me filling out all these reports, it costs me $20,000 a year to tell you I don't owe you any money. Why don't we split it, you take $10,000 and I will take $10,000; everybody is happy. They wouldn't do that. So for 5 years, I spent $20,000 a year to tell them I don't owe them any money.

How many thousands of dollars are spent each year with our Tax Code in that area? Would anybody want to just—Mr. Williams, I am sure when you all got started, for several years that is what you did.

Mr. WILLIAMS. We were actually pretty fortunate that we were profitable within the fifth month of business. And since 1982 and in our marketplace, we have owed—we have—we have owed taxes. But I think the—you know, there are two things that we have that are in life and that is life and death, and we are taxed to death while we are here and then we are going to be taxed half again when we die; and the—that is the issue right now.

We are talking about substantial costs. And I think I measured over $6 million if my parents were to die today, that I would have to go back and if we did not have any estate planning going on right now, we would have to write a check and we could not afford to do that. I don't know many businesses out there that, as their value continues to increase, they could afford to do that.

Mr. HANCOCK. One final question: You talk about the millionaires and the fact that you are saying, yes, we have been successful, we worked hard, but we look at it as 600 employees. How many times—and I am just guessing here—on April 15 have you paid taxes on the previous year's profits without having taken from the business enough cash money to even pay the taxes on it?

Mr. WILLIAMS. Oh, I think that in the last 4 years that has been the case. In fact, this last year we got hit pretty hard.

And I might add, in talking about from a millionaire status, based on the value of this company, we have got a 401(k) contribution that gives 54 percent return to every dollar that the employees

put in. We pay quarterly profit-sharing bonuses to the employees. We changed the 401(k) contribution, instead of taking people at 21, we put it to 18, so we can encourage savings.

We have got over an 80 percent contribution right now in these employees investing for the future. We have got excellent medical benefits. They take—they understand this; they see it. And when you take and look and have to pay nearly $1 million, like we did this last April 15, in income tax and have to borrow to do it—I mean, we operate off—all the profits in the company are rolled back into the company, and we operate off a line of credit like most businesses do. And when you have to borrow to pay the income tax, I mean it significantly hits your company, because there is nothing that is benefiting out of that.

Especially, I might add, we are not publicly held. And when you operate that way, you take that money right out of a company that—that is their cash flow. You are operating off cash flows all the time. That is the future business and the growth.

This year we are projecting 35-percent growth, and we could be hindered because of not having the cash necessary to maintain a sustainable growth rate in the business.

And all these things, you know—the employees, they are benefiting; I would rather see them benefit, the employees benefit, have the money go back into their pockets than I would to have the substantial amount of cash being outflowed to the Federal Government at this point.

Chairman ARCHER. The gentleman's time has expired.

Mr. Johnson may inquire.

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

I would be interested to know, Ms. Skidmore, why you favor this with the ultimate result of possibly downsizing your business. Can you tell me about it?

Mr. TYLER. Who are you talking to?

Ms. SKIDMORE. To me.

Mr. JOHNSON OF TEXAS. The young lady next to you, sir.

Ms. SKIDMORE. In our advisory capacity for our clients, we anticipate that we want our clients' businesses to grow and prosper. And with the level of undue complexity that we have today in this current system, it is very counterproductive for our clients. That is really why we propose that the Committee look at both consistent policymaking as well as simplicity in its deliberations.

Mr. JOHNSON OF TEXAS. Well, do you anticipate talk that accountants are going to go out of business? I don't think that is true at all. But can you talk to that question?

Ms. SKIDMORE. As each of the alternative systems is looked at, it depends on what details will be components of each system. And only then can we really ascertain just what level of compliance is going to be required at the basic level or beyond.

Mr. JOHNSON OF TEXAS. Even in a sales tax situation, you would still be required to help companies put their tax systems together, right?

Ms. SKIDMORE. Very likely, if there are any such details that require definitional interpretations or other interpretations.

Mr. JOHNSON OF TEXAS. Yes, OK. Thank you.

In the case of Mobil, I like the question that has been asked about how can you verify the authenticity of all that information. And, you know, from an individual standpoint, I know filing an income tax return is difficult at best. I mean, just from a personal standpoint, you have got a whole pile of papers, so you are relying on your employees. All those employees in that picture, I presume are full-time employees, year-round?

Mr. DAKIN. All of the employees in the picture are full-time employees, but not all of our full-time employees are in that picture. That is just all the folks that were in the shop on the date that the picture was taken.

Mr. JOHNSON OF TEXAS. So they are not all there?

Mr. DAKIN. No, sir. And it does not include those people who are not located in Dallas. We have people in Fairfax and we have people all around the world that contribute to this.

Mr. JOHNSON OF TEXAS. I kind of like Dallas. Why don't you move them all down there? You don't want to answer that, do you?

Listen, I appreciate your input, because I think you have given us a vivid demonstration of what is wrong with the system. And I hope that you all can help us put it together. And I thank the Chairman for doing these hearings and for your approach to the process. Thank you, sir.

Chairman ARCHER. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman. I am glad we are holding these hearings. I very much believe we have to look at our present Code to strive to do better and, if possible, much better. I think one of the goals should be simplification. I hope we don't get too simplistic as we seek simplification.

So, Mr. Dakin, let me ask you a few questions. This is a panel that mixes small and perhaps medium and big business; and I guess you represent big business here. Do you file returns in other countries?

Mr. DAKIN. Yes, sir, we file tax returns in more than 100 countries outside the United States.

Mr. LEVIN. Is there any other country where the system is a bit complex?

Mr. DAKIN. There are some countries that have systems that are a bit complex, but the majority—there are no countries that have systems anywhere near like ours.

Mr. LEVIN. So you think, for you, ours is the most complex?

Mr. DAKIN. Very much so.

Mr. LEVIN. You mentioned the cost of $10 million. I think this is public, not proprietary information. If it is proprietary, don't indicate it.

How much did you pay in income taxes last year to the U.S. Government?

Mr. DAKIN. I have the information on how much we paid in taxes for a series of years, back at my office, and I would be happy to send it to you.

Mr. LEVIN. Give me an estimate.

Mr. DAKIN. It comes to hundreds of millions of dollars a year.

Mr. LEVIN. And the cost you say here was $10 million?

Mr. DAKIN. Yes, sir.

Mr. LEVIN. Is it possible your tax liabilities were over $1 billion last year?

Mr. DAKIN. I do not have with me the exact figures on what our tax liabilities were, Mr. Levin, but I will be happy to send that to you this afternoon.

Mr. LEVIN. How about the gentleman, Mr. Book, do you have any idea what you paid in taxes? I am just trying to get some idea of what percentage of your taxes is represented by the $10 million.

Mr. DAKIN. If you would give me a moment, I will see if I can look it up for you.

Mr. LEVIN. While you are doing that, let me ask Mrs., or Ms. Skidmore, you mentioned the principles, two principles, consistent policy choices, and simplicity. How about equity?

Ms. SKIDMORE. Equity is a principle that I hope this Committee will ponder as it makes the choices and as it looks at both simplicity and consistent policymaking.

Mr. LEVIN. Well, would you raise that to the level of clear, consistent choices, and simplicity?

Ms. SKIDMORE. Without looking at each alternative system and understanding the details, it is difficult to——

Mr. LEVIN. No, no, but should the—should the system be equitable? Do your clients care about——

Ms. SKIDMORE. We are going to be studying for our clients, on our clients' behalf, what each of our clients ask us to look at in each system with regard to what they perceive as being fair, based on each detail of the systems. But at this point——

Mr. LEVIN. I am not asking you which system is more fair than another. I am asking you, don't the American people want a system that is fair as well as consistent and simple?

Ms. SKIDMORE. I hope that is a decision that this Committee will make with care—you will make the decision as to what is equitable or not.

Mr. LEVIN. You think that is an issue, whether it should be equitable?

Ms. SKIDMORE. I think that what is equitable is a decision for the Committee.

Mr. LEVIN. But should it be a guiding principle?

Ms. SKIDMORE. That is a decision for the Committee, Mr. Levin. Thank you.

Mr. LEVIN. All right.

Let me go back to Mobil, if I—my time is running out. Do you know?

Mr. DAKIN. The total income taxes that we paid, according to our annual report for 1994, were somewhat in excess of $2 billion. That is worldwide taxes on worldwide income.

Mr. LEVIN. And it costs you $10 million-plus, I don't mean to minimize that; I just think we want some perspective here.

Let me finish by asking you, some of this complexity is the relationship of the taxes you pay here to your foreign operations, right?

Mr. DAKIN. Yes. The——

Mr. LEVIN. You want some deduction for what you pay in other countries, for example?

Mr. DAKIN. Yes. We do not wish to be taxed twice on the same item of income.

Mr. LEVIN. And so any system that we impose, new system, would have to have enough complexity so you don't pay twice, right?

Mr. DAKIN. It can be handled two ways. If you wish to have a system by which the United States taxes all of the income of its residents, wherever that income is earned, then you must have a foreign tax credit system so that if the country in which the income was earned, where the economic activity took place, exercises its prior claim to tax that income, you don't tax it a second time in the United States.

Other countries have gone to a territorial-based system where they have elected to tax only the income which is derived from the economic activities carried on within their borders.

Mr. LEVIN. And to just finish, do you think your company should pay any tax, any income taxes to the U.S. Government?

Mr. DAKIN. Do I think we should pay any——

Mr. LEVIN. Do you favor a system under which you would pay any income taxes or should the shift be entirely away from any taxation to the corporation?

Mr. DAKIN. We do not have an official company position on the alternatives that have been put forward. Our focus this morning is really on compliance rather than on the alternative systems. But to the extent that we earn income in the United States, we are perfectly happy to pay tax on it. The problem is that figuring out how much tax we pay is more expensive than it ought to be.

Mr. LEVIN. OK.

Chairman ARCHER. The gentleman's time has expired.

Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. And I too want to thank and congratulate the Chairman of our Ways and Means Committee for giving us the opportunity to hold these hearings, and I thank all of you for coming back for them. We are going to spend the next 3 days trying to figure out the pluses and minuses of all the different tax systems, and there is nobody better in this room today to help us understand these pluses and minuses than you, members of the panel.

In the last 2 months, I have held about 13 townhall meetings in my district in Washington State, and there has been consistent support for the simplicity and the clarity of a flat tax system. There are points that have come up on behalf of all the systems that we are looking at in these—beginning with these hearings, during the next 3 days, but there are some important negatives to each of the systems that I think we have the responsibility of investigating.

For example, when you come to a consumption-based tax, senior citizens have gone through their income-producing years and they have paid income taxes and they planned ahead for their future incomes and they are living on a set income; and that would be seriously invaded by a consumption-based tax. But I am very, very interested in learning the pluses of that system but naturally would like to investigate it from all points of view.

I have heard your testimony that the flat tax—that any kind of tax system that replaces the income tax system should be simple and should be fair, and my constituents would agree with you. You have brought up an additional factor that is very important to our

considerations, and that is the compliance costs as you try to comply with the requirements of the IRS and this strange and convoluted tax system that we have right now.

I wonder if those of you who are representatives of companies have had your companies examine the costs of the various systems we will be considering and looking at—the value-added tax, the national sales tax, the consumption tax and the flat tax—and you have calculated how your costs would be affected by our replacing the current income tax system with any of those other alternatives.

Mr. Williams, since you are from my State, maybe you could talk to me first about this.

Mr. WILLIAMS. This was measurement on the three different types of taxes and what the costs would be? It is interesting, because hearing different comments from each of the representatives, we haven't done that evaluation, but it seems like—that no matter what, there are still the comments leading back toward, well, do we leave this in or take this out. And so it would be really difficult, without seeing true proposals for each of the three, to do the measurement on what our compliance costs would be. That is why we are interested in almost seeing something come out if there is a true proposal on what the consumption tax would be and seeing all those, to measure those up.

Because I have heard comments, well, should businesses be exempt from any income tax at all or should they not be, and so which one of these, is this from a flat tax, I didn't have to ask the question, are businesses going to be charged with one flat tax and people going to be charged with another flat tax, or everybody charged with the same, and we haven't had a chance to measure those.

Ms. BEARD. I did find the question earlier, it relates to yours, there is an excellent article that is in the new Fortune magazine that I picked up at the airport, and an economist, James Payne of Standpoint, Idaho, estimates total costs for the Nation to prepare our Nation's tax bill that we send as we write our checks and pay our taxes, an astonishing $593 billion a year. That is a lot.

But I have to agree that we do need to see what exactly is in the proposals. I do think if we could do something like a flat tax on a cash basis for a business and get rid of a lot of these schedules and the complications that go into it. This would also help spur the economy and would also create additional jobs.

Ms. DUNN. Mr. Tyler.

Mr. TYLER. Yes.

Ms. DUNN. Do you have any—has your company taken a look at which of the alternative tax systems would be less expensive for you as far as compliance goes?

Mr. TYLER. Well, you know, when you are in small business, it is a little different than being—with our friend here, these other, there is an angle to everything. Now, in my case, I don't care what you do; I am going to figure how to make some money.

However, it is obvious if I didn't have to spend so much money on other things dealing with the government—to my accountant and lawyers—not only my lawyer for taxes, but if I get in trouble with the National Labor Relations Board or any of these other peo-

ple, it is costing money. That money does not go to my employees, it doesn't go into my pension fund.

I have a pension fund I give 3 percent a year to. I pay full hospitalization for one person. Now, I also have profit sharing. One year I had a very successful year; I put 14 percent into the profit sharing and 3 percent into the pension, which are both—are fed into the same thing.

Now, I could—these people would have a lot more money for retirement if I didn't have to spend all this money on compliance.

I don't really spend that much money for taxes. This year, I spent $20,000 Federal and $4,000 District franchise tax. So it isn't a big deal with me, except that all this money I am spending in compliance on these things would go to the employees. If you are smart, take care of your employees.

One thing I think this Committee should think about has nothing to do with actual taxes, which I don't like to bring up. There is a tremendous—there is a tremendous backlash at the government today. Now, one reason for this is fear. Fear. Every time I have a thing go across my desk, it says Bureau of Internal Revenue—I have no trouble with the Bureau of Internal Revenue—a fear sets in. I have got to open that envelope right away.

If I have any envelope that comes from OSHA, whatever you call it, the fear sets in there. If it is anything that comes from the Department of Labor, fear sets in there. And a lot of it is because it is so complicated.

I have had two cut fingers in my—in 35 years, and I still was fined by OSHA this year when they came in, which—it is another compliance, it is cost. So I think this Congress should start thinking a little bit about the Internal Revenue striking fear into the hearts of people.

The first thing that happens when you are afraid, if you have ever been in combat, your first thing is fear, you are frightened. The second thing is embarrassment. The third thing is resentment, and there is a lot of resentment in this country toward this government. So that is another tax factor.

Chairman ARCHER. The gentlelady's time has expired.

Mr. Thomas.

Mr. THOMAS. Thank you very much, Mr. Chairman. I have been visiting for the last few minutes with some friends to this country, and if I might I would like to ask the visitors from Russia and the Ukraine and the other republics to stand up briefly, please, in the back of the room. We have a dozen young leaders from the former Soviet Union.

In listening to Mr. Tyler in terms of fear of government, what I have been learning over the last few minutes is basically what not to do to make sure that we avoid the mistakes of others. Mr. Chairman, I am just absolutely pleased that these hearings are underway. I thought over the years as we talked about our desire to examine the tax structure, that it would probably take a change in the Majority in the House of Representatives to actually have this occur. And guess what? It did.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. I also want to offer my thanks for your leadership in holding these hearings. I come to these hearings committed to looking at significant radical change in our tax structure, because our tax structure is too complicated. My constituents don't understand it, and they feel that people in similar economic positions are treated differently and they don't like it. The system adds to a lack of confidence in our tax structure.

I applaud your leadership on broad-based consumption taxes. I think that is a better way to go than our income tax base. I think we can take care of some of the regressivity problems associated with consumption taxes through tax credits which are not very complicated or difficult to enforce. I think these hearings are extremely important because we must understand the impact of changing from our current tax structure.

I think Mrs. Johnson's point as to what impact it will have on business decisions related to either health insurance or pension benefits are important questions on which we need to get expert information before we act. I must tell you I am also concerned as to what impact the change will have on our State and local governments, and we need to take a look at the impact of tax changes in that regard.

With the panel before us, though, I would like to concentrate on the small business decisions. I have heard from many small businesses in my district about the concern that so much of the small business entrepreneur's time is spent in dealing with government that it drains their ability to deal with their business. But I must tell you, I have heard about that in many contexts, whether it be in tax compliance or dealing with environmental regulations or dealing with Workman's Comp. issues or dealing with tort liability concerns. It seems to me that the leaders of small business spend an exorbitant amount of time in dealing with these issues. So I would like to at least get some sense from our panelists on the relative importance of the tax issues to the other concerns that you must deal with as small business individuals.

Understanding Mr. Gibbons' caution, we are not talking about the level of taxes, how much taxes we are going to collect, but the compliance costs, how much time you must spend in dealing with our tax structure, how the current tax structure lines up in relationship to some of the other concerns that small businesses have about simplifying the way in which government interferes with your lives. Perhaps—I have 1 minute left on my time, but perhaps the panelists who represent small businesses could give me some help in that regard.

Ms. BEARD. Earlier, I provided you with actual numbers from the survey completed by an accountant in Springfield, Ill.

Mr. CARDIN. I heard your percentages, but I am concerned that that may be coupled with——

Ms. BEARD. But that is actual——

Mr. CARDIN. Yes, that may be coupled with the tax burden. People don't like to pay taxes.

Ms. BEARD. No, that was primarily, where do you need help; as far as when they pick, they had different services and different areas of concern for small business, which included increasing

sales, payroll, inventory, cash flow, bank loans, capital, various things to choose from.

Mr. CARDIN. Mr. Tyler, could you help me in this issue as far as small business concerns?

Mr. TYLER. Well, all I can say is this. I think you have got too many people running around this Congress with a doctor's degree from Harvard's Economic—School of Business.

If I agree to pay my employees, I agree with the government to pay my employees 3 percent a year taxes on their—I mean, retirement on their salaries, I also have a vent there for extra profits of a profit sharing where I can pay—1 year I paid 14 percent, as I have told you, on the profit sharing, which builds up a nice little tax-deferred thing.

I don't see why everything has got to be so complicated. I have a degree from George Washington University. I have night schools of another year and a half credits. And I have to take a thing this thick from my bank to pay 3 percent a year on the retirement?

Let's get with it. What in the world is all this about? I mean, what are they trying to—am I trying to prove that I am honest? I mean, what is this all about? I mean——

Mr. CARDIN. How much of your time is spent on this?

Mr. TYLER. It used to be more than it is now. I will tell you why. I used to do the pension plan myself and pay an actuarial lawyer $1,000 a year to figure it out. All right. So I took the time. I used to pay my taxes; this is 30 years ago, I used to pay my own taxes, and this took a little time. But now, I don't do this anymore. I paid the bank $26,000 last year to take care of the pension fund, because I wouldn't dare do it.

I pay another accountant $9,000 a year to advise me and do my taxes. I pay a lawyer, another lawyer, if I need anything else. A couple years ago I paid $40,000 to a labor lawyer to get me out of a mess which I shouldn't have been in in the first place. I fired a man and—very justifiable, and people even testified. I tell you, the cost of all those complications you have got going on around here——

Mr. BUNNING [presiding]. The gentleman's time has expired.

Mr. English will inquire.

Mr. ENGLISH. Thank you, Mr. Chairman. And I appreciate all of the panelists participating today in the opening of what I think is going to be a series of historical hearings on our tax system, which will ultimately lead the way for Congress to fundamentally overhaul our Federal tax system.

I wanted to particularly discuss with this panel some of the problems of excess burden, that is, the extent to which the tax system distorts decisions in a way that may lead to an unproductive allocation of resources. I wonder if each of you would, from your own experience, offer some examples of how the current tax system, beyond what you already have, in your testimony—of how the current tax system distorts decisions, allocates resources into lower priority areas and leads to an inefficiency in your productive enterprise—starting with Mr. Williams.

Mr. WILLIAMS. I would say that probably for the owners and our board, which consists of my parents and I and our vice president/general manager, we probably spend 20 percent of our time dealing

with the issues that are related to—25 percent of the time related to the "future planning for the estate" issue. It has caused us in the last 8 years to start a couple of corporations, make sure that the value inside those corporations are selling a lot of the products, merge the corporations in so that we can plan for the future, to work in all different areas, figuring out how much money we are going to have to spend this year and what the income tax burden is going to be. We have to plan for that ahead of time, you know, and almost be paying quarterly amounts that are going to be for next year's liability.

And so it takes up quite a bit of our time, while the rest of the employees are hopefully running the business the way that you want to, and in our case they are. But it is significant.

Mr. ENGLISH. Ms. Beard.

Ms. BEARD. Well, I know we have—and as I said, I am a real small business, with only six employees and two crews that go out and put up fence. I know at one point we had a 401(k) program, and actually what we discovered is it was costing us more to keep it in place than what any of the workers were willing to put into it. With a tax system as complicated as ours, it makes compliance even more costly and burdensome. Even with the "tax incentives" available—the administrative compliance is more of a disincentive. I hate dealing with them.

Mr. ENGLISH. Mr. Tyler, have you had this experience in your company?

Mr. TYLER. Well, let's get back to the time I have been in business. I have been in this business 35 years. Prior to that, I worked for—I was a secretary to one of the heads of Anaconda Wire & Cable Co. I got a lot of information from them. And prior to that, I worked for a Senator as a secretary. So I got around a lot of big people. So I got—I am going to repeat, there is an angle to everything.

Now, when you pay pensions for people, you have got an angle; there, you are trying to help those people become better workers. When you pay bonuses, you are trying to help them be happier and make more money and so forth. When you pay overtime, quite often this is the case there, too.

Now, one thing that should interest you is—a very simple thing, is the—I just purchased—now, let's see, this year I purchased a $55,000 press. I am in the small press business. I put $30,000 in the typesetting. I put—I bought another inserter for $35,000.

Now, I have to pay taxes on all this cash, and then I write it off in 7 years. Well, now that meant that I had to pay taxes of $20,000 corporation tax, and $4,000. If I could just take this cash that I have made and just pay for this stuff and then not have to worry about all these taxes, it would be a lot better, I would buy more equipment, or a lot of people would.

Mr. ENGLISH. Thank you, Mr. Tyler.

Mr. Dakin, with regard to the alternative minimum tax which I know has an enormous impact on many capital-intensive companies like yours, what is the cost of having to maintain an extra set of books and what impact has the AMT had in general terms on your investment decisions?

I know it is always touchy to ask any enterprise how, specifically, they make investment decisions, but in broad terms can you enlighten us on how AMT and other provisions in the Tax Code have distorted your behavior and pushed you into less productive activities?

Mr. DAKIN. To answer your first question, the AMT is about 30 percent of our compliance burden, so without the AMT, we would cut the cost of preparing our return by about $3 million per year.

To answer your second question, our management has no difficulty in making it clear to the tax department that the tax tail will not wag the business dog, so our management makes its investment decisions based upon their view of the long-term strategic goals of the company; and if it winds up that by making that investment, we owe minimum tax, then paying minimum tax is just one of the costs we bear in making that investment. It is a cash flow deterrent, but I could not honestly say that our management has been deterred from making an important investment for the long-time viability of the company for tax considerations.

Mr. BUNNING. Thank you, Mr. English.

Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman. I come to these hearings excited because, as a small business person that had never been involved with politics—I am a veterinarian and own my own animal hospital; as you go through different processes and you learn, as a small business person, you are trying to run your business, you are trying to be a success, you are trying to see what the customer wants, especially when you are brandnew in business.

All of a sudden you get a notice from the IRS, you think, oh, no, have I done something wrong? A lot of times you have done something wrong and you had no idea there was a law that even concerned that.

Now you have to pay a penalty, pay the fine because you had so many employees, now you have to report more often; and the complexities—I can relate to what you are saying because I experienced all of those complexities, not only to do with IRS, but OSHA.

My family has a closely held corporation that they recently sold to a public company that had a lot to do with the estate laws, because it was not liquid; and the chances, we felt, of holding on to that were very little without the market to be able to sell in. When you are in a public market you are in a liquid market and can do that to handle the tax burden.

I think we are pointing out a lot of problems at all levels. Whether you are talking about the size of a company like Mobil or six employees, we are talking about an incredibly burdensome tax system that hurts productivity.

In my own company, if we are looking at buying maybe a piece of equipment that would allow us to practice a higher quality medicine and, instead, we are looking at how much we have to pay the accountant each month and how much we have to pay to comply with these tax laws, that may be something we don't buy that year, or for 2 or 3 years, simply because of those costs involved.

We had a profit-sharing plan and we had the same kind of experience, where I stopped the profit-sharing plan. I was contributing 15 percent a year to employees, but the costs got to be so great for

administering it and the incentives were taken off because it is either pay the tax now or pay the tax later; it looked like taxes were going to go up over the years, and I decided to pay the tax now. So my experience has been virtually the same.

I want to champion this cause as far as doing away with the current tax system. Whether that is a national sales tax or a flat tax, to me either is better than the current system as long as we look at issues that deal with fairness.

On the issue of fairness, I have not heard anybody address dealing with flat tax, whether it is 10 or 20 percent or whatever it is. If the same percent isn't fair for all income levels, then what percent is? Should rich people pay 30 percent, 40 percent, 50 percent, 90 percent, 100 percent? How can you define "fairness" by putting a percentage that is different for different income levels? I have never heard that issue addressed from a "fairness" standpoint.

Ms. BEARD. There was an older version of a flat tax, although people just are hearing about it; within the last couple of years, there has been more and more talk about a flat tax. There was a flat tax back in 1982 that was talked about. What they did with that was, from the gross income they deducted an amount and then charged a flat tax on everything above that amount. So, yes, it was a flat tax as far as there was one consistent rate on income over a certain amount, beyond that deduction; but in effect what happened, those who have been on the lower edge of the wage scale were paying a reduced tax and it was still progressive, but not nearly to the degree as what we have seen today.

Mr. ENSIGN. OK.

Mr. WILLIAMS. I think that measurement, too—in talking about the percentages for the wealthy, I think it is significant to know that 60 percent, I read at one point, of the gross national product comes from small businesses and a dominant amount of those businesses are subchapter S corporations—I don't know what the exact percentage is. But when we talk about taxing the wealthy, when we look at the taxing of wealthy people, you mentioned yourself that you needed to go, public offering. We are looking at the value of the corporation. It is not liquid. I can't sell it. We are looking at keeping this business on, generation through generation, providing jobs, and it is significant.

So that element needs to be taken out and maybe we wouldn't have all these corporations to have to worry about if the tax system were completely overhauled. Because we are changing some of these avenues—why are you an S corporation, why are you a C corporation—and the effects that that has on each business that is out there.

Mr. BUNNING. The time of the gentleman has expired.

Mr. McDermott.

Mr. MCDERMOTT. I thank the Chairman for having these hearings. I don't think there is anybody on the dais who wants to pay taxes, so we share with our constituents a common feeling. It is nice to have a discussion about not paying any taxes.

Mr. Dakin, what are the total worldwide revenues of Mobil? Because it is a rare opportunity to have you here. We don't generally get an 800-pound gorilla. If I could get unanimous consent to enter your tax return into the record, I would do it.

Mr. DAKIN. What do you mean by revenues? Do you mean gross receipts from all sources before——

Mr. MCDERMOTT. I am not an accountant or a tax lawyer. How much money comes in to you?

Mr. DAKIN. The total gross receipts in terms of what we collect from the total amount we sell during the year in 1994 was about $67 billion.

Mr. MCDERMOTT. And you paid $2 billion in taxes?

Mr. DAKIN. That is why I asked you what you meant, because that is not profits, that is not the income we made. That is our total sales.

Mr. MCDERMOTT. But out of all that, on that $67 billion you paid $2 billion in taxes?

Mr. DAKIN. Our income on those sales was about $1.7 billion.

Mr. MCDERMOTT. So you lost money paying taxes; is that what you are saying?

Mr. DAKIN. No, sir.

Mr. MCDERMOTT. You are saying profits after taxes were $1.7 billion; is that what you are trying to tell me?

Mr. DAKIN. Yes. I am having a little trouble finding my place on tables on the annual report.

The income after tax would have been $1.7 billion, $1.7 billion income after paying all expenses and after paying all taxes.

Mr. MCDERMOTT. And you spent about $10 million in compliance?

Mr. DAKIN. We spent $10 million preparing our U.S. Federal income tax return.

Mr. MCDERMOTT. So you are spending less than one-half of 1 percent to produce a tax document to give $2 billion to the Federal Government?

Mr. DAKIN. Sir, to put this in focus, we are a worldwide company, and you asked what was our worldwide income. We have to distinguish between the total worldwide taxes we pay on our total worldwide income. That was the figure that I was giving. The $10 million——

Mr. MCDERMOTT. Let me move to my next question, because I know that they would not run a bill through here if you had not had a chance to review. This Committee passed a bill which included a provision to eliminate the alternative minimum tax. What tax break does that give you? What is your benefit from the bill that passed out of here?

Mr. DAKIN. I was called here to testify on the compliance costs. I can tell you that the compliance costs of just filling out and filing the data on the AMT is 30 percent of our total compliance costs of about $3 million a year.

Mr. MCDERMOTT. It would help us if we knew how much you would save in taxes out of that $2 billion that you pay?

Mr. DAKIN. We haven't saved anything in taxes.

Mr. MCDERMOTT. You mean that AMT proposal that went out of here had no impact on Mobil?

Mr. DAKIN. We don't pay on proposals, Mr. McDermott.

Mr. MCDERMOTT. It must have been submitted to you and you ran it through your tax department and they said, under this pro-

posal, we would pay only $1.4 or $1.1 billion or $600 million or something.

Mr. DAKIN. Because we are a very heavy investor in the United States to the tune of about $1 or $1.1 billion every year, we throw off a lot of depreciation. The AMT depreciation recovery rules are so slow that that is what causes us to become an AMT taxpayer. So obviously allowing better capital recovery for investment in the United States would reduce the amount of AMT that we pay.

Mr. MCDERMOTT. So you would get a big tax break. I find it hard to believe that you would want a system to be thrown out in favor of a flat tax when you can come here and adjust it down and get it so it works just right for you—maybe I don't understand corporate mentality.

One of the things that troubles me about the flat tax business is the question of equity. The Coopers & Lybrand witness really factored herself out. She is not willing to comment on whether they believe in fairness or not.

I would like to hear the rest of you, because I have a report from the American Enterprise Institute and one from Treasury which say, under every flat tax, whether you are talking fat or you are talking a flat tax, you wind up with 80 percent of Americans paying more taxes and the top group getting the tax break.

Does that trouble anybody at the table?

Mr. TYLER. Why do they get a tax break?

Mr. BUNNING. Your time has expired. We need to move on.

Mr. Christensen will inquire.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. I applaud Chairman Archer for instituting these hearings, because I believe, as Mr. Tyler said earlier, that our tax system is too complex and it causes fear in the American people. We need to institute a system that is simple, fair and one that is a whole lot less in size; I think our current system has roughly 10,000 pages, compared to the one in 1914 that had 14 pages. The amount of money that is spent in compilation and time is money put down a drain, and we need to fix that.

I knew sooner or later that this discussion on an alternative tax system would turn to a class warfare argument. I think that is unfortunate. I think we need to focus on the fact that the system we have today doesn't work. We need to find a more simple, more fair system.

I think Mr. Dakin's testimony was well received, in the fact that it is not the amount of tax that they pay or don't pay. We are talking about the type of system that we have and the complexity and the various props that you brought along, I think, helped add to that system. I want to thank the witnesses today and appreciate your testimony.

More than anything, I compliment the Chairman for bringing in people from the business community—small; large; medium-sized businesses—that had the opportunity to testify first, prior to some of the expert panelists that we sometimes refer to as bringing in some of the policy ideas, that have the Ph.D.s behind their names. Not that they don't have some good ideas, but it is enjoyable, for the first time since I have been on this Committee, to hear from the people in the trenches first, and I applaud the Chairman for that and thank you, Mr. Chairman.

Mr. BUNNING. Mr. Payne will inquire.

Mr. PAYNE OF VIRGINIA. Thank you very much, Mr. Chairman. I too want to commend Chairman Archer for holding this hearing and these hearings that we will have this week. As a former small business man myself, certainly I understand what I am hearing from this panel that the Code today is too complex. We are way behind in terms of providing regulations for the IRS, and because of the complexity, not only is a burden being imposed upon large businesses and small businesses, but upon individuals as well. These are things that we need to look at and things that we need to correct.

I would say, too, that it is very important with a Tax Code that it provide some degree of certainty. Especially when you are in business, it is very difficult when the Code changes or when you anticipate changes as you are trying to make decisions about investment. Even hearings like the ones that we are having this week can create some uncertainty. People who may be thinking about making some investment, hearing what is going on, may say, maybe I should wait because maybe the tax climate will be more advantageous in the future. I think it is important to understand that we are beginning a process that will be a very long process, but a very important one.

I would certainly think, Ms. Skidmore, for you and others in your profession, as people approach you and ask about what is going on in Washington and about investments that they are thinking of, that people need to put this in perspective. They should not make decisions or investments because of things that are going on here. These are important hearings to lay the groundwork for changes that may be made, but at some time in the future, perhaps no earlier than 2 years or more from now.

So I think that is an important thing to keep in mind about hearings like this, that they should not be disruptive to the kind of important activity that is going on in the economy at the present time.

Let me use the few minutes I have left to inquire of the small business people about the taxes, really, in three areas. Let me break these down into three large groups—payroll taxes, income taxes, and other, such as the pension issues that have been brought up by Mr. Tyler.

Would you comment, as you see it, on how much each of these three takes away from your doing business that you would normally do—payroll taxes, income taxes and other?

Mr. Williams, maybe I could start with you.

Mr. WILLIAMS. Again, without having all the timeframe that is there, I think the time that is taken for each of us to even come here, the plane flight back here to have to talk about the issues that are going on in our business today, when we go out and spend time with our employees and work in manufacturing for a day. I ask the same thing, like Mr. McDermott, that he does not have the corporate information and has not been in business. For him to come and to sit down with our people for a day, any one of you, we would give you an opportunity to work inside figuring out what it takes to comply with the costs, payroll and income. It is some-

thing that I did not come here prepared to talk about, each of the percentages.

Mr. PAYNE OF VIRGINIA. Not the percentages so much, but if we look at overhauling the Income Tax Code and leave in place the payroll taxes as they are now, to what extent have you been benefited as a small business. Is it not likely that you would be back saying, this is OK, but what we really need to address are the payroll taxes because of the amount of time that it takes to get somebody on the payroll, the forms we have to fill out, the compliance as well as the amount of money that the employee and we have to put aside in order to pay these particular taxes?

Mr. WILLIAMS. I would say out of our accounting department, which—we have probably 10 people, there are 3½ devoted to just taking care of payables of expenses with our suppliers, and the rest, 80 to 90 percent of their time is dealing with payroll and income tax issues, State, local and Federal, all Federal issues.

Mr. PAYNE OF VIRGINIA. Ms. Beard, could you comment on this, please.

Ms. BEARD. As far as actually adding up the time, I haven't. There were many nights I was in the office until 2 or 3 o'clock in the morning because it had to get done. When you are in business for yourself and you are doing everything, you don't add up the hours; you are trying to get things accomplished. Until a year ago I was doing all the payroll and handling the payroll deductions and getting the reports done. There are many nights when you are sitting there trying to figure out, and it doesn't balance.

We have a gentleman on our delegation who is a veterinarian, and he is very vocal, that this is servitude in his eyes, and he is from England originally.

Mr. BUNNING. The gentleman's time has expired. I thank the panel members for their input today and take the privilege of the Chair to request that Hon. Michael Boskin, David Bradford and Gary Hufbauer would come forward. We know that you are pressed for time. If the other panelists would hold back until we receive testimony from these three gentlemen and we could question them. Thank you very much, panel.

Mr. BUNNING. Mr. Boskin, if you would begin, we would appreciate that.

STATEMENT OF HON. MICHAEL J. BOSKIN, PH.D., TULLY M. FRIEDMAN PROFESSOR OF ECONOMICS AND SENIOR FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY, STANFORD, CALIF., AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. BOSKIN. Thank you, Mr. Bunning. It is a privilege to be back to testify before the Ways and Means Committee.

I want to congratulate the Members of the Committee for initiating these historic hearings. There is a tremendous opportunity to greatly improve the Federal system of corporate and personal income taxation in a manner that will accomplish two important goals: First, dramatically improve economic performance, and second, substantially reduce the compliance and administrative burden on America's families and firms. But it must be accompanied by spending control, devolution of some Federal functions to the

States and localities, less and more flexible regulation and sound money. We have an opportunity to launch a new era of prosperity over the long term in America. Why would a fundamental change in the tax system change our economic performance, improve it?

While tax collections in personal and corporate income tax today total only about 10 percent of GDP, the system systematically affects private behavior, household and firm behavior, affecting the overwhelming bulk of GDP; and the result, overwhelmingly, is that behavior is heavily tilted toward the present against the future, toward consuming today and saving and investing for the future.

I have five standards or tests that I apply to tax reform that I will briefly mention before mentioning a few words about the specific proposals under consideration.

Will the reform improve the performance of the economy? And by far the overwhelming and most important standard of performance is the rate of economic growth because that determines future living standards. There are other goals of economic performance that I won't get into here. The most important way the tax system affects economic growth is through the rate of saving, investment and entrepreneurship, which is heavily retarded by the current corporate and personal income tax.

Will the tax system likely affect the size of government? It is my own view that it is important for the point of finance and the point and purpose of spending to be more closely tied. That, in my view, will be the best brake we can apply to ensure more effective and efficient government.

Will the tax structure affect federalism and, if so, how?

Will the new tax structure likely endure? As this Committee knows better than I, we have had major or fundamental tax reforms eight or nine times since the late seventies. We should be concerned that when we move to a better tax system it won't be undone shortly thereafter.

In 1986, for example, the tradeoff was to lower rates for a broader base. That was undone in 1990 and dramatically worsened in 1993.

And finally, over time, will the tax reform contribute to a prosperous, stable democracy? I have mentioned prosperity. I am concerned that starting from where we are now, as we move forward, the press of demography is going to cause us to have an ever-growing ratio of people receiving, on balance, income from the government to people paying taxes. That will have to be addressed on the entitlement side primarily, but we also should be concerned on the tax side, whether we are collecting the proper amount, we have enough taxpayers, we are getting at the underground economy, and so forth.

The overall burden the tax system imposes on the economy is composed of two parts. You heard mostly this morning about the compliance burden. The lowest estimate I have heard is over $100 billion. I have heard estimates up to $600 billion for filling out forms, the paperwork, and so forth. That is important. It is the thing that affects a large majority of people.

The tax system, however, as one of the last questions asked implied, distorts the allocation of our activity between consumption and savings, consumption and investment, and so forth. The sizes

of those distortions are proportional to tax rates. The cost goes up with the square of tax rates, so we want a broad base and low rates to the maximum extent possible.

What does that imply for tax reform? It seems to me that the two fundamental purposes of tax reform in order to achieve a better system and a stronger growth in the economy should have a much broader base that is equal to or much more closely aligned with consumption in the economy as opposed to income on the one hand, and that we get the rate as low as possible on the other. That will lead to some tradeoffs between what gets deducted, rebated and so on, but I would say that, overwhelmingly, we have an opportunity to make a major improvement. Estimates suggest we could gain as much as perhaps 10 percent of GDP higher in the long run, with a very low rate broad-based form of consumption tax, whether that is done on the retail sales value-added type or through the income side, allowing people to deduct their saving, or through an income-type flat tax that winds up with consumption as its base rather than income.

Quickly speaking, my own view is that simplicity and the underground economy and things of that sort, and GATT border tax adjustment rules, weigh in favor of the retail sales tax. The flat tax would get us partway there; it has a lot of appeal, as well. It raises additional issues.

Each of them would run the risk of having some of the good they do undone by raising rates later or by having to have exemptions, deductions or rebates.

I would suggest the Committee go through the task of fundamental tax reform if we are pretty sure that we will be able to keep that fundamental reform relatively intact for some time to come. I think those opportunities are substantial and I commend the Committee for beginning the education process for the country. I think much education needs to be done before we can get the bulk of the population understanding what we are really talking about.

The gains are large, potentially large enough in my opinion to seriously consider such fundamental reforms. Thank you.

[The prepared statement follows:]

TESTIMONY OF HON. MICHAEL J. BOSKIN
STANFORD UNIVERSITY

Chairman Archer, Ranking Member Gibbons, and other distinguished members of the committee, I appreciate the opportunity to appear before you today to discuss the important question of fundamental tax reform. There is a tremendous opportunity to greatly improve the federal system of corporate and personal income taxation in a manner that will both significantly improve economic performance and substantially reduce the compliance and administrative burden on America's families and firms.

Estimates put the annual compliance burden range well upwards from over $100 billion to almost $600 billion, with well over 5 billion hours of human effort devoted to that task. The cost in distortions of economic decisions is many times higher. And the Internal Revenue Service apparently only gives correct answers to taxpayer inquiries about 63 percent of the time. **The tax system is clearly too complex**. Remarkably, the system of voluntary compliance yields a very high percentage of tax liabilities actually due, especially when viewed relative to other countries. That speaks well of Americans' basic values. But there is widespread concern that the system of voluntary compliance will be decreasingly effective over time unless tax rates are reduced and the tax system made far less complex.

I hope these hearings start an educational process, a national dialogue and debate that will help build a consensus on the need for tax reform and on the best route to it.

Tax Reform and Economic Policy

Tax policy is imbedded in the overall economic system and the overall system of public policy instruments. Taxes--current or future--are how government spending is financed. The tax system affects and is affected by other areas of policy.

The current tax system as well as government spending, deficits, and regulation, are the subject not only of intense legislative political debate currently, but are widely viewed, according to all public opinion polls, as out of control. **Taxes are too high and complex; the government spends too much; it is too centralized and too inefficient; the government borrows too much, and regulates too much private activity too inflexibly.** So an improved tax system has the potential to significantly improve the economy. But it must be accompanied by slower spending growth to balance the budget, devolution of some federal functions to the states and localities, less and more flexible regulation and sound money.

The current tax reform debate focuses on the personal and corporate federal income taxes. These amount to about 10% of GDP, and about a quarter of all explicit and implicit taxes. Total federal, state, and local government spending is about 40 percent of GDP. Current explicit taxes are somewhat less than that, the difference being budget deficits. The current reform debate generally does not focus on the payroll tax or excise taxes. Nor is it explicitly directed at state and local taxes, although some proposals would affect them.

Recall also that there are two partially hidden taxes that we generally do not list as taxes in our budgets. One is the hidden tax imposed by our regulatory and legal system. (Some of those regulations and part of our legal system work reasonably well, but some does not, imposing unnecessary additional costs on families and firms.) The costs are very much like a tax. Estimates range all over the place, but recently have been in the $400 to $500 billion range per year. That is the yield of the payroll tax and a large fraction of the yield of the income tax.

There are also large future tax liabilities implied (but not terribly well measured) by the budget deficit. America was born in a revolution against taxation without representation; who is less represented than the future generations who will bear this burden?

There is a general feeling that we have increasingly seen the point of tax and the point and purpose of expenditure diverge. That is one of the reasons there is so much discontent with government. In the Eisenhower Administration, say 1958, six out of every seven dollars the then much smaller federal government spent was on purchases of goods and services such as national defense and roads. Only one out of every seven dollars was spent on transfer payments. Today, net of interest on the debt, transfer payments are the bulk of the absolutely and relatively much larger federal spending. So one can no longer speak of the tax side of the budget by itself. At the

very least, taxes and transfers must be considered simultaneously; better yet, taxes and spending more generally.

Tax policy interacts with trade and trade policy. In an era of large and expanding trade in goods and services, and investment, more foreign source income flows across national borders.

Finally, tax policy interacts with monetary policy. Tax brackets were indexed in the early 1980's, but not the definition of income. Nominal capital gains and nominal interest are taxed, nominal interest is deducted, historic cost depreciation is used, etc. So inflation still affects effective tax rates.

While all these other areas of policy must also be improved to spur economic growth, the tax reforms currently under discussion would go a very long way to improving the economy. **That is because, while the tax collections themselves are only a modest part of overall GDP, the current tax system systematically affects private sector (household and firm) behavior affecting the bulk of GDP. And the result is that behavior is heavily tilted toward the present against the future.** For example, the current corporate and personal income tax system taxes saving, investment, and entrepreneurship quite heavily. Indeed, some types of saving are doubly or triply taxed. Our tax system is one reason America's net national saving--the amount the nation has available to invest in a more productive future--is so low relative to other advanced economies, a point I return to below.

Five Tests for Tax Reform

I have five standards or tests that I apply to tax reform before I get to the specifics of the tax proposals.

1. Will the tax reform improve the performance of the economy?

By far the most important aspect of economic performance is the rate of economic growth because that determines future living standards. The most important way the tax system affects economic growth is through the rate of saving, investment, entrepreneurship and work effort.

2. Will the tax reform likely affect the size of government?

Tax reforms that more closely tie the payment of taxes to expenditures and get the individual citizen and taxpayer focusing on the fact that their taxes are being used to finance expenditure will better insure a more effective and efficient government. Also, any new tax--a broad-based consumption tax, for example--should completely replace the income tax. Otherwise, there is a risk the new tax will just be piled on the old and used to raise revenue to grow government--the European disease that has so damaged their economies.

3. Will the new tax structure affect federalism?

Closely tied to item 2, I believe it is important to strengthen the federal system. Tax reforms can affect the federal system in many ways and we should favor those that strengthen it and devolve authority to state and local government and private institutions to the extent possible.

4. Will the new tax structure likely endure?

We have had major tax reforms or fundamental tax reforms in each of the following years: 1978, 1981, 1982, 1983, 1985, 1986, 1990, and 1993. We should be concerned that we could move to a better tax system only to undo it shortly thereafter. In 1986, the tradeoff was lower rates for a broader base. That was undone in 1990 and dramatically worsened in 1993.

5. Over time, will the tax reform contribute to a prosperous stable democracy?

I have emphasized prosperity above. Now I want to emphasize stable democracy in the following sense: Are we likely to see over time a change relative to what is currently projected in the ratio of taxpayers to people receiving income from government? We now have a much higher ratio of people who are net income recipients to people who are taxpayers than in any previous time in our history. Fortunately, that number is still well under 50%. But as we move through

time, as we see the retired population grow, the baby boom approach retirement and then retire, the fraction of the population in any given year who are receiving more than they are paying will grow. We must deal with this both on the tax side (underground economy, perhaps too many off the tax rolls), but especially on the transfer payment side, the entitlements programs, and do so soon, or we will get into a spiral of higher benefits, higher tax rates, and a weaker economy and intergenerational conflict.

Before discussing alternative reforms and how they relate to these standards, a simple parable will distill much economic knowledge on the subject of the economic cost of taxation. Suppose the government takes a dollar away from the taxpayer's to finance spending. In order to collect that dollar, the government has to distort the allocation of resources. The tax will affect private decisions: an income tax is well-known to doubly or triply tax saving, and thus distorts the incentive to consume versus save, or alternatively to consume in the present versus in the future. Both income and payroll taxes distort the incentive to work in the market versus the home and/or of employers to hire permanent or temporary workers, etc.

The severity of these distortions depends on two things: first, the size of the tax wedge, how high is the real effective marginal tax rate that drives a wedge between doing one of the activities versus the other, between consuming and saving, between working in the market and working in the home, etc.? And second, how sensitive or elastic is the activity to changes in tax rates? Some activities are well known through numerous studies to be quite sensitive to tax rates; for example, the realization of capital gains and the labor supply of second earners in families. The combination of the size of the wedge and the sensitivity of the activity to it determine the severity of the tax distortion.

Generally, **the overall total burden that these tax distortions impose on the economy goes up with the square of marginal tax rates. The marginal cost goes up proportionally with tax rates. Thus, high marginal tax rates are very bad for the economy.** So, the income tax distorts many decisions. Workers switch between taxable income and fringe benefits; investors between low dividend and high dividend stocks; and so on. A lower bound estimate of the cost to the economy of each additional tax dollar is $1.40 or $1.50. Some estimates go much higher.

Now the tax dollar (which costs us $1.40 or $1.50) is put into a bucket. Some of it leaks out in overhead, waste, etc. In a well-managed program, the government may spend $.80 or $.90 of that dollar on achieving its goals. Inefficient programs would be much lower, $.30 or $.40 on the dollar. This immediately tells us that a key to the quality of the tax system, how badly it distorts the economy, hinders growth, misallocates resources, is the level of **effective** marginal tax rates. **The lower the effective marginal tax rates, the smaller the distortion of private decisions.**

Unfortunately, some examine just the statutory rates rather than the effective marginal tax rates. **The effective tax rates on private activity can be quite different from statutory rates because they interact with the tax base and can cascade across several taxes. For example, there are people who, despite a statutory rate of 28 percent, pay tax rates in excess of 100% on real capital gains, because they have nominal gains but real losses.**

Perhaps nowhere is the current income tax system more harmful than in the taxation of saving, investment and entrepreneurship. One of the nation's most serious problems is that we have a very low rate of national saving. It is low relative to the nations with which we compete. It is low relative to our own historical average. If it was the result of a tax, budget and regulatory and legal system that was neutral with respect to whether people and firms consumed or saved and invested, I would not necessarily see much problem with it. **But the overwhelming evidence is that all these public policies wind up favoring current consumption and penalizing saving and investment.**

Our net national saving rate in the 1990's has been slightly under 2%. That is the sum of what households, businesses, and governmental units add, net of depreciation, to our nation's ability to grow in the future. Two percent is remarkably low. Fortunately, we have been an attractive enough place to invest that our net investment rate has been higher than that, the difference being financed by importing capital.

There are two reasons the nation's saving rate is so low. Most people focus on the budget deficit. The budget deficit clearly is one reason. But just as important has been a decline in the private saving rate. I want to spend one minute on the relationship between the two. **Those who have argued that the best thing we can do to raise the nation's saving rate is to reduce the budget deficit are only correct if they add the proviso: in a manner that does not reduce private saving.**

The 1993 tax increases, for example, clobbered private saving. In addition to the direct limits on 401(k) plans, etc., the rate increases apply to the highest propensity to save groups: well-off households; middle income two-earner households in their peak earning and saving years; and small businesses. 80% of American businesses are unincorporated; 42% of corporations are sub-S corporations. These businesses use the same 1040 form you and I use, and had large increases in their effective tax rates on profits available for re-investment. Not surprisingly, personal saving declined at about a $60 billion annual rate. **So even if the tax increases collect the projected revenues--and my guess is they will not--they had no net effect on national saving. The smaller deficit is being matched by less saving. This is at best circular.**

I favor tax policies that reduce or redress the disincentives to save, invest and innovate in our current tax system, as well as policies to reduce the federal budget deficit. Indeed, that is how I tie the current debate together on whether it makes sense to have tax cuts as well as spending cuts given the budget deficit. **My answer is yes when those tax reductions will increase private saving to complement the reduction in government borrowing from the spending cuts.**

What does all this imply for fundamental tax reform?

As Congress moves forward to debate legislation on various piecemeal tax proposals this year, such as capital gains rate reduction and indexing, expanded IRAs, and other tax cuts, a useful way to think about these reforms as well as the more fundamental reforms, is that they are designed to redress the severe distortion of saving and capital formation caused by the current system of income taxation. Most other countries rely much more heavily on taxes on consumption--so-called indirect consumption taxes such as sales taxes and value-added taxes, and income tax systems that exempt far larger amounts of saving from the tax base (thereby leaving most households' tax base as income minus all saving, i.e. only that part of income that is consumed). Most of their corporate taxes have various features that allow more rapid write-off of investment than does the U.S. corporate tax; some have features by which they integrate the corporate and personal tax; others, such as Japan, have corporations that have much higher leverage and therefore finance a much larger fraction of investment through tax advantaged debt.

The U.S. corporate and personal income taxes (and other taxes at both the federal and state level) tax some types of saving once, others twice, some three times and in some instances even four times. To set concepts, **it is generally understood that a pure income tax would tax saving twice: first when it is earned as part of income, and again when it earns a return in the form of interest or dividends.** An alternative way to think about this is that present consumption is taxed once while future consumption is taxed twice, since the bulk of saving is done for the purpose of future consumption, for example during retirement.

Now consider the separate corporate and personal income tax and a family putting their saving in corporate equities. The family first pays taxes on their own income (perhaps their wages). That is tax one. They save some of that after-tax income in the form of corporate equities. But the corporation pays corporate taxes (on behalf of the family as a shareholder). That is a second tax. Then the family pays taxes again when it receives dividends or capital gains (in this case one has to net out inflation, deferral, the possibly slightly lower tax rate, incomplete loss offset, etc. to determine the true effective tax rate). That is a third tax on the saving. If the family is fortunate enough to accumulate, perhaps at a few thousand dollars a year compounded over a lifetime, enough to leave a taxable estate, the saving is taxed a fourth time.

Of course, there are numerous exceptions to this rule. For example, employer provided pensions, 401k plans, IRAs, etc. are forms of tax deferral (not tax forgiveness) that eliminate one layer of the taxation of saving. But going through the entire complexity of the tax code still

produces the overall conclusion that capital formation is taxed especially heavily in the United States, relative to other uses of income and relative to our competitors.

There are numerous ways to simplify the tax system and remove the distortion between the present and the future, between consumption and saving of households, and among types of investments. That is, there are numerous ways to tax consumption in the economy. We can generally divide these into two approaches--direct and indirect. So-called indirect taxes include a national retail sales tax, various types of value-added taxes, etc. So-called direct taxes would tax households and firms on the part of income which was consumed. They are sometimes called consumed income taxes. **It is important to examine the combination of the business-level tax and the personal-level tax to determine what the final tax base will be.**

Economists use a concept called the circular flow of income and product to describe the economy. Business firms use capital and labor, which they pay wages and interest or other forms of capital income, to produce products, which they sell to obtain revenues out of which the payments to labor and capital are made. One can look at the total value of the production of the firms or the total income received by households as two equivalent sides of the nation's accounts. Thus, households can be taxed at the personal level by taxing their total income, or various components of it such as wages, interest, dividends, etc. Alternatively, households can be taxed by taxing firms on the capital and labor they employ, or on their output. The taxes thus collected would reduce the flow of payments back to households. In this sense, **a tax at the business level should be thought of as a withholding tax on households.** To repeat the old saying, corporations do not pay taxes, people do. Taxes collected at the business level are paid either by shareholders, owners of capital in general, workers, or consumers.

Thus, a tax on output sold by firms is equivalent to an equal rate tax on the wage income and capital income paid by the firm from the sales of the output. Alternatively, households could be taxed when they use the income they receive from the firms to purchase goods and services or to save, the two broad uses that are made of income. Alternatively, since saving equals investment (ignoring complexities of the international economy for the moment), income can also be taxed by taxing consumption plus investment in the economy.

Turning from taxing output or income to taxing consumption, the government can do so in a variety of ways. The most obvious is taxing the purchase of goods as through a retail sales tax. A second option is to tax income of households but allow them to deduct net saving , leaving a tax base of consumed income. An alternative is to tax wage income at the personal level but to tax capital income at the business level (a withholding tax on the capital income of the shareholders) but to make the tax a consumption tax we would allow immediate expensing, i.e. a business tax deduction for investment in the year made.

While these are very different approaches to consumption taxation, with very different attributes, I want to begin by stressing the conceptual equivalence of these approaches to taxing consumption. Consumption equals income minus saving, so the Nunn-Domenici type tax with an unlimited net saving deduction is a consumed income tax (in the case of Nunn-Domenici, levied at progressive rates). Consumption taxes can be levied directly as a retail sales tax on the purchases of goods **and** services. But consumption is also equal to income less investment and therefore labor income plus capital income less investment. Hence, a tax such as the so-called flat tax of Majority Leader Armey, which owes much to my Hoover colleagues Bob Hall and Alvin Rabushka, which taxes wages at the personal level and capital income less expensed investment at the business level also winds up having as its tax base total consumption in the economy.

I noted above the importance of low tax rates. The broader the base, the lower the rate or rates. Thus, a national retail sales tax on all consumption goods, including services, replacing the current corporate and personal income tax, would greatly reduce the drag on saving, investment, entrepreneurship and economic growth. It could be implemented in a manner which is far less intrusive and burdensome on taxpayers. It would, however, be a proportional tax on consumption. If greater progressivity is desired, a refundable tax credit, or exempting commodities consumed disproportionately by the poor, would be the two approaches. The latter is inefficient in the sense of exempting, for example, food for rich and poor alike. The former would require some cumbersome administrative apparatus, and as we have seen with the earned income tax credit, open up opportunities for abuse. I believe each of these problems is

surmountable. Also, while it would not completely eliminate the underground economy, this approach probably would get at more of the underground economy than any other.

The approach of allowing an unlimited saving deduction (sort of a super net IRA) in a system similar to the current income tax system, offered recently by Senators Nunn and Domenici, is a progressive rate consumed income tax. While it has many admirable features (such as offsetting the payroll tax), as currently configured it winds up with tax rates that are too high for the health of the economy (a top rate of 51 percent). A serious complexity issue is the need to track of all pre-existing assets. Also, since a huge part of the complexity of the tax system is in the treatment of capital income, I believe the alternative of taxing labor income at the personal level while taxing capital income minus investment (business cash flow) at the business level would be administratively simpler. My former CEA colleague David Bradford has designed such a tax, with lower progressive rates, which he calls the "X Tax."

This approach to the tax base, with a flat rate, is the so-called flat tax. While common usage calls it a flat rate income tax, as proposed by Majority Leader Armey, the flat tax taxes labor income or wages at the personal level and capital income minus investment at the business level at the same proportional rate. Some of the simplicity is due to the single rate, as various transactions just net out, such as a business deducting interest paid and a household paying taxes on interest received, since these would be at the same rate. Some progressivity is introduced into the flat tax with very high personal exemptions, which therefore remove many households from the income tax rolls. While the tax rate is constant, the ratio of taxes to income rises with income until it gradually approaches the flat rate. For example, if the exemption level for a family of four were set at $25,000, a family earning $25,000 would have an average tax rate of zero; one earning $50,000 would have an average tax rate of 10 percent if the flat rate is 20 percent (20 percent on the $50,000 minus the $25,000 exemption); a family earning $100,000 would have an average tax rate of 15 percent (20 percent on $100,000 minus $25,000); at extremely high earnings, the average tax rate gets very close to the marginal rate of 20 percent.

The value-added tax (VAT), which is in widespread use in other countries, (although as mentioned above is often viewed as the way to finance the much larger government spending) also taxes income minus investment. It does so for each good and service, by taxing income minus investment at each stage of production. Adding up across stages of production and across all goods and services leaves the tax base as aggregate income minus investment, or aggregate consumption in the economy. As a technical matter, among types of VAT's, a subtraction method VAT with destination principle border tax adjustments on balance would be better than the other types of VAT's.

Each of these alternatives has its pluses and minuses. I can only begin to mention a few here, by using the criteria I laid out before. **Each type of tax will require far greater examination from the polity and the public, as they are not yet very well understood.** If it really could completely replace the corporate and personal income tax, a national retail sales tax probably in the end would be the simplest to administer and do the best job at getting at the underground economy. Some argue it would encroach on the states' revenue source. With no income tax, there would be no deductibility of state and local taxes and no tax-exempt bonds (the same would be true in a pure flat tax with no deductions), although lower interest rates would partly offset this effect. A broad-based indirect consumption tax would be rebatable at the border under GATT rules. To the extent refundable credits and/or exemptions were necessary, tax rates would have to be higher, and the advantages of a low rate broad-based consumption tax would be diminished.

The same is true of a value-added tax, which while it has a self-policing feature, is somewhat more complex than the retail sales tax, but still relatively simple compared to income taxes. **In either case, I personally would strongly object to such an approach unless it was used to replace income taxes, lest it be used to expand the scope of government.**

The flat rate tax would be a huge improvement over the existing income tax system, but again to the extent that exemptions, deductions, etc. were left in place, or crept back in over time, some of its advantages would be eroded. And, as with a broad-based sales tax or VAT, I would be concerned that small increases in the rate would raise lots of revenue, and that over time, we would evolve back toward a higher rate system **unless spending was strictly controlled**.

Every deduction in the income tax has its supporters--including the direct beneficiaries--and an apparent rationale. But the general interest in lower rates and a healthier economy overwhelms most, perhaps all, such arguments.

The two I would be most concerned about are the mortgage interest deduction and the charitable deduction. The equity in their home is the largest asset for a majority of American families and home values would fall under a pure flat tax. Perhaps a gradual transition would mitigate this effect. I believe charities strengthen a pluralistic democracy and the evidence (including work for the Filer Commission by Martin Feldstein and myself) is that the charitable deduction yields **more** for charities than it "loses the Treasury," i.e. is an efficient way to finance charities. I would rather have thousands of charities doing their good deeds than have government bureaucracies try to do them. Note that these deductions also vanish with a retail sales tax or VAT. Some of the same federalism issues arise if there is no deduction for state and local taxes and local government bonds lose their tax-free advantage.

The progressive consumed income tax, whether of the saving deduction Nunn-Domenici variety, or the Bradford "X Tax" (a progressive tax on labor income at the personal level plus taxing capital income minus expensed investment, business cash flow, at the **highest** tax rate at the business level), would be improvements over the current system, but not nearly so much as the other approaches. I do believe there is a stronger case for the Bradford approach than the Nunn-Domenici approach for compliance and administrative reasons, but again, recall the general statement made above that **from the standpoint of economic performance, lower effective marginal tax rates are best.** While the tax rates on consumed income get quite high under Nunn-Domenici, it is the only approach that attempts to integrate payroll tax credits to reduce the marginal impact of the payroll tax on labor supply and employment.

What is likely to be gained by moving to one of these tax systems? Will it be worth the substantial political capital and transition costs to various families, firms, industries, and economic disruption that accompany any major tax change? The answer, in my opinion, is that the gains are **potentially** quite large. My review of the literature plus my own modeling reveal estimates of long-run GDP up to ten percent higher per year by replacing the current corporate and personal income taxes with a broad-based, direct or indirect, tax on consumption or consumed income. Perhaps a conservative estimate would be five percent per year, which however, is gained partly by foregoing some consumption. This occurs because the increased saving and capital formation increases wages, and future income. **These are large potential gains; large enough, in my opinion, to begin a serious dialogue and discussion, indeed national debate, on the desirability and feasibility of fundamental tax reform, which in turn might develop the support for legislation in the near future.**

Chairman ARCHER [presiding]. Professor Bradford.

STATEMENT OF DAVID F. BRADFORD, PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, WOODROW WILSON SCHOOL, PRINCETON UNIVERSITY, PRINCETON, N.J.

Mr. BRADFORD. Thank you, Mr. Chairman. Mr. Chairman and Members of this distinguished Committee, it is a pleasure to appear before you again to discuss fundamental tax reform. The last time I did so was almost exactly 10 years ago, June 11, 1985.

It may seem that tax reform is always with us. I am hopeful, however, that these hearings reflect the approach of a critical mass of those who favor a thoroughgoing reorganization of the U.S. tax system around the idea of taxing on the basis of consumption rather than income.

In my few minutes, I would like to review with the Committee the main reasons it makes sense to have another go at fundamental tax reform and to explain why a consumption guidepost for writing tax rules provides the key for a tax system that is fundamentally fairer than the one we have now, that is vastly simpler and less intrusive in compliance, and that enhances U.S. living standards.

I will try to make two simple points: First, the present taxation should be viewed in the same light as other structures of regulation in our economy. In this case, the regulatory system is designed to define and protect the revenue base. Our tax regulatory system has become absurdly complex and counterproductive.

Second, a consumption-based tax offers a way to cut through the problems.

So, first, why reform again? In my earlier testimony, I spelled out many reasons the tax system at that time was defective and should be reformed. Most of those reasons persist. Rather than reiterate those here, I describe in my written testimony three examples of the ways in which the tax system now requires simplification and rationalization.

I won't go through the time to tell you about them now, but one concerns financial innovation, as an example. It is one of the ways in which our U.S. economy is most innovative and flexible, and profound changes have taken place. It is a case where the tax rules impede development and the tax rules themselves are the focus of a great deal of very high talent devoted, in effect, to drawing revenue out of the Treasury.

The second area is retirement saving. I give an example there. It is a very, very important area of our lives. Practitioners know this is one of the most complex areas of the tax law. The contractual relations between employer and employee serve a large variety of economic functions, and as with financial innovation, we are, on the one hand, wasting resources figuring out how to make arrangements that most exploit the tax advantages while staying within the law and, on the other hand, tying the hands of our employers and employees in reaching the most effective compensation arrangements.

My third example—and these are just examples—is capital gains. That probably defines itself; I don't need to tell this Committee about capital gains. In view of the interminable controversy

about capital gains taxation, it need hardly be said that the rules involve much more than fees for accountants and lawyers, but enter into every aspect of the business life of the country, with costly effect.

All three of these examples—and they could be multiplied—have in common that they are sources of great complexity and impose serious costs on the U.S. economy. And these costs are borne not just by the businesses and often high-income individuals who must directly comply with these rules. But like the banking laws or the securities laws or the telecommunications regulations, the costs they impose are spread throughout the economy, striking workers and consumers at all income levels.

The second thing these three examples have in common is that the harm that they cause could be easily avoided by adopting a consumption-based tax system.

Why is that? The reason that this is true is because cash flow accounting gets the right answer for implementing a consumption-based tax. I would refer to the written testimony for just a sketch of the details. It is amazing that that apparently technical accounting detail makes all the difference in the world.

Is a consumption-based tax feasible? The answer is yes. There are many ways it could be done. There are currently under active discussion three possible reforms—a retail sales, or value-added tax; the flat tax; the Nunn-Domenici unlimited savings allowance tax. All three have in common that they would replace the existing income tax and perhaps the payroll tax and they would shift the tax system to a consumption base.

I want to emphasize a couple of further points. In my view, a consumption-based tax is fairer than an income-based tax. Equity was much discussed in a previous hearing. In my view, personally, equity is perhaps the most important property of a tax system. If a tax system isn't fair, it won't stick and it shouldn't.

Many people feel that an income tax is the fairest tax, but that we should adopt a consumption-based tax, regrettably, because it would encourage saving. I disagree with this on several counts. Most important, in my view, a strong reason for adopting a consumption tax is that it is fairer than an income tax.

The central principle is this. As between two people who are similarly situated in terms of their economic opportunities, broadly speaking, how rich they are, well to do they are, the tax system should not assign a greater tax burden to the one who postpones consumption relative to the person who consumes. In other words, don't assign a higher tax burden on someone just because he or she saves.

In conclusion, as in other realms of policy, one might decide to impose an unfair tax system if it were needed to serve some other public purpose. I am asserting here that the income-based tax system is unfair relative to a consumption tax. But on all counts—administrability, compliance costs, interference in economic decisions—an income tax, even a much more consistent one than ours, is inferior to a properly constructed consumption tax.

The advantage of a consumption-based tax in terms of improved incentives to save and invest and, equally important, in terms of equalized treatment of investments of all types and by all people,

are going to be emphasized sufficiently by others in today's hearings and beyond. I would like simply to reiterate here the advantages of the reduced regulatory burden. By replacing an outdated and unnecessarily costly regulatory system with a consistent, simple system we can reap gains for everyone in the U.S. economy.

This is the true meaning of international competitiveness, and it has the advantage of allowing us to gain at no cost to the rest of the world. Indeed, if the rest of the world follows our example, the benefits will be multiplied. I hope the time is approaching when we will make the move.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of David F. Bradford
before the Committee on Ways and Means
House of Representatives
U.S. Congress

June 6, 1995

Mr. Chairman and members of this distinguished committee, I very much appreciate the opportunity to appear before you again to discuss, *again*, the subject of basic tax reform.

The last time was ten years ago almost to the day (June 11, 1985, to be exact). In that case, my testimony concerned President Reagan's reform proposal, which was to emerge as the Tax Reform Act of 1986. As a matter of interest, in preparing for today's session, I pulled that old testimony out of my files.

Since my views have continued to evolve with time and experience, I was rather surprised to see how much of that statement could be delivered again today. Specifically, I said, in effect, that

- The proposed reform failed to deal with a number of serious structural problems of the income tax, such as the need to correct the income-measurement for inflation and to rationalize the treatment of corporations and individuals.

- As a consequence of several inconsistencies in the treatment of various sorts of income, the plan included *ad hoc* patches, such as a minimum income tax, limitations on the deductibility of interest, and a new surtax on distributions from retirement plans, that were sources of complexity and undesirable incentives.

- I foresaw that the accretion of such patches would only worsen in the future, as taxpayers followed their natural inclination to exploit inconsistencies in order to reduce their taxes and the rule-writers struggled to plug the gaps.

In that statement, I also suggested an alternative approach, a phased introduction of something I dubbed the *X-Tax*, a close relative of the Flat Tax that is being debated today, arguing that this consumption-based system represented the sort of genuine transformation of the tax system that was called for.

Ten years later, it seems to me that the predictions have been borne out. And my advice for how to proceed from here is much the same.

It may seem that tax reform is always with us. I am hopeful, however, that these hearings reflect the approach of a critical mass of those who favor a thoroughgoing reorientation of the U.S. tax system around the idea of taxing on the basis of consumption, rather than income. In my few minutes, I would like to review with the Committee the main reasons it makes sense to have another go at fundamental reform and to explain why a consumption guidepost for writing tax rules provides the key for a tax system that is fundamentally fairer than the one we have now, that is vastly simpler and less intrusive in compliance, and that enhances U.S. living standards.

I will make two simple points:

- The present tax system should be viewed in the same light as other structures of regulation in our economy. In this case, the regulatory system is designed to define and protect the revenue base. Our tax regulatory system has become absurdly complex and counterproductive.

- A consumption-based tax offers the way to cut through the problems.

Why Reform Again?

In my earlier testimony (and in other testimony), I spelled out many reasons the tax system at that time was defective and should be reformed. Most of those reasons persist. Rather than reiterate those here, I would like to use three instances of problems in the present law as illustrations of the need to simplify and rationalize our tax system today.

Financial Innovation

The U.S. economy is extraordinarily dynamic. Innovation and flexibility are its hallmarks. Nowhere has innovation proceeded more rapidly than in financial markets. The ingenuity of Wall Street's rocket scientists is legendary.

The tax system relates to these developments in two ways. First, much of the ingenuity is directed toward obtaining the best tax results in connection with any particular economic activity. Indeed, some of the ingenuity is directed to making profit at the expense of the U.S. Treasury. Second, the tax rules get in the way of accomplishing new financial arrangements.

The week before last I participated in a colloquium at New York University Law School on the taxation of new financial instruments. Among the papers was one by a practitioner, David Hariton, in which he took as an illustration of the state of the law the steps involved in advising a taxpayer who owns low-basis stock and borrows identical stock and sells it short. This would seem to be a pretty straighforward, if not exactly everyday transaction. Having first established that any number of possible complicating characteristics of the taxpayer do not apply (the taxpayer is not a controlled foreign corporation, for example), Hariton goes on for nearly fifty pages of options that the tax advisor must resolve, rules that may or may not apply, apparent inconsistencies, and so on. It was quite a convincing demonstration that the law has become unworkable. If the most expert tax advisers cannot establish with certainty how a "plain vanilla" transaction is to be treated by the tax law, how is the IRS to enforce the law? Any particular result has to be essentially arbitrary.

Retirement Saving

When I started as an assistant professor at Princeton University a long time ago, there was a retirement plan that called for contributions that were graded according to age, one rate up to age 30, another to age 40, and the highest rate over age 50. At some point Princeton changed its plan, but let existing faculty elect to continue on the "old plan." The new plan was more generous up to age 50 and less generous than the old plan after age 50. I chose to stay on the old plan. By the time I reached age 50, most faculty members were on the new plan. Those of us who had survived so long at the University were, perforce, in the senior and hence better-paid ranks of the faculty. At that point it was determined that the old plan discriminated in favor of better-paid employees, and was therefore ineligible for favoral tax treatment. We had to switch to the new plan, notwithstanding the fact that we had just reached the point where our persistence in the old plan was about to pay off!

Believe it or not, my objective here is not to plead for relief from this injustice, but simply to call attention to one of the most complex areas of the tax law. Practitioners know how difficult it is to assure compliance with the law, and how much talent is devoted to designing plans that fit within the regulatory constraints. Yet the contractual relations between employer and employees serve a large variety of economic functions. As with financial innovation, we are, on the one hand, wasting resources figuring out how to make the arrangements that most exploit the tax advantages, while staying within the law, and on the other hand, tying the hands of our employers and employees in reaching the most effective compensation arrangements.

Capital Gains

My third example probably explains itself: capital gains. It used to be said that half of the business of a tax accountant or lawyer was converting ordinary income to capital gains. The other half was converting capital losses to ordinary income losses. This was especially true when the difference in the rate of tax applied to the two types of income was larger than it has been until recently. But the difference has widened again. And in any case, because of the necessity to limit capital losses, the rules that distinguish the income according to its ordinary or capital gain "character" have continued in force and account for many inches of tax law books.

In view of the interminable controversy about capital gains taxation, it need hardly be said that the rules involve much more than fees for accountants and lawyers, but enter into every aspect of the business life of the country, with costly effect.

All three of these examples have in common that they are sources of great complexity and impose serious costs on the U.S. economy. These costs are not borne just by the businesses and individuals who must directly comply with the rules in question. Like banking laws or securities laws or telecommunications regulations, the costs that they impose are spread throughout the economy, striking workers and consumers at all income levels.

The second thing these three examples have in common is that the harm they cause could be easily avoided by adopting a consumption-based tax system.

Why A Consumption-Based Approach Offers the Solution

Cash-Flow Accounting Gets the Right Answer in a Consumption-Based Tax

Tax specialists generally take as a standard an idealized concept of a person's income, often referred to as *accretion* income. Accretion income is defined as the *sum* of what the person consumes during the year, and the *increase* in the person's *wealth*. The first component is, obviously, consumption, and the second is the economic definition of *saving*. So accretion income is defined as the sum of consumption and saving.

To the uninitiated, it usually seems odd that what theorists mean by income is something that looks more like *outlay* by the person on consumption and the acquisition of assets (or reduction of indebtedness). To the uninitiated, income is, logically, something that comes *in*, like wages or dividends. This view is almost certainly what the enactors of the income tax had in mind, but in the process of trying to impose consistency on a variety of cash inflows (for example, the proceeds from the sale of an asset like a house), tax rule-writers concluded that it was the underlying power to consume, either exercised currently or accumulated for future exercise, rather than the flow of incoming cash, that constituted the essence of income as a measure of ability to pay. So income tax rules are designed to take information on transactions such as receipt of wages or dividends or the proceeds of the sale of an asset and convert it to a measure that reflects the sum of a person's consumption and saving (increase in wealth) during the year.

In an ideal income tax accounting system, all changes in a person's wealth are tracked and subjected to tax (or tax relief, in the case of a decline in wealth). In the practical income tax world, not all wealth changes are taken into account. The unrealized capital gain in a person's portfolio of stock is a notable example. But practicality is not the only reason the actual tax system contains many deviations from accretion income. The special rules that apply to retirement savings, for example, are intended to alleviate the burden on saving that is characteristic of an income tax. Indeed, one could say that the existing system is notable mainly for its remarkable *inconsistency* in taxing accruing income. To cite just one other example, the corporation income tax, viewed as part of a system to measure and tax people's income, is largely uncoordinated with the individual income tax.

In comparison with a consumption-based tax, an income tax is inherently difficult to administer because in order to tax income consistently accruing wealth has to be measured. By contrast, correctly taxing consumption requires simply keeping track of cash flow.

The importance of this apparently technical, accounting point cannot be exaggerated. The hardest part of measuring income is tracking changing wealth.

Again, capital gains provides a good example. If for no other reason than that it is impractical to measure what has happened to the value of a person's assets except when they are actually sold, gain or loss is taken into account only at that point. This would not necessarily be serious except that where rules for measuring accruing wealth are inconsistent, there is generally an opportunity for taxpayers to profit by taking offsetting positions. One position produces a current loss on the tax accounts, while the other position produces an equivalent gain that is deferred into a future year. Positions that are exactly offsetting from a true economic point of view, are not offsetting from a taxable income point of view.

To plug the revenue leak, Congress and the Treasury have to write special rules. Because there is always some inconsistency left, taxpayers devise further ways to profit at the expense of the fisc. The tax-rule writers are always playing catch-up ball, and the system becomes more and more and more complex.

Contrast this accounting problem with the way a sequence of transactions leading to a capital gain is properly taxed in a consumption-based system. There are basically two possible approaches: Either the cost of the asset is deducted from the tax base at the time it is acquired, in which case any cash proceeds arising by virtue of holding the asset, including the proceeds of sale of the asset, are included in the tax base. Or the cost of the asset is not deducted on acquisition, and the return flow is ignored in the calculation of tax. (This would, for example, be the way the transaction would be treated under a value-added tax.) Either approach is simple, gives rise to no special incentive effects (such as the lock-in effect that characterizes the realization treatment of capital gains in the present tax system), and gives the right answer. In a consumption-based system, we could throw away the distinction between ordinary income and capital gains. Think what that would do to the law books. Think what it would do to the everyday economic affairs of the country.

The rules relating to retirement saving alluded to in my second example, compose another extremely complex area of current law. In this case the source of the problem is the special treatment of retirement saving that we have adopted as a matter of policy. Qualified retirement saving is accounted for on consumption-tax principles: the amount saved is deducted from income (or simply not included, when it is put aside by the employer), and no tax results until there is a cash flow to the beneficiary at the time of retirement. This cash-flow accounting is an entirely natural approach. But it is inconsistent with proper accrual accounting, which would not allow a deduction for (or exclusion of) the amount put aside, would tax the earnings on the savings as the amount grew over the years, and would not tax the benefits, any more than withdrawals from one's savings account are subject to tax.

"Proper" accounting for the pension saving probably sounds bizarre to anyone other than an income tax expert, and I would guess that the treatment of qualified pension plans was thought of as no more than the natural way to handle them when the income tax was young (and had low rates). The problem is that the inconsistency in treatment of this form of saving and, say, putting money in a savings account, meant a payoff to tax planning. There was money to be made by borrowing with the left hand and putting the money away in pension savings with the right hand. The taxpayer's true economic position was unaffected by this combination, but it gave rise to deductible interest payments currently, offset by an inclusion in income in the future.

Games of this sort are worth more, the higher the applicable tax rate and the lower the cost of the needed transactions. When tax rates got high enough, the needed transactions began to be available more cheaply and those with the highest tax rates took most advantage of tax-deferred retirement saving. The result was the phenomenon of highly paid executives making extensive use of pension savings, while low paid rank and file workers did not. Policy makers saw in this absolutely predictable pattern of use of pensions an unfair distribution of a "tax preference," and so we have "anti-discrimination" rules, some of the most arcane provisions of the tax code.

In a consumption-based system, cash-flow treatment of retirement saving is nothing more than one of the two correct and consistent ways of accounting. In a consumption-based system, we could throw away the antidiscrimination rules, along with all the other

retirement income regulations (insofar as their purpose is to limit the use of the "tax preference" in the current system).

A Consumption-Based Tax Is Feasible

Currently, there is active discussion of three reform plans:

- a retail sales tax or a value-added tax,
- the Flat Tax,
- the Nunn-Domenici Unlimited Savings Allowance (USA) Tax.

In terms of implementation, these three reforms have certain features in common. The first approach, a retail sales tax, is a proportional tax paid by businesses. The second and third, the Flat Tax and the USA Tax, both constitute integrated systems, consisting of a proportional tax paid by businesses, more or less similar to a value-added tax, and a personal-level tax, along the lines of the existing individual income tax. In the case of the Flat Tax, the individual tax is imposed only on a person's compensation, such as wages and salary. The individual-level tax in the USA system is an example of what has come to be called a "consumed income" tax, which is to say, it is based on something like the present taxable income with a deduction for net saving (and inclusion of net dissaving).

All three systems are conceived of as replacements for the federal income tax, both corporate and individual. In addition, the USA Tax integrates the social security taxes through a system of credits. All three approaches would shift the U.S. tax system to a consumption base.

Why a Consumption-Based Tax is Fairer Than an Income-Based Tax

It seems to me that the fairness of a tax system is its most important property. If people do not feel that the tax system is fair, they will try to evade the tax, or they will change it through the political process.

Fairness is, however, not a scientific concept, something that we can measure objectively. Some people think the tax system should be more progressive, some less. Some think there should be better provision for charities, or older citizens, or children. The choice between income and consumption as a tax base is independent of these debates.

The administrative advantages of a consumption-based approach really cannot be denied. But clearly administrative advantages are not the only important characteristic of the tax system. Do we perhaps need to accept the huge complexities and wasteful incentives in the present system in order to serve the goal of fairness in distributing the burden of tax?

Many people feel that an income tax is the fairest tax, but that we should adopt a consumption-based tax because it would encourage saving. I disagree with this on several counts. Most important, in my view, a strong reason for adopting a consumption tax is that it is fairer than an income tax.

The central issue is this: As between two people *who are similarly situated in terms of their economic opportunities*, the tax system should not assign a greater tax burden to the person who postpones consumption, relative to the person who consumes in the present.

It seems to me that an argument could be made that the person who postpones consumption, saves, in other words, should be rewarded with a lower tax burden. To listen to the rhetoric about encouraging saving, one would think this would be the position most people would take. I, myself, think that people should be free to decide for themselves, neither rewarded nor penalized by the fiscal system for their choices. That is, in my view, savers and dissavers should be treated alike.

An income tax, by its nature, penalizes savers. To me, this seems inherently unfair. A consumption tax imposes the same burden on the saver and the dissaver. (I

would not describe them as saver and consumer, because the matter is one of timing. The present saver is a future consumer.)

To be sure, the unfairness of an income tax, relative to a consumption tax is not fatal. The two tax bases have much in common. But of the two, the consumption base seems to me to occupy the high ground on the criterion of fairness.

There are many plausible arguments to the contrary. Most of these concern progressivity and are based on a mistaken view that a consumption-based tax is less progressive than an income-based tax. Progressivity is a characteristic that is designed into a tax system (or, rather, into a fiscal system more broadly conceived, encompassing expenditure and transfer programs as well as taxes). There is nothing that makes an income tax inherently more progressive than a consumption tax. The degree of progressivity is a policy choice under either approach.

Under some versions of consumption taxes (for example, the Flat Tax), people are not obliged to report and pay taxes on dividends, interest, or capital gains. It is not surprising that observers would conclude that such a tax must not be very progressive. One imagines a millionaire, sitting on his terrace sipping a Martini, not paying any taxes. But the image is a trick and the conclusion is false, because it is based on reasoning that stops short of looking behind the dividends, interest, or capital gains to the tax treatment of the businesses that create them.

I am told that the American electorate will never be able to understand this point. It may be so, but I doubt it. I think that if political leaders thoroughly grasp the way a consumption-based tax system works, they will themselves be convinced of its superiority and will in turn be able to convince the electorate.

As in other realms of policy, one might decide to impose an unfair tax system if it were needed to serve some other public purpose. But the contrary is the case. On all other counts -- administrability, compliance cost, interference in economic decisions -- an income tax (even a much more consistent one than ours) is inferior to a properly constructed consumption tax.

Why a Consumption-Based Tax is Conducive to National Prosperity

The advantages of a consumption-based tax in terms of improved incentives to save and invest, and, equally important, in terms of equalized treatment of investments of all types and by all people, are going to be emphasized sufficiently by others on today's panel. I would like in this connection simply to reiterate the advantages of the reduced regulatory burden. By replacing an outdated and unnecessarily costly regulatory system with a consistent, simple system, we can reap gains for everyone in the U.S. economy. This is the true meaning of international competitiveness, and it has the advantage of allowing us to gain at no cost to the rest of the world. Indeed, if the rest of the world follows our example the benefits will be multiplied.

I hope the time is approaching when we will make the move.

Chairman ARCHER. Thank you.

Our last witness is Gary Hufbauer.

STATEMENT OF GARY C. HUFBAUER, REGINALD JONES SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. HUFBAUER. Thank you, Mr. Chairman.

I want to generically refer to all the proposals for reform—the retail sales tax, the flat tax and the U.S.A. tax—I want to refer to all of them as taxes on business activity. My statement concentrates on the business side, not the personal side, of tax reform.

There are two strong arguments for a TBA system, a tax on business activity. One is the savings/investment argument. A TBA system will boost savings and investment. And the second argument is the complexity argument. A TBA system will cut through our grotesquely complicated tax system.

I have been invited to discuss the international side of a tax on business activity. There are two broad principles of dealing with the international side of a tax on business activity. One is the so-called destination principle of border tax adjustments. I realize that is a mouthful. The destination principle taxes goods and services where they are used or consumed. What that means, in practice, is that goods or services exported from the United States would be relieved, exempted of any of these TBA taxes. The goods and services will be taxed, if at all, where they are consumed—Germany, Japan, or wherever.

Conversely, goods and services imported into the United States will pay a tax at the border when they come into the United States. Some services will arrive electronically, for example, value-added telecom services. Merchandise will arrive at the various customs districts. Taxation upon arrival is the destination principle.

There is a second principle of border tax adjustment. It could be called a principle of nonborder tax adjustment. Under the origin principle, goods and services are taxed only where they are produced. In the case of a tax on business activity paid in the United States, there would be no adjustment when the goods and services are exported and, conversely, when goods and services are imported there would be no tax placed on them at the border.

The origin principle is the current system with respect to the corporate income tax. We do not remit the corporate income tax when goods and services are exported that are produced in the United States, and we do not impose a corporate income tax on goods and services that are imported from abroad.

Let me discuss quickly how these two different principles deal with three important issues: First, how the principle chosen deals with price distortions which are a feature of nearly every tax system; second, how the principle chosen affects the trade balance, sometimes referred to as the current account balance; and third, how the principle chosen facilitates the transition from one tax system, namely what we have today, to a new tax system, one of the TBA reform proposals.

So, first, the price distortion question. A choice must be made between two evils, if you will. One is distortion of prices in consumption. The origin principle minimizes price distortion at the consumption level. This principle means that the prices in the United

States will be largely dominated by world prices, because goods and services will be imported at world prices, and U.S. exports must be priced to meet world prices, so that export firms will tend to price the same in the United States as they price abroad. So the origin principle minimizes distortion at the consumption level.

But the destination principle minimizes distortion at the producer's level. What the destination principle does is ensure that producers, when they sell abroad, get world prices because the U.S. taxes don't affect them. Meanwhile, when goods and services are imported, consumers pay U.S. tax at U.S. rates, so U.S. producers are not disadvantaged by comparison with their foreign competitors.

Between these two principles, I think it is much more important to minimize price distortion at the producer's level. If there are questions of why that is so, I can give some examples. They are set forth in my testimony. I think reflection will show that reducing price distortions facing producers is a much more important principle in our economy. For that reason, I favor the destination principle.

Let me quickly turn to the issue of impact on trade balances. Briefly, choosing one or the other of these principles will make no longrun difference in the trade balance. The U.S. trade balance is determined by our savings and investment decisions. The change in the tax system will change those decisions. That will affect the trade balance; whether we choose the origin or destination principle will not make a difference. It may make a difference in the extent of necessary exchange rate adjustments, but that is all. So I would dismiss trade balance arguments as a reason for choosing between these two principles.

Let me come to the critical reason for favoring a destination principle approach, and that is the transition from the old system to the new system. Any transition will entail higher taxes on some producers than they pay today. And those producers will be extremely concerned about being disadvantaged in world markets, disadvantaged when they export because they are paying higher taxes than they were before, and disadvantaged by comparison with competing imported goods and services because they are being taxed and their import competitors are not.

So I think it is terribly important to have the destination principle border tax adjustment for a new TBA system. I think that the ability to have destination principle adjustments should work into the evaluation of the various TBA systems.

I think it is quite clear that the retail sales tax is adjustable at the border under the destination principle. I think the U.S.A. tax is also adjustable. However, I have not had time to study the flat tax in this important respect.

Thank you.

[The prepared statement follows:]

TESTIMONY OF GARY C. HUFBAUER
INSTITUTE FOR INTERNATIONAL ECONOMICS

A TAX ON BUSINESS ACTIVITY AND BORDER TAX ADJUSTMENTS

It is a pleasure to appear before the Committee. Today, I intend to briefly discuss the international consequences of reforming the current tax system by replacing large portions of the current system with a tax on business activity (or TBA system).[1] There are two strong arguments for a TBA system: it should increase private savings and investment and it would certainly simplify the grotesquely complex U.S. tax code.

Over the past decades, various TBA systems have been proposed. In 1969 President Nixon considered a federal VAT to finance the reduction in local property taxes or the federal corporate income tax. Other initiatives were considered in the ensuing two decades. More recently, in 1993, Senators Sam Nunn (D-Ga) and Pete Domenici (R-N.M.) propounded the Unlimited Savings Allowance Income Tax System (the USA Tax) and, in 1994, Representative Armey (R-Tx) proposed a flat tax.

My testimony focuses on five issues related to a TBA system:

1. To what extent a TBA system would promote savings and investment.
2. Different principles for adjusting taxes at the border.
3. How border adjustments compensate for price distortions.
4. Whether border adjustments would affect the trade balance.
5. How border adjustments would facilitate the transition to a new tax system.

1. Promoting Savings and Investment

A TBA system would encourage savings and investment. The rationale is simple: unlike the present system, savings and investment would either be untaxed, or taxed at a lower rate, under a TBA system.

A higher U.S. savings rate is widely regarded as an essential ingredient for maintaining annual economic growth at 2.5 to 3.0 percent over an extended period of time. The Competitiveness Policy Council recommends an increase of the national savings rate by 5 to 7 percentage points of GDP in order to finance larger national investment, and hence a higher trend rate of growth.[2] The U.S. investment rate has long been lower than the rates of other G-7 countries. For the other G-7 countries in the 1980s, the unweighted average gross investment rate was 22 percent of GDP versus 19 percent in the United States.

Low U.S. investment rates are directly attributable to the low U.S. savings rate. Even in today's world of high capital mobility, low domestic savings lead to low domestic investment. OECD statistics show that the United States now has one of the lowest gross savings rates of any G-7 country: gross saving as a proportion of GDP averaged 18 percent in the 1980s compared with an unweighted average of 21 percent for the other G-7 countries.[3]

Nearly everyone agrees that reducing the federal deficit is a sure way to raise national savings, at least by 2 or 3 percentage points of GDP.[4] Between the 1960s and the 1980s, the U.S. public accounts (federal, state and local combined) dropped from a positive 1.9 percent of GDP to a negative 2.9 percent of GDP.

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[1]For further analysis, see Gary Hufbauer, assisted by Carol Gabyzon, Border Tax Adjustments and the USA Tax, Institute for International Economics (unpublished), April 1995.

[2]Competitiveness Policy Council, Promoting Long-Term Prosperity, Third Report to the President and Congress, May 1994.

[3]OECD, OECD National Accounts, Paris 1994.

[4]See for example, Competitiveness Policy Council, Promoting Long-Term Prosperity, Third Report to the President and Congress (May 1994).

Recent federal budget decisions, with the implied reduction of public spending, seem likely to reverse this path.

Few if any TBA advocates suggest that a tax on business activity should be added to the existing tax structure. Instead, they see the TBA system as a replacement for personal and corporate income taxes. The debate, therefore, concerns the impact of a revenue-neutral TBA system both on private savings -- namely the combination of household savings (e.g., pensions) and corporate savings (retained earnings) -- and on private investment.

The savings impact of a TBA system depends on how the new system changes private behavior. My opinion is that heightened public awareness of the importance of savings that would come with an historic shift from income taxation to the TBA system would make a positive difference in total private savings of 2 to 3 percentage points of GDP.

By enlarging the US savings pool, a TBA system would indirectly promote investment. In addition, a TBA system would directly spur investment because investment outlays would be expensed immediately. My guess is that the spur to gross investment rates might amount to 2 percentage points of GDP.

2. Principles of Border Tax Adjustments

Adjustments at the border for taxes on goods and services are an established practice in international trade. During the last two centuries, national laws and international agreements have progressively enlarged the scope of permissible border tax adjustments. The rules have been articulated both in national legislation and international agreements such as the Uruguay Round Agreement on Subsidies and Countervailing Measures.

Border tax adjustments are based on the destination principle of taxation which calls for taxing goods or services shipped across an international border only in the jurisdiction where the goods or services are consumed. The destination principle is applied via the non-excessive remission (or exemption) of taxes when goods or services are exported and the equivalent imposition of taxes when like goods or services are imported.

By contrast, the origin principle of taxation calls for the taxation of all goods and services only in the country of production, irrespective of where the goods or services are consumed. Under the origin principle, there can be no remission (or exemption) of taxes when goods or services are exported and there can be no imposition of corresponding taxes when like goods or services are imported. In other words, under the origin principle, there are no adjustments at the border.

There are three main consequences of the choice between the destination principle (which complements taxation at the consumption stage) and the origin principle (which complements taxation at the production stage):

- How the principle chosen addresses the price distortions which are an inevitable complement of almost all tax systems;
- The extent to which border adjustments affect the trade balance; and
- The extent to which they facilitate the transition between tax systems.

3. How Border Adjustments Compensate for Price Distortions

Nearly every tax system distorts prices in an economy. The question therefore is which principle of border adjustment -- the origin principle or the destination principle -- better compensates for tax-induced price distortions.

In select circumstances, the choice between the destination and the origin principle in fact makes no difference. If the tax in question is a general tax, namely one that applies proportionately to all goods and services produced in the economy, or to all factor incomes earned in the economy, and if all prices

and wages are flexible, and if factor supplies are inelastic, then in the long run it makes no difference to a country's economic structure whether it chooses the origin or destination principle. Under these highly restrictive circumstances, the underlying tax system will not distort relative prices, and any border adjustment is akin to an exchange rate change.

However, in most circumstances, these restrictive conditions are not met, and thus the choice between border adjustment principles has important economic implications. Moreover, the short run matters as much as the long run, especially when making big changes from one tax system to another. To be specific, the origin principle will minimize price distortions facing consumers, since purchasers can still buy at world prices. By contrast the destination principle will minimize price distortions facing producers. In my opinion, it is far more important to minimize price distortions facing producers.

Talk of "price distortions facing producers" is, in fact, a rather antiseptic way of describing real world events. For example, if U.S. producers of computer software must pay a 10 percent tax on sales, when other U.S. products are taxed at 5 percent, and if sales taxes are not adjusted at the border, it seems very likely that U.S. software firms will decide to make their diskettes in Canada, Korea, or France. The reason is that any compensating exchange rate change will not affect the heavily taxed computer software firms any more than it affects the average sector. Therefore, computer software firms will have a harder time retaining skilled workers. The result will be the closure of plants in places like Seattle and Boston -- costing thousands of jobs. In other words, when it comes to taxes that are unevenly applied to different activities, only the destination principle can effectively prevent the contraction of industries that are more heavily taxed than other sectors of the economy.

In this example, destination principle border tax adjustments will give a larger export exemption to computer software firms (10 percent) than to average firms (5 percent). Correspondingly, it will apply a higher compensating tax on imported computer software (10 percent) than on average imports (5 percent). These differences will enable Seattle and Boston to retain their competitive edge in the computer software industry. The same illustrative example would be relevant if a shift from tax system A (the current US tax code) to tax system B (a TBA system) resulted in a bigger tax increase on computer software firms than on average U.S. business firms.

To some degree, national and international rules have evolved to accommodate these practical concerns about output effects. Indirect taxes can normally be adjusted at the border. Since the core definition of indirect taxes includes excise and sales taxes, a country can elect to apply the destination principle to those taxes that most conspicuously differ in their burden from sector to sector. However, international rules do not permit direct taxes to be adjusted at the border. Corporate income taxes and social security charges often differ considerably from sector to sector, but variations in their burden cannot be compensated by destination principle border adjustments since these taxes are defined as direct taxes.

The Uruguay Round Agreement on Subsidies and Countervailing Measures makes the distinction between direct and indirect taxes as follows:

> Direct taxes are defined as "...taxes on wages, profits, interests, rents, royalties, and al other forms of income, and taxes on the ownership of real property..."
>
> Indirect taxes are defined as "...sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges..."

Where do TBA systems lie on the spectrum between direct and indirect taxes? I cannot comment on all TBA systems, because I

USA Tax, and I am convinced that it is adjustable at the border under current GATT (WTO) rules. The reasons are spelled out in another paper.[5]

4. Impact on Trade Balances

Many businessmen see destination principle border tax adjustments as conducive to a national trade surplus. However, in the long run, the choice between origin principle and destination principle border tax adjustments exerts little or no impact on national trade balances. Instead, trade balances reflect savings and investment balances in each national economy.

The structure of a country's tax system may alter its savings and investment balance; if so, there will be an impact on its exchange rate and its trade balance. But whether or not taxes are adjusted at the border will have little effect on these fundamental forces. If the tax system is reformed, and if the reform alters the balance between savings and investment, and if the new taxes are not adjusted at the border, then the country's exchange rate will change to accommodate the new tax system. Conversely, if the new taxes are adjusted at the border, then the exchange rate may not have to change so much to accommodate the new system. As far as the trade balance is concerned, therefore, destination principle border tax adjustments can be seen as a substitute for exchange rate changes.

To summarize: border tax adjustments are not required to ensure that the trade balance responds to the new savings-investment balance. However, border tax adjustments may facilitate the required adjustment and require less move in the exchange rate.

5. Facilitating the Transition to a New Tax System

These statements about the interchangeability of border tax adjustments and exchange rate changes are sound as long-run technical propositions, but they miss the short-run political economy of radically reforming a country's tax system.

The fundamental reason for border tax adjustments is neither to alter the nation's trade balance nor to find a substitute for exchange rate adjustments. The fundamental reason for border tax adjustments is to deal with the burden on sectors that are more heavily taxed under the new system than the old. Any TBA system will impose higher taxes on many business firms than the current corporate income tax, both because some firms pay little or no tax under the present complicated system and because, under some TBA systems, a larger portion of wage taxes will be paid at the corporate level.

Producers that suddenly find themselves paying more taxes than before will inevitably (and rightly) worry that the new TBA system will erode their ability both to sell abroad and to meet the competition of foreign firms in the U.S. market. This fear is best answered by destination principle border tax adjustments. Such adjustments will help many U.S. firms accept reform of the U.S. tax system. In fact, it is no exaggeration to say that, without the feature of destination principle border adjustments, it may be impossible to gather the requisite political support to enact a TBA system.

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[5] See Gary Hufbauer, assisted by Carol Gabyzon, Border Tax Adjustments and the USA Tax, Institute for International Economics (unpublished), April 1995.

The views expressed in this statement are those of the author and do not necessarily reflect the views of individual members of the Institute's Board of Directors or Advisory Committee.

Chairman ARCHER. Thank you, Mr. Hufbauer.

I understand that both Dr. Boskin and Professor Bradford have to leave in 10 minutes. Do you have any other time constraints, Mr. Hufbauer?

Mr. HUFBAUER. I can stay.

Chairman ARCHER. I would ask that in the limited time available for Dr. Boskin and Professor Bradford that the questions be directed to them.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

Dr. Boskin, you raise the problem of the mutability of the Tax Code in your testimony, and it seems that over and over again in our history we have been subjected to a bait-and-switch technique where there is a flat, low tax imposed and then the rates go up, most recently in 1986 when the deal was that the many deductions would be eliminated in exchange for lower marginal rates which are now more than 40 percent higher than they were at the time.

As we try to get this right, can you advise us as to how we can protect against this phenomenon and the related phenomenon of putting more loopholes in the Code as the nominal rates go up?

Mr. BOSKIN. I think that is a very good question.

I think there are two things. I personally favor a supermajority for tax rate increases. I know that has been discussed and is under consideration, and I would hope there would be an opportunity for the Congress to reconsider that in and of itself, perhaps even in House rules, as opposed to just as a variant of a balanced budget amendment.

Second, in the reform that you move to, if your reform really ties and makes obvious that the taxes are the cost of financing government spending, it seems to me that will exercise some constraint through the taxpayers.

One problem we ought to be worried about is if taxes are very much hidden. There are people who complain that withholding does that in the existing system or that a value-added tax might be somewhat hidden. I personally think that we need to make it more obvious that the tax system is the price we are paying for government spending—or the current taxes and the future taxes, if we are deficit spending, are the price we are paying. And I think that will help ensure that the taxpayers themselves will exercise great restraint through their voting in elections.

Mr. ZIMMER. Mr. Bradford, do you have any thoughts on that?

Mr. BRADFORD. I would join Mike Boskin in saying something like requiring a supermajority for rate changes would seem a reasonable thing to do. One reason it is very important is not simply that politically one may like lower rates, but also in a tax system of the type we are talking about, the incentive effect on investment is very strong. If you anticipate an increase in the rate, let's say, of a value-added tax or a retail sales tax or flat tax, there is a strong incentive to postpone investment; and it would be very important from the point of view of the stability of the economy to assure against very sharp increases in rates. And decreases are mischievous, too. So I endorse that idea.

There is another possible mechanism that could be built into these systems, and that is, in effect, the use of the IRA-type device,

which allows people, in effect, to lock in the rates that prevail at the current time. That would be too far afield to discuss that further now, but I think that could also have a stabilizing effect and that could be very important.

Mr. ZIMMER. Professor, I appreciate your being here, Princeton is in my district. I appreciate your clarity. I must confess that Princeton is the only community in my district where people complain that taxes are too low, but not necessarily their own taxes.

Let me ask you a fundamental question, both of you. When we considered the tax cut legislation earlier this year, some of our friends on the other side of the aisle differed with us on one of our principal premises, which is that changing the Tax Code can actually encourage savings and investment and economic growth. What would you say to those people and how can you convince them that in fact that will happen?

Mr. BOSKIN. I think there is no doubt fundamental reforms like moving to a retail sales tax or VAT or perhaps even to a flat rate, consumption-based income tax would increase the rate of savings and that would have all sorts of beneficial effects. The way I tie together the issue of a tax cut, why we are trying to slow the growth of spending to balance the budget is—the reason we want to reduce the deficit, in addition to the moral reason about liabilities to our children and grandchildren, is to free up saving to make it available to finance investment, so we reduce the government's drag. If you can, through capital gains rate reduction or an IRA or something of that sort, raise private saving—one of the two reasons we have the lowest national saving rate of any country in the world if we could simultaneously do that, then you are accomplishing with another leg of the stool the exact same purpose. That is how the two tie together.

If we could have prosaving, proinvestment, progrowth tax rate reductions and get enough spending cuts to finance them in the short term, before they have a chance fully to kick in and help the economy grow, those two policies complement each other. They are not substitutes.

Chairman ARCHER. The gentleman's time has expired.

Mr. McCrery will inquire and he will be the last inquisitor for Professor Bradford and Dr. Boskin.

Mr. MCCRERY. Thank you, Mr. Chairman.

I have a question that neither of you may want to answer, because Mr. Hufbauer punted on it. The question is "have you looked at the flat tax in terms of our ability to adjust it at the border under GATT rules"? Have either of you done that?

Mr. BOSKIN. I have thought about it. I am not a trade lawyer, but I do believe it is an open question. It may not be.

Mr. BRADFORD. I have the same impression. It is very much a legal question, as you have probably heard from other economists. Economists think, at least this economist thinks, that the distinction on which the rebatability or not of a tax turns is fundamentally a legal and not a real economic one. A tax that looks one way will be rebatable, and if it doesn't look right, it won't be even though it is economically equivalent.

I think that is the situation with the flat tax. The flat tax is economically identically equivalent to a value-added tax and should

therefore be rebatable. I am talking about the business tax rate on all exports and subject to imports, according to the same rationale as applies in the case of a value-added tax. I think it is very much an open issue, legally.

Mr. McCrery. As economists, do you think it is important that we consider that as part of the debate?

Mr. Boskin. I do. Gary sort of said this only affects the trade balance through its beneficial effects on the saving rate, and I would agree with that beneficial effect on balance, on the trade picture. But the notion that somehow this washes in exchange rates envisions a regime of permanently totally flexible exchange rates that totally adjust or a major adjustment in domestic prices. I think the world we live in now is a little bit different than that, and there is a lot of fixing and a lot of pegging and a lot of attempted intervention. So it is something that ought to be considered, but I also wouldn't assume that there would be no adjustment at all in exchange rates.

Mr. Bradford. I think I would be more on the side of saying it doesn't make much difference, but I would agree that the issue where it does make a difference is a matter of transition. Which way we did it wouldn't make any difference 5 years from now. But there are significant differences in the administrative problems that arise. For example, if you have a border tax adjustment and you have a tax of any significant size, or even not too large a size, you then have to assess the tax on the way in and you have all the problems of checking at the border when goods come in, the same as applying a tariff. Tourists would have to declare their goods and so forth. There are problems of that kind and differences in implementation that do matter.

For example, as to where you choose to locate a business, there can be a difference in the way these two taxes work out as a matter of implementation, and I think it is important to pay attention to that.

Mr. Boskin. I would stress that in today's world a larger fraction of firms and more and more industries find it easy and less costly to spatially separate their headquarters from their manufacturing, from their R&D, from their sales and marketing, and so forth. So I would be a bit concerned about being careful that any change we made in its border tax adjustments and its international features didn't wind up creating an additional incentive for firms to outsource some of their activity outside the border.

Mr. McCrery. Thank you, Mr. Chairman.

Chairman Archer. You gentlemen are 4 minutes past your deadline. I just want to quickly ask you this—when you responded to the flat tax, as to whether it is adjustable at the border, what is your definition of a flat tax?

Mr. Boskin. The definition I was using was the kind of Hall-Rabushka archetype that apparently forms the basis for the generic proposal that Majority Leader Armey has proposed, which I think has not been fully specified as yet. And the business side of that has a feature whereby capital income is taxed and wages are deducted and business investment is expensed in the year it is acquired. So it is from an archetype, not from a proposal that I have seen written down by the Joint Committee and laid out in law.

There are many other ways to have a single tax rate besides that, and various people have exemptions and deductions and other things they propose and other ways they would go about taxing some income at the business level, some at the personal level. I was responding to that generic idea, which is perhaps more common in academia.

Mr. BRADFORD. I would say the same. I have in mind the flat tax proposal that was authored by Robert Hall and Alvin Rabushka and appeared about 10 years ago and I think is the basis for systems currently under discussions as flat taxes.

Chairman ARCHER. Isn't that just a modified way to tax income?

Mr. BRADFORD. Yes.

Chairman ARCHER. I am not a legal scholar on GATT either, but it seems to me that when you are just having a modified method of taxing income, they are going to rule that that is not border adjustable and GATT-legal.

Mr. BOSKIN. That is definitely the argument. I think legally that is right, but I am demurring because I am not a lawyer.

Chairman ARCHER. David, I know you have to leave. I want to give you the opportunity to leave; and Dr. Boskin, if you need to leave, certainly take advantage of that.

Mr. BRADFORD. I think I had better go. Thank you very much.

Mr. BOSKIN. I will be happy to take a few more questions.

Chairman ARCHER. Would you like to respond to that, Mr. Hufbauer?

Mr. HUFBAUER. Since this has become an item of interest to Mr. McCrery and yourself, let me summarize what is a very complicated debate.

First, concerning a retail sales tax, there will be no issue in terms of the international rules whether it is or is not adjustable. It is adjustable; that is established international practice. I have a long paper I can give you on that matter.

Chairman ARCHER. Isn't that virtually a sine qua non, inasmuch as a sales tax wouldn't be charged in the first place and wouldn't have to be rebated?

Mr. HUFBAUER. When I use the word "rebate," I include both exemptions and remission. The retail sales tax follows an exemption approach.

Second, concerning the U.S.A. tax, if enacted and if we had destination principle adjustments for it, that will entail a big fight in the WTO. It will be a big issue internationally, and there will be a panel proceeding. When I say it is "adjustable," that is my judgment of how a fairly long international panel proceeding will come out. It will come out that the U.S.A. tax is adjustable. It is similar enough, in its business tax application, to the credit invoice VAT, that it will be adjustable.

The reason I raise a flag of doubt in the case of the flat tax as the one you referred to by my colleague Mr. Bradford, is under the flat tax, wages are a business deduction, which is not true in the case of the U.S.A. tax. With wages being a deduction, the flat tax as imposed on business firms has an appearance which is closer to the corporate income tax than the VAT.

And that is why the battle for destination border tax adjustments for the flat tax will be harder to fight, and harder to win, on legal

grounds. Let me take 1 more minute to step outside of current GATT law.

I also ventured the opinion, and I stick with it, that if the United States undertakes a major reform in its tax system, and if we determine that we want to adjust the new taxes at the border, the WTO will in turn accommodate us. In other words, if we lose the legal case, but we still want to adjust the tax at the border, my belief is the WTO system will adjust to our adjustment.

Now, there will be a lot of consequences of that adjustment. I won't take your time to go into them. But I think ultimately we can, if we wish, adjust even the flat tax at the border.

Chairman ARCHER. I don't want to belabor this issue, but I really worry about your last comment, for the reason that in the case of a consumption tax, you can relate the tax percentagewise to the price of the product. In the case of an income tax, there is no direct relationship to the price of the product. And even if you go to a flat income tax, how do you know what to take off of the price of the product?

Mr. HUFBAUER. This is the core of the legal debate: How closely can you link the tax in question, levied on some kind of income concept, to a product price. And with the retail sales it is a nice and clear link, or at least people think the link is nice and clear, and as you segue over to income taxes, the link becomes less clear.

If a flat tax is truly flat, the U.S. Government can, in its legal proceedings, commission a lot of authoritative studies from eminent economists urging that the tax is passed on, akin to a retail sales tax, in product prices. Therefore, adjustment at the border is appropriate—here I am telescoping a very long debate here into a few sentences—and that argument gives us a possibility for winning.

But the less uniform the tax rate is, the more there are the kinds of loopholes and deductions we have in our corporate income tax system, the harder and harder it is to identify the tax with price shifting effects. In turn, that weakens the legal argument for adjustment at the border.

Chairman ARCHER. Thank you very much.

Mr. Rangel.

Mr. RANGEL. Thank you.

My question is one to both of you as economists. Do you believe that there should be any relationship in the type of tax collection system that we acquire to the type of services the central Federal Government would render?

The reason I ask the question is that I am constantly reminded that governments who use the value-added tax seem to be governments that provide a broader-based social service network. And I am not saying that that is the correct thing to do, but I am really asking, when you are determining a tax system that would be best for the United States, is there any relationship at all to the services that the government provides?

Mr. BOSKIN. Certainly, and the causality I think goes in both directions. If you have a very low-rate, broad-based tax, for example, you are causing much less compliance and distortion in the economy, so that weighs to being able to finance, if you can do it efficiently, other services.

Mr. RANGEL. When you say, Doctor, efficiently, I would want to really know, what would you think those services should be in the first instance. In other words, if we decide that we are not going to get involved in the health care industry, then I assume that someone else would have to think of how do you provide incentives to assure access to health.

Mr. BOSKIN. Well, I think that debate is one we will continue to have, and whether we should do a variety of reforms, allow the private sector to do that, or whether the Federal Government should primarily be an insurer—making sure everybody can have catastrophic insurance and so on, is not an issue I propose to get into here. But I think that is one that is worth enjoining.

My basic point is the history has been that when new tax devices are piled on top of old tax devices, they have not really replaced the old devices. So in my testimony earlier, in my introduction, I said, let's make sure if we move to a new tax which is superior in a number of dimensions, such as a broad-based consumption tax, let's make sure we don't wind up getting both, unless we really want to see a big expansion of government.

Mr. RANGEL. No, I am talking to you, both of you, on the basis that we are starting this thing all over. We are starting from scratch. We are not building on anything. And the question would be, if we were starting from scratch, would you not as economists want to know, well, what is it that you want to provide as a nation before you can determine the system that you are going to collect the revenues?

Mr. BOSKIN. You are exactly right. I say that in my written testimony, we ought to think of the tax system and the outlay side of the budget simultaneously, there is no doubt about that.

Mr. RANGEL. Great. Because my basic question would be, what—as you envision the most effective way and least complex way to collect the tax, what do you believe the national responsibility should be? Besides national defense, which is just number one, is there any other responsibility you think that we should have as a debit? Maybe for political purposes we will keep Social Security so you won't have to worry about that.

Mr. BOSKIN. Well, I think between the Federal and State and local governments, the proper assignment of authority, among which——

Mr. RANGEL. Stick with me, Doctor, because anything that we decide we are not going to do, we would assume that we are going to lower the tax base sufficiently so that local and State government could decide what they would want to do and pick up the taxes. So we will assume anything that we don't do, they can or cannot do.

But I am talking about in terms of mandates, entitlements, do you see anything that we should do as a Federal Government, besides national defense, and now that we are stuck with Social Security, we will keep that for a while, but anything else?

Mr. BOSKIN. Yes, I believe there are a variety of functions the Federal Government should either perform or finance. However, I do believe that in most instances, the Federal—not all, but in most instances the Federal Government has gone too far or they are projected——

Mr. RANGEL. I agree with you 100 percent, but we are starting from scratch. What type of things do you think that we should do?

Mr. BOSKIN. For example, I think there is a national interest in funding certain—in helping to finance certain types of research that individual firms cannot capture the benefits of and would not get done otherwise.

Mr. RANGEL. OK. So we are joined in——

Mr. BOSKIN. I think you have to be very careful about where you draw that line. I think everybody will come in and claim that their research satisfies. And that is a problem in all these cases, sure.

Mr. RANGEL. I know, but let me be more specific. How about education and housing and nutrition programs and health; you think they could come up to the priority of sharing in research?

Mr. BOSKIN. I am a strong believer in a humane but cost-conscious social safety net. I believe we have not been as cost conscious as we should be. We have transfer payments that transfer lots of resources to upper middle income and higher income people. And we are not doing as careful a job at targeting effectively, and from the recipient's point of view and efficiently from the taxpayers' point of view, in our broad social programs to provide that safety net.

Mr. RANGEL. My time has expired, but you are saying that we should continue some of these programs in a more effective way?

Mr. BOSKIN. Yes, although some of them I would devolve to the States, others I would continue at the Federal Government, others I would aim the slowdown in the projected growth of spending disproportionately at people beyond some minimum level of income.

Mr. RANGEL. Is that in your paper?

Mr. BOSKIN. Only the generic statement that we should be thinking about the outlay side of the budget and the tax side of the budget, both.

Mr. RANGEL. OK.

Thank you, Madam Chairlady.

Mrs. JOHNSON OF CONNECTICUT [presiding]. Thank you, Mr. Rangel.

Mr. Boskin, another way of asking the same question that my colleague from New York was discussing with you, is the following: Do you think the economic impact of an extremely simple system, whether it is U.S.A. tax or a VAT or whatever, is worth sacrificing any use of the Tax Code to encourage any specific activity?

In other words, is it worth eliminating the R&D tax credit, eliminating any mortgage deduction, eliminating any deduction for health premiums, any incentive for pension savings, any encouragement of education?

You know, those are all social policies that we pursue through the Tax Code. And as we talk about simplicity, and in your testimony you specifically said let's broaden the base and lower the rate, so if you are going to really broaden the base, you have to eliminate any incentives or any deductions. And those deductions currently go primarily to research, education, and to a much lesser extent some historic preservation. It is really education, research, home ownership, a few basic activities that we have put a very high value on in our society.

Do you support eliminating absolutely all of those?

Mr. BOSKIN. My own preference would be if we kept an income-type tax, although it wound up allowing an unlimited savings deduction, a la Nunn-Domenici, or the alternative flat tax approach which would exempt capital income and so on. Let me point out that those would provide more incentives for saving and so on than the current system does.

And while—a truly broad-based consumption tax, if you had everything, all consumption in it, would have a tax base that is far larger than the current base of the income tax, even though you are exempting certain things, because we have a tax base of the personal or corporate income tax is only a very modest fraction of personal income in the country.

There are obviously a large number of deductions, any one of which originally was put in for some noble purpose, and some of them may indeed be achieving some of those noble purposes. The two I worry most about, although I would not reject out of hand the prospect of eliminating them, but the two I raised as specific examples, and undoubtedly there are many and everybody has their own list, in my testimony, were if we kept the income-type tax, are the deduction for charities and the mortgage interest deduction.

And the reasons I mentioned those are twofold. One is I think there is a great benefit in a pluralistic society to having many institutions doing good works rather than to having—relying more heavily on the government to provide the services that charities provide. And there is ample evidence that the tax deduction is an efficient—matter of fact, the evidence is my own work with Martin Feldstein for the Filer Commission—that charities get more than the Treasury loses from the deduction.

The mortgage interest deduction is a slightly different story. We do have a tax system that heavily biases investment toward investment in owner-occupied housing, as opposed to other types of savings and investment. And it would be—there is an open issue whether we are getting enough as a society out of that to justify the existing level, whether the cap should be brought down, whether it should be eliminated or kept where it is.

One thing I do know is if we move to eliminate it, that we would—not only would people as they wrote their tax checks have a slight change, but the value of their homes would be reduced because the value of their home capitalizes the value of the mortgage-interest deduction. So I would be concerned to have two-thirds of the families in the country all of a sudden have the value of their largest asset decline. So I would be cautious before I did that in thinking it through.

Mrs. JOHNSON OF CONNECTICUT. And you would make no differentiation among businesses that are capital intensive and businesses that are not capital intensive, and you would be willing to eliminate the current incentives for health benefits and for education?

Mr. BOSKIN. As a general matter, yes. I think the education benefits, most of the cost of education is foregone earnings, unless you are going to somewhere like Stanford which is extremely expensive. And that is treated obviously as if it is immediately expensed.

With respect to health benefits, I think there is an issue but I would deal with this in the context of health reform. I personally believe one of the problems we have is that the price of health is not perceived at the margin by the consumers, and that is one reason we have gotten into the health care cost problems that we have seen in the last decade.

Mrs. JOHNSON OF CONNECTICUT. Thank you.

I am going to move on to another Member, but when you say the problem with education incentives is that it mostly has to do with foregone earnings, that is a big problem. And we have had hearings recently on the tax incentives to help people get the education they need to earn at higher levels. And it is very hard for middle-class working people to move up. Those breaks that we give them are material to their ability to do it. And the cost to the foregone earnings to society is really enormous.

So I just wave a flag of caution, because over the years we have stripped out a lot of the tax expenditures, and those that are left have a fairly high level of social value. And as we move forward, I think we do have to be deliberate about what the consequences are going to be, and if we think savings and investment is the only value, then we have to be up front about that.

Mr. BOSKIN. Well, I think I would just concur with your general description of—my reading of history is the same as yours. As a rough approximation, not item by item, the least bang for the buck so-called tax expenditures are probably the ones——

Mrs. JOHNSON OF CONNECTICUT. We will be talking more with you about this in the future. I have to move on to Mr. Hancock.

Mr. BOSKIN. I take the point and I apologize, but as Chairman Archer mentioned, I stayed over another meeting, so I apologize.

Mr. MCCRERY. Will the Chairwoman yield for a brief question, following up Mr. Rangel's comments?

Dr. Boskin, you rightly answered to Mr. Rangel that we should consider in crafting a tax system what it is we want to finance. But isn't there another question we should consider in crafting a tax system, and that is how much of what our society produces should the government take to finance all services?

Mr. BOSKIN. Yes. The two are interrelated. That is what I meant by using the jargon, "it goes in both directions."

Let me give you a very brief parable I point out in my testimony. For the government to collect a dollar of taxes from the private sector, it is going to wind up distorting some resources, even if it has a very minimal compliance version as would be reduced by some of the reforms we are talking about. So it is going to distort Gary's or mine or yours or other people's incentive to consume versus save or what you are going to consume or how you live, you know, do you own a home or rent, things of that sort.

Economists study the costs of this and at a minimum the cost to the economy of collecting $1 is $1.40 or $1.50. It goes up, the cost goes up with the square of the marginal tax rate, the marginal cost goes up proportionally with the tax rate. So we get $1 into the government's hands, it costs the private economy about $1.40, $1.50, when we take account of all those changes and behaviors that have occurred that have distorted resource allocation. In a well-run program that is desirable, that is efficient, a large fraction of that dol-

lar will be spent on the purpose; on a poorly run program or a poorly targeted program, a small fraction. It will be transferred in a leaky bucket; some will leak out.

So I just think you need a very rigorous benefit-cost standard, and I think you are right, that you have to be very cautious in the actual cost to the economy a lot more than the actual dollars collected by the Federal Government.

Mrs. JOHNSON OF CONNECTICUT. Thank you, Mr. Boskin, and thank you for staying with us a little extra time.

And thank you very much, Mr. Hufbauer, for being with us. The issues that you raise will receive a great deal more attention in the months ahead.

Let us call forward then Charls Walker, Dale Jorgenson and Laurence Kotlikoff, to conclude the second panel. And thereafter we will proceed with the others we have invited to testify.

We will start with Mr. Walker, who is the chairman of the American Council for Capital Formation.

STATEMENT OF CHARLS E. WALKER, PH.D., CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. WALKER. Thank you very much, Madam Chairman. It is a pleasure to be back before this Committee where I have testified over many, many years. I agree with you that these are historic hearings.

Most of my statement, which grows out of the research and analysis sponsored by the American Council for Capital Formation, over the past 20 years and done by many of the gentlemen you have listened to today, concentrates on the demand side of the saving/investment picture. And as always in economics, we need to look at supply and demand; that is, the supply of savings available for investment, and the demand for that savings from businesses for investment in plant and equipment.

I would like to take just a moment to extract from my statement a point or two on the savings side of the picture, since most of the analysis that we have is on the demand side.

To what extent can public policy promote national saving and thus make more and cheaper funds available for business investment?

First and foremost, and most important of course, is to balance the Federal budget, or preferably get a small surplus over the business cycle. But that is not the end-all and be-all. Other things equal, an elimination of the deficit today would raise our national savings rate up to a level that is still below our past experience and less than half of Western Europe and a third of Japan. So that is not enough in and of itself.

Second, reducing the budget deficit to increase savings—that is one of the results of it, there are a lot of other reasons—ignores the demand side of business incentives to borrow the savings that are generated by Federal surpluses, personal saving, and so on. And at times in the past, we have not had enough of that investment demand. So it is important that we look at both sides of the equation.

The second major point I would like to make, our analysis of the studies by Lawrence Summers, Martin Feldstein, David Wise, James Poterba, a whole host of scholars, leads us to the conclusion

that the IRAs and the 401(k)s have contributed very economically to an increase in the personal savings rate. The U.S. personal savings rate has dropped, but it would have dropped much more, we think, without these incentives.

Because of that, I think we should give very serious consideration to the initiation of a very strong national savings campaign based on patriotism. Such a campaign would be good for the country.

When I was Deputy Secretary of the Treasury in the late sixties, we had a very strong U.S. savings bond program based on patriotism and on self-interest. Read yesterday's Wall Street Journal, lead piece, right side. The baby boomers are saving less than one-third of what they expect to need when they retire. So this program could be sold both on the basis of patriotism and the self-interest side.

Finally, on stimulating business saving, which is a big part of the picture, the lower capital gains tax rates which were voted in this Committee are a positive step. Taxes on capital gains are basically taxes on retained income. The higher the capital gains tax, the much more difficult it is for corporations to retain earnings and increase business saving. So what was done in that respect is a very positive factor to increase business saving.

I will pass over but just mention the point that Mr. Bradford made and with which I fully agree, that actually the taxation of saving can be viewed as very unfair in our system. Typically, the questions you see in the polls, such as in the Wall Street Journal a few weeks ago, where you ask people whether they would rather pay or should they pay higher or lower taxes on their saving investment income versus their wage income, they think of Donald Trump and David Rockefeller and people like that. But if you ask them directly whether if they save out of their income and pay taxes and invest, should they pay taxes again on that return, I think you get much different answers. And most Americans believe that taxation of saving is unfair.

In my conclusion, I state that 1 year ago I would have said this task that the Chairman and others have embarked upon is impossible, as you could never replace the income tax in our system. I have changed that view over the last few months. And I think it is an extremely worthwhile effort because the income tax is not only a bad tax economically, as you have heard here, but also a bad tax politically for two major reasons. It is always an invitation for groups that can benefit from lower tax rates or special preferences to come in and get amendments to that effect. That might be true under its successor, but it still will tend to be less, I think, than under the income tax system.

The second factor is that because rich people save more money than poor people, any efforts to move the tax system in a direction of reducing saving can rise to a demagogic sort of argument of rich versus poor, rich Americans versus working Americans. And that is the worst possible situation we could get into in our capitalistic economy.

Thank you and congratulations for these hearings.

[The prepared statement and attachments follow:]

ACCF

AMERICAN COUNCIL FOR CAPITAL FORMATION

Statement of
Charls E. Walker
Chairman
American Council for Capital Formation
before the House Committee on Ways and Means
June 6, 1995

INTRODUCTION

My name is Charls E. Walker. I am chairman of the American Council for Capital Formation (ACCF). I am accompanied by Mark Bloomfield and Margo Thorning, respectively the president and chief economist of the ACCF. The ACCF represents a broad cross section of the American business community, including the manufacturing and investment sectors, Fortune 500 companies and smaller firms, individuals, and associations. Our board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders and public finance experts. We appreciate this opportunity to present testimony on the impact of fundamental tax reform on U.S. saving and investment, and economic growth.

We commend the Committee's decision to examine how a shift from an income-based tax system to a consumption-based tax could increase U.S. economic growth by eliminating the bias against saving and investment inherent in the income tax. Almost 10 years after the enactment of the Tax Reform Act of 1986 (TRA), it is clear that U.S. tax policies toward saving and investment must be revised if we are to create better jobs, restore strong growth in living standards, and help the U.S. retain its leading role in world affairs.

Our testimony today will focus on the need to increase saving and investment and how a shift to a consumption-based tax system might achieve that goal. In addition, there could be other likely consequences from such a shift, including reduction in the regulatory burdens and compliance costs associated with the income tax.

SAVING AND INVESTMENT AND ECONOMIC GROWTH

Investment spending in the United States in recent years compares unfavorably with that of other nations as well as with our own past experience. From 1973 to 1992, gross nonresidential investment as a percent of gross domestic product (GDP) was lower for the United States than for any of our major competitors (see Table 1). The U.S. net saving rate during the same period is also low relative to other countries, averaging 4.6 percent compared to 19.0 percent in Japan, 10.6 percent in Germany, and 7.5 percent in Canada.

Even more disturbing is the fact that net business investment in this country has in recent years fallen to only half the level of the 1960s and 1970s. Net private domestic investment averaged 7.4 percent of GDP from 1960 to 1980; since 1991 it has averaged only 3.1 percent (see Table 2). The U.S. net saving rate, a key determinant of U.S. investment, has also fallen sharply, from an average of 7.6 percent in the 1960-1980 period to only 2.0 percent in the 1990s (see Table 2). While larger Federal budget deficits are part of the reason for the saving rate's decline, personal and business saving rates have also fallen.

Reflecting the reduced share of GDP being invested each year, the U.S. capital stock has also grown more slowly. In the three decades prior to 1980, the total capital stock grew an average rate of 4.0 percent per year; in the 1980s and 1990s, the rate fell to 2.7 and 1.9 percent respectively (see Table 3). The stock of equipment, which many experts regard as critical for strong productivity growth, has increased much more slowly since 1980 than in earlier decades. Industrial equipment, which grew at an average rate of 4.3 percent over the 1950-1979 period, increased by just 1.2 percent annually in the 1980s and 0.5 percent since 1990.

The overwhelming importance of investment in plant and equipment for economic growth is emphasized in Harvard Professor Dale Jorgenson's new book, *Productivity: Postwar U.S. Economic Growth*. This study analyzed economic growth between peaks in the business cycle

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over the 1948-1979 period. Allocating increases in output to three sources—growth in the capital stock, labor supply, and multifactor productivity—Professor Jorgenson found that increases in the capital stock had the strongest impact on growth in output.

Studies by Harvard Professors Bradford De Long and Lawrence H. Summers, now on leave at the U.S. Department of Treasury, concluded that investment in equipment is perhaps the single most importance factor in economic growth and development. Their research provided strong evidence that for a broad cross section of nations every 1 percent of GDP invested in equipment is associated with an increase in the GDP growth rate itself of one-third of one percent—a very substantial social rate of return.

Investment's key role in advancing technological progress and productivity growth is also stressed in recent research by New York University Professor Edward N. Wolff. He concluded that U.S. labor productivity growth rates are depressed by the recent slower growth in the capital-to-labor ratio—from a peak of 2.0 percent per year in the 1950s to 1.2 percent per year in the 1972-1992 period. Professor Wolff stressed that the effects of the decline in U.S. capital-labor growth are perhaps even more pernicious than they appear at first glance. First, an increasing capital-labor ratio will increase labor productivity through capital deepening. Second, there appears to be an important and significant interaction effect between capital investment and technological advance. U.S. manufacturing productivity growth lagged behind that of most major industrial countries over the 1973-1993 period. Labor productivity, or output per worker per hour, grew at only 2.4 percent in the 1979-1993 period compared to 4.3 percent in Japan and Belgium, and 4.1 percent in the United Kingdom (see Figure 1). Lagging U.S. labor productivity growth is a concern because of its role in helping to increase real living standards for U.S. workers.

THE SAVING/INVESTMENT EQUATION

Few analyses of business investment levels point out that at the heart of the issue is an old standby of economics—a supply and demand equation. In this instance, supply consists of the national saving available for investment; demand arises from efforts of businesses to earn more in the future by investing in new projects today.

Much of the analysis elsewhere in this testimony concentrates on the demand side of the equation; after all, it is on business incentives to invest that taxes have their most direct and identifiable impact. But national saving as related to tax policy should not be ignored. Without doubt, effective steps to raise the national saving rate reduce interest rates (and therefore capital costs) and foster investment.

The national saving referred to here is not confined to saving by individuals, although they are important participants in the process. Net national saving consists of individual saving, or that part of their income that people do not consume; business saving, defined as annual increases in retained earnings (earnings after taxes not paid out as dividends); and government saving, or the surplus (saving) or deficits (dissaving) realized by Federal, state and local governments.

To what extent can public policy promote national saving and thus make more and cheaper funds available for business investment? Several points should be made.

First and foremost, conversion of the structural Federal deficit into balance or, preferably, a modest surplus over the period of the business cycle would represent the single most important contribution of public policy to generation of more national saving. Such deficits arise when spending exceeds tax revenues; thus determined restraint in Federal spending to bring outlays down to or below revenue levels can properly be viewed as a fiscal policy that adds to saving. The budget plans approved by both House and Senate, if implemented, would therefore mark a significant step toward raising the national saving rate.

One should not conclude, however, that a balanced budget is all that is needed to solve this nation's capital formation problem. Personal and business saving are also historically low and need to be increased. We must also make certain that tax policy is "capital-friendly," so that businesses have adequate incentives to invest any increase in the supply of saving.

Second, turning to enhancement of personal saving, recent experience in the U.S. suggests that lower tax rates on saving do have a positive effect on saving rates. This is an important point; some economists still contest the view that tax policy can influence personal saving to any great degree.

Our most recent experience in this respect is of course the Individual Retirement Account (IRAs) and 401(k)s. We commend the bill approved by this committee, which would liberalize IRAs. Earlier experience with IRAs and 401(k)s convinced many of us that a combination of tax relief (especially in the form of deductions for saving and postponement of taxes on the income generated within the IRA and 401(k)s), well-structured market instruments, and aggressive marketing campaigns by financial institution can raise the personal saving rate. Studies to this effect have been produced by former Council of Economic Advisers Chairman Martin Feldstein, Harvard Professor Lawrence Summers (now on leave as U.S. Treasury Undersecretary for International Affairs), Professors David A. Wise of Harvard University, James M. Poterba of Massachusetts Institute of Technology, Steven F. Venti of Dartmouth College, Jonathan Skinner of the University of Virginia, and Richard A. Thaler of Cornell University. These studies have in part been answered by some analysts, but in our view the rebuttals are far from convincing. We would be glad to provide the Committee with a set of studies on both sides of the issue.

The success of IRAs and 401ks suggests to me that an aggressive National Saving Campaign, based on a combination of patriotism and self-interest, would be a highly worthwhile project that could raise the personal saving rate. Skeptics argue that the U.S. "culture" of high spending and low saving cannot be changed, contrasting this with the high propensity to save among the Japanese. But the fact is that Japanese saving rates were very low before World War II, and it was only through deliberate national policy—mainly through low taxes on individual saving—that Japan became such a high-saving nation. Self-interest can and should play an important role in any such campaign. Professor Douglas Bernheim of Stanford University estimates that "baby-boomers" are now saving only one-third of what they need for comfortable retirement. This can be a powerful selling point.

Third, tax policy can have a very important impact on business saving, which is at a historically low level. Recall that business saving is simply another term for retained earnings and recognize that both public finance experts and Wall Streeters view the capital gains tax as a tax on such earnings. Many purchasers of corporate stock purchase in anticipation of appreciation in its value, preferring such appreciation to dividends. The higher the capital gains tax, the less the incentive to buy stocks for appreciation, and the more difficult it is for corporations which enjoy good investment opportunities to retain the funds to finance them internally. (Such funds might be obtained in the equity or debt markets, but only at higher cost in terms of management time, investment banker fees, etc.)

Finally, with respect to business saving and investment, tax policy that enhances business incentives to invest increases the demand for saving. This higher demand for funds increases the return to savers, and will help increase the amount of savings supplied.

One final point on the saving side of the saving/investment equation: is it fair to tax saving? Or more important, do the American people think it's fair to do so? In answering this question, many peoples' minds immediately turn to high-income Americans, who admittedly save much larger portions of their incomes than do lower-income Americans.

But the fact is that many middle-income Americans do save and invest in various instruments, including mutual funds. Those investments are made out of income already taxed once; is it fair to tax these peoples' saving again? I doubt that many of them would think so. And, for upper-income Americans, only the amounts differ; the principle of unfair, multiple taxation of individual saving is the same.

In the words of the highly respected public finance scholar, Arnold Harberger, a member of the ACCF Center for Policy Research Board of Scholars:

> "As is well-known, the personal income tax is in effect a double tax on savings, taxing the income from which savings are generated and at the same time taxing the proceeds of such savings. In the United States, we add to this double tax on savings a third tax, that on real property, and a fourth, that on the income of corporation...

[T]his treatment is objectionable, particularly in the light of the lip service that is constantly being paid to saving and investment." [Walker and Bloomfield, eds., *New Directions in Federal Tax Policy*, 1983, p. 161.]

Tax Policy and Capital Costs

The user cost of capital is the pretax rate of return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, inflation, risk, economic depreciation, and taxes. This capital cost concept is often called the "hurdle rate" because it measures the return an investment must yield before a firm will be willing to start a new capital project.

Economists are in broad agreement that capital costs are affected by tax policy. For example, John Shoven, Stanford's Dean of Arts & Sciences, estimated that in the U.S. about one-third of the cost of capital is due to taxes. In other words, hurdle rates are 50 percent higher than they otherwise would be due to the tax liability on the income produced by the investment. The higher the tax rate on new investment, the less investment that will take place.

Several measures show that the United States taxes new investment more heavily than most of our competitors. For example, according to a study by the centrist Progressive Foundation, the "think tank" affiliate of the Progressive Policy Institute, the marginal tax rate on domestic U.S. corporate investment is 37.5 percent, exceeding that of every country in the survey except Canada (see Figure 2). The tax rate calculations include the major features of each country's tax code, including individual and corporate income tax rates, depreciation allowances, and whether the corporate and individual tax systems are integrated.

Taxes on machinery and equipment investment, which Professors De Long and Summers concluded are major factors in economic growth, are higher in the United States than in other industrialized countries (see Figure 3). Research by Professor Jorgenson shows that the United States taxes new investment in machinery at 18.5 percent, compared to 8.8 percent in Japan and 8.0 percent in the United Kingdom. Tax rates on machinery investment are *negative* in Italy, France, and Sweden due to generous capital cost recovery allowances.

Prior to TRA, the United States had one of the best capital cost recovery systems in the world. For example, the present value of the deductions for investment in modern and competitive continuous casting equipment for steel production under the strongly pro-investment tax regime in effect from 1981 to 1985 was close to 100 percent, according to a study by Arthur Andersen & Co. In contrast, under current law the present value of capital cost recovery allowance for that same investment today is only 81 percent for a corporation paying the regular income tax. And if a corporation is subject to the corporate AMT, as many major steel companies are, the present value is only 59 percent (see Table 4).

The Arthur Andersen study also showed that the United States lags behind many of our major competitors in capital cost recovery for equipment that is technologically innovative, is crucial to U.S. economic strength, or helps prevent pollution. Capital cost recovery provisions for pollution-control equipment are much less favorable now than prior to TRA's passage. For example, the present value of cost recovery allowances for wastewater treatment facilities used in pulp and paper production was approximately 100 percent prior to TRA. Under regular TRA income tax, the present value for wastewater treatment facilities dropped to 81 percent; for AMT payers the figure became 63 percent. Scrubbers used in the production of electricity fared even worse. Prior to TRA, the present value was only 55 percent; for AMT payers the figure dropped to 42 percent. As is true in the case of productive equipment, loss of the investment tax credit and lengthening of depreciable lives both raise effective tax rates.

According to estimates by Dr. Joel Prakken of Laurence H. Meyer & Associates, the user cost of capital for most types of productive equipment would now be about 15 percent lower had TRA not been enacted (see Figure 4). In effect, therefore, the 1986 legislation sharply raised the hurdle rate for new business investment projects and thus helped significantly to slow the rate of growth of the U.S. capital stock.

CONSUMPTION TAXES AND ECONOMIC GROWTH

Most other industrial countries tax consumption more heavily than does the United States. For example, consumption is taxed at an average rate of 22.1 percent in Germany and 14.6 percent in Canada, compared to only 6.2 percent in the United States (see Figure 5). Other countries also derive a much larger share of their total tax revenue from taxes on consumption. The average for the other G-7 countries is 26 percent, compared to 16.8 percent in the United States, according to OECD data.

Switching to a tax system based on consumption rather than on income would have a significant, positive impact on the U.S. growth rate according to studies by many top flight public finance scholars. A brief survey of some of these studies appears below.

- *Fullerton, Shoven and Whalley.* In "Replacing the U.S. Income Tax with a Progressive Consumption Tax" [*Journal of Public Economics* 2 (1983)]. Professors Don Fullerton of the University of Texas, John Shoven of Stanford University, and John Whalley of the University of Western Ontario, employ a general equilibrium model of the U.S. economy and tax system to measure the short- and long-run consequences of tax restructuring. A general equilibrium model provides "dynamic" estimates of how a change in tax policy will affect factor prices, investment, output and employment after the economy has had time to adjust to the new system. Their study shows that the initial impact of switching to a progressive consumption tax is to increase saving and reduce consumption. Initially, after the switch, consumption falls below the baseline but eventually it will exceed it because of a larger capital stock. The authors conclude that the stream of net gains to the economy has a discounted present value of 1 percent of GDP ($698 billion at 1995 income levels).

- *Jorgenson.* Harvard Professor Dale Jorgenson's study,"The Economic Impact of Fundamental Tax Reform" [prepared for the Hoover Institution, May 1995], employs a general equilibrium model to study the impact of switching to a consumption tax from the income tax. He concludes that switching to a consumption tax system such as those embodied in the Armey Flat Tax and Nunn-Domenici Unlimited Savings Account (USA Tax) would provide for a substantial increase in the U.S. standard of living over time. Professor Jorgenson estimates that this increase has a discounted present value of $2 trillion dollars.

- *Kotlikoff.* Boston University Professor and National Bureau of Economic Research scholar, Laurence J. Kotlikoff, employs a general equilibrium model to show the impact of replacing the income tax with a 17 percent sales tax. His study, also prepared for the Hoover Institution (May, 1995), finds that switching to a sales tax, will by the tenth year of the transition, increase the U.S. saving rate from the current level of about 2.6 percent to 6 percent. The increase in saving produces a concomitant increase in investment. Capital costs and real interest rates decline. Greater investment causes an increase in the per capita stock of capital which raises worker productivity and real wages. In the long run, Kotlikoff concludes per capital output will be 8 percent larger than it would have been without the substitution of a sales tax for the income tax.

- *Hall and Rabushka.* In "The Flat Tax: A Simple Progressive Consumption Tax," Professors Robert Hall and Alvin Rabushka of the Hoover Institution of Stanford University [prepared for the Hoover Institution, May 1995], predict, on the basis of various general equilibrium model analyses of substituting consumption taxes for income taxes, that their flat tax proposal would raise GDP by 4 to 8 percent within seven years (compared to the current law).

- *Prakken.* Joel Prakken of Laurence H. Meyer & Associates, a macroeconomic forecasting group, used a general equilibrium model to analyze the impact of providing improved depreciation for capital equipment (250 percent declining balance over 5 years) by imposing a VAT of 0.5 percent to offset the revenue loss. In "The Macroeconomics of Tax Reform" [Walker and Bloomfield, eds., *The Consumption Tax: A Better Alternative?* Ballenger Publishing Company (1987)], Prakken concludes that "buying" additional investment incentives would increase the capital stock, raise the level of real GDP, and raise real wages by 0.7 per year.

TAX RESTRUCTURING AND THE 104TH CONGRESS

Restructuring the federal tax system to reduce the multiple taxation of saving and investment inherent in the income tax—and thus to promote productivity and higher living standards—appears to be gaining favor among congressional leaders. In addition to Chairman Archer, Speaker of the House Newt Gingrich (R-GA); Majority Leader Richard Armey (R-TX); Ranking Democrat on the Ways and Means Committee Sam Gibbons (D-FL); Senate Finance Committee Chairman Bob Packwood (R-OR); and Senators Pete Domenici (R-NM) and Sam Nunn (D-GA); Arlen Specter (R-PA); and Richard Lugar (R-IN) have also expressed interest in broad tax restructuring. The proposals have more similarities than differences and each has many desirable qualities; all would go a long way toward reducing the bias against saving and investment in our current Federal income tax. Brief summaries of the major proposals follow.

The Flat Tax

House Majority Leader Richard K. Armey (R-TX), introduced the Freedom and Fairness Restoration Act on June 16, 1994. This bill replaces the current individual and corporate federal income tax with a flat tax modeled after the proposal by Stanford economist Robert Hall and Alvin Rabushka of the Hoover Institution. Businesses pay a 17 percent rate on the difference (if positive) between revenue and expenses. The tax covers corporate, partnership, professional, farm, and rental profits and royalties. The base for the tax is gross revenue less purchases of goods and services, capital equipment, structures, land, and wages and pension contributions paid to employees. No deductions are permitted for fringe benefits, interest, or payments to owners.

Personal income is taxed only once at a rate of 17 percent. Personal income is defined as the total of wage, salary, and pensions. thus, the income on savings is exempt from tax. The following personal allowances are permitted: $13,000 for an individual, $17,200 for a single head of household, $26,200 for a married couple, and a dependent deduction of $5,300.

Senator Arlen Specter (R-PA) advocates a modified version of the flat tax which maintains deductions for charitable contributions and a limited home mortgage interest deduction.

USA Tax

Senators Sam Nunn (D-GA) and Pete V. Domenici (R-NM) propose to replace the individual and corporate federal income tax and a portion of the Social Security tax with the Unlimited Savings Account Tax. The USA Tax was introduced as legislation on April 25, 1995. Total revenues from the USA Tax would equal total revenues from individual and corporate income taxes, plus the revenues needed to pay for the Social Security payroll tax credits. To compute its tax base under the USA Tax, a business takes the total value of its business receipts from domestic sales (which, by definition, exclude exports sales, income from overseas operations, and financial income) and subtracts its purchases from other businesses, including regular and pollution control equipment. Purchases of imported goods also are subtracted, assuming that the imports had been taxed at the border.

To compute its tax liability, a business multiplies its tax base by the business tax rate (11.0 percent). The business then takes a tax credit equal to the employer's portion of the payroll tax payments for its employees. The USA Tax does not allow a business to deduct wages, state and local tax payments, or interest and dividend payments.

Most of the other features of the individual-level USA Tax resemble those of the current individual income tax; however, saving is fully deducted from income and money withdrawn from savings and spent is taxable. The USA Tax retains personal exemptions, the standard deduction, the mortgage interest and charitable deduction, and graduated tax rate schedules ranging from 16 to 55 percent. It also has an earned income tax credit for low-income taxpayers.

Value-Added Tax

Congressman Sam M. Gibbons (D-FL) has proposed to replace the current individual and corporate federal income tax, and the Social Security payroll tax with a simplified value-added

tax (VAT). A new personal income tax addresses the regressivity of the VAT. The VAT for business is computed by the subtraction method and uses a uniform tax rate for all goods and services according to the destination principle. The destination principle means that the tax would not be levied on exports but that it would be levied on imports as allowed by the General Agreement on Tariffs and Trade (GATT). Gross receipts from sales of goods and services are the tentative taxable amount. Gross costs for purchases of goods and services from other businesses and for plant and equipment are deducted from that amount. The balance is the business' value-added base, which is multiplied by the tax rate to determine the tax liability.

The tax rate is not specified in Congressman Gibbons' proposal; he states that the rate would be that needed to offset the revenue loss stemming from the repeal of the individual and corporate income tax and payroll taxes. His proposal has not been introduced as legislation.

Sales Tax

Senator Richard Lugar (R-IN) is drafting a proposal for a national sales tax (NST) of about 17 percent on goods and services to replace Federal personal and corporate income taxes. The capital gains and estate taxes would be eliminated as well. The proposal would not revise the current social security tax or FICA systems except that Social Security benefits would not be taxed.

CONCLUSIONS

Mr. Chairman, a year ago I would have strongly argued that the income tax is a permanent, irreplaceable part of the U.S. tax system. In fact, my work over the past quarter-century has been aimed primarily at incrementally moving the tax toward a consumed income tax. Such things as investment tax credits, accelerated depreciation, capital gains tax cuts, IRAs and the like have that effect. This would be, as is most often the case in public policy, a second-best solution to our need for tax policies that are fair and promote good jobs, solid growth, and international competitiveness.

My view a year ago on the "impossibility" of repealing the income tax was not based on any liking for the tax itself. Complete elimination of the Federal income tax—to "tear it out by the roots," in your words—is a consummation devoutly to be wished. As we have shown, the income tax is a very bad tax economically.

It is also very bad politically. Let's look briefly at its major political drawbacks. First, as long as the income tax is on the books, it is a most attractive invitation for individuals and businesses to seek special provisions—some of which may be most worthy—to reduce their tax burdens. Not that such efforts will cease under a successor to the income tax, whatever that might be, but my feeling is that the income tax is especially subject to these legislative forays.

Second, the progressivity in rates that is almost synonymous with the income tax provides a fertile field for those who would try to use the tax for significant income redistribution (an effort that has proved futile in the past) or as the basis of demagogic, "Rich Man versus Working American" politics of envy. Any success in these efforts strikes at the very heart of our capital formation problem because, like it or not, upper-income Americans save more than lower-income Americans. So, to soak the rich is to soak the saver—and that's not good for the world's leading capitalist nation.

Having said that, I think your task is exceedingly difficult. But I will not predict failure as I would have a year ago. This very hearing today is a sign of the great change that has occurred in our political system in recent months. The goal justifies every bit of the effort that you and your associates will have to apply to the task. And, speaking personally, I want to help in your effort.

Thank you very much.

Table 1 Saving and Investment as a Percent of Gross Domestic Product, 1973-1992

	United States	Canada	Japan	France	West Germany	United Kingdom
SAVING						
Net saving[1]	4.6%	7.5%	19.0%	8.7%	10.6%	4.4%
Personal saving[2]	5.8%	7.6%	11.7%	6.3%	8.2%	3.5%
Gross saving (net saving plus consumption of fixed capital)[3]	17.5%	19.1%	32.9%	21.2%	22.9%	15.8%
INVESTMENT						
Gross nonresidential fixed capital formation	13.9%	15.1%	24.2%	15.5%	14.8%	14.2%
Gross fixed capital formation	18.3%	21.5%	30.3%	21.0%	20.7%	17.8%

[1]*The main components of the OECD definition of net saving are: personal saving, business saving (undistributed corporate profits), and government saving (or dissaving). The OECD definition of net saving differs from that used in the National Income and Product Accounts published by the Department of Commerce, primarily because of the treatment of government capital formation.*
[2]*Personal saving is comprised of household saving and private unincorporated enterprise.*
[3]*The main components of the OECD definition of consumption of fixed capital are the capital consumption allowances (depreciation charges) for both the private and the government sector.*

Source: Derived from National Accounts, Vol. II, 1973-1985 and 1980-1992, Organization for Economic Cooperation and Development (OECD), 1987 and 1994 eds. Prepared by the American Council for Capital Formation Center for Policy Research, April 1995.

Table 2 Flow of U.S. Net Saving and Investment (percent of GDP in current $)

	Average 1960-1980	Average 1981-1985	Average 1986-1990	Average 1991-1995[1]
Net private domestic saving	8.2%	7.2%	5.1%	5.2%
State and local government surpluses	0.4%	1.2%	0.9%	0.4%
Subtotal of private and state saving	8.6%	8.4%	5.9%	5.6%
Less: federal budget deficit	-1.0%	-4.1%	-3.2%	-3.6%
Net domestic saving available for private investment	7.6%	4.3%	2.7%	2.0%
Net inflow of foreign saving[2]	-0.4%	1.2%	2.4%	1.1%
Net private domestic investment	7.2%	5.5%	5.1%	3.1%
Personal saving	5.1%	5.6%	3.4%	3.5%
Net business saving[3]	3.1%	1.6%	1.7%	1.8%

[1]*In the 1960-80 period the United States sent more capital abroad than it received; thus net inflow was negative during this period.*
[2]*Net business saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.*
[3]*The 1995 figures included in this average reflect only the first quarter.*

Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, May 1995.

Table 3 Growth in the Net Capital Stock by Type
(average annual growth rates in 1987 dollars)

	1950-59	1960-69	1970-79	1980-89	1990-94	1994 level (billions of 1987 $)
Total	3.6	4.5	3.8	2.7	1.9	5144.4
Equipment	4.1	5.0	4.9	2.6	3.3	2511.7
Information processing	8.8	8.9	8.9	9.3	8.8	847.0
Equipment less information processing	3.8	4.7	4.4	1.2	1.0	1664.7
Industrial[1]	5.0	4.3	3.6	1.2	0.5	769.3
Structures	3.3	4.2	2.8	2.8	0.6	2632.7

[1]*Industrial equipment includes fabricated metal products, engines and turbines, metal working machinery, special industry machinery, general industrial (including materials handing, equipment, and electrical transmission), distribution, and industrial apparatus.*

Source: "Fixed Nonresidential Private Capital, by Type of Equipment and Structures," Department of Commerce, Bureau of Economic Analysis, April, 1995. Chart prepared by the American Council for Capital Formation Center for Policy Research, May 1995.

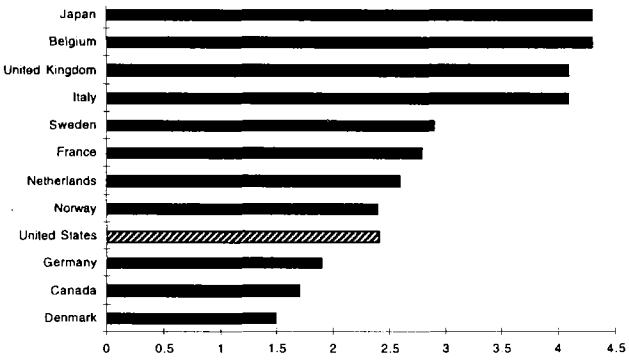
Table 4 International Comparison of the Present Value of Equipment Used to Make Selected Manufacturing Products and Pollution-Control Equipment (as a percent of cost)

	Computer Chips	Telephone Switching Equipment	Factory Robots	Crank-shafts	Continuous Casting for Steel Production	Engine Blocks	Wastewater Treatment for Chemical Production	Wastewater Treatment for Pulp and Paper Equipment	Scrubbers Used in Electricity Plants
United States									
1985 Law	100.1	100.1	100.1	100.1	100.1	100.1	100.1	100.1	89.7
MACRS[1]	85.2	85.2	80.8	80.8	80.8	80.8	85.2	80.8	54.5
AMT[2]	81.1	78.4	68.8	64.6	59.0	60.8	70.0	62.7	41.5
Brazil	75.7	74.8	74.7	74.7	88.3	74.7	74.7	74.7	79.4
Canada	76.9	75.9	74.0	73.8	74.2	73.6	85.3	85.3	85.3
Germany	83.6	83.0	82.7	83.9	82.2	83.9	71.8	69.7	68.9
Japan	87.1	86.2	83.4	83.9	81.4	83.7	84.6	83.7	82.4
Korea (w/3% ITC)	88.7	84.3	82.6	80.1	77.7	79.6	95.2	93.9	92.2
Singapore	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7	91.7
Taiwan	83.9	78.0	79.0	64.3	63.5	63.7	147.0	147.0	147.0

Notes: [1]*MACRS* = *Modified Accelerated Cost Recovery System (Current Law for regular taxpayers)*
[2]*AMT* = *Alternative Minimum Tax (Current Law)*

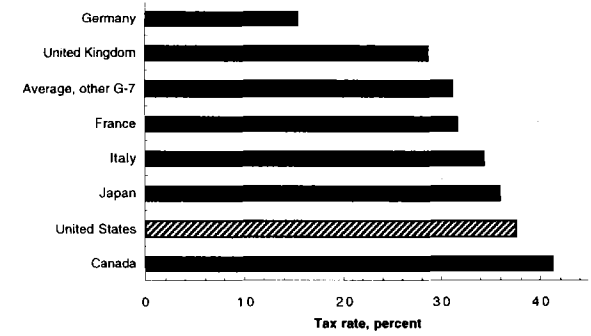
Source: Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad is Bad," in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: American Council for Capital Formation Center for Policy Research, September 1991); and unpublished data incorporating the AMT provisions of OBRA 1993. Updated by Arthur Andersen LLP, Office of Federal Tax Services, Washington, D.C., January 1995.

Figure 1 International Comparison of Manufacturing Productivity, 1979-1993 (annual percent change)



Source: Monthly Labor Review, February 1995.

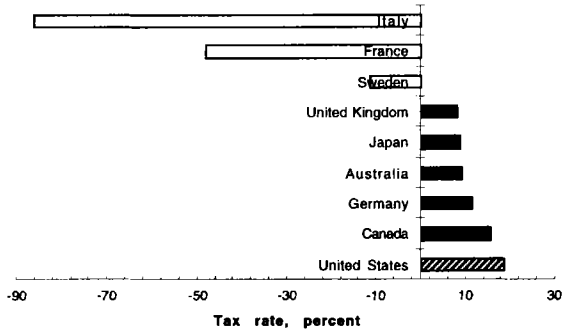
Figure 2 Effective Tax Rates on Domestic Corporate Investment, 1991



Note: Tax rates include both the corporate and personal income tax on investment.

Source: Enterprise Economics and Tax Reform, Progressive Foundation, Progressive Policy Institute, Washington, D.C., October 1994.

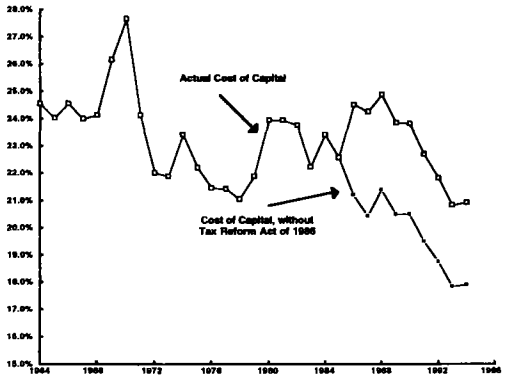
Figure 3 Marginal Effective Corporate Tax Rates on Machinery Assets, 1990



Note: Tax rates are negative in Italy, France, and Sweden due to incentives included in capital cost recovery provisions. Tax rates are based on corporate income taxes and do not include personal income taxes.

Source: Dale Jorgenson, "Tax Reform and the Cost of Capital: An International Comparison," *Tax Notes International*, April 19, 1993.

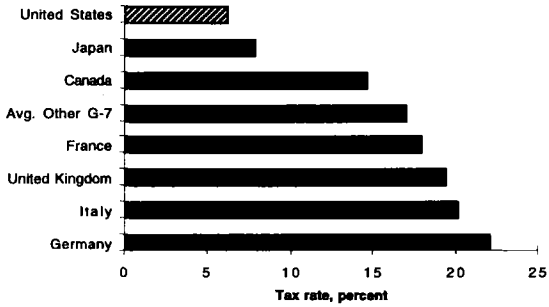
Figure 4 Cost of Capital for Equipment (less computers)



Note: The cost of capital is defined as the user cost of capital; it includes economic depreciation. Personal tax rates are not factored into the calculations.

Source: Joel Prakken, Laurence H. Meyer and Associates, unpublished data, August 1994.

Figure 5 Average Consumption Tax Rates in the G-7 Countries, 1991



Source: OECD, *National Accounts 1993 Vol. II*; and OECD, *Revenue Statistics*

Mrs. JOHNSON OF CONNECTICUT. Thank you, Dr. Walker.
Dr. Jorgenson.

STATEMENT OF DALE W. JORGENSON, PH.D., PROFESSOR, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY

Mr. JORGENSON. Thank you very much, Madam Chairman.

I am very pleased to testify on the economic impact of fundamental tax reform. It is important to start out with a definition of fundamental tax reform. And the definition I would like to use is the one that you have heard many times this morning, which is that the tax system would be reformed by moving the base for taxation at the Federal level from income to consumption. So what I am going to concentrate on is the effect of shifting to a consumption-based tax at the Federal level.

At least four different ideas have been discussed today for administering a consumption tax system, and they have advantages and disadvantages. The scheme that is referred to as a value-added tax is used in Europe, and involves taking a credit for taxes paid on business purchases against one's value-added tax liability. Needless to say, adoption of a system like this for the United States would require a new administrative structure for the tax system.

The second approach that has been discussed is the idea of a retail sales tax. That is something that is used by many State governments and some local governments, and that could be collected in much the same manner as a State sales tax. In fact, you might even conceive of a system where the Federal Government would subcontract the collection to State tax agencies.

A third set of ideas is related to the notion of preserving the existing structure of a business tax and an individual tax and using that tax structure to change the tax base to consumption by allowing investment expenditures as a writeoff against business receipts, in much the same way that other business expenses are allowed. This is the basic idea of the Armey flat tax and the Nunn-Domenici U.S.A. tax.

What I have shown in my written testimony is that all of these systems, if they succeed in shifting the tax base to consumption, would have a very major positive impact on the growth of our economy. Just to calibrate the scale, we could start from the last major tax reform enacted by the Congress, which was the Tax Reform Act of 1986. This tax reform eliminated a number of barriers to efficient allocation of capital such as the investment tax credit for investment in equipment.

In my written testimony, I show that this created nearly $1 trillion in new opportunities for U.S. economic growth. What do I mean by growth opportunities? Well, let me be precise. The objective of government policy, which we have discussed a couple times this morning, is to enhance the standard of living of U.S. consumers. And the concept of growth opportunities is a summary measure of the value of all future increases in this standard of living, both of present consumers and of future generations.

What I show in the paper is that the 1986 tax act created nearly $1 trillion in growth opportunities defined in that way, increases in our standard of living. While recognizing the significant achieve-

ments of the 1986 tax act, I show that this legislation fell far short of exploiting the available growth opportunities and that changing the tax base from income to consumption would have generated $2 trillion in opportunities for economic growth.

I conclude, therefore, that adopting consumption as the tax base at the time of the 1986 tax reform would have doubled the benefits.

What is the intuitive basis for these calculations? I have already suggested that the 1986 tax act removed a number of obstacles to efficient allocation. A consumption based tax would remove all the remaining obstacles to efficient allocation of capital, and in addition to that, would eliminate the double taxation of saving. And those two effects account for the impact of a shift toward consumption taxation on our national growth.

So I conclude that changing the Federal tax base from income to consumption is an idea whose time has come. This change will create very important new opportunities for growth in the standard of living of all Americans. The traditional objections to consumption as the base for taxation on the grounds of fairness have been successfully addressed, for example, in the Armey flat tax proposal and the Nunn-Domenici U.S.A. tax.

These proposals or a retail sales tax or a value-added tax would create substantial new growth opportunities and are based on well-established economic ideas. These ideas could serve as the point of departure for tax reform legislation.

Thank you very much.

[The prepared statement follows:]

Prepared for presentation
to the
Ways and Means Committee
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June 6, 1995

HE ECONOMIC IMPACT OF FUNDAMENTAL TAX REFORM

by

Dale W. Jorgenson

ABSTRACT

Tax policy for saving and investment is critical for stimulating U.S. economic growth, since investment is the most important source of growth. In order to achieve a more satisfactory growth performance the tax burden on investment must be reduced substantially. This could be achieved by fundamental tax reforms that would shift the base for taxation at the federal level from income to consumption.

At least four alternative proposals for shifting the federal tax base to consumption have been developed. The first of these is a value added tax, like that employed in Europe and Japan. A consumption-base value added tax would eliminate investment from the tax base. A second proposal is to tax consumption at the retail level through a sales tax like that employed by many state governments in the U.S. This would also eliminate investment from the tax base.

Two alternative proposals have been developed for shifting the federal tax base from income to consumption, while retaining the existing administrative structure of the income tax. The U.S.A. (Unlimited Savings Allowance) Tax, proposed by Senators Sam Nunn and Pete Domenici, and the Flat Tax, advanced by Congressman Richard Armey, would exclude investment from the tax base by allowing a tax deduction for investment like that for any other business expense. Under these proposals a consumption tax could be made progressive by introducing a system of personal exemptions.

Neutral Cost Recovery, recently passed by the House of Representatives as Title II of the Job Creation and Wage Enhancement Act of 1995, is an important step toward a consumption-based tax system. This system for recovery of capital cost would provide tax deductions with the same present value as investment, thereby excluding investment from the tax base. To complete the shift in the tax base to consumption it would be necessary to eliminate other deductions from income at the same time, including deductions for interest expenses.

Current consumption tax proposals are based on well-tested economic ideas and could serve as an appropriate starting point for fundamental tax reform. In this testimony I compare the economic impact of a consumption tax with the Tax Reform Act of 1986, the most recent fundamental tax reform in the United States. I show that the 1986 Tax Act created nearly one trillion dollars in new opportunities for economic growth, but that adopting consumption as a tax base would have generated more that two trillion dollars in growth opportunities!

1. Introduction

Tax policy for saving and investment is critical for stimulating U.S. economic growth, since investment is the most important source of growth. In order to achieve a more satisfactory growth performance the tax burden on investment must be reduced substantially. This could be achieved by fundamental tax reforms like the Flat Tax, proposed by Congressman Dick Armey, or the U.S.A. (Unlimited Savings Allowance) Tax, proposed by Senators Sam Nunn and Pete Domenici. These tax proposals would have the effect of shifting the base for taxation at the federal level from income to consumption, while preserving the existing administrative structure of the income tax.

An alternative approach for shifting the federal tax base to consumption would be to adopt a value added tax, like that employed in Europe and Japan. A consumption-base value added tax would eliminate investment from the tax base. The system for value added taxation common in

Europe is based on allowing credit for the value added tax already paid on business purchases of goods and services. Adoption of this system for the United States would require a new structure for tax administration, based on auditing of sales and purchases by all businesses.

A third alternative approach to consumption taxation is a retail sales tax like that employed by many state governments and some local governments in the U.S. The existing administrative structure established by state governments could be employed for federal retail sales tax collections, possibly by having these collections done by existing state agencies but financed by the federal government. In order to exclude investment from the federal sales tax base such a tax would have to be levied only on purchases by final consumers -- households and institutions -- and not on purchases by businesses.

Current consumption tax proposals are based on well-tested economic ideas and could serve as an appropriate starting point for fundamental tax reform. An important advantage of the Armey Flat Tax and the Nunn-Domenici U.S. Tax proposals is that the resulting consumption tax systems could would be administered in much the same way as the present income tax system. The traditional objection to a consumption tax is that it would be regressive rather than progressive, falling disproportionately on low income taxpayers. Both the Flat Tax and the U.S.A. Tax would achieve progressivity by means of a system of personal exemptions.

The Tax Reform Act of 1986 is the most recent fundamental tax reform in the United States. This landmark legislation preserved income as the tax base for the federal revenue system. However, the federal income tax was substantially reformed by eliminating special tax provisions for a number of specific types of investment, such as the investment tax credit for investment in equipment. These reforms removed important barriers to the efficient allocation of capital. In this paper I show that the 1986 Tax Act created nearly one trillion dollars in new opportunities for economic growth!

While recognizing the significant achievements of the 1986 Tax Act, I show that this legislation fell far short of exploiting the available opportunities for stimulating U.S. economic growth through tax reform. Changing the tax base from income to consumption would have generated more than two trillion dollars in opportunities for economic growth! I conclude that adopting consumption as the tax base would have *doubled* the benefits from fundamental tax reform. Ironically, a consumption tax was explicitly considered and rejected in the debate that preceded the 1986 tax legislation.

In a 1977 study, *Blueprints for Tax Reform*, the U.S. Treasury had proposed two alternative approaches for shifting the federal tax base from income to consumption. The first of these is a value added tax, like that employed in Europe and Japan. The second would eliminate investment from the tax base by permitting taxpayers to treat investment expenditures as a tax deduction like that for any other business expense. Since investment would be excluded from the tax base, all other deductions from capital income, such as deductions for interest expenses, would be eliminated. However, these approaches to tax reform were considered and rejected by the U.S. Treasury in a 1984 report that initiated the debate leading to the 1986 Tax Act.

Neutral Cost Recovery, recently passed by the House of Representatives as Title II of the Job Creation and Wage Enhancement Act of 1995, is an important step toward revival of the Treasury proposals of 1977. This system for recovery of capital cost would provide depreciation deductions with the same present value as immediate "expensing" of investment. These deductions would be based on the recovery of capital cost over the lifetime of an asset, as under current law. However, the deductions would be increased annually to allow a return on capital of three and a half percent per year and compensate for inflation. At a discount rate of three and a half percent, these deductions would have the same present value as an immediate write-off of capital outlays.

Neutral Cost Recovery, like the Treasury proposal of 1977, would eliminate investment from the tax base. To complete the shift in the tax base to consumption, however, it would be necessary to eliminate other deductions from capital income at the same time, including deductions for interest expenses. Otherwise, the U.S. Treasury would be in the position of providing subsidiesthrough tax deductions for taxpayers who choose to finance investment through debt rather than equity. These subsidies could stimulate a revival of the tax shelter industry that flourished prior to the Tax Reform Act of 1986.

The recovery of capital costs should be regarded as one component of a tax system based on consumption rather than income. Shifting the federal tax base from income to consumption, as recommended in *Blueprints*, would require deductions equivalent to "expensing" of investment. However, other deductions from capital income would have to be eliminated at the same time. Adoption of a consumption tax would create very important new opportunities for U.S. economic growth.

2. The 1986 Tax Reform

I will support my conclusions by first reviewing the achievements of the 1986 tax reform.[1] I have presented simulations of future U.S. economic growth under alternative tax policies in Table 1. These simulations show that the economic impact of the 1986 tax reform was positive and substantial at rates of inflation like those prevailing at the time. As the rate of inflation has declined these benefits have grown very substantially, reflecting the fact that capital cost recovery deductions under the 1986 legislation were not indexed for inflation. These deductions decline in present value as the rate of inflation increases.

Table 1
Growth Opportunities Created by the 1986 Tax Reform
(Billions of 1987 Dollars)

Rate of Inflation	Revenue Adjustment	1985 Tax Law	Treasury Proposal	President's Proposal	1986 Tax Act
	Lump Sum Tax	724.0	1489.6	1691.4	1561.8
0%	Labor Income Tax	478.2	1468.8	1642.4	1565.0
	Sales Tax	400.3	1452.9	1614.6	1558.7
	Individual Income Tax	374.5	1456.1	1619.1	1563.1
	Lump Sum Tax	0.0	1907.6	2452.2	448.4
6%	Labor Income Tax	0.0	1711.4	2170.4	746.9
	Sales Tax	0.0	1600.1	2104.9	901.2
	Individual Income Tax	0.0	1595.8	2007.9	999.4
	Lump Sum Tax	-477.1	2060.4	3015.6	-200.8
10%	Labor Income Tax	-333.7	1791.6	2584.7	267.3
	Sales Tax	-285.2	1623.5	2356.4	517.0
	Individual Income Tax	-221.9	1604.8	2353.1	748.6

Note: In 1987, the national wealth (beginning of the year) was $15,920.2 billion dollars.

More specifically, I have compared growth opportunities available to the U.S. economy under the 1986 Tax Act with the those available under the pre-existing 1985 Tax Law and two tax reform proposals advanced by the Treasury in 1984 and the President in 1985. The benchmark for comparison is the 1985 Tax Law at a six percent inflation rate. Table 1 presents the difference between growth opportunities under alternative tax reforms with those resulting from no change

[1]This review is based on my paper, "Tax Reform and U.S. Economic Growth" with Kun-Young Yun. The paper provides a more detailed appraisal of the Tax Reform Act of 1986.

in tax policy and an unchanged rate of inflation. It is important to be explicit about the role of inflation, since the 1985 Tax Law and the 1986 Tax Act omitted important provisions for indexing the tax structure for inflation included in the Treasury proposal and the President's proposal.

In comparing U.S. economic growth under alternative tax policies I require that all changes tax policy are revenue neutral, that is, revenue and expenditure of the government are the same as in the base case given by the Tax Law of 1985. This requires adjusting tax revenues to maintain the budgetary position of the government. A hypothetical "lump-sum" tax or subsidy does not add to tax induced distortions of private decisions and serves as a standard for comparison among alternative tax policies. I also consider three alternative methods for adjusting government revenues. These involve proportional changes in taxes on labor income, sales taxes on investment and consumption goods, and taxes on income from both capital and labor. Table 1 presents estimates of the growth opportunities created or destroyed by alternative tax reform packages; all estimates are in billions of 1987 dollars. Let me first be precise about the meaning of the term "growth opportunities." The objective of government policy, including tax policy, is to enhance the standard of living of U.S. consumers now and in the future. The concept of growth opportunities is a summary measure of the present value of future increases in the standard of living. It represents the willingness of the present generation of taxpayers to pay for a change in tax policy that will affect their own standard of living and that of future generations of taxpayers.[2]

Turning to the impact of the 1986 Tax Act, we see that this fundamental tax reform produces a sizable gain in opportunities for future U.S. economic growth. For the revenue adjustments based on proportional changes in tax rates these gains range from $746.9 billion 1987 dollars to $999.4 billions, or nearly *one trillion dollars!* There are important differences between results for a hypothetical "lump sum" tax adjustment and adjustments based on changes in tax rates. However, the results do not depend significantly on which of the tax rates is used in maintaining revenue neutrality.

While the Tax Reform Act of 1986 obviously generated very substantial growth opportunities for the U.S. economy, the Treasury and President's proposals would have done substantially more to enhance economic growth. For tax adjustments based on changes in tax rates to maintain revenue neutrality, the Treasury proposal would have produced growth opportunities ranging from $1,595.8 billion 1987 dollars to $1,711.4 billions. The President's proposal would have produced gains ranging from $2,007.9 billion 1987 dollars to $2,170.4 billions or more than *double* the gains from the 1986 Tax Act! Nonetheless, tax policy makers should recognize the 1986 reform as a giant step in the right direction.

The estimates presented in the first column of Table 1 also make it possible to isolate the effects of changes in inflation with no change in tax policy. The 1985 Tax Law, like the Tax Reform Act of 1986, was not completely indexed for inflation, so that the tax burden increases with the inflation rate. By contrast the Treasury proposal and the President's proposal involved indexing the tax structure for inflation. With no change in tax law the results presented in Table 1 show that an increase in the inflation rate from six to ten percent would have imposed a loss on the economy in the range of $221.9-333.7 billion dollars of 1987. Reducing the inflation rate to zero would have produced a gain in the range of $374.5-478.2 billions.

If we compare the Treasury and President's proposals with the 1986 Tax Act at a six percent inflation rate, we find that these proposals would have produced much greater gains in growth opportunities. Gains from the President's proposal would have been more than double those of the 1986 Tax Act and gains from the Treasury proposal would have been fifty percent higher. However, at a zero inflation rate the two proposals and the actual 1986 tax legislation would have had very similar economic impacts, resulting in gains in growth opportunities of one and a half trillions. Under the 1986 Tax Act the gains shrink with increased inflation, but these gains actually grow with increased inflation under the two alternative proposals.

In summary, the Tax Reform Act of 1986 created almost one trillion dollars in growth opportunities for the U.S. economy. This demonstrates the potential contribution to growth from fundamental tax reform. As the inflation rate has gradually subsided, these growth opportunities have steadily increased. At azero rate of inflation the impact of the 1986 Tax Act on U.S. economic growth would have been closely comparable to that of the Treasury proposal or the President's proposal. However, the 1986 Tax Act did not incorporate provisions from these proposals that would have largely insulated the U.S. tax structure from the impact of inflation.

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[2]Further details are given in my paper with Yun, "The Excess Burden of Taxation."

3. Fundamental Tax Reform

In this section I consider the economic impact of a shift in the tax base for the federal revenue system from consumption to income. I also consider a number of alternative tax reforms. As in the previous section, I use the 1985 Tax Law with a six percent inflation rate as a benchmark. These alternative reforms focus on tax distortions induced by differences in the tax treatment of income from corporate, noncorporate, and household sectors, and short-lived and long-lived assets. In the parlance of the 1986 tax debate, these are different ways of "leveling the playing field." As before, I achieve revenue neutrality for each proposal by adjusting tax rates to preserve the balance between revenues and expenditures.

Initially, I will focus attention on the seventh panel in Table 2. This is the consumption tax scheme proposed in the Treasury's 1977 *Blueprints for Tax Reform* and now embodied in the Armey Flat Tax and Nunn-Domenici U.S.A. Tax proposals.Under these proposals the tax base for the federal tax system would be shiftedfrom income to consumption by excluding investment from the tax base. In the business sector this would be achieved through deductions for investment outlays like those for any other business expenses. The eighth panel of Table 2 is a more thorough-going version of this scheme that would eliminate sales taxes on investment as well.

Table 2
Growth Opportunities Created by "Leveling the Playing Field,"
(Billions of 1987 dollars)

		1985 Law
1.	**Within Sector Interasset Distortion**	
	Lump Sum Tax Adjustment	443.9
	Labor Income Tax Adjustment	248.1
	Sales Tax Adjustment	168.7
	Individual Income Tax Adjustment	70.2
2.	**Intersector Distortion: C and NC Sectors**	
	Lump Sum Tax Adjustment	-93.3
	Labor Income Tax Adjustment	-416.7
	Sales Tax Adjustment	-523.8
	Individual Income Tax Adjustment	-715.5
3.	**Intersector Distortion: All Sectors**	
	Lump Sum Tax Adjustment	2262.6
	Labor Income Tax Adjustment	2156.9
	Sales Tax Adjustment	2118.6
	Individual Income Tax Adjustment	2067.7
4.	**No Tax Distortion: C and NC Sectors, All Assets**	
	Lump Sum Tax Adjustment	326.4
	Labor Income Tax Adjustment	69.2
	Sales Tax Adjustment	-29.1
	Individual Income Tax Adjustment	-169.7
5.	**No Tax Distortion: All Sectors, All Assets**	
	Lump Sum Tax Adjustment	2663.7
	Labor Income Tax Adjustment	2603.9
	Sales Tax Adjustment	2572.4
	Individual Income Tax Adjustment	2547.2
6.	**Corporate Tax Integration**	
	Lump Sum Tax Adjustment	1313.1
	Labor Income Tax Adjustment	493.4
	Sales Tax Adjustment	238.1
	Individual Income Tax Adjustment	-274.5
7.	**Consumption Tax Rules (Zero Effective Tax Rates)**	
	Lump Sum Tax Adjustment	3853.9
	Labor Income Tax Adjustment	2045.4
	Sales Tax Adjustment	1749.3
	Individual Income Tax Adjustment	2045.4

8. **Consumption Tax Rules (Zero Effective Tax Rates; No Sales Tax On Investment Goods)**	
Lump Sum Tax Adjustment	4128.1
Labor Income Tax Adjustment	1988.0
Sales Tax Adjustment	1722.1
Individual Income Tax Adjustment	1988.0

The introduction of consumption tax rules for capital cost recovery in 1986 would have generated growth opportunities of more than *two trillion dollars*. This fundamental tax reform would have doubled the gains in U.S. economic growth that resulted from the 1986 Tax Act. This is the consequence of "leveling the playing field" among all economic sectors\-households, noncorporate businesses, and corporations. At the same time income from different types of assets\-plant, equipment, inventories, and land-would be treated symmetrically under the tax law. The tax treatment of income from all assets employed in the U.S. economy would be completely neutral under consumption tax rules like those proposed in *Blueprints*.

The first panel of Table 2 is a hypothetical tax reform that would eliminate differences in the tax treatment of different assets, but would leave the existing tax distortions due to differences in the tax treatment of corporate, noncorporate, and household capital income unaffected. The second panel would removes distortions between corporate and noncorporate business, but would not alter the treatment of income from household assets, such as owner-occupied residential housing. The third panel extends this treatment to the household sector.

The fourth panel would "level the playing field" among assets in corporate and noncorporate sectors, while the fifth would extend this treatment to the household sector as well. The sixth would reduce taxation on corporate assets to those of noncorporate assets through "corporate tax integration," as proposed by the Treasury's 1992 report, *Taxing Business Income Once*. Equalizing the treatment of income from assets in business and household sectors would create the greatest opportunities for U.S. economic growth, as indicated in the simulations summarized in the third and fifth panels of Table 2.

An important advantage of consumption tax rules is that income from capital employed in the household sector, such as owner-occupied residential housing, would be treated symmetrically with income from capital employed by corporate and noncorporate businesses. An alternative approach to equalizing the treatment of all forms of capital income would be to try to include income from owner-occupied residential housing in the federal tax base. However, this would require such politically unpalatable measures as reducing or totally eliminating popular tax deductions for home mortgage interest and state and local property taxes.

As a practical matter, the inclusion of income from the services of owner-occupied residential housing in the tax base for income would be highly problematical. Although owner-occupied residential housing is an investment from the economic point of view, the services of this housing are part of both consumption and income. A possible approach to the taxation of this part of income would be to treat each owner-occupier as a business owning a residence. This approach would involve an "imputation" for the rental value of housing as part of taxable income. European experience[3] shows that this approach is nearly impossible to implement.

A second approach to the taxation of income from owner-occupied housing would be to exclude the value of new residential construction from investment by disallowing a deduction for the purchase of a home along with all other housing-related deductions, such as home mortgage interest and state and local property taxes. In the Armey Flat Tax proposal the appeal of a low flat rate of taxation would help to offset the political consequences of eliminating these popular deductions.

A third approach to taxation of housing, employed in the Nunn-Domenici U.S.A Tax proposal represents a compromise between the existing income tax treatment and a full-scale consumption tax treatment. In this approach the current tax treatment of owner-occupied housing would be retained, while business income would be treated under consumption tax rules. This would nearly equalize the tax burdens on the household sector and the business sector. An important advantage of this compromise between income and consumption taxation would be to avoid complex transition rules for owner-occupied housing already in existence at the time of fundamental tax reform.

In summary, the principal conclusion that emerges from comparison of all eight hypothetical reform proposals is very transparent. The most important opportunities for future growth of the U.S.

[3]This experience is reviewed in my book with Ralph Landau, *Tax Reform and the Cost of Capital: An International Comparison*,

economy would be created by the adoption of consumption-tax rules for capital income. This would make it possible to reduce business taxes at both corporate and individual levels very substantially. If this approach to tax reform had been adopted in 1986 the gains would have been equivalent to almost two trillion dollars or *double* the gains resulting from the 1986 Tax Act.

4. Directions for Future Tax Reform

The purpose of the simulations of U.S. economic growth described in the preceding section is to compare actual tax reform proposals with the Tax Reform Act of 1986. The current tax structure retains many of the features that resulted from the 1986 reform. However, important changes in tax policy were incorporated into the Budget Enforcement Act of 1990 under President Bush and President Clinton's Omnibus Budget Reconciliation Act of 1993. Both of these budget agreements raised tax rates for upper income tax payers, increasing the reliance on capital income taxes relative to those on labor income. These changes have created important new opportunities for generating economic growth through fundamental tax reform.

I next provide a more precise assessment of opportunities to contribute to the future growth of the U.S. economy through tax reform.[4] For this purpose I link tax induced losses in economic efficiency directly to U.S. economic growth. I employ use a nondistorting tax system as a benchmark in measuring the loss in efficiency from taxation. In this tax system all revenue is raised by purely hypothetical "lump sum" taxes that do not distort private decisions and involve no efficiency loss. By focusing on differences in losses among alternative tax programs, I am able to identify promising avenues for future tax reform.

My first conclusion is that the loss in efficiency imposed on the U.S. economy by the current tax system is very large. The efficiency loss is equivalent to eighteen percent of government tax revenue. Each dollar of tax revenue costs the private sector a dollar of foregone investment or consumption and an additional loss in growth opportunities of eighteen cents. I refer to this estimate as the *average excess burden,* defined as the gain in efficiency that would result from replacing the whole U.S. tax system by a nondistorting system. Let me hasten to emphasize that this replacement is purely hypothetical.

The concept of efficiency loss most relevant to tax reform is the *marginal excess burden.* The marginal excess burden of the U.S. tax system is defined in terms of the efficiency loss *per dollar* for the final dollar of revenue raised. The marginal excess burden enables me to quantify one of the most familiar propositions in tax policy analysis. Since efficiency losses rise as tax burdens increase, the marginal cost of raising tax revenue is much greater than the average cost. I estimate that the marginal efficiency loss is 39.1 cents per dollar of revenue, more than double the average loss.

Most important, large differences in marginal excess burdens among different tax programs remain. For example, the marginal cost of raising a dollar through taxes on capital income at the individual level is one dollar and 1.7 cents, while the cost of raising a dollar from labor income taxes is only 37.6 cents. For every dollar of tax revenue transferred from capital income to labor income, the U.S. economy *gains* 64.1 cents in future growth opportunities. This transfer would be revenue neutral, so that it would be in perfect conformity to the Clinton Budget Plan of 1993. This provides a clear indication of important potential gains in future U.S. economic growth through tax reform.

I next describe the efficiency costs of various parts of the U.S. tax system in greater detail. For this purpose, I analyze the growth of the U.S. economy under reductions of tax rates for the following nine components of the U.S. tax system: (1) the corporate income tax; (2) capital income taxes at the individual level, including taxes levied on noncorporate capital income and taxes on individual capital income originating in the corporate sector; (3) property taxes on corporate, noncorporate, and household assets; (4) capital income taxes at both corporate and individual levels; (5) labor income taxes; (6) capital and labor income taxes; (7) the individual income tax; (8) sales taxes on consumption and investment goods; and (9) all taxes.

Table 3 presents the average and marginal efficiency costs of all components of the U.S. tax system under the Tax Reform Act of 1986. The marginal efficiency costs of the whole U.S. tax system in the ninth panel of Table 3 show that the marginal efficiency cost at rates prevailing under the 1986 tax act was .391 so that the loss in efficiency for each dollar of tax revenue raised was 39.1 cents. However, the average efficiency cost for the whole tax system was .180, so that replacing all taxes by a nondistorting tax would have increased opportunities for economic growth by an average of 18 cents per dollar of tax revenue.

The marginal efficiency cost of sales taxes given in the eighth panel of Table 3 was .262 after the reform, while the cost of property taxes given in the third panel was .176. By contrast, the

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[4]Here I draw on a second paper, "The Excess Burden of U.S. Taxation", that I have published with Yun.

marginal efficiency cost of all income taxes given in the sixth panel of Table 3 was .497. The efficiency losses were 49.7 cents per dollar of income tax revenue, only 17.6 cents per dollar of property tax revenue, and only 26.2 cents per dollar of sales tax revenue. A substantial increase in efficiency could have been realized by reducing income tax rates and increasing the rates of sales and property taxes. We conclude that the Tax Reform Act of 1986 did not successfully overcome the excessive reliance of the U.S. tax system on income taxes.

The structure of the income tax itself is completely out of balance with marginal efficiency costs of labor income taxes at .376, individual capital income taxes at 1.017, and corporate income taxes at .448. Very substantial gains in efficiency could have been realized by further reductions in marginal tax rates on individual and corporate taxes on capital income, even at the expense of increases in marginal tax rates on labor income. Considerable gains in growth opportunities for the U.S. economy could have resulted from reduced reliance on individual income taxes on capital income and more reliance on corporate income taxes.

Table 3
Efficiency Costs of US Tax Revenues After the Tax Reform Act of 1986

Tax Bases		Reduction in Tax Rates (5)										
		5	10	20	30	40	50	60	70	80	90	100
1. Corporate Income	MEC	.448	.435	.418	.397	.379	.363	.348	.334	.322	.310	.301
	AEC	.448	.442	.431	.421	.412	.404	.397	.391	.384	.379	.374
2. Individual Capital Income	MEC	1.017	.989	.951	.904	.853	.812	.767	.727	.688	.650	.613
	AEC	1.017	1.003	.977	.953	.928	.906	.884	.863	.842	.822	.803
3. Property Value	MEC	.176	.174	.171	.168	.164	.160	.157	.153	.149	.145	.142
	AEC	.176	.175	.173	.171	.169	.168	.166	.164	.162	.160	.158
4. All Capital Income	MEC	.675	.650	.616	.573	.533	.498	.466	.435	.407	.382	.359
	AEC	.675	.663	.640	.619	.600	.582	.566	.551	.537	.524	.512
5. Labor Income	MEC	.376	.358	.333	.303	.276	.253	.237	.216	.201	.190	.183
	AEC	.376	.367	.350	.334	.320	.307	.296	.285	.275	.266	.259
6. 1 + 2 + 5 = 4 + 5	MEC	.497	.462	.414	.355	.301	.254	.212	.175	.142	.114	.091
	AEC	.497	.480	.448	.418	.391	.366	.343	.323	.304	.287	.271
7. Indiviual Income	MEC	.520	.490	.449	.396	.349	.305	.265	.229	.196	.167	.140
	AEC	.520	.505	.477	.451	.426	.403	.381	.361	.342	.325	.308
8. Sales Value	MEC	.262	.259	.254	.249	.242	.236	.230	.224	.218	.211	.205
	AEC	.262	.261	.257	.254	.251	.248	.245	.242	.239	.236	.232
9. All Tax Bases	MEC	.391	.356	.308	.249	.197	.151	.113	.082	.063	.048	.040
	AEC	.391	.374	.342	.312	.285	.260	.238	.220	.204	.190	.180

Second, within the income tax there is excessive reliance on taxes on capital income at the individual level.

Finally, existing taxes on capital income put excessive burdens on individuals, relative to corporations. Taxes on capital income at both corporate and individual levels are too burdensome, relative to taxes on labor income. Every dollar transferred to labor income taxes from capital income taxes at the individual level costs the U.S. economy 64.1 cents in lost growth opportunities. Reversing the direction of the 1986 reform by raising marginal rates for "high income" taxpayers has greatly increased the tax burden on capital income. This will be enormously costly in terms of opportunities for reviving the growth of the U.S. economy.

In summary, the best way to create new growth opportunities for the U.S. economy would be to reduce the top rates of taxation at the individual level, not to increase these rates. This could be financed by cutting back on tax expenditure programs such as deductions for mortgage interest and state and local property taxes. President Bush's Budget Enforcement Act of 1990 and the Clinton Omnibus Budget Reconciliation Act of 1993 have substantially increased taxes on capital income at the individual level. A growth-oriented tax policy requires reinforcing the basic thrust of the Tax Reform Act of 1986 by reducing differences in the marginal excess burdens imposed by different parts of the U.S. tax system.

5. Conclusion

My first overall conclusion is that increases in tax rates for upper income taxpayers in 1990 and 1993 have nullified many of the growth opportunities for the U.S. economy created by the Tax Reform Act of 1986. It is important to underline this conclusion, since the recent emphasis on "soaking the rich" has increased reliance on capital income taxes relative to those on labor income. This will be enormously costly in terms of future opportunities for growth of the U.S. economy. Future tax reforms should strengthen rather than weaken the basic thrust of the Tax Reform Act of 1986.

Second, Neutral Cost Recovery is an important contribution to the debate over tax reform. This tax proposal would introduce provisions for recovery of capital costs that are equivalent to the expensing of investment expenditures required under consumption tax rules. However, Neutral Cost Recovery must be combined with other tax reforms, such as the elimination of deductions for interest expenses, in order to enhance the neutrality of the federal tax system. Achieving neutrality in the taxation of income from all assets in the U.S. economy is the most important goal for future tax reform.

Finally, changing the federal tax base from income to consumption is an idea whose time has come. This change will create very important new opportunities for growth in the standard of living of all Americans. The traditional objections to consumption as a base for taxation on grounds of fairness have been successfully addressed in the Armey Flat Tax and the Nunn-Domenici U.S.A. Tax proposals. These proposals would create substantial new growth opportunities for the U.S. economy. Both are based on weel established economic ideas and could serve as a point of departure for tax reform legislation.

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Mrs. JOHNSON OF CONNECTICUT. Thank you, Dr. Jorgenson. Professor Kotlikoff.

STATEMENT OF LAURENCE J. KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY

Mr. KOTLIKOFF. Thank you, Madam Chairman.

Madam Chairman and other Members of the Committee on Ways and Means, I am honored by this opportunity to discuss with you the economic effects of consumption taxation.

My testimony makes five points. First, consumption taxation would be very good for the U.S. economy. It would raise saving, investment, employment, output, and real wages. It would also eliminate a number of major distortions in our current tax structure and thereby significantly raise U.S. economic efficiency.

The second point is that the predicted economic benefits from consumption taxation are substantial. Generic simulations of shifting from income to consumption taxation in the standard, neoclassical economic growth model, the life cycle model, produced long-run increases in living standards ranging from about 10 to 20 percent. These simulations provide some sense of the beneficial economic effects of consumption taxation, although much more detailed simulation studies are needed of particular proposals.

Third, consumption taxation increases saving in large part—and I think this is a point that many of you may not be aware of—consumption taxation increases saving in large part by redistributing from older generations, with high propensities to consume, to younger and future generations with low or zero propensities to consume. In redistributing from the old to the young, and to the unborn, consumption taxation would offset to a small degree the enormous past and ongoing reverse redistribution from the young to the old that has resulted from the expansion of pay-as-you-go entitlement programs, and which is the primary cause for the critically low current rate of U.S. saving.

The fourth point is that consumption taxation, even one levied at a single rate with no exceptions, is much more progressive than is generally believed to be the case. And again here is I think something that is not generally understood by Members of Congress. The reason that consumption taxation is much more progressive than is commonly believed is that consumption taxation represents a tax on wages and a tax on wealth. If you think about how Donald Trump would fare under, for example, a retail sales tax, whenever he went out to spend his money on whatever he buys, Mercedes or vacation trips, diamonds for friends and relatives, he would pay the tax. But under the current income tax, he is paying taxes just on his interest income, his capital income, dividend income and capital gains; he is not being taxed on his principal.

Since a consumption tax combines wage and wealth taxation, it is really taxed principal. And since much of the inequality in living standards across members of each generation represent differences in the amounts of inherited wealth, the wealth tax component of a consumption tax would enhance intragenerational equity.

I think that if the proponents of consumption taxation really understood it, they would be less for it; and if the opponents of it really understood it, they would be more supportive.

The fifth point is that the U.S. economy needs consumption taxation. Whether that consumption taxation should be in the form of a retail sales tax, a flat tax, a personal consumption tax, an electronic consumption tax or a value-added tax, can provide hours of very fascinating debate. But each of the different methods of taxing consumption does tax consumption. Each has its own advantages and disadvantages. But it will be a tragedy if we fail to adopt one of the methods of consumption taxation because we are locked in a debate over which is the best one.

In my view, any of the alternative proposed consumption taxes would be far superior to our current system of taxation.

Thank you.

[The prepared statement and attachments follow:]

TESTIMONY OF LAURENCE J. KOTLIKOFF
BOSTON UNIVERSITY

Chairman Archer and Other Distinguished Members of The Committee on Ways and Means:

I am honored by this opportunity to discuss with you the economics effects of consumption taxation.

My testimony makes five points.

First, consumption taxation would be very good for the U.S. economy. It would raise saving, investment, employment, output, and real wages. It would also eliminate a number of major distortions in our current tax structure and thereby significantly raise U.S. economic efficiency.

Second, the predicted economic benefits from consumption taxation are substantial. Generic simulations of shifting from income to consumption taxation in the standard neoclassical economic growth model -- the life-cycle model -- produce long-run increases in living standards ranging from about 10 to 20 percent. These simulations provide some sense of the beneficial economic effects of consumption taxation, although much more detailed simulation studies are needed of particular proposals.

Third, consumption taxation increases saving, in large part, by redistributing from older generations, with high propensities to consume, to younger and future generations with low or zero propensities to consume. In redistributing from the old to the young and unborn, consumption taxation would offset to a small degree the enormous past and ongoing reverse redistribution that has resulted from the expansion of pay-as-you-go entitlement programs and which is primarily responsible for the critically low level of U.S. saving.

Fourth, a consumption tax, even one levied at a single rate with no exemptions, is much more progressive than is generally believed to be the case. The reason is that consumption taxation represents the combination of wage taxation and wealth taxation. Since much of the inequality in living standards across members of each generation represents differences in the amounts of inherited wealth, the wealth tax component of a consumption tax would enhance intragenerational equity.

Fifth, the U.S. economy needs consumption taxation. Whether consumption taxation should come in the form of a retail sales tax, a flat tax, a personal consumption tax, an Electronic Consumption Tax[1], or a value-added tax is a question that can provide hours of interesting debate. Each of the different

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[1] Under the Electronic Consumption Tax (the ECT), discussed in Kotlikoff (1995), households pass their ECT card through a card reader when they purchase goods and services. Montly purchases (but not the composition of purchases) are tallied and transmitted to the IRS, which withholds taxes. On April 15th, the IRS calculates consumption over the previous calender year, assesses taxes based on a progressive rate structure, and makes tax refunds or witholds additional taxes depending on whether total monthly withholdings in the prior calender year exceeds or falls short of the household's annual tax liability. Since the IRS' withholding of taxes and refunds of overpayments can be made electronically, the ECT entails no use of tax forms.

methods of taxing consumption has it advantages and disadvantages. But it will be a tragedy if we fail to adopt one of these methods of consumption taxation because we are locked in debate over which is the best one. In my view, any of the alternative proposed consumption taxes would be far superior to our current system of taxation.

The Crisis in U.S. Saving

In 1950, the U.S. rate of net national saving was 12.3 percent. In 1994, it was only 3.5 percent. The difference in these saving rates is illustrative of a dramatic long-term decline in U.S. saving. The U.S. saving rate averaged 9.1 percent per year in the 1950s and 1960s, 8.5 percent in the 1970s, 4.7 percent in the 80s, and just 2.7 percent in the first five years of the 1990s.

The decline in U.S. saving has been associated with an equally dramatic decline in U.S. domestic investment. Since 1990, net domestic investment as a share of net national product has averaged 3.6 percent per year, compared with 8.2 percent in the 1950s, 7.9 percent in the 1960s and 1970s, and 6.1 percent in the 1980s.

The low rate of domestic investment has limited growth in labor productivity and, consequently, growth in real wages. Since 1980, labor productivity has grown at less than half the rate observed between 1950 and 1979, and total real compensation (wages plus fringe benefits) per hour has grown at only one-eighth its previously observed rate.

Understanding the Decline In Saving

Table 1 reports average values of the net national saving rate for the 1950s, 1960s, 1970s, and 1980s as well as the first five years of the 1990s. The table also reports rates of government and household consumption out of output. In addition, the table reports my preferred measure of private-sector saving, the *household saving rate*, which equals the share saved of the output left over to the household sector after the government has consumed.

As Table 1 indicates, government spending is not responsible for reducing the rate of national saving. Indeed, government spending in the 1990s has averaged just 21.0 percent of output -- as low a rate as any observed in the five periods. The rate of household consumption spending, on the other hand, rose from 69.9 percent of output in the 1950s to 76.6 percent in the early 1990s. This increased rate of household consumption was associated with a decline in the household saving rate from 11.5 percent in the 1950s to 3.2 percent in the 1990s.

Whose Consumption Has Risen?

If the driving force behind the decline in U.S. saving is an increase in the rate of household consumption, it's natural to ask whose consumption within the household sector has risen so rapidly? The answer is the elderly's. Tables 2 and 3 document this fact.[2] They show a remarkable increase in the relative

[2] These tables come from Gokhale, Kotlikoff, and Sabelhaus (1995).

consumption of the elderly over four periods for which Consumer Expenditure Survey data are available. This increase is more pronounced if medical care is included in the measure of consumption, but the increase in the relative consumption of non medical goods and services is also striking.

As shown in Table 4, the striking increase in the relative consumption of the elderly has coincided with an equally remarkable increase in their relative resources.[3] Indeed, as described in Gokhale, Kotlikoff, and Sabelhaus (1995), the the postwar decline in U.S. saving can be traced to two factors: a) this redistribution of resources toward older generations, with high propensities to consume, from younger ones (including those not yet born), with low or zero propensities to consume and b) increases in the propensity of the elderly to consume.

Much of the redistribution to the elderly reflects the growth in Social Security, Medicare, and Medicaid benefits. The increase in the elderly's consumption propensities may also reflect government policy, namely the fact that government transfers to the elderly come in the form of annuities. In providing these annuities, which are, of course, indexed for inflation, the government has, in effect, told the elderly they needn't worry as much about over-consuming and running out of income.[4]

Implications of the U.S. Saving Decline for Evaluating Consumption Taxation

The fact that the government's past and ongoing intergenerational redistribution appears to be the chief culprit for the decline in U.S. saving is worth bearing in mind in considering switching from income to consumption taxation. Such a switch would partially offset this process of taking from the young and unborn and giving to the old. It would do so by placing a somewhat higher tax burden on the initial elderly and a somewhat lower tax burden on younger and future generations. In switching tax structures (and thus redistributing from the elderly with high propensities to consume to the young and unborn with low or zero propensities to consume), the government can engineer a reduction in aggregate consumption and a concomitant rise in national saving. This redistributional or "income" effect is the key reason that consumption taxation raises national saving.

Alternative Ways to Tax Consumption?

As indicated above, there are a number of different ways of taxing consumption. One way, which you, Mr. Chairman, and Senator Lugar have proposed is through a federal retail sales tax under which the consumption purchases of all Americans are taxed at the same rate. Although a retail sales tax would produce a proportional rather than progressive consumption tax, progressivity vis a vie

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[3] The term "resources" refers to a generation's net worth plus the present values its future labor income, pension income, and Social Security, Medicare, and other transfer payments, less the present value of its future taxes.

[4] In addition, the medical care annuities that the government provides through Medicare and Medicaid come in the form of in-kind consumption of medical goods and services which the elderly cannot help but consume.

consumption could be achieved by combining a retail sales tax with a graduated refundable tax credit or by exempting from sales taxation those commodities on which the poor spend disproportionately more than do the rich.[5]

Another way to tax consumption, proposed by Senators Nunn and Domenici in their USA Tax, is to tax households on their incomes, but allow them a deduction for the amount they save. This personal consumption tax can be assessed at progressive rates since the government receives a tax return specifying each household's total annual consumption.[6]

The Electronic Consumption Tax (ECT) falls between a retail sales tax and a personal consumption tax. Like a retail sales tax, it taxes consumption directly. But like a personal consumption tax, it taxes consumption at progressive rates. Under the ECT, households would be required to run their ATM card through an electronic reader in making their consumption purchases. The amount of the purchase would be recorded by the household's bank. Running the card through the reader will be required regardless of whether the household pays for its purchases with cash or through an electronic withdrawal from its bank. Each month the total amount of households' consumption purchases (but not the composition of these purchases) would be reported to the government, and estimated taxes would be withheld, on a progressive basis, based on the amount reported. Tax witholding would be made electronically either as payroll deductions or as deductions from the household's checking account, so there would be no need for households to file any tax forms. At the end of the year, the government would calculate, on a progressive basis, each household's annual consumption and its annual consumption tax. Households which overpaid taxes during the year would receive an electronic refund, and those who underpaid would experience an electronic withdrawal.

David Bradford, Professor of Economics at Princeton University and former Member of the President's Council of Economic Advisers, has suggested taxing household labor income Y*l* at progressive rates and taxing, at the business level, the difference between capital income and investment (Y*k* - I, business cash flow) at the highest tax rate. This proposal, which he calls "The X Tax," also produces a form of progressive consumption taxation.

Congressman Armey's and Senator Specter's proposed flat taxes also tax Y*l* at the personal level and Y*k*-I at the business level, but they apply a single proportional tax rate.[7] Since these proposed flat taxes include quite high personal exemptions, low income household are exempt from taxation.

A proportional value added tax is another option for taxing consumption. The value added tax, which is used in virtually all other developed countries, taxes Y -

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[5] Differential rates of sales taxation of consumption goods and services would, however, potentially produce significant economic distortions in consumer choice. It would also undermine one of the main advantages of retail sales taxation -- its simplicity and clarity.

[6] David Bradford originally proposed this form of progressive consumption taxation in Blueprints for Basic Tax Reform, U.S. Department of Treasury, Washington, D.C.: U.S. Government Printing Office, 1976.

[7] Armey's Flat Tax proposal is quite similar to that in Hall, Robert E. and Alvin Rabushka, The Flat Tax, Stanford University: Hoover Institution Press, 1986.

I, but does so, for each commodity, by taxing Y - I in each stage of the commodity's production.

Why Tax Consumption?

Given that governments can tax consumption directly or indirectly and that they can do so either with progressive or proportional tax rates, why would they want to tax only output that is consumed and exempt from taxation output that is save (invested)? The answer is that a consumption tax provides more incentive to save (invest) than does an income tax. As the identity Y = C+S, where Y is output, C is consumption, and S is saving, indicates, taxing output can be viewed as taxing saving as well as consumption. Now economists view saving, not as an end in itself, but as a means to finance future consumption. So by taxing consumption and saving, an income tax effectively taxes future consumption twice, once when households save funds for future consumption and once when they engage in that future consumption. Since current consumption is taxed only once (ignoring past taxes on saving because bygones are bygones), in deciding between consuming more now and saving for future consumption, an income tax provides an incentive, at any point in time, to consume more now and save less for the future.

In addition to providing better saving incentives, moving from an income to a consumption tax produces, as previously mentioned, an intergenerational redistribution away from older generations toward younger and future generations that also lowers aggregate consumption and raises national saving. The reason this intergenerational redistribution occurs is that older generations pay a larger share of consumption taxes than they do of income taxes. Under an income tax, elderly retirees pay tax on only their capital income, whereas under a consumption tax, they pay tax on all their consumption purchases. Since elderly retirees finance their consumption by spending not just capital income earned on their net worth, but also their net worth (their principal) as well as private and social security pension benefits, the consumption of the elderly, taken together, exceeds their capital income. Moreover, the consumption of the elderly is a larger share of aggregate consumption than is their capital income as a share of aggregate taxable income. Consequently, a shift from taxing income (including the capital income of the elderly), to taxing consumption (including that of the elderly), places a relatively higher tax burden on the elderly.

Economists refer to the change in economic behavior, such as saving, that arise from a change in one's resource position as *income effects*. They refer to changes in economic behavior due to changes in incentives, holding resources constant, as *substitution effects*. The above discussion indicates that the substitution and income effects of moving from income taxation to consumption taxation reinforce one another. Both work in favor of lowering aggregate consumption and raising national saving.

Why Consumption Taxation Represents a Combination of Wage and Wealth Taxation

The income effects from consumption taxation arise, in large part, because the consumption tax represents a combination of a tax on wages and a tax on

wealth.[8] The reason is that the goods and services that households purchase over time are ultimately financed by the wages they earn plus their initial wealth. Consider, for example, a millionaire who doesn't work, but spends his wealth on consumption. In the case of a retail sales tax or the ECT, the millionaire pays tax as he spends down his wealth; hence, the consumption tax effectively taxes his wealth. Now suppose the millionaire also works. Then when he spends his wage earnings, he also pays consumption taxes, so the consumption tax also effectively taxes wage earnings. If the millionaire chooses not to consume and passes his wealth to his heirs, they will be taxed when they spend their inherited wealth.

The USA tax also includes an implicit wealth tax, albeit a modified one because of its transition rules. Under the USA tax, households that spend more than $50,000 of their assets on consumption must include the excess spending as taxable income.

The flat tax, at least the one originally designed by Hall and Rabushka, also represents an effective tax on real wealth. Under the flat tax, as under our current income tax structure, the sale, by businesses (really, by the owners of businesses), of their real assets (their plant, equipment, and inventories) is included in the calculation of business revenues and is subject to tax. But, unlike the current tax structure, the flat tax permits no deduction of the basis of the asset when it is sold. If the basis of the asset could be deducted, the flat tax, like our current income taxation of businesses, would be taxing simply the capital gains realized by businesses on the sale of their real assets. Why? Because capital gains are calculated as the difference between the sale price of the asset and its depreciated tax basis.

Can owners of real assets avoid the additional tax arising from not being able to deduct basis by simply not selling their asset, but instead, continue to use them to produce business income? The answer is no. The market value of real assets will fall to the point that the owners of the assets will be indifferent between retaining and selling their assets. This decline in the market value of existing real wealth (which will be registered on the stock market) represents an effective tax on real wealth.

To understand why the market value of real business assets must fall, consider an investor, ABC Co., which is considering purchasing a newly produced real asset, say a drill press, for $1000 or buying an existing business, DEF Co., with, for simplicity, a single asset -- an identical drill press which it had purchased prior to the switch to the flat tax and which has a basis of $1000. Assume, for simplicity,

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[8] To see this algebraically, note that at time t, $C_t = Yl_t + Yk_t - S_t$. But, if we let W_t stand for wealth at time t, then $Yk_t = rW_t$, where r_t is the rate of return earned on wealth (i.e., rW_t equals capital income). Also, $S_t = W_{t+1} - W_t$. Hence, $C_t = Yl_t + rW_t - W_{t+1} + W_t$. Write this equation out for time t+1, t+2, etc., and then use the t+1 equation to substitute out for W_{t+1} in the time t equation, to get a new time t equation that will depend on W_{t+2}. Next use the time t+2 equation to substitute out for W_{t+2} in the new time t equation. Proceding in this manner leads to an equation in which the present value of consumption equals the present value of current plus future labor earnings plus initial wealth. Multiplying each side of this present value budget constraint by the tax rate t shows that taxing consumption through time at rate τ is equivalent to taxing earnings through time at rate τ plus taxing initial (time t) wealth at rate τ.

that drill presses do not physically depreciate, so the two machines are physically identical. If ABC purchases the new drill press, it can immediately expense it (deduct its purchase price from its business income). If the flat tax rate is 20 percent, the value of the write off is $200. If ABC purchases DEF, it acquires the same machine, but can't expense it. Consequently, the market value of DEF must fall until ABC and other potential investors are indifferent between purchasing DEF directly and purchasing the same real asset owned by DEF, but expensing it. Hence, the market value of DEF will be $800.

Now, if ABC purchases and then liquidates DEF, it will be able to sell DEF's drill press on the market for $1000, because the new owner can treat the press as a new asset and expense it. But in selling the drill press, ABC will produce $1000 in sales revenues for its subsidiary, DEF, and, thus, a $200 tax liability. Hence, in liquidating DEF, ABC will end up with $800. So whether ABC buys DEF to hold it or to liquidate it, the most it will pay is $800. If it tries to buy DEF for less than $800, the owners of DEF will refuse, because they will be able to find other buyers willing to pay $800. Hence, the market price of DEF will be $800.

Wealth Taxation and National Saving

Since, as just mentioned, the elderly have a disproportionately large share of wealth, a switch from income to consumption taxation places a relatively large share of the tax burden on them. Although the consumption tax also, in effect, taxes wage income, which is also taxed under the income tax, it does so at a lower rate than under the income tax because the consumption tax provides more revenue from its effective wealth taxation. Hence, the young, who are disproportionately larger earners of labor income, benefit from the shift from income to consumption taxation because their effective rate of wage taxation is reduced.

The reduction in the effective rate of wage taxation stimulates labor supply, thereby raising output and further increasing aggregate saving. This stimulus to labor supply will be even greater if the switch in tax structures is from a progressive income tax to a proportional consumption tax. Why? Because the incentive to work depends on the marginal rate of taxation of labor supply, not the average rate. Under progressive income taxation, the marginal effective rate of taxation of labor supply is higher than under a proportional income tax, which is higher still than under a proportional consumption tax.

The Importance of Implicit Wealth Taxation

Note that if initial wealth is effectively exempted from consumption taxation through the design of special transition rules, a switch from income to consumption taxation will really end up as a switch from income to wage taxation. In this case, "consumption" taxation will produce a much smaller reduction in consumption and, consequently, a much small increase in aggregate saving. Why? Because the switch from income to wage taxation redistributes from the young to the old, since the elderly have relatively little wage income, but benefit from the elimination of capital income taxation. Although a wage tax structure provides better incentives to save, its income effects work to reduce saving. Indeed, the net impact, according to simulation studies (see Auerbach and

Kotlikoff, 1987) of a switch from income to wage taxation is a relatively modest increase in aggregate saving, investment, and output.

Efficiency Gains from Consumption Taxation

The current tax system contains a number of distortions which also could be eliminated by switching to consumption taxation. One of these distortions is the differential tax treatment of corporate and noncorporate business that distort business ownership and control decisions. A second is the differential tax treatment of capital gains and dividends that distort firms' decisions about retaining earnings and that lock investors in from selling shares of stock which have accrued capital gains. A third is the implicit subsidy to home ownership, as well as automobiles, and other durable goods that arises from our failure to tax, under the income tax, the rental income we implicitly earn from the services on these durables.[9] A fourth is the subsidization of current relative to future consumption (the tax on saving) associated with the taxation of capital income. A fifth is the differential tax treatment of investment in equipment, structures, and inventories. A sixth is the distortion in corporate financial structure due to the deductibility of interest payments, but the nondeductibility of dividends. And an seventh is the subsidization of health insurance premia and other fringe benefits that are currently exempt from income taxation, but would be treated like wage compensation under most consumption tax proposals.

The distortion of labor supply incentives associated with income taxation would also be eliminated by the proposed tax shift. But a consumption tax would distort this margin of choice as well, so one needs to compare the efficiency gains from eliminating the income tax's distortion of labor supply with the efficiency loss from adding the consumption tax's distortion of labor supply. There is good reason, however, to expect the tax shift to result in a net reduction in the distortion of labor supply. The reason, as mentioned above, is that consumption taxation will extract a larger share of its revenues from older generations, many of whom are retired. As a result, the total tax that needs to be collected from working generations is smaller under a consumption tax than it is under the income tax.

The distortion of labor supply will also be substantially reduced if our progressive income tax rate is replaced by a low, single-rate consumption tax because the low tax rate will leave most workers facing significantly lower total effective marginal tax rates on their labor supply than is currently the case. The size of economic distortions of particular economic activities rises with the square of the total effective marginal tax rate on that activity. In the case of labor supply, most Americans face marginal taxes above 50 percent on their earnings once one adds together the effects of all the different tax and transfer programs at the federal, state, and local government levels. This is an extremely high level of marginal

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[9] To see this, suppose homeowners, owners of automobiles, and owners of other durables were forced to pay rent to themselves for their use of their homes, cars, furniture, etc. At one level, this would be a wash, since the person writing the check would also be the recipient of the check. But this requirement would raise households' taxable income, leading them to pay more income taxes. Does it make sense to think of, say, a home owner as renting her house to herself? The answer is yes since in occupying her house, the home owner is effectively earning the rent on the house and then spending it on herself.

taxation, which is highly distortive. The reduction in this marginal rate of taxation through a retail sales tax or a flat tax, represents a very strong argument for their adoption.

The Auerbach-Kotlikoff Dynamic Life Cycle Simulation Model[10]

The Auerbach-Kotlikoff Model (henceforth, the AK model) can provide some sense of the potential saving, investment, and growth effects of shifting to a consumption tax.[11] The AK model calculates the time-path of all economic variables in its economy over a 150 year period. The model has 55 overlapping generations. Each adult agent in the model lives for 55 years (from age 20 to age 75).

There are three sectors in the model: households, firms, and the government. Households (adult agents) make decisions concerning how much to work and how much to save based on the after-tax wages and after-tax rates of return they can earn in the present and the future on their labor supply and saving, respectively. The work decision involves not only deciding how much to work in those years that one is working, but also when to retire. The AK model's particular form of consumption and leisure preferences that agents use in making their labor supply and saving decisions were chosen in light of evidence on actual labor supply and saving behavior.5

As agents age in the model, they experience a realistic profile of increases in wages. This age-wage profile is separate from the general level of wages, the time-path of which is determined in solving the model. Fiscal policies affect households by altering their after-tax wages, their after-tax rates of return, and, in the case of consumption taxes, their after-tax prices of goods and services. The model is equipped to deal with income taxes, wage taxes, capital income taxes, and consumption taxes. It is also able to handle progressive as well as proportional tax rates.

All agents are assumed to have the same preferences, so differences in behavior across agents arise solely from differences in economic opportunities. Since all agents within an age cohort are assumed to be identical, differences in economic opportunities are present only across cohorts. In this study, the model's population growth rate is set at a constant 1 percent rate, with the population of each new cohort being 1 percent larger than that of the previous cohort.

The AK Model's production sector is characterized by perfectly competitive firms that hire labor and capital to maximize their profits. The production relationships that underlie firms' hiring decisions and production of output are based on

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[10] This section presents the results reported in Kotlikoff (1992) of simulations of a switch from federal income taxation to a retail sales tax. Because a retail sales tax is equivalent to a flat tax of the type originally proposed by Hall and Rabushka, the simulation findings apply to the flat tax as well. The simulations are highly stylized. They do not, for example, take into account proposed exemptions from taxation as well as a number of other features of the flat tax proposals recently advanced by Congressman Armey and Senator Specter.

[11] For a detailed description of the AK Model see Auerbach and Kotlikoff (1987).

empirical findings for the U.S. The government sector consists of a treasury that collects resources from the private sector to finance government consumption and an unfunded, "pay as you go" Social Security system which levies payroll taxes to pay for contemporaneous retiree benefit payments. The model does not distinguish federal from state and local government. Hence, in simulating with the model the elimination of income taxation in favor of consumption taxation, we will, in effect, replace all state and local income taxes, as well as federal income taxes, with a federal consumption tax which can be thought of as a federal retail sales tax, a value added tax, or a flat tax. There is no money in the model, and thus, no monetary policy. There is, however, government debt, and the model can handle deficit-financed tax cuts. It can also handle gradual phase-ins of one tax for the other.

While the model handles a great number of complex processes, its predictions need to be viewed cautiously for several reasons. First, the model does not deal with several of the real world distortions associated with the income tax that were mentioned above. For example, it doesn't distinguish corporate from noncorporate production, housing consumption from non housing consumption, different forms of corporate finance, different types of investment, or differences in capital gains and dividend tax rates. Nor does it permit the kind of tax arbitrage that is available to most tax-paying Americans through tax-subsidized saving accounts. Second, the model's agents are heterogeneous only with respect to their age. There are no welfare recipients or millionaires, whose saving and work behavior might differ dramatically from that of the model's agents. Third, the model does not include saving for purposes other than retirement, such as bequests. Fourth, the model does not incorporate uncertainty either with respect to individual or macroeconomic outcomes. Fifth, the model ignores illegal tax avoidance, an issue that would certainly arise in implementing any and all other form of consumption taxation. While the model abstracts from a significant portion of reality, it can, nonetheless, suggest the degree to which a switch from consumption taxation to income taxation might raise U.S. national saving.

Simulating the Switch from Proportional Income to Proportional Consumption Taxation

In simulating the switch from income taxation to a federal consumption tax, one needs to specify the economy's initial position as well as the way the tax change takes place. To begin, let's assume that the economy has a 15 percent proportional income tax and a 17 percent sales tax. The 15 income tax figure is based on the 1991 ratio of the sum of federal, state, and local personal and corporate income taxes to net national product. The 17 percent sales tax figure is based on the 1991 ratio of the sum of federal, state, and local sales and excise taxes to total personal consumption.6 These taxes are used to finance government consumption spending as well as pay interest on the government debt. The level of government debt is set at 50 percent of output.7 In addition to these features of fiscal policy, the economy is assumed to have a "pay-as-you-go" social security system with a 15 percent payroll tax rates.

Findings

Table 5 shows the transition-path of the economy that results from replacing in year 0 the model's income tax with a proportional consumption tax. I set the new

federal consumption tax rate at the level needed, in conjunction with the pre-existing 17 percent sales tax, to continue to finance the same level of government spending as well as pay interest on the stock of government debt. The first row in the table indicates the economy's initial (year 0) position. With no change in tax policy the economy would remain in this position through time. I measure annual saving rates, annual interest rates, and tax rates in percentage points. In the case of our economy's other variables, the units of measurement are arbitrary, so I describe each of these variables in terms of an index which has an initial (base-year) value of 100.

The initial position of the economy features a 2.6 percent saving rate, a per capita capital stock of 100, a per capita labor supply of 100, a level of per capita output of 100, a real wage rate of 100, a real interest rate of 9.4 percent and, of course, a zero federal consumption tax rate. The 2.6 percent saving rate is close to the current U.S. rate of saving, and the 9.4 percent real interest rate is close to the annual real rate of return that has been earned, on average, on the U.S. capital stock in the postwar period.

The remaining rows in Table 5 show how each of these variables reacts to the introduction at time 0 of the federal consumption tax. As row 1 indicates, the tax change produces an immediate and dramatic increase in the economy's saving rate from 2.6 percent to 9.0 percent. While the saving rate gradually declines after year 1, it remains above 6 percent through the tenth year of the transition. The long-run (year 150) value of the saving rate is 3.2 percent -- 23 percent larger than the year 0 value.

The increased saving produces a concomitant increase in investment. As a result, the capital stock rises. Indeed, the switch in tax regimes leads, eventually (by year 150), to a 34 percent increase in the per capita capital stock. The increase in the capital stock is gradual; only about one quarter of the ultimate increase occurs in the first 10 years of the transition. The increase in the capital stock raises the productivity of workers and thus their real wage. The policy also lowers the return to capital. The real interest rate falls by almost 200 basis points in the course of the transition.

While the real wage ultimately ends up 7 percent higher than it would have been without the tax change, for the first few years of the transition the real wage actually falls. The reason is that agents respond to the prospect of higher real wages and higher short-term real interest rates by increasing their labor supply. In the short run, before the capital stock has had much of a chance to increase, there is an increase in the supply of labor relative to the supply of capital. As a result, labor in the first few years of the transition becomes relatively abundant, meaning that the price it receives in the market -- the real wage -- falls. Eventually, as interest rates fall, the incentive to work more in order to save more and receive higher rates of return on the additional savings diminishes. As a result, labor supply declines. In the long run, the supply of labor is only one percent greater than it is in year 0.

The changes in the supplies of capital and labor alter the per capita level of output. Between year zero and year 1, there is a 4 percent increase in output. In the following 10 or so years the switch in the tax structure raises the economy's growth rate by two tenths of one percent per year. In the long-run, the level of per capita output is 8 percent larger than it is at time 0.

The final variable to discuss is the consumption tax rate. The year 1 value of this tax rate is 23.1 percent. But it declines through time, with its value in the long-run ending up at 16.7 percent. The reason the tax rate can decline is that the growth of the economy permits a higher level of consumption and thus produces a higher consumption tax base. In addition, the reduction in the interest rate lowers required interest payments on the government's debt.

To summarize the findings in Table 5, the simulation of a switch to a federal consumption tax produces a significant increase in saving, capital accumulation, the real wage, and the level of per capita income. While the dynamics are nonlinear (e.g., labor supply first rises and then falls), all of the results make intuitive sense.

Maintaining a Constant Consumption Tax Rate

As an alternative to having the consumption tax rate decline through time, we might want to have a tax rate that is constant through time. I've used the model to simulate such a policy. I've found that if I set the tax rate equal to 19 percent, the model produces deficits in the short-run, since the additional tax revenue raised with the 19 percent tax falls short of the loss in revenue from eliminating the 15 percent income tax. But over time, the growth of output and the consumption tax base associated with the reform raises the amount of revenue collected by the 19 percent tax permitting the full retirement of the additional debt that is issued in the short-run. In this constant tax rate simulation the long-run capital stock and output levels are 32 percent and 7 percent higher than their respective year 0 values. These long-run percentage increases may be compared with the 34 percent and 8 percent increases of Table 5.

Are the Results Reasonable?

Given the size of the model's predicted response to a switch to a consumption tax, one might ask whether the results are really plausible or whether they simply reflect some extreme assumptions about labor supply and saving behavior. The answer is that the labor supply and saving responses assumed in the model are quite conservative. They are certainly well within the range of responses that have been estimated in the empirical economics literature. In addition, the life cycle model being simulated is the basic bread and butter model of neoclassical economics.8

There is, however, one feature of the model which may make the transition occur faster in the model than it would in the real world. This is the model's assumption that new capital can be immediately added to the existing stock of capital without the incursion of installation costs. As discussed in Auerbach and Kotlikoff (1987), the addition of such installation costs would slow down the transition, but would not alter the size of the long-run change of any of the economy's variables.

Another issue, with which I have not yet dealt, is the progressivity of the income tax which is to be replaced. As mentioned, the AK model can handle progressive as well as proportional tax rates. In the case of a progressive income tax, whose degree of progressivity is roughly comparable to that now in the U.S., the year 0

position of the economy from which the transition begins is one featuring a 2.2 percent, rather than a 2.6 percent, saving rate, a per capita capital stock that is 18.1 percent smaller, a per capita labor supply that is 5.2 percent smaller, a per capita output level that is 8.6 percent smaller, a real wage that is 3.5 percent smaller, and an interest rate of 10.4 percent rather than 9.4 percent. Since the switch from this progressive income tax regime to a proportional consumption tax produces the same long-run outcome as indicated in the last row of Table 6, the saving, capital accumulation, and growth effects of the tax change are all magnified by assuming that the initial income tax is progressive. For example, the long-run increase in the per capita capital stock is 63.4 percent, and the long-run increase in per capita output is 18.3 percent.[12]

The Impact on the Initial Elderly

While switching to a consumption tax has a lot to recommend it, this does not include the treatment of the initially elderly who, as mentioned, end up paying much more in consumption taxes than they would have paid in income taxes. For example, in the simulation of Table 5, the oldest elderly in year 1, those who are age 55, suffer a 23 percent decline in their final year's consumption. There are different ways to avoid, or at least mitigate, this redistribution away from those who are old at the time of the switch in tax structures. One is to make additional transfer payments to the initial elderly by, for example, raising social security benefits. The problem with making transfer payments to the initial elderly is that these transfer payments will lead them to consume more and this additional consumption will limit the increase in saving and capital accumulation.

Table 6 points this out. It shows the transition arising from an immediate switch to a retail sale tax, but one in which the government makes transfer payments to all generations alive at the time of the transition to ensure that none of these generations is made worse off from the tax switch. These transfer payments are, of course, largest for the oldest generations alive at the time of the tax switch, since they do not benefit as much from the elimination of income taxes as do younger generations. While the provision of this compensation to initial generations limits the additional saving generated by the consumption tax, there remains, nonetheless, a substantial saving response. According to Table 6, there is a 22 percent increase in the economy's long-run capital stock. While this is less than the 34 percent increase of Table 5, it is still quite substantial. With the compensation scheme in place, the long-run increase in per capita income is 6 percent (compared with 8 percent with no compensation). The fact that one can compensate initial generations in switching to a federal consumption tax and still make future generations significantly better off is reflective of the inefficiency of an income tax structure relative to a consumption tax structure.

Summary and Conclusion

Our nation is facing a grave saving crisis. We are saving at record low levels, and unless we start saving more, we will continue our slide toward second-class

[12] Interestingly, as described in Auerbach and Kotlikoff (1987), almost the same final steady state arises if the switch is to a progressive consumption tax.

economic status. A shift to consumption taxation, be in the form of a retail sales tax, a flat tax, a value-added tax, the Electronic Consumption Tax, the X Tax, or the USA Tax, has the potential for dramatically increasing our saving rate. It would do so by improving incentives to save and by redistributing from the elderly with high propensities to consume to young and future generations with low or zero propensities to consume.

In addition to raising saving and investment, consumption taxation would reduce many of the distortions of the current tax system. Indeed, the distortion of saving behavior alone is so great under our current system of income taxation that it appears we could switch to consumption taxation, fully compensate the initial elderly for their higher tax burden, and still end up with a much higher saving, capital formation, and per capita income.

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Table 1

Saving and Spending Rates

Period	Net National Saving Rate (Y-C-G)/Y	Government Spending Rate G/Y	Household Consumption Rate C/Y	Household Saving Rate (Y-G-C)/(Y-G)
1950-59	.091	.210	.699	.115
1960-69	.091	.221	.688	.117
1970-79	.085	.214	.701	.108
1980-89	.047	.213	.740	.059
1990-94	.027	.207	.766	.031

Y stands for net national product, C stands for household consumption expenditure, and G stands for government purchases of goods and services.

Table 2

Consumption of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.17	1.37	1.58	1.59
Age 70/Age 20	0.97	1.21	1.56	1.64
Age 80/Age 20	0.89	1.16	1.61	1.60
Age 60/Age 30	0.86	0.93	1.09	1.15
Age 70/Age 30	0.71	0.82	1.07	1.18
Age 80/Age 30	0.65	0.79	1.11	1.16
Age 60/Age 40	0.77	0.83	0.87	0.91
Age 70/Age 40	0.64	0.73	0.86	0.94
Age 80/Age 40	0.58	0.70	0.89	0.92

Source: Gokhale, Kotlikoff, and Sabelhaus (1995).

Table 3

Non Medical Consumption of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.11	1.28	1.43	1.42
Age 70/Age 20	0.86	1.04	1.22	1.28
Age 80/Age 20	0.75	0.91	1.16	1.11
Age 60/Age 30	0.81	0.86	0.97	1.02
Age 70/Age 30	0.63	0.70	0.83	0.91
Age 80/Age 30	0.55	0.61	0.78	0.80
Age 60/Age 40	0.73	0.78	0.77	0.80
Age 70/Age 40	0.57	0.63	0.66	0.72
Age 80/Age 40	0.49	0.55	0.62	0.63

Source: Gokhale, Kotlikoff, and Sabelhaus (1995)

Table 4

Resources[a] of the Elderly Relative to the Young

Comparison	1960-61	1972-73	1984-86	1987-90
Age 60/Age 20	1.10	1.41	1.72	1.81
Age 70/Age 20	0.85	1.14	1.49	1.58
Age 80/Age 20	0.63	0.71	0.76	0.83
Age 60/Age 30	0.92	1.07	1.26	1.31
Age 70/Age 30	0.72	0.86	1.09	1.15
Age 80/Age 30	0.53	0.54	0.56	0.60
Age 60/Age 40	0.82	0.95	1.05	1.10
Age 70/Age 40	0.64	0.77	0.91	0.96
Age 80/Age 40	0.47	0.48	0.47	0.51

[a]Resources refers to net worth plus the present values of future labor income, private and government pension benefits, and government transfer payments less the present value of government taxes.
Source: Gokhale, Kotlikoff, and Sabelhaus (1995)

Table 5

Simulating An Immediate Switch From Income Taxation to a Consumption Tax

Year	Saving Rate	Capital[a] Stock Index	Labor[a] Supply Index	Output[a] Index	Wage Index	Interest Rate	Consumption Tax Rate
0	2.6	100	100	100	100	9.4	0.0
1	9.0	100	105	104	99	9.7	23.1
2	8.5	102	105	104	99	9.6	22.5
3	8.1	105	105	105	100	9.4	21.9
4	7.8	107	105	105	100	9.2	21.5
5	7.5	109	104	105	101	9.1	21.1
.							
10	6.2	117	103	106	103	8.5	19.5
20	4.5	127	101	107	106	7.9	17.9
.							
60	3.7	131	101	108	107	7.8	17.3
.							
90	3.2	134	101	108	107	7.5	16.8
.							
150[b]	3.2	134	101	108	107	7.5	16.7

a The capital stock, labor supply, and output are per capita measures.
b Year 150 represents the economy's final steady state.

Table 6

Simulating An Immediate Switch From Income Taxation to a Consumption Tax But Compensating Initial Elderly for their Increased Tax Burden

Year	Saving Rate	Capital[a] Stock Index	Labor[a] Supply Index	Output[a] Index	Wage Index	Interest Rate	Consumption Tax Rate
0	2.6	100	100	100	100	9.4	0.0
1	6.6	100	104	103	99	9.7	22.1
2	6.4	101	104	104	99	9.5	21.8
3	6.3	103	104	104	100	9.4	21.5
4	6.1	104	104	104	100	9.3	21.2
5	5.9	106	104	104	100	9.2	21.0
.							
10	5.1	111	103	105	102	8.8	19.9
.							
20	4.1	118	102	106	104	8.4	18.7
.							
60	3.0	122	101	106	105	8.1	17.8
.							
90	3.0	122	101	106	105	8.1	17.8
.							
150[b]	3.0	122	101	106	105	8.1	17.8

a The capital stock, labor supply, and output are measured per capita.
b Year 150 represents the economy's steady state.

Mr. ZIMMER [presiding]. Thank you very much.

Mr. English will inquire.

Mr. ENGLISH. Thank you.

Again, I appreciate the opportunity to participate with such a distinguished group of panelists. I guess I wanted each of you to comment on an issue which has been raised earlier as it applies to each of these systems. And I notice that one of the earlier participants in the hearing raised the question of tax equity.

Obviously, it is very difficult to measure tax equity, and I am not sure that there has been a very precise standard offered here. I guess what I would like you to do is answer the question, in assessing the tax equity of each of these systems, should we also be taking into account the impact of growth and opportunity that might arise from the tax changes that each of these systems contemplates for middle-class families and for working families?

Dr. Walker, would you care to comment?

Mr. WALKER. Congressman, you put your finger on an extremely important issue. It has become the fashion in recent years, with tax policy and tax changes, to get the Joint Committee on Taxation to draw up burden tables, which is an extremely difficult, if not impossible task, depending on the set of assumptions which many might not agree with. But to bring those into the picture and suggest that any change in the tax system which on paper changes that distribution, is unfair.

That leaves out the most important thing that you mentioned, and that is the creation of good, high-paying, high-quality jobs, restoring growth to our living standards, which are practically not growing at all, and maintaining the economic strength of the United States so that we can remain a world leader.

A second point I would make, some people define fairness of a tax solely in terms of progressivity of rates. The point that I made earlier having to do with the demagoguery of rich versus poor is put frequently in terms of how progressive the rate structure is, as if that is the end-all and be-all of the tax system's fairness to the taxpayer. And it is his or her perception that makes a difference.

Consequently—and I am not coming down for the flat tax per se. Any one of these, as Professor Kotlikoff says, is better than what we have now. But if you say that the flat tax is not fair because you cannot produce the progressivity in rates that you have under systems in the past, and ignore completely the fact that the taxpayer, number one, would love the simplicity, and two, would believe that the simplicity would stop the ripping off that he knows is there because it would be so simple and not so complex, then you need to think a little more carefully about the question of fairness.

Let me close my statement with a quote from the Wall Street Journal which David Bradford put in his excellent book a few years ago. In 1985, a typical taxpayer was queried on, How do you feel about the income tax system? He said, I am mad as hell. When asked, why are you mad?, he said, I am getting ripped off. How are you getting ripped off?, he was asked. He said, I don't understand how I am getting ripped off, but if I understood how I am getting ripped off, I would be even madder than I am right now.

Mr. ENGLISH. Thank you, Dr. Walker.

Dr. Kotlikoff.

Mr. KOTLIKOFF. I am not sure I recall exactly the original question, but the——

Mr. ENGLISH. Had to do with equity.

Mr. KOTLIKOFF. I think equity is an important part of a tax structure. I think that we have to distinguish different aspects of equity. For example, we need to think about intergenerational equity, how we are treating young versus old. The current fiscal system is extremely inequitable from that perspective, because it is leaving an enormous bill for the next generation, as generational accounting.

The other key aspect of equity is intragenerational equity. Unfortunately, we are not producing good measures of intragenerational equity. If we move to consumption taxation, as I was pointing out in my testimony, we will enhance intragenerational equity because we will be really shifting from taxing income to taxing the combination of wages and wealth.

Now, I think that point is extremely important. It is one that I don't think has been raised by other witnesses before you. I think you really need to focus on that. This is a combination of a wage and wealth tax. This is what we teach our graduate students when they come to learn about what happens when you shift from income to consumption taxation; you are really shifting from income taxation to the combination of a wage and a wealth tax. A millionaire who goes and spends his principal, Donald Trump, if he blew all his money today after, let's say, the Archer retail sales tax was put into place, he would pay taxes, perhaps 20 percent of his wealth would go in the form of taxes in terms of retail sales taxes.

So we are really taxing the principal of wealth under a consumption tax, whether it be a sales tax or a flat tax. Each of these taxes has a wealth tax aspect to it.

Again, if the advocates of consumption taxation really understood how equitable it is, how redistributive it is, they would be less for it. And if the opponents really understood it, how it works, they would be more in favor of it. I think it would be very healthy. I think it would improve intragenerational equity, because a lot of the inequity within generations reflects inherited wealth, which is very unevenly distributed.

So I think that consumption taxation wins out on equity grounds as well as efficiency grounds, as well as savings and investment and growth grounds. It is hard to beat it.

Mr. ENGLISH. Thank you for that powerful testimony, and my time has elapsed.

Chairman ARCHER [presiding]. Who is next at this point?

Mr. RANGEL. Mr. Chairman.

Chairman ARCHER. Charlie, you have never been bashful. You are always going to step forward, so I will recognize you.

Mr. RANGEL. Thank you so much for your kindness, Mr. Chairman.

Dr. Walker, it has been a long time since we have had a chance to exchange views on this subject that is very dear to you. In the past you never used such mean-spirited language about people envious of those that have been able to acquire wealth. And to think that they would attempt to manipulate the system in order to redistribute—it would seem like those who have earned it, have

taken the risk, certainly should be given the opportunity to save and invest and, as you pointed out, allow America to continue to provide leadership in the world commerce, and therefore create better jobs for more people, and they too should aspire to be able to save more of what they earn and there should be a constant source of people not trying to take advantage of the earnings of someone else, but to strive to reach that level where they too can earn.

In the previous question, I was trying to find out from the economists just what responsibility would a government have, not only to provide for less consumption, more savings and more investment in plant and machinery, but how do we invest in labor in order to make certain that we are prepared to accept the responsibilities of providing people for these new high-paying jobs?

Clearly, all of us would agree that pumping money into a prison system and an emergency ward system and an aid system and addiction system and a police system is not the way to go. And whether or not the Federal Government should be involved in education and training, that is outside of it.

But you, Dr. Walker, to make certain that we don't have this envy in terms of income, at what level of government, if government should be involved at all, should we depend on the investment in the training of individuals with the same degree of concern as we should for the concern in saving?

Mr. WALKER. Well, it is good to exchange views with you again, Congressman Rangel. It seems to me that what we are talking about here is one of the beauties of our capitalistic system, of the way our economy works.

I was surprised when Mr. English told me some time back what a terrific amount of export and manufacturing activity he has in his particular district. If you create, in my judgment, the proper rules of the game for the system to work, which we do not have particularly in the tax system, it is the worst part of it, at all, business itself will step in and see that the people who work for them get the proper training, provided we attack this fundamental question of the inadequacy of our secondary educational system and the transition from high school into productive work.

Mr. RANGEL. How do we deal with that, Dr. Walker?

Mr. WALKER. I think the basic approach is at the State level. Mr. Archer may have heard this, I have heard it from friends in Texas, my home State, that Texas corporations have despaired at hiring Texas high school graduates, some of whom can't even read their diplomas. And I have friends in Texas that I could name that are eagerly awaiting the chance with the new administration in Texas to attack the K through 12 problem in the educational system.

Mr. RANGEL. Texas traditionally has not really been a major investor in education. Over the years when I was sitting next to Jake Pickle, we have noticed the tables of investment, and taxes, for whatever reason, the reason——

Mr. WALKER. I don't think Texas, though, is churning out any more students than other parts in the country that are spending a lot more money on education.

Mr. RANGEL. No, I didn't mean it in that way. What I meant was that if you and I want to achieve the highest potential of talents with our employers in terms of national interests, whether it is

Texas or New York, and certainly amount of money doesn't guide as to who has the best system available to them, but do you really want to turn over whether or not our country is producing a sufficient quality employee to the private sector, that we should leave that to the States?

Mr. WALKER. Not a question of leaving that to the States. There may be ways to give them incentives to do more. But I know that Texas businessmen and corporate leaders can't wait to get to the reform issue in Texas. And I think this is true of other States also.

Now, look at the other side. When did we establish the Department of Education? I don't remember, but it has been around a long, a very long period of time. And Federal activity has grown and what has happened to the quality of our high school graduates? You give business good high school graduates that can read, write and have good work habits, they will turn them into the people or help turn them into the people to occupy these better, more challenging, high-paying jobs, at least in my opinion.

Mr. RANGEL. Thank you, Doctor.

Chairman ARCHER. Well, this is a very illuminating discussion.

Mr. RANGEL. My time passes by. I just wanted to point out that while you don't always agree, you are beginning to sound more like me, at least in terms of your voice.

Mr. WALKER. I am a little under the weather.

Chairman ARCHER. Very interesting discussion about an issue that is not before the Committee today, but the gentleman's time has expired, and Mr. Christensen may inquire.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Dr. Walker, I really appreciate your testimony. You—no offense to my friends from the academic world, but you really seem to have your head screwed on straight with a Ph.D. And I appreciate your perspective.

Mr. WALKER. Thank you, I appreciate your remark.

Mr. CHRISTENSEN. And I know that Dr. Kotlikoff and Dr. Jorgenson have given a lot of thought to this, so I want to get their ideas on a couple questions. The first one would be, Dr. Kotlikoff, you have—and am I pronouncing that name correct?

Mr. KOTLIKOFF. Very good. Better than me.

Mr. CHRISTENSEN. Can you tell me more about this electronic consumption tax? It is the first I have read about it and I see you have a little bit about it in your written testimony. Could you walk that through with us and how that would work?

Mr. KOTLIKOFF. OK. It is an idea I just came up with. It is not that I am advocating electronic consumption tax over the other proposals. I think each has pluses and minuses, but anyway the electronic consumption tax would work like this.

Everyone would have a card, and when you go to the store to buy something, whether you are buying it with cash or a credit card or ATM card, you take your ECT card and just run it through the card reader. And that would send to your bank the information about how much you spent on consumption. At the end of the month, the bank would tally up your total purchases, your total expenditure on consumption, and send that information to the IRS. It wouldn't send the information about the composition of your purchases, just the total.

Then the IRS would withhold taxes and it could do it on progressive rates or proportional rates, depending on what Congress chose to legislate. So it is a way of having a retail sales tax, while having progressive tax rates.

Mr. CHRISTENSEN. In your idea of the ECT card, would this be mainly a tracking system for the tax or would this also be a mode of payment for your goods and services then?

Mr. KOTLIKOFF. Well, you pay—this would track your tax liability, and then the government could electronically withhold the tax payment from your, for example, from your wages or from your checking account. So potentially we could set this tax up in such a way that absolutely no tax forms need being filed. That beats a postcard.

This is one way to have a progressive consumption tax where the actual tax is a little bit more transparent to the individual taxpayer. Because every time he buys a good or service, he'll have to run his card through the card reader.

Mr. CHRISTENSEN. I would like to get your opinion and Dr. Jorgenson's opinion on the flat tax proposal and whether or not in your opinion it would be an advantage to go with a—if we were to go with a flat tax, whether it would be a pure flat tax or whether it would be a modified flat tax with, say, the two exemptions that I continue to hear discussed are the mortgage interest deduction and the charitable deduction.

I know that there is going to be a lot of discussion on this and a lot of debate, but in your own personal opinion, where do you think we would go if we were to follow the flat tax philosophy?

Mr. JORGENSON. Well, I think of the flat tax philosophy which would be applied without any modification would involve the following guiding principle. Everybody who had a home would have a schedule C, and would treat ownership of a home as a business, for which there would be some kind of rental liability.

None of the flat tax proposals that I have seen, the Armey proposal or the Hall-Rabushka proposal, involve anything like that. In fact, owner-occupied housing is carefully excluded from the definition of investment in both of those proposals. So I think that that would be one way to treat the housing, would be to simply leave it out of the tax system and leave out capital gains. And that is the flat tax in the Hall-Rabushka variety.

Another approach which is represented in the U.S.A. tax approach of Senators Nunn and Domenici, involves preserving the current system of having a system of mortgage tax deductions and tax deductions for State and local interest. That has very important advantages, because that would I think put the treatment of investment in housing pretty much on par with business assets, if the rest of the taxation of investment was treated on the basis of a flat tax or consumption tax approach.

So I think either of those approaches are compatible with the basic flat tax. And I certainly would not advocate the extreme form of everybody has a schedule C and treats their home ownership like a business, which would be a perhaps principled version of a flat tax proposal with a consumption tax base.

Mr. CHRISTENSEN. Dr. Kotlikoff.

Mr. KOTLIKOFF. Well, I agree with Professor Jorgenson. I think that we have been oversubsidizing housing, and too much of our capital stock through time, our precious capital stock, has gone into housing relative to plant and equipment, which will raise the productivity of workers and ultimately their real wages.

So I think that if we do adopt a flat tax, that we should do it without special provisions for housing other than deductibility of mortgage interest. I think the Hall-Rabushka proposal deals with housing in a reasonable manner, and the beauty of a flat tax or a retail sales tax is keeping it simple, keeping it pure. Once you start opening the door, you are going to have all kinds of claims to exemptions and deductions and you will get back through time where you started.

In the case of the sales tax, if you start exempting certain kinds of commodities, you will through time end up with a very complicated system, one in which there is great disincentive to purchase certain kinds of goods versus others and a lot of economic distortion. Really, the beauty of these ideas is that they are very simple and pure. They should be kept in that form.

Mr. CHRISTENSEN. Thank you. And I tend to agree. I appreciate your comments.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Payne may inquire.

Mr. PAYNE OF VIRGINIA. Thank you very much, Mr. Chairman.

I must say I agree with much of what you said, but I think we have here a responsibility to look more broadly than just at the Tax Code, at the implications of home mortgage interest deductions or charitable deductions or many of these elements of the Tax Code, because there will be some very broad ramifications of what some actions might do and some unintended consequences. Certainly we need to look at those as well.

I just had one question. It had do with the 1986 tax act, and, Dr. Jorgenson, you talked about it in your testimony. I was struck this morning when Mr. Dakin from Mobil Oil was here, he mentioned that since 1986 the amount of resources required for him to complete all the documents that he needs to complete for Mobil Oil, has increased by about 34 percent.

The year 1986 then was an attempt to, among other things, simplify the Tax Code. And if this is any indication of the simplification that occurred as a result of 1986, it must be that from a public policy point of view, we missed the mark at least on that account.

Would you comment on that and what is it that we might learn from that experience as we begin to look once again at reforming the Tax Code?

Mr. JORGENSON. Well, I think that the key decision that was made at the beginning of the debate in 1986, almost before the matter came before this Committee, was to stick with the income tax and not consider seriously the possibility of shifting to a completely new system, as has been proposed by advocates of a consumption tax.

I think that that is the starting point for the kind of complexification of the Tax Code, as opposed to simplification, that actually took place in 1986. As people begin to think about trying to reform the income taxation, they begin to think about things like

being sure that everybody paid some tax. That led to the alternative minimum tax, which accounts for a very large part of this increased administrative burden that you heard about at the opening testimony this morning.

So it seems to me that Chairman Archer has pointed this out on many different occasions, including this morning, that starting with a totally new system, based on a consumption tax or consumption tax base as opposed to an income tax base, offers the only hope it seems to me for simplification.

What we found out in 1986 was that as a result of sticking with the old income tax system, we ended up with a system that was much more complex, although I think from the economic point of view, it certainly had some sizable benefits. If we had shifted to a consumption tax at that time, I think those benefits would have been doubled.

Mr. PAYNE OF VIRGINIA. Are you suggesting then that if we do look at a flat tax there is no way that it would be a simpler system than the system we have in place, that there is no reform of the present income tax system that would result in a simpler system.

Mr. JORGENSON. Yes. The reason is that income is an idea that is much more difficult to define in economic or legal terms than consumption. Consumption is something which is relatively unambiguous in both economic and legal definitions. That being the case, a consumption tax lends itself to simplification.

A good example are the comsumption-based taxes that are actually used in Europe, the so-called value-added taxes, tax systems that involve very complicated administrative systems, with a system of credit for previous tax paid, but from the economic point of view and from the legal point of view, we have to think in terms of legal implementation of these systems.

It is clear that the definition of consumption is something that is intrinsically a good deal simpler than the idea of income, which compares income from labor, income from different forms of capital, different forms of capital income, from equities, from self-employments, from debt; these involve legal complexities that can be done away with by a shift to a consumption-based tax.

Mr. PAYNE. Thank you very much.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

I want to ask Dr. Walker a question, because your presentation on savings was very interesting to me. During the debate that many of us were involved in during the first few months of this congressional session when we proposed a tax relief bill, there were many on the other side who explained that providing tax cuts to people or companies was simply going to add to the deficit and create problems for us.

I would like to take advantage of your expertise in the area of capital gains to ask you to explain how the capital gains rate cut contributes to our much healthier degree of savings and investment here in the country.

Mr. WALKER. Well, I would approach that by first taking a look at the assistance a cut on capital gains taxes provides to the entrepreneur, which is a great part of the vigor of our capitalistic system. A young man who invents a better mousetrap and it is a good

one and tries to raise the money and needs to market it, produce it and needs to hire some $300,000-a-year engineers from GE and others, and he doesn't have the money but he can promise them stock or stock options. The lower the capital gains tax, the much easier it is for him to do that because they will get a higher rate of return.

Second, if a lower capital gains tax happened tomorrow, all capitalized assets would rise in value, stocks, anything that is subjected to a capital gain. That in turn gives you more vigor in your economy through what economists call the wealth effect, and so forth. These are commonly recognized.

What is not sufficiently recognized even by corporate CEOs themselves—chief financial officers, frequently, yes; chief executive officers, I have been very surprised and somewhat disappointed. What is important, and I have served on several boards, in an investment decision is whether the internal rate of return which you have all these young MBAs figuring out covers your cost of capital.

Several factors go into that cost of capital. Lower capital gains rates will give you a lower cost of capital. People buy stock for one reason. They want a return and they can get that as a dividend or as appreciation of the value of stock. I don't buy for dividends. I don't want any more current income in that sense. I buy for appreciation.

Now, if Uncle Sam lays a 100 percent capital gains tax on that, I am not interested. Fifty percent at least I have more interest. Twenty-five percent I have more interest, and 19.8 percent, I have a dickens of a lot more interest. So it is easier for us directors in corporations that are making investment decisions to retain the earnings and save the stockholders who don't want dividends—no, we retain the earnings because of their capital gains and the good return. This lowers their capital costs actually and increases business investment.

On the saving side, that is just a part of the overall picture of how much of an impact of saving you get from reducing taxes on savings because that is what capital gains are.

Ms. DUNN. Thank you.

Chairman ARCHER. Do any other Members wish to inquire?

Gentlemen, thank you very much. I appreciate your testimony.

The Chair invites our next panel to come to the witness table: Jennie Stathis, Arthur Hall, Charles Adams, James Payne and David Raboy.

We would like you to keep your oral testimony to 5 minutes and you may submit for the record more extensive testimony in writing.

Ms. Stathis, with the GAO, would you proceed, please?

STATEMENT OF JENNIE S. STATHIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Ms. STATHIS. Yes, sir. Thank you, Mr. Chairman and Members of the Committee. I am pleased to be here today to participate in your hearing.

I was invited to talk about the tax gap, and that is in fact one of the problems with the current income tax system. One of the

challenges that IRS has is to reduce the amount of income taxes that are owed but not paid.

IRS' current estimate is that the tax gap amounts to more than $100 billion annually. While these types of estimates are necessarily imprecise, they do give you some ballpark ideas of the challenge.

To summarize, I would like to ask Committee Members to turn to page 6 of my statement where I have attached a table which shows the components of IRS' tax gap estimates. You will see there that 74 percent is attributed to individual taxpayers and only about a fourth to corporations.

You will also see that unreported income is considered to be by far the largest problem, overstated deductions accounting for a small percentage. One piece of information that might be of interest to you in considering changes, is that only about 30 percent of individual taxpayers now itemize; so it is not surprising that deductions make up such a small percentage of this gap.

If you turn to the next page, you will see a further breakdown by type of income for individual taxpayers and what IRS calls voluntary reporting rates. In wages and salaries, there is a reporting rate of 97 percent. Where you have interest and dividends which are largely subject to information reporting, the compliance rate drops to 90 and 87 percent. But if you will look down the page, you will get to sole proprietors where there is largely not withholding or information reporting, and the reporting rate is 36 percent. A subcomponent of that is the informal suppliers. They are estimated to report only 11 percent of their income.

Also missing from these estimates is the illegal economy. IRS does not make estimates for the income tax gap from illegal activities anymore, believing that both the data and the methodology are lacking with which to do that.

I have also included in the statement beginning on page 3 some of the factors that we believe are important in influencing the level of compliance in any system that you decide to embark upon. The first is that the simpler the rules, the better. The second is that collecting from fewer sources is easier. The third is that more visible tax information promotes higher compliance. The fourth is that good information is critical to identifying any compliance problems that you have. The tax administrator needs to be on top of that.

Fifth is that you then use that information to focus whatever compliance efforts you might have where they will do the most good. And sixth is dealing with problems quickly. Those are factors that seem to permeate all types of noncompliance that IRS has thus far identified with the income tax.

In closing, let me just say that promoting or encouraging uniform compliance with whatever system we have is important. I know there was some discussion this morning about equity and one subcomponent of equity is trying to ensure that everyone complies to a similar extent. That is why compliance levels are going to be important in whatever system you decide to embark upon.

With that, I will conclude my summary.

[The prepared statement and attachments follow:]

TAXPAYER COMPLIANCE

STATEMENT OF
JENNIE S. STATHIS
DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee:

We are pleased to be invited by the Committee to discuss the income tax gap. One of the biggest challenges facing the Internal Revenue Service (IRS) is finding ways to reduce the gross income tax gap--the difference between income taxes owed and voluntarily paid. IRS has estimated that taxpayers do not voluntarily pay more than $100 billion annually in taxes due on income from legal sources. While such a "tax gap" estimate is necessarily imprecise, it does indicate the size of the challenge confronting tax administration.

My statement covers four points:

-- IRS information, while dated, suggests that U.S. taxpayers voluntarily pay 83 percent of the income taxes they owe--87 percent after IRS audits and other IRS programs. Although this compliance level may be relatively high by world standards, it translates into large sums of "tax gap" dollars because of the size of our economy.

-- Compliance is not uniform across groups of taxpayers. IRS estimates that wage earners report 97 percent of their wages; the self-employed report 36 percent of their income; and "informal suppliers"--self-employed individuals who operate on a cash basis--report just 11 percent of theirs.

-- Significantly, the IRS data show that compliance is highest where there is tax withholding, a little lower where there is information reporting to IRS, and much lower where there is neither. In addition to the relative visibility of the income to tax administrators, the complexity of tax rules, together with a number of other factors, also influence the level of tax compliance.

-- Some of the "tax gap" may not be collectible at an acceptable cost. Collection, in some instances, could require either more recordkeeping or reporting than the public is thought willing to accept or too costly an IRS effort. Thus, it is important that IRS measure compliance with the tax laws and use that information to effectively focus its resources.

I would like to begin with a discussion of the "tax gap" estimates and how they are derived.

TAX GAP ESTIMATES

Tax gap estimates, for the most part, begin with IRS' Taxpayer Compliance Measurement Program (TCMP). In this program, IRS audits a random sample of tax returns, examining every item to identify both under- and over-reporting. These results are then used to estimate compliance levels for the population as a whole. Other sources are used to estimate taxes not paid by large corporations, by those who do not file tax returns, and by those "informal suppliers" who operate cash-based businesses.

Excluded from the estimates are taxes that go uncollected from illegal activities such as drug dealing and prostitution. IRS researchers believe the data and methodology for including such estimates are lacking. Also excluded are other types of taxes--for example, employment and excise taxes.

IRS last estimated the gross tax gap in 1988, for tax years 1973 through 1992. (See table I.1.) The estimates relied on earlier TCMP results, the latest covering tax year 1982. Later TCMP results for tax years 1985 and 1988 (for individuals) and 1987 (for small corporations) have not yet been reflected in tax gap estimates. After making some adjustments for tax law changes and shifts in types of income, IRS estimated that taxpayers have been paying about 83 percent of the taxes they owe. Factoring in estimates of economic growth, IRS derived an income tax gap of as much as $127 billion for tax year 1992. Thus, regardless of the adequacy of IRS enforcement programs, the tax gap could continue to grow in current dollars because of economic growth and changes in tax law that could have the unintended effect of increasing opportunities for noncompliance.

By IRS' estimates, its enforcement programs have, on average, recovered about 4 percent of total income taxes due in any particular tax year. Thus, overall compliance has tended to reach about 87 percent after IRS audits and other IRS programs. But, because of the time consumed by IRS' activities and subsequent appeals and litigation, it may take a number of years to reach the 87-percent compliance level.

COMPONENTS OF THE TAX GAP

Tax administrators from other countries have told us that IRS' data suggest a relatively high level of tax compliance in the United States compared to other countries. Yet, within this overall average level of compliance, are a range of estimates by type of taxpayer or income.

As shown in table I.2, IRS attributes about three-fourths of the tax gap to individuals and one-fourth to corporations. The individual tax gap is due primarily to individuals not fully reporting their income (about $73 billion of the $94 billion estimate). In comparison, smaller estimates were attributed to individuals overstating their deductions ($8 billion) or not making full payment with their returns ($11 billion). The tax gap estimate for corporations is divided between large corporations ($24 billion) and small corporations ($7 billion).

Within these overall tax gap measures, however, compliance across groups of individual taxpayers is not uniform. (See table I.3.)

-- Wage earners whose salaries are subject to tax withholding (the most visible form of income to IRS) are estimated to report 97 percent of their wages.

-- Those with interest and dividends are estimated to report 90 percent of their interest income and 87 percent of dividends--income that for the most part is subject to tax information reporting but not to tax-withholding.

-- In contrast, IRS estimates that the self-employed report about 36 percent of their income--income that is neither subject to withholding nor necessarily covered by information reporting.

-- And finally, among the self-employed who operate informally and thus are even less likely to have income reported to IRS on information returns, compliance is estimated to be about 11 percent.

Similarly, variations in compliance patterns exist in the corporate sector. Small corporations, whose compliance level dropped to 61 percent in IRS' tax year 1987 TCMP, tend to mirror the compliance patterns of sole proprietors. Underreported income is the biggest compliance problem and sufficient documentation is often a problem. Large corporations, in contrast, tend to have issues associated with the ambiguity and

complexity of the tax code. Upon audit, IRS auditors and corporations sometimes interpret tax provisions differently, leading to contested issues. For example, IRS has ultimately collected about 22 cents for each $1 of proposed audit assessments of the nation's 1,700 largest corporations.

Analyzing such tax gap patterns suggests a number of factors which influence the size of the tax gap.

SYSTEMIC FACTORS THAT INFLUENCE TAX COMPLIANCE

Tax administrators around the globe work to promote compliance with whatever tax regime is in place. Some common factors influence their success level.

First: The simpler the rules, the better. This reflects the basic principle that the simpler the tax code and the more certain the results in applying it, the fewer the opportunities for disagreement over the "fine points" of the law. However, very few would argue that the existing U.S. tax system is either simple or certain. For example, some paragraphs in the Internal Revenue Code have generated as much as 250 pages of implementing regulations.

Second: Collecting from fewer sources is easier. Tax withholding allows the tax collector to focus cn the relatively small number of employers, rather than all employees. Congress also followed this reasoning in changing the collection point for diesel fuel taxes to the smaller number of businesses earlier in the production chain. Subsequent to this and other changes in the taxation scheme for diesel fuel, collections have risen significantly.

Third: More visible tax information promotes higher compliance. Tax-withholding and information reporting are two means of making income and some deductions visible to both the taxpayer and the tax administrator, which results in compliance rates that are significantly higher. Good records and other types of paper trails also lead to better results when the tax administrator audits a return or takes some other enforcement action. Other countries have transaction information from administering value-added taxes--information not readily available to IRS.

Fourth: Good information is critical to identifying compliance problems. This factor recognizes the importance of systematically estimating the extent of noncompliance and variations in taxpayer behavior. In this way, the tax administrator can identify areas warranting attention, tax returns to audit, and the results of any efforts to improve compliance.

Fifth: Focus compliance efforts where they will do the most good. Having information on the most significant compliance problems allows IRS to tailor its efforts accordingly. At present, the largest component of the income tax gap is attributable to individuals not fully reporting their income--an estimate that has led IRS to train its auditors to better detect such situations.

Sixth: Deal with problems quickly. Another potential byproduct of assessing problem areas is the ability to deal with them quicker. IRS has found that the longer it takes to reach a taxpayer, the less likely it will achieve a favorable outcome.

THE CHALLENGE FOR IRS

When some taxpayers do not pay all the taxes they owe, the burden of funding government programs shifts to taxpayers who do comply. Thus, maintaining high levels of compliance is important for equity reasons. Yet, it would not be realistic to assume that

all of the tax gap revenues can be recovered. To do so would mean imposing burdens and costs that our society is unlikely to accept. While we do not know how much recovery is realistic, IRS' current plans are to improve compliance from the estimated 87-percent level to 90 percent by the year 2001.

One method by which IRS hopes to achieve such results is by increasing its compliance presence. And there is room for growth. Over the last 30 years, the rates at which IRS has audited income tax returns have declined over 75 percent. And, while alternative mechanisms such as document matching reach certain types of income, IRS has no such substitute for more complex issues.

This year IRS will also undertake another TCMP. This TCMP will be larger than earlier ones because it will cover four types of taxpayers. The most recent TCMP for individual taxpayers was tax year 1988, for small corporations tax year 1987, for partnerships tax year 1981, and for S corporations tax year 1984. The TCMP is very important because it is IRS' only tool for measuring compliance levels and developing formulas for objectively selecting returns to audit. The time and documentation requirements may be of concern to taxpayers selected for a TCMP audit. But TCMP audits will actually reduce the overall long-term burden[1] on taxpayers to the extent that they reduce the number of compliant taxpayers selected for other IRS audits.

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In concluding my testimony this morning, I would like to reiterate how important it is for IRS (or other tax administrators) to invest agency resources to measure noncompliance and use that information to balance efforts among the competing goals of (1) maximizing tax revenues, (2) promoting uniform compliance, and (3) minimizing taxpayer burden. I would welcome any questions you or Members of the Committee may have.

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[1]GAO's prior testimony Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, Dec. 9, 1994) discusses the difficulties of measuring tax system burden. An extract of that testimony is shown at Appendix II.

SELECTIVE TAX GAP SUMMARY STATISTICS

Table I.1: Range of Estimates of the Gross Legal-Sector Income Tax Gap and Voluntary Compliance Rates for Selected Tax Years 1973-1992

Tax year	Gross income tax gap[1] ($ billions)						Voluntary compliance rate[2] (percent)					
	Total		Individual income tax		Corporate income tax		Total		Individual income tax		Corporate income tax	
1973	27.9	32.0	22.0	22.7	5.9	9.3	83.9	82.0	83.0	82.6	86.6	80.3
1976	39.7	45.5	32.6	33.7	7.1	11.8	82.7	80.7	81.2	80.7	87.3	80.6
1979	61.0	69.0	51.5	53.2	9.6	15.9	81.9	80.0	80.3	79.8	87.2	80.4
1982	64.6	70.5	57.5	59.1	7.1	11.4	82.9	81.7	82.2	81.8	87.1	80.8
1984	83.0	91.3	73.5	75.7	9.6	15.6	81.6	80.1	80.4	80.0	87.2	80.6
1986	96.1	105.6	86.0	88.8	10.1	16.8	81.0	79.5	79.7	79.2	87.7	81.1
1988	84.5	96.8	70.3	72.6	14.2	24.3	84.0	82.0	82.7	82.3	88.1	81.2
1992	110.1	127.0	91.0	94.0	19.1	33.1	84.6	82.7	83.6	83.1	88.1	81.1

[1]The higher IRS estimates of the tax gap in the right hand columns are based on the amounts of additional tax recommended by IRS examiners, and the lower estimates of the gap in the left hand columns are based on the amounts of tax ultimately assessed after all appeals and litigation. Since IRS examiners cannot detect all tax deficiencies, IRS believes the actual tax gap lies between these two sets of estimates.

[2]The voluntary compliance rate is what taxpayers voluntarily pay as a percentage of their total tax liability. See note 1 for an explanation of the range of rates.

Source: Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Publication 1415 (4-90).

Table I.2: Gross Tax Gap Estimates for Tax Years 1992
(Dollars in millions)

Source of tax gap	Tax gap amount	Tax gap distribution (percent)
Individual tax gap	$93,994	73.9%
Unreported income	72,991	57.4
Sole proprietors	33,683	26.5
All other income	39,308	30.9
Overstated deductions[a]	8,081	6.4
Individual remittance gap	11,400	9.0
Math errors	1,521	1.2
Corporate tax gap	33,135	26.1
Small corporations	6,999	5.5
Large corporations	23,716	18.7
Other[b]	420	.3
Corporate remittance gap	2,000	1.6
Total tax gap[c]	$127,129	100.0%

[a]Includes subtractions for erroneous deductions, exemptions, credits, and other adjustments.

[b]Includes unreported income and overstated deductions for exempt organizations' unrelated business income and for fiduciaries.

[c] Totals may not add due to rounding.

Sources: Income Tax Compliance Research, IRS Publication 1415 (7-88); and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Publication 1415 (4-90).

Table I.3: 1992 Individual Reporting Rates and Gross Tax Gap Estimates by Source

(Dollars in millions)

Description	Voluntary Reporting Rate[b]	1992 tax gap amount
Wages and salaries	96.6%	$3,667
Interest	90.1	2,680
Dividends	87.3	2,125
State tax refund	87.6	193
Alimony	65.2	279
Capital gains	85.0	10,232
IRS Form 4797	38.2	1,180
Pensions and annuities	84.6	2,809
Taxable unemployment	81.8	539
Farm income	--[c]	6,775
Partnership income	67.5	2,371
Small business corporation	57.0	750
Estates and trusts	95.1	195
Rents and royalties	80.7	2,467
Nonfarm sole proprietors:		
Informal suppliers	36.0	33,683
Other sole proprietors	11.4	10,410
	44.3	23,273
Other income	39.3	3,003
Taxable Social Security	83.2	43
Adjustments to income	106.3	694
Deductions	104.4	3,889
Exemptions	104.1	2,224
Credits	113.0	1,274
Math errors	--[d]	1,521
Nonremittance	--[d]	11,400
Total individual tax gap[a]	--[e]	$93,994

[a]Totals may not add due to rounding.

[b]The voluntary reporting rate is what taxpayers voluntarily report on their tax returns as a percentage of what they should have reported.

[c]Not computable, negative income reported.

[d]Not applicable.

[e]Voluntary compliance rate as computed by IRS is 83.1 percent (see table I.1).

Source: Income Tax Compliance Research, IRS Publication 1415 (7-88).

RELIABLE ESTIMATE OF OVERALL COMPLIANCE COSTS DIFFICULT TO DEVELOP

EXTRACT FROM DECEMBER 9, 1994 STATEMENT OF
LYNDA D. WILLIS
ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

"As business taxpayers strive to comply with federal, state, and local tax requirements, they expend time, incur costs, and experience frustrations. GAO refers to this time, cost, and frustration as taxpayer compliance burden . . .

"GAO collected information on compliance burden from the management and tax staffs of selected businesses, tax accountants, tax lawyers, representatives of tax associations, and officials of the Internal Revenue Service. In addition, GAO reviewed academic research and other studies on compliance burden and tax simplification . . .

". . . [With respect] to the overall cost to businesses of complying with the tax code, we did not identify a readily available, reliable estimate of such costs. While there was a general consensus that compliance is burdensome and some businesses offered anecdotal examples of their costs, our discussions with businesses and review of available studies indicate that developing a reliable estimate would require that several practical and severe problems be overcome. These problems include working with a broad spectrum of businesses to accurately separate tax costs from other costs and obtaining accurate and consistent responses from businesses on tax burden questions. This would be an expensive and burdensome process in itself.

"In our interviews with business officials and tax experts, we found that business tax compliance strategies usually were not done in isolation from other business operations; few of their activities were done solely or even primarily for tax reasons. More often, tax considerations affected the timing or structure of a business action not whether the action would occur. For example, a business in acquiring equipment would consider tax implications in terms of whether to buy or lease the equipment.

"Few of the businesses we spoke with could readily separate tax compliance costs from other costs of doing business. The integration of the tax compliance activities with other business activities makes it difficult and time-consuming to collect the information necessary from businesses to generate reliable cost estimates. For example, businesses said it would be difficult to take payroll expenditures and isolate those associated with tax compliance.

"Further, business respondents said that they do not routinely need, thus it does not make sense for them to collect, information on compliance costs. And, to separate tax compliance costs from other costs of doing business would be burdensome and of questionable usefulness to them.

"A few business officials provided estimates of some compliance costs, such as legal fees, payroll management fees, and tax software expenditures, but expressed limited confidence in their ability to provide accurate, comprehensive cost data. In addition, those few businesses that said they could isolate some of their tax compliance costs indicated that even in their cases,

it would be difficult to separate federal compliance costs from state and local compliance costs.

"We reviewed seven studies issued since 1980 that provide some estimate of compliance cost associated with the federal and some state tax systems. [We reviewed only those studies that produced original-source estimates and excluded those that made projections from these original studies.] None of these studies attempted to provide an overall compliance cost estimate. Rather, they focused on specific taxpayer populations, such as large corporations, or a limited range of compliance activities, such as record-keeping and filing tax returns. Because of the limited scope, it would not be appropriate to use the estimates from these studies as the basis for estimating the compliance costs for other taxpayer groups, or for different time periods.

"These studies were also subject to the general difficulties inherent in data collection and analysis that limit efforts to obtain reliable cost data. Most used a questionnaire survey approach, sometimes along with group interviews and diary-usage record-keeping, and each has significant limitations. Each of these techniques requires taxpayers to respond accurately, completely, and consistently to compliance burden questions that may be difficult to interpret. The difficulties faced by businesses in answering these types of questions may in part be reflected in the low--less than 50 percent--response rate these studies achieved. The low response rate also affects the reliability of the estimates generated by the studies we reviewed."

RECENT RELATED GAO PRODUCTS

Tax Gap: Many Actions Taken, But a Cohesive Compliance Strategy Needed (GAO/GGD-94-123, May 11, 1994).

Reducing the Tax Gap: Results of a GAO-Sponsored Symposium (GAO/GGD-95-157, June 2, 1995).

Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program (GAO/GGD-95-39, Dec. 30, 1994).

International Taxation: Transfer Pricing and Information on Nonpayment of Tax (GAO/GGD-95-101, April 13, 1995).

International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89, June 15, 1992).

Tax Administration: Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59, Dec. 28, 1994).

Tax Administration: IRS Can Better Pursue Noncompliant Sole Proprietors (GAO/GGD-94-175, Aug. 2, 1994).

Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992).

Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement (GAO/GGD-94-70, Sep. 1, 1994).

Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, Dec. 9, 1994).

Chairman ARCHER. Thank you.
Dr. Hall.

STATEMENT OF ARTHUR P. HALL II, PH.D., SENIOR ECONOMIST, TAX FOUNDATION

Mr. HALL. Thank you, Mr. Chairman. It is a privilege for me to represent the Tax Foundation at these important hearings.

The Tax Foundation has estimated that complying with the entire Federal tax system costs Americans approximately $200 billion annually. The rules and regulations for the Federal income tax alone accounts for about $140 billion of this cost. Approximately two-thirds of the cost is borne by the business sector.

The cost of compliance, which adds nothing to national output, is tantamount to a tax surcharge on all taxpayers. One way to comprehend the magnitude—and economic waste—of the $140 billion tax surcharge is to imagine putting every vehicle sold by General Motors in 1994 onto ships and dumping them in the ocean.

If Congress were to replace the current Federal income tax with any one of the three predominant alternatives being discussed, whether it is Representative Armey's flat tax, the U.S.A. tax as sponsored by Senators Domenici and Nunn, or a national retail sales tax, it could dramatically reduce America's tax-related burden without necessarily sacrificing a dime of Federal tax revenue.

Using methods that underlie IRS estimates about paperwork burdens and assuming a reasonable transition period for each alternative plan, the Tax Foundation has estimated how much each plan could reduce the current system's $140 billion tax surcharge.

Representative Armey's flat tax could reduce the surcharge by 94 percent to $8.4 billion assuming that the current convention of annual tax filing is retained. However, if he achieves his stated goal of eliminating individual income tax withholding and moving to monthly tax payments, the flat tax would reduce the surcharge by 72 percent to $39 billion.

The U.S.A. tax system could reduce the surcharge by 81 percent to $27 billion. A national retail sales tax could reduce the surcharge by 92 percent to $11.2 billion, assuming that the sales tax plan also included a per person rebate scheme to create a progressive tax system. If no rebate scheme were part of the retail sales tax, it could reduce the surcharge by an estimated 96.5 percent, to $4.9 billion. But the entire burden of that sum would fall on retail businesses.

In considering these estimates, please be mindful that they are based on pure versions of the alternative tax systems. It is reasonable to assume that the effect of molding any of the alternatives into a functioning Tax Code could increase their complexity and therefore their associated compliance costs.

The cost of complying with a tax system is directly related to the complexity of the system. In terms of complexity, it is fair to say that the income tax, the core of the U.S. Government's tax system, ranks among the worst of the tax systems currently in operation around the world.

The give and take of politics, by continually expanding and revising the definition of taxable income, accounts for a substantial measure of the complexity of the current Code. However, in the context of these hearings, it is important to emphasize that the income tax is inherently complex. Ironically, the term "income" itself accounts for the inherent complexity. Income, particularly business income and investment income, is tricky to define and has always added excess complexity to our tax system.

I have discovered complaints about the complexity of the Federal income tax system that date back to 1914, the year immediately following adoption of the 16th amendment to the Constitution which authorized the tax. Indeed, the 1927 report of the Joint Committee on Internal Revenue Taxation states that "it must be recognized that while the degree of simplification is possible, a simple income tax for complex business is not."

The complexity of systems that directly tax people and businesses—like the current income tax, the flat tax and the U.S.A. tax—is almost wholly related to tax-based questions, that is, questions or uncertainty about the timing or definition of taxable transactions. Multiple statutory tax rates alone do not generate much complexity. On the other hand, the complexity of indirect taxes, like the value-added taxes or retail sales taxes, result primarily from the application of multiple tax rates to differentiated products.

The inherent complexity of an income tax base which bears most predominantly on the income taxation of commercial activity results from the difficulty of defining income and determining when to recognize income and expense for tax purposes.

Furthermore, a properly constructed income tax, unlike the current Federal income tax, also must adopt the added complications associated with adjusting for the effect inflation has on these difficult timing issues. The flat tax and U.S.A. tax are direct taxes that should immediately eliminate these timing-related complexities and therefore their attendant compliance costs.

Both plans accomplish this objective by moving to a cash flow tax base rather than accrued income tax base. A cash flow tax, as it applies to business, simply calls for the totaling of business receipts and then subtracting off purchases from other businesses. There is no reason to synchronize timing of income and expenses in such a system. A business cash flow type tax also eliminates any need for the complexities associated with depreciation and depletion allowances, foreign source income rules, inventory capitalization, amortization of intangibles and long-term contracting.

This list of items accounts for the bulk of business compliance costs. For example, based on research sponsored by the Tax Foundation, the current rules pertaining to foreign source income alone account for 45.5 percent of the total Federal income tax compliance costs for the firms of the Fortune 500. In fact, adoption of either the flat tax or the U.S.A. tax would make obsolete almost every Tax Code provision commonly cited as a major source of complexity, and of course the retail sales tax fits into that as well.

Although the flat tax, the U.S.A. tax, or a retail sales tax are inherently far less complex than even the most pure income tax system, misguided political tampering can ruin the integrity of any system. Nevertheless, any one of these plans could be a sound replacement for the current income tax. They can satisfy the current political demand for tax revenue, they stop punishing savings and investment, and by offering the potential for huge reductions in the cost of compliance, they can eliminate hundreds of billions of dollars of pure economic waste.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of Arthur P. Hall, II
Senior Economist, Tax Foundation
Washington, D.C.

Before the Committee on Ways and Means,
U.S. House of Representatives
on the Subject of
Replacing the Federal Income Tax
June 6, 1995

The Tax Foundation estimates that complying with the entire federal tax system costs Americans $200 billion annually. The rules and regulations for the federal income tax alone account for approximately $140 billion of this cost.

The cost of compliance, which adds nothing to national output, is tantamount to a tax surcharge on all taxpayers. One way to comprehend the magnitude — and economic waste — of the $140 billion federal income tax surcharge is to imagine putting every vehicle sold by General Motors in 1994 onto ships and dumping them into the ocean.

If Congress were to replace the current federal income tax with any one of the three predominant alternatives currently being discussed — Representative Armey's (R-TX) Flat Tax, the USA Tax System sponsored by Senators Domenici (R-NM) and Nunn (D-GA), or a national retail sales tax — it could dramatically reduce America's tax-related burden without necessarily sacrificing a dime of federal tax revenue. The Tax Foundation has estimated how much each plan could reduce the current system's $140 billion tax surcharge, assuming a reasonable transition period had ensued.

Rep. Armey's Flat Tax could reduce the surcharge by 94 percent to $8.4 billion, assuming that the current convention of annual tax filing is retained. However, if Rep. Armey achieves his stated goal of eliminating individual income tax withholding and moving to monthly tax payments, the Flat Tax would reduce the surcharge by 72 percent to $39 billion. The USA Tax System could reduce the surcharge by 81 percent to $27 billion. A national retail sales tax could reduce the surcharge by 92 percent to $11.2, assuming the sales tax plan included a per-person rebate scheme to create a progressive tax system. If no rebate scheme were part of the retail sales tax, it could reduce the surcharge by an estimated 96.5 percent to $4.9 billion, but the entire burden of this sum would fall on retail businesses.

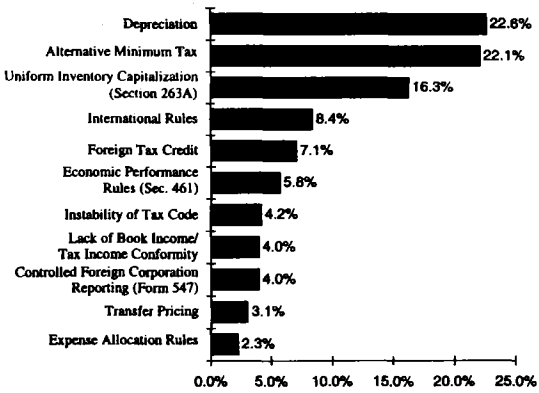
These estimates are based on pure versions of the alternative tax systems. It is reasonable to assume that the effect of molding any of the alternative plans into a functioning tax code could increase the complexity, and therefore their associated compliance costs.

Fundamental Sources of Tax Complexity

The cost of complying with a tax system is directly related to the complexity of the system. In terms of complexity, it is fair to say that an income tax — the core of the U.S. government's tax system — ranks among the top of the tax systems currently in operation around the world. Ironically, the term "income" itself accounts for the inherent complexity. Income, particularly business and investment income, is tricky to define, and has, therefore, always added excess complexity to our tax system.

I have discovered complaints about the complexity of the federal income tax system that date back to 1914, the year immediately following the adoption the 16th Amendment to the Constitution which authorized the income tax. Indeed, the 1927 Report of the Joint Committee on Internal Revenue Taxation (Vol. 1, p. 5) states that: "It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not."

Figure 1
Where the Tax Code is Most Complex (percent of total survey mentions)



Note: 315 of 365 survey respondents answered this question. Many respondents listed more than one aspect. Only the responses receiving at least 10 mentions were included.

Source: Tax Foundation.

The complexity of systems that directly tax people and businesses — like the current income tax, the Flat Tax, and the USA Tax System — is almost wholly related to tax base questions, that is, questions or uncertainty about the timing or definition of taxable transactions. Multiple statutory tax rates alone do not generate much complexity. On the other hand, the complexity of indirect taxes — like value-added taxes or retail sales taxes — results primarily from the application of multiple tax rates to differentiated products.

The inherent complexity of an income tax base, which bears most predominantly on the income taxation of businesses, results from the difficulty of defining income and determining when to recognize income and expense for tax purposes. Furthermore, a properly constructed income tax (unlike the current federal income tax) also must adopt the added complications associated with adjusting for the effect inflation has on these difficult timing issues.

The Flat Tax and the USA Tax System immediately eliminate these timing-related complexities and, therefore, their attendant compliance costs. Both plans accomplish this objective by moving to a cashflow tax base, rather than an accrued income tax base. A cashflow tax, as it applies to business, simply calls for the totaling of business receipts and then subtracting off purchases from other businesses. There is no reason to synchronize the timing of income and expenses in such a system.

A business cashflow-type tax also eliminates any need for the complexities associated with depreciation and depletion allowances, foreign-source income rules, inventory capitalization, amortization of intangibles, and long-term contracting. This list of items accounts for the bulk of business compliance costs. For example, based on research sponsored by the Tax Foundation, the current rules pertaining to foreign-source income alone account for 45.5 percent of the total federal income tax compliance cost for the firms of the Fortune 500. In fact, adoption of either the Flat Tax or the USA Tax would eliminate virtually every item on Figure 1, which illustrates the findings of a Tax Foundation-sponsored survey of senior corporate tax officers about the sources

Table 1
Comparison of 1954 Code and 1986 Code (as of 1994)

Subchapter of Income Tax Code	Number of Sections in Subchapter 1954	1994	Percent Growth
Determination of Tax Liability	4	44	1000%
Computation of Taxable Income	9	145	1511
Corporate Distributions and Adjustments	14	35	150
Deferred Compensation	2	30	1400
Accounting Periods and Methods	6	33	450
Tax-Exempt Organizations	4	17	325
Corporations Used to Avoid Income Tax on Shareholders	4	27	575
Banking Institutions	3	20	567
Natural Resources	3	10	233
Estates, Trusts, Beneficiaries, Etc.	7	29	314
Partners and Partnerships	7	29	314
Insurance Companies	5	29	480
Regulated Investment Companies, Etc.	1	17	1600
Tax Based on Income from Within or Without the United States	9	78	767
Gain/Loss on Disposition of Property	7	42	500
Capital Gains and Losses	4	52	1200
Readjustment of Tax Between Years and Special Limitations	6	5	-17
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	42	425
Total	103	698	578%

(a) Includes all subchapters not explicitly listed as well as Chapters 2-6 of Subtitle A of the Internal Revenue Code.
Source: Tax Foundation computations from Internal Revenue Code.

of complexity in the current federal income tax code.

Political Sources of Tax Complexity

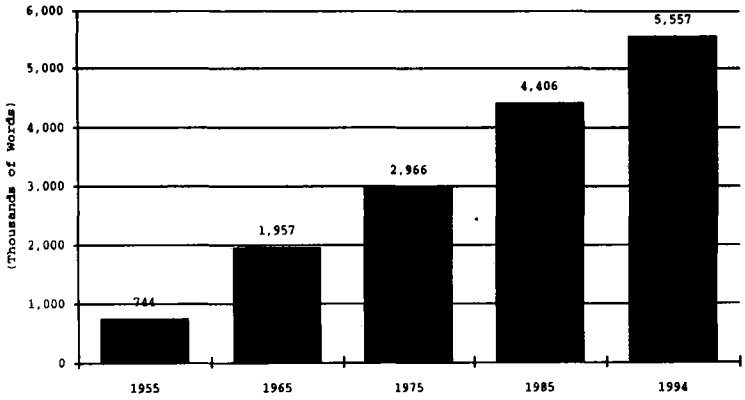
Although the Flat Tax, USA Tax System, or a retail sales tax are inherently far less complex than even the most pure income tax system, misguided political tampering can ruin the integrity of any system. Indeed, over time, the political process of give and take has exacerbated the inherent complexities of the federal income tax system. The definition of taxable income has not only expanded dramatically, but it has undergone chronic revision.

Table 1 reveals the dramatic growth in the income tax code over the past 40 years. In 1954, the federal income tax law comprised 103 code sections. Today, that law comprises 698 code sections, a 578 percent increase. Almost all of the growth relates to tax base questions. Note that since 1954 the number of sections dealing with the "Determination of Tax Liability" has grown 1,000 percent; the number of sections dealing with "Capital Gains and Losses," most of which detail "special rules" for calculating capital gains and losses, has grown 1,200 percent; the number of sections dealing with "Deferred Compensation" (e.g., pension plans) has grown 1,400 percent; and the number of sections dealing with the "Computation of Taxable Income" has grown more than 1,500 percent.

Perhaps a more revealing measure of the growth in tax code complexity is the growth in the number of words that comprise the income tax law and its attendant regulations. Figure 2 charts the growth in the combined number of words that define the body of both the federal income tax laws and their attendant regulations. The Tax Foundation has determined that over the past 40 years the number of words detailing the income tax laws has grown 369 percent. The words detailing income tax regulations, which provide taxpayers with the "guidance" they need to calculate their taxable income, have grown 730 percent. The combined growth is 647 percent.

The growth in the volume of the income tax laws and regulations has resulted piecemeal

Figure 2
Growth of the Income Tax Code (Laws and Regulations)



Source: Tax Foundation.

from the 31 major tax enactments and the more than 400 other public laws that have amended the Internal Revenue Code since the 1954 Act. Based on a sample of one-fifth of the core sections of the income tax code, these enactments have not only increased the volume of the code but have resulted, on average, in the amendment of each code section once every four years. As Figure 3 illustrates, this instability has been much more pronounced in the past 20 years than it was during the 20 years immediately following the 1954 Act.

The complexity generated by the growth and constant change of the tax code creates two general types of economic costs. One is the overhead cost associated with the economically sterile exercise of tax planning, compliance, and litigation. The second cost results from the economic opportunities that are foregone because of taxpayer uncertainty.

Because of complexity and instability, despite substantial cost to fund diligent and expert research, taxpayers may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment. In many businesses, research and development require longer and longer lead times. If taxpayers cannot accurately predict the tax consequences of a particular economic activity, either because of vagueness, complexity, or instability in the tax code, then tax policy is handicapping the growth and dynamism of the U.S. economy.

Quantifying the Overhead Cost of Tax Compliance

In 1995, according to the Internal Revenue Service and the Office of Management and Budget, taxpayers will spent 5.1 billion hours complying with federal tax laws. An hourly cost of $39.6 can be derived by averaging the average labor cost of both the IRS and the accounting firm of Price-Waterhouse. Applying that hourly cost figure to 5.1 billion hours results in a total compliance cost of $202 billion. Historically, about two-thirds of the compliance burden (or $135.3 billion) is borne by the business sector.

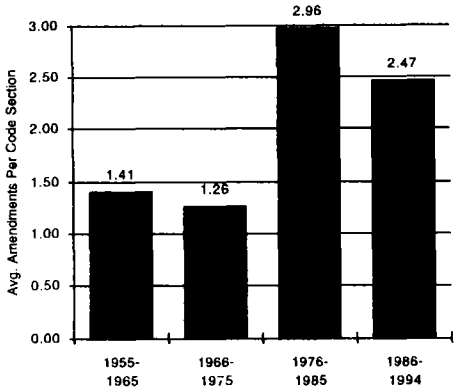
Based on my calculations, at least 70 percent of the total cost of federal tax compliance is due to the income tax, indicating that businesses will pay an estimated $94.7 billion in 1995 to

Table 2
Estimated Cost of Corporate Income Tax Compliance by Amount of Company's Asset Size

Asset Size/1 ($Thousands)	Compliance Cost as % of Assets	Estimated Compliance Cost
$1,000	0.74%	$7,400
$25,000	0.40%	$100,000
$50,000	0.40%	$200,000
$100,000	0.40%	$400,000
$250,000	0.14%	$350,000
$500,000	0.10%	$500,000
$1,000,000	0.09%	$900,000
$2,000,000	0.08%	$1,600,000
$3,000,000	0.08%	$2,400,000
$4,000,000	0.04%	$1,600,000
$5,000,000	0.04%	$2,000,000
$7,500,000	0.05%	$3,750,000
$10,000,000	0.03%	$3,000,000

1. Excludes financial and life insurance firms.
Source: Tax Foundation.

Figure 3
Instability in the Federal Income Tax Code Based on Selected Code Items



Source: Tax Foundation compilation from U.S. Code Annotated (Title 26).

comply with the federal income tax. That figure is up from an estimated $81.2 billion in 1991 (70 percent of $116 billion), the latest year for which complete income tax revenue data is available. The 1991 cost of $81.2 billion amounted to 74 percent of the income tax revenue received from all businesses. This ratio offers solid evidence that the income tax on business, particularly the corporate income tax, is a grossly inefficient revenue system for the federal government.

To date, the Tax Foundation has focused its detailed research on the cost to corporations of complying with the federal income tax. The total cost of compliance differs widely across companies of different size. Based on a 1992 survey of large corporations sponsored by the Tax Foundation, the 1995 cost of complying with the federal corporate income tax for the average Fortune 500

Table 3
Compliance Costs to Businesses of the Value-Added Tax in Great Britain, 1986 and 1987

Size of Business (Annual taxable sales per business in $U.S.)	Compliance Costs as a Percentage of Taxable Sales
0 to 30,000	1.940
30,000 to 75,000	0.780
75,000 to 150,000	0.520
150,000 to 750,000	0.420
750,000 to 1.5 Million	0.260
1.5 Million to 15 Million	0.040
15 Million or More	0.003

Source: Congressional Budget Office, Effects of Adopting a Value-Added Tax, Feberuary 1992, p. 71. Original data from Cedric Sandford, et. al., Administrative and Compliance Costs of Taxation (Bath, England: Fiscal Publications, 1989), p. 116.

firm will amount to an estimated $1.58 million (or $790 million for the entire Fortune 500). For the average small corporation, those with $1 million or less in assets, the minimum cost amounted to an estimated $7,400. But simple averages are quite misleading.

A common research finding clearly demonstrated in Table 2 is that economies of scale exist in tax compliance. That is, relative to asset size, small corporations bear a compliance cost burden at least 24.6 times greater (and, on average, perhaps as much as 177 times greater) than the largest U.S. corporations, those with $10 billion or more in assets. What makes this huge differential more amazing from a public policy standpoint is that only 0.16 percent (5,933, in 1991) of all U.S. corporations paid about three-quarters of all corporate income taxes in 1991.

More than 90 percent of all U.S. corporations have assets of $1 million or less and, therefore, bear tremendous relative compliance burdens. In 1991, as a group, these small corporations had to pay at a minimum $382 in compliance costs for every $100 they paid in income tax. They bore about $14 billion in compliance costs for $3.7 billion in income taxes. (That represents about 4 percent of corporate income taxes paid and about 90 percent of the minimum measure of the corporate income tax compliance cost.)

Because complying with tax laws is a fixed cost for any business, it seems likely that smaller companies will bear a greater compliance burden than larger companies under virtually any type of tax system. For example, Table 3 demonstrates that the value-added tax in Great Britain imposes a compliance burden on that country's smallest companies that is 647 times greater than the burden on the largest firms. Interestingly, however, one measure taken by tax authorities to reduce the compliance burden on small companies in countries that have a value-added tax is to allow these companies to calculate their tax liabilities in a way that is identical to the cashflow method proposed by the Flat Tax and the USA Tax System.

Comparing the Relative Compliance Burden of the Federal Income Tax and the Alternative Replacement Proposals

Tables 4 and 5 form the basis of the Tax Foundation's comparison of the cost of complying with the current federal income tax and the various replacement alternatives. Table 4 compiles a list of the core individual income tax forms along with both the estimated paperwork-burden calculations (in hours of compliance time) generated by the Internal Revenue Service. It also reports IRS projections for 1995 of the number of tax returns by type. Table 5 compiles a similar list for the business sector. These lists are far from exhaustive, and trusts and estates (Form 1041) are not even included. The lists are also incomplete to the degree that adequate tax return informa-

tion could not be obtained or estimated for the many schedules and forms that are common auxiliary components of the core forms.

Tables 4 and 5 combined report a total of 3.2 billion hours of required compliance time for the items reported. This figure is well short of the IRS-estimated 5.1 billion hours of compliance time required for the entire federal tax system. However, the magnitude of the minimal lists compiled provide ample information to make comparisons with the replacement alternatives.

To estimate the paperwork burden associated with the alternative replacement proposals (with the exception of the compliance burden on retail businesses of a national sales tax), the Tax Foundation used the same methods that underlie the IRS estimates. These methods are laid out in Development of Methodology for Estimating the Taxpayer Paperwork Burden, the 1988 report to the IRS delivered by the consulting company of Arthur D. Little, Inc. In brief, these methods estimate taxpayer paperwork burdens using the various characteristics of tax forms and the informational content of the instructions for these forms.

A. The Flat Tax

The postcard-size tax forms advertised by the Flat Tax plan makes the paperwork requirements readily discernible. The average individual taxpayer should take no longer than one hour and eight minutes each year (assuming an annual tax filing) to comply with Rep. Armey's Flat Tax. However, if monthly tax payments become a requirement because of the elimination of withholding, the cost of the "preparation" and "sending" elements listed in Table 4 will have to be repeated each month, adding substantially to the overall compliance costs. The compliance time for the Flat Tax is compared to 11 hours and 36 minutes for the average 1040 Form and two hours and 54 minutes for the average 1040-EZ Form.

Recordkeeping would be simple under the Flat Tax. Both the wage and pension distribution data are supplied on an employer-provided form (Form W-2 and Form 1099). The average compliance time would be somewhat lower, but, because of the current tax treatment of contributions to pension plans, for the foreseeable future many taxpayers reporting pension and individual retirement account distributions would probably have to make extra calculations to determine what part of the distribution is taxable.

The average business taxpayer should take no longer than three hours and 24 minutes each year to comply with the Flat Tax. That compares to an average 21 hours and 54 minutes for a nonfarm sole proprietor under the current income tax system. It compares to 100-plus hours for the average partnership and the 200-plus hours for the average C corporation. The reduction in compliance time comes from a major reduction in every aspect of the overall paperwork burden.

B. The USA Tax System

The USA Tax streamlines the definition of taxable income and would, therefore, substantially reduce the compliance burden associated with the current income tax. However, the USA Tax would require a somewhat greater paperwork burden than a Flat Tax that required only annual filing. The big difference is in the "recordkeeping" and "education" components of the paperwork burden. The USA Tax places a levy on both wage and nonwage income and then allows individuals to deduct an unlimited amount of current-year saving. (It also allows individuals to take a credit for payroll taxes paid.) The Flat Tax by contrast adopts a "prepayment" approach that taxes all of an individual's wages (over the exemption threshold), but never taxes income that results from saving.

As a result of this procedural difference, the USA Tax would retain a tax form similar to the current system's 1040-EZ Form and suggests two new basic tax forms — Schedule S (Net

Table 4
A Comparison of the Compliance Burden on Individuals of the Current Income Tax and Alternative Replacement Plans

Individuals Only	1995 Estimated Number of Returns	Average Time in Hours per Form for 1995 Tax Year: Record-keeping	Education Stage	Form Preparation	Packaging/ Sending	Total	Total Hours
Forms							
1040	57,574,816	3.1	2.9	4.7	0.9	11.6	666,908,285
1040A[a]	18,195,000	2.2	2.8	4.2	2.1	11.2	203,480,750
1040EZ	17,189,000	0.1	0.8	1.3	0.7	2.9	49,848,100
1040ES	38,020,100	1.3	0.3	0.8	0.2	2.6	99,485,928
1040X	1,870,000	1.2	0.4	1.2	0.6	3.4	6,295,667
4868 (Extention of Time)	4,813,000	0.4	0.2	0.3	0.3	1.3	6,016,250
1040 Schedules							
Sch A	43,116,920	2.5	0.4	1.2	0.5	4.6	197,619,218
Sch B	61,595,600	0.6	0.1	0.3	0.3	1.3	80,074,281
Sch D	21,558,460	0.9	0.7	1.0	0.7	3.3	70,064,995
Sch E	26,178,130	2.9	1.1	1.3	0.6	5.8	152,705,759
Sch EIC	7,699,450	0.0	0.0	0.1	0.1	0.2	1,411,566
Sch R	461,967	0.3	0.3	0.4	0.6	1.5	708,349
Individual Totals-Current Income Tax (Forms + Schedules)	298,272,444	NA	NA	NA	NA	NA	1,534,619,148
Flat Tax	92,958,816[c]	0.04	0.4	0.3	0.4	1.14	821,755,933[b]
USA Tax System							
Basic Form	92,958,816[c]	0.1	0.8	1.3	0.7	2.9	269,580,566
Sch S (Net Savings Deduction)	65,071,171	0.03	0.3	0.63	0.4	1.36	88,496,793
Sch S-1 (Savings and Withdrawl Info)	65,071,171	0.14	0.8	1.26	0.4	2.6	169,185,045
Individual Totals - USA Tax (Forms + Schedules)	223,101,158	0.77	0.03	0.28	0.4	1.48	527,262,404
Retail Sales Tax (Assuming a rebate system to create a progressive incidence)	99,528,030[d]	0.77	0.03	0.28	0.4	1.48	147,301,484

[a]Schedules 1-3 are included in the average time.
[b]Assumes that withholding is eliminated and that taxpayers must make monthly payments. If annual filing is maintained the total hours amount to 105,973,050.
[c]Equals sum of nonbusiness 1040, 1040A, and 1040EZ Forms.
[d]Equals estimated number of U.S. households for 1995.

Source: Tax Foundation, using Internal Revenue Service data and estimation methods.

Savings Deduction) and Schedule S-1 (Savings and Withdrawal Information). For the average taxpayer that took advantage of the savings deduction, the USA Tax should require no more than six hours and 52 minutes of compliance time.

The business side of the USA Tax is similar to the Flat Tax in that it is a business cashflow tax. From a compliance perspective, one difference is that the USA Tax would be border adjustable. That is, U.S. businesses could deduct the receipts they generate from the sale of exported goods and services. Border adjustability, therefore, would add to an average business's recordkeeping requirements relative to a Flat Tax. This added recordkeeping accounts for the small difference in business compliance time between the Flat Tax and the USA Tax. In addition, the USA Tax allows for a payroll tax credit. However, the additional compliance costs associated with this credit should be minimal.

C. A National Retail Sales Tax

In 1990, the accounting firm of Price-Waterhouse submitted to the American Retail Education Foundation their final report for the Study to Estimate the Costs of Collecting State and Local

Table 5
A Comparison of the Compliance Burden on Businesses of the Current Income Tax and Alternative Replacement Plans

Businesses	1995 Estimated Number of Returns	Average Time in Hours per Form for 1995 Tax Year: Record-keeping	Education Stage	Form Preparation	Packaging/ Sending	Total	Total Hours
Sole Proprietorships*							
Form 1040	18,394,184	3.1	2.9	4.7	0.9	11.6	213,065,965
Sch C	16,525,451	6.4	1.2	2.1	0.6	10.3	169,661,296
Sch F	1,868,733	4.4	0.4	1.3	0.3	6.5	12,022,184
Partnerships							
Form 1065	1,510,400	38.4	19.8	35.4	4.0	97.6	147,389,867
Partnership Schedules							
Sch D	1,510,400	5.5	1.2	1.3	0.0	8.0	12,133,547
Sch K-1	1,510,400	24.6	8.6	9.4	0.0	42.7	64,468,907
Sch L	1,510,400	15.5	0.1	0.4	0.0	16.0	24,166,400
Sch M-1	1,510,400	3.4	0.2	0.3	0.0	3.8	5,764,693
Sch M-2	1,510,400	1.6	0.2	0.3	0.0	2.1	3,121,493
Corporations							
Forms							
1120	2,116,200	71.3	41.1	72.0	8.0	192.5	407,297,960
1120A	340,300	43.3	23.3	40.8	4.6	111.9	38,073,898
1120S	2,084,200	62.7	20.7	36.6	4.0	124.0	258,475,537
1120X	24,700	12.2	1.1	3.2	0.5	17.1	422,370
1120L	2,748	75.3	23.9	37.3	3.2	139.8	384,142
1120F	20,600	102.4	36.8	64.5	7.0	210.6	4,338,017
1120PC	2,748	106.4	33.3	54.2	5.1	199.0	546,988
1120RIC	6,800	52.4	15.3	29.9	3.8	101.3	688,500
1120REIT	322	55.7	17.3	33.9	4.3	111.2	35,801
7004	2,230,200	5.5	0.8	1.8	0.3	8.4	18,622,170
4626 (AMT)	339,472	18.4	18.2	15.2	0.0	51.9	17,612,913
4562 (Depreciation)	2,456,500	33.7	4.5	5.2	0.0	43.4	106,612,100
1120 Schedules							
Sch D	2,116,200	6.9	3.5	5.7	0.5	16.6	35,199,460
Sch H	211,620	6.0	0.6	0.7	0.0	7.3	1,541,299
Sch PH	105,810	15.3	6.1	8.5	0.5	30.4	3,220,151
1120S Schedules							
Sch D	2,084,200	9.3	4.2	9.2	1.3	24.1	50,229,220
Sch K-1	2,084,200	14.8	10.3	14.7	1.1	41.0	85,347,990
Business Total (Forms + Schedules)	59,621,089	NA	NA	NA	NA	NA	1,680,442,867
Flat Tax	24,445,284	2.3	0.3	0.4	0.4	3.4	83,113,966
USA Tax System	24,445,284	2.5	0.3	0.4	0.4	3.6	88,003,023
Retail Sales Tax (Retail Firms Only)	NA	NA	NA	NA	NA	NA	123,484,848

* No attempt is made to estimate the other schedules of the 1040 Form that a business filer may be required to complete. Such compliance burdens are left in the Individual section (Table 4).

Source: Tax Foundation, using Internal Revenue Service data and estimation methods.

Sales and Use Tax. The study determined that the cost of sales tax compliance for the nation's retailers, on average, amounted to 3.48 percent of total sales tax liability. In dollar terms, this amounted to a 1990 cost of $4.4 billion. The 3.48 percent figure is best viewed as an historic relationship that does not necessarily generalize to future tax collections. Therefore, the 1990 cost is increased by the increase in inflation-adjusted retail sales (12 percent) to yield a $4.9 billion estimated 1995 compliance cost of a national retail sales tax. The total hours reported in Table 5 result from dividing the 1995 cost by the hourly labor cost of $39.6, the labor cost figure used to generate the Tax Foundation's $202 billion total compliance cost estimate.

To offset the regressive incidence commonly attributed to a broad-based sales tax, some proponents of a national sales tax suggest that a rebate scheme be devised to reimburse the tax

paid on a given dollar amount of consumption expenditures made per person in a household. Such a scheme would probably require paperwork of some type for three reasons: (1) to request a rebate, (2) to verify that the designated amount of taxable expenditures were in fact made, and (3) to verify the number of people per household that count toward the requested rebate amount. The estimated time needed to comply with a sales tax rebate scheme is reported in Table 4. The time elements were derived by pooling the time elements of existing tax forms that have similar reporting requirements (namely, Schedules B and EIC of Form 1040 and Schedule 2 of Form 1040A).

Chairman ARCHER. Thank you, Dr. Hall.

Mr. Adams.

STATEMENT OF CHARLES ADAMS, AUTHOR OF "FOR GOOD AND EVIL: THE IMPACT OF TAXES ON THE COURSE OF CIVILIZATION"

Mr. ADAMS. Thank you.

I am here pretty much as a historian. I have written a book of a 20-year study of the impact of taxes and history. If you are determined to tear out the income tax by its roots, I want you to know that you have history on your side. History is your friend. "A page of history," said Oliver Wendell Holmes in one of his great decisions, "is worth a whole volume of logic," and in the few minutes I speak to you I would like to give you a page of history.

I am referring to the first modern energy tax which was invented by the British. All modern income taxes go back to that as the father, or as the mother depending on your gender. That tax was the tax to beat Napoleon. He didn't have a revenue system and the British did, and Waterloo was inevitable at some point.

The British people lived under this tax for 18 years and complied with it, but when Waterloo happened and when the Congress of Vienna settled the political situation, the British Government decided that this was really a great tax, so they then proposed in the House of Commons, in the House of Lords that income tax be continued and they had debate on that.

The leader of the opposition to the tax said that he hoped that the British nation would rise up as one man and object to this monstrosity. He said that this extension of bureaucratic power into everyday life might be the herald of an all-embracing tyranny, and the House of Commons cheered and the House of Lords cheered and then they had a vote and there was a quiet in the House and as the vote was being tallied, the Speaker of the House announced that the income tax had been repealed. And according to historians, there was the loudest exultation ever heard in the British Parliament in 500 years. There were celebrations, church bells rang out, there were bonfires in the countryside. There was more celebration and more joy over abolition of the first income tax than there was over defeat of Napoleon at Waterloo.

Another interesting thing happened. After the debate finally quieted in the House of Lords and the House of Commons, there was then a motion made that all the records of the income tax be destroyed and that motion was carried and they had a huge bonfire and the Chancellor of the Exchequer, and the Chancellor was the key taxman, it is said he stoked the fires as they brought in the tax records—he secretly kept a copy of those tax records hidden in the Exchequer Court which years later were discovered. That was the end of the income tax.

I think they were sending a message that this is a terrible tax system and they destroyed the records. You know why? Dead men tell no tales. Burned tax records tell no tales. It turned out that about 20 years later the Reform Parliament—the parliament that gave us the abolition of slavery ultimately coming to the United States—they brought up the question of an income tax again. The generation of Napoleon was still around. The Chancellor of the Ex-

chequer said, "if ever inquisitorial powers are spoken of, where will you find inquisitorial powers worse than at that time in British history." So the income tax stayed dead.

You might think with that experience, with the page of history being a volume of logic, maybe we should not have adopted an income tax. But history gave a mixed message, because in 1842 Sir Robert Peel put in a flat income tax. And he said, This will only be for 3 years, it is going to be 3 percent and will be collected at the source, and will be nothing like what you lived under during Napoleon's time. And they adopted it.

That income tax continued for 70 years as a simple flat tax. It was held up in the great debates in America over the income tax amendment, it was held up that you could have a good income tax and you don't have to have a bad income tax. What eventually happened is that we got a bad one.

I think from my experience and study as a historian, I would like to add to the four points that the Chairman mentioned about what kind of a tax system we want. I think there are four great lessons that history teaches. The first lesson on adopting a tax is that the tax should be indirect. The Greeks and Romans believed that, the Founding Fathers believed that. The argument was made that an indirect tax is consistent with liberty; a direct tax is consistent with slavery, said Montesquieu.

I think the next main lesson of history is that taxes must not be excessive. That is a hard word to define. When they had some terrible revolts in Britain around 1750, a fellow named Henry Fox spoke about what kind of a tax lesson the British had learned from this. He said that not only is it what people are able to pay, but it is what people are willing to pay.

That is another great point in determining a tax law: Is this what people are willing to pay? During the war with Napoleon, they were willing to pay a lot, but not afterward.

The only other two points I would make is that the taxes should be moderate and they should have a broad base.

I see my time is up. Thank you.

[The prepared statement follows:]

Address
by
CHARLES ADAMS
On Replacing the Income Tax
The Committee on Ways and Means
U.S. House of Representatives
104th Congress
Washington D.C.
June 6, 1995

"Down, Down to hell! & say I sent thee!!"

Mr. Chairman, my name is Charles Adams, author of a 20 year study, entitled, For Good and Evil: The Impact of Taxes on the Course of Civilization. History reveals that most great empires taxed themselves to death, while others became great because of the right kind of taxes--taxes that stimulated growth, peace and commerce. If the Congress decides it is time to replace the income tax, then history provides some wonderful guides on how to do so. Let me begin with the unusual repeal of the first modern income tax, almost two centuries ago.

European cartoonists in the 18th and 19th centuries loved to depict taxes the people hated as a many-headed monster, and the first modern income tax was no exception. Britain's most renown cartoonists, Cruikshank, marked the repeal of the income tax in 1816 with the following cartoon. A battered Britannia on the ground is told, "Rise Britannia! The Monster that so long oppressed and trampled on you is at last Subdued." Members of Parliament wielding their clubs on the monster, shout: "Down, Down to hell! & say I sent thee!!"

No doubt a great percentage of American taxpayers would like to send their Internal Revenue Code, "Down to Hell, and say I sent thee!"

This British income tax with its many schedules and concept of income was the forerunner of modern income taxation today. It was the tax that beat Napoleon. But when the Corsican general was finally put away and the political issues settled at the Congress of Vienna, The British people let their government know they despised the tax, but accepted it for 18 years as a wartime measure only. In the debates over retaining the tax, the leader of the opposition to the tax received a rousing ovation when he proclaimed:

> He hoped that the country would rise up as one man against it...This extension of bureaucratic power into everyday life might be the herald of an all-embracing tyranny.

The Crown followed with a motion to retain the income tax. When the Speaker announced the defeat of the motion, there was "the loudest exultation ever witnessed" within the halls of Parliament. A motion then followed to have all the records of the tax destroyed. It was carried--burned tax records, like dead men, tell no tales. The Crown was a bad loser. The Chancellor of the Exchequer is said to have stoked the fires as the records were being burned, while secretly retaining a duplicate copy of the records hidden away in the basement of the Exchequer Court.

Seventeen years later the famous Reform Parliament (which abolished slavery), considered instituting an income tax. Even the Chancellor opposed the idea with these words:

> If inquisitorial powers are spoken of, where will you find inquisitorial powers greater than those which were then [Napoleonic times] exercised. The tax was--detested by the whole country.

The entire generation of Britons who lived under that first income tax had to pass away before the Crown could pass another income tax law. In 1842, to put the government's finances in shape, Sir Robert Peel pushed through Parliament a simple, 3% flat tax, with stoppage at the source. To allay any fears this tax might become permanent, Peel promised its repeal in a few years once the government's finances were in balance. Of course, that never happened. The tax has continued to this day. But the low rate, flat tax, lasted for almost 70 years, and became a shining example for proponents of income taxation everywhere, and played no small role in the adopted of income taxes in the U.S.

In 1911, Professor Edwin Seligman came forth with a book, The Income Tax, which extolled the virtues of income taxation. He dismissed the experiences under the Napoleonic tax, "Early complaints against the inquisitorial character of the tax have long since well-nigh completely disappeared." That observation looks ludicrous today, but in 1911, with 70 years of tolerable experience under Britain's modest flat tax, how could anyone have predicted otherwise?

But all was not entirely rosy. Germany had instituted an income tax in the late 19th Century which involved extensive audits (like today), which prompted one German legislator to acknowledge, "The country is covered with a perfect system of espionage." But German tax oppression would not happen in America, said Professor Seligman, "Nowhere else are people so

meek in the face of officialdom. In no other country in the world would it be possible to enforce so inquisitorial a procedure as we have learned to be customary in Prussia." And what was the procedure? The audit. The inquisitorial procedure the proponents for the 16th Amendment said would not happen here has become a way of life for all America, and today, most American taxpayers want out, like the British did in 1816.

"A disgrace to the human race"

Our income tax code has been in disrepute for decades. In President Carter's acceptance speech at the Democratic Convention in 1976, he called for major tax reform, labelling the Internal Revenue Code "A disgrace to the human race." No one objected on the Republican side, yet no significant tax reform came about. The whole issue seemed to degenerate into a national debate in our major periodicals over the deductibility of the three martini lunch. Carter's condemnation of the tax code was almost 20 years ago. The Internal Revenue Code and Regulations today are almost twice as thick and certainly twice as complicated and down right unintelligible. One of our most respected income tax scholars, Professor James Eustice, of NYU, when asked about certain new provisions of the tax code, said, "About all I can do is laugh."

Polybius, the great Greek historian of the second century B.C., said that the best preparation for politics was the study of history--in order to avoid the disasters of others. And one of our most revered thinkers in the 20th Century, Oliver Wendall Holmes, echoed the same idea in a 1922 case, "A page of history is worth a volume of logic." However, history gives us a mixed voice when it comes to income taxes. The early British income tax, the German income tax, and our own income tax monster all attest to the dangers inherent in income taxation. On the other hand, the simple flat British tax in the latter half of the 19th Century suggests that, with the utmost care, an income tax can be administered consistent with the spirit of a free nation. But if not controlled, the tax, like fire, can burn down the very civilization we seek to perpetuate. Our income tax is a monster because of our zeal for revenue; we ignored the lessons of history--what Polybius called, "The disasters of others."

Getting rid of our current income tax may seem like an impossibility, considering the huge national debt and deficits, but the seemingly impossible may turn into reality if the American taxpayer, like our cousins in Britain in 1816, has a say. Actually, the Congress and the Treasury have been, unwittingly, digging a grave for the income tax code for over 30 years. President Ulysses S. Grant, said that the best way to get rid of a bad law, is to strictly enforce it, and that has been happening to the income tax law for the past three decades. For the first 50 years, the income tax in America was an honor system. In my first tax audit as a professional, some 30+ years ago, a veteran IRS agent on the eve of retirement, said to me, "You know, our income tax system is an honor system, which is the only way it will work in a free society." Today, the honor part is gone. Does that mean the free society is gone as well? In a sense, yes--although no one wants to accept that painful judgment.

Thirty years ago the ubiquitous information return was almost unknown, and that is why it was an honor system. Today, besides mandatory reporting on just about every aspect of one's financial life, everything going through one's bank account is photographed and held in storage for the tax man to see. Our tax administration is now a spy system, not an honor system. Does that mean there has been a tragic decline in the honor and integrity of our citizens? Or, is there another explanation?

Almost 50 years ago, Supreme Court Justice Jackson, who was formerly chief counsel for the Internal Revenue Bureau, wrote, praising the tax integrity of the American taxpayer:

> The United States has a system of taxation by confession. That a people so numerous, scattered and individualistic annually assess itself with a tax liability often in highly burdensome amounts, is a reassuring sign of the stability and vitality of our system of government.

This praise was repeated by many others at that time. But in 1983, Richard Neely, Chief Justice of the West Virginia Supreme Court, made this disturbing observation:

> Cheating on federal and state income tax is all pervasive in all classes of society; except among the compulsively honest, cheating usually occurs in direct proportion to opportunity.

Justice Jackson spoke of the rare instances of self-serving mistakes and outright evasion--and that was when the income tax was indeed an honor system. Justice Neely, writing almost 40 years later, saw such misdeeds as the norm if people have the opportunity. The government has two choices: cover the nation with even more espionage against taxpayers as the Germans did, or get rid of the monster.

What has gone wrong?

Rather than attack the integrity of the people, what we are experiencing is a broad, non-violent revolt against the tax system. Wealthy citizens are revolting with their shoes--they take flight to more gentler tax climes; others, not so fortunate, resort to just about anything that works: legal, and not-so-legal. To add even more extensive surveillance, more and more penalties, and even worse, more savage punishments, is like adding gasoline to a smoldering fire. The better solution is to bring in a wrecking crew and tear down the whole disreputable edifice. The American people have had a belly-full of a bad tax law; they are fed-up with it and with the many phoney attempts at tax reform. They want out, and their defiance and rebelliousness is a warning to tax policy makers. In fact, politicians who fail to see this sign-of-the-times, had better prepare for a short-lived political career, as George Bush learned. We saw that happen last November. Fortunately, it was a lynching by votes. In other times past, when taxpayer representatives approved taxes the people didn't want, they were lynched by ropes or the headsman.

History has not been kind to governments that taxed too much, or in ways the people disliked. The American Revolution is a reminder we can hardly ignore. In the French Revolution angry, over-taxed Frenchmen hauled every tax man they could find down to the guillotine and cut their heads off. No tears were shed when their heads flopped into the basket. Thomas Jefferson wrote that a government needs a rebellion every 20 years or so, and that the governors should not punish the rebels

severely, for the rebels are pointing out sicknesses to which the government needs to give attention. Looking at Jefferson's historical frame of reference, we discover something other writers who quote Jefferson have ignored. There were about a dozen revolts in Europe and America when he lived--and all of them were over taxes. His was an era of violent tax revolts. Ours is an age of tax revolts by everything but violence. But the revolt is real, and the message the same.

These hearings on replacing the Federal Income tax should be the most important fiscal inquiries since the debates in the nation at the turn of this century over the income tax Amendment. The outcome will determine what kind of civil liberties we will pass on to our children in the next century: i.e., whether or not we pass to them a tax system that is unintelligible, corrupt, and tyrannical; or a system in which all citizens will know that the costs of running the government are apportioned among the people by a standard of fairness they can understand and see. Today, they can neither understand it, nor see it. "Duty, honor and country" have been replaced with beating Uncle Sam out of every penny you can, and this, to a large extent because the tax law is, as President Carter charged, "A disgrace to the human race." How can you expect rational citizens to support a law with such a condemnation?

What should be done?

Nero in one of his fits of madness, said that he wanted to abolish all taxes and "make a beautiful gift tothe human race." Not a bad idea, unless you want civilized life. For taxes are the fuel that makes civilization run. But if you have bad fuel with impediments, or not properly designed for the engine, then civilization will run badly, and that has happened too many times in history to need explaining

Our income tax can be likened to a dirty industrial smelter that polutes the air, poisons the streams, and kills the forests. It will be tolerated so long as nothing else has been invented, and the smelter is essential for society. Like a dirty smelter we pollute the social order with our income tax system. We seek a society in which equality, integrity, and liberty abound, but our current tax system pulls us in the opposite direction. Instead of equality, we have inequality, intentionally and deliberately fostered upon us. Instead of integrity, we have fraud. Instead of liberty we have totalitarian surveillance and inquisitions. In short, our income tax is a dirty tax and the more we demand of it the dirtier it becomes. We are stuck with it because we haven't taken the time to develop something better. Now is the time. We need heroic leadership in matters of taxation and expenditure. Hopefully, that leadership will begin with this Committee.

What guidance can the past give us?

There are both positive and negative lessons. Taxes that wrecked empires, tell us a great deal about human nature, and about taxes that produced the "disasters" Polybius warned us about. And then there were taxes that were compatible with liberty, democracy and respected private property. We need to focus on those taxes as well. Besides these historical examples we have the marvelous wisdom of the great minds of the past; of men who pondered the wreckage bad taxation had wrought, and sought out answers for the best way to tax and spend. We need to look to these great sages of the past, and fortunately, so many of them were prominent in the formation of the United States

200 years ago. They spoke our language. We don't need a translation. All we need to do is listen.

1. Any permanent forms of taxation should be as indirect as possible.

The condemnation of direct forms of taxation as the arch-enemy of liberty, is a truism over 2500 years old. It came from the Greeks and Romans who taught that direct taxation produced tyranny. They came to that conclusion from history--from examining the tax systems of the great empires of their day and their past--Assyria, Babylon, Persia, and Egypt. These were civilizations that were devoid of liberty and respect for private property. The Greeks concluded from history that tyranny was the consequence of the wrong kind of taxes, and liberty came from the right kind of taxes, like sales, imports, or taxes on commerce.

Cicero, the great Roman lawyer, wrote that direct taxes should instituted only if there was no alternative other than complete national collapse.

When Rome declined and fell in A.D. 476, direct taxaes had been in operation for over 175 years, and, at the same time, all forms of liberty had been taken away, starting with the Emperor Diocletian, who enslaved the Roman world to make the tax system work.

The Founders were schooled in classical history, and their greatest sage was from Europe, Baron du Montesquieu. His The Spirit of Laws was quoted more than any other writer by the Founders. He picked up the Greek and Roman theme and said that direct taxation was natural to slavery, but indirect taxes, like those on merchandise, were more compatible to liberty, "because it has not so direct a relation to the person."

I have searched through the debates at the Constitutional Convention and the debates in the state legislatures, and there is not one word of support for direct taxation. Madison and Hamilton wanted the power of direct taxation in the Constitution but only for "extraordinary emergencies." James Wilson, from New York, whom some believe was the primary architect of the Constitution stated that direct taxes were for "all cases of emergency." Luther Martin, a delegate from Maryland, said direct taxes "should not be used but in cases of absolute necessity." In the state debates, a representative, Alexander Hanson, reasoned that direct taxes were to be held in reserve, "nothing but some unforeseen disaster will ever drive them [the federal government] to such ineligible expedients."

It is clear from the writings and thinking of the Founders and of the ancient Greeks and Romans, that a nation bent on preserving liberty should avoid direct taxation and rely on indirect taxes, like sales and import duties, taxes on commerce, not the individual. Add to that historical wisdom the experience of the British under the Napoleonic income tax. They tried to pass on to later generations that the income tax they had experienced over 18 years was a tyranny of the worst kind, and by destroying all the records of this hated tax, they left a message for future generations to come. A message, we might add that never got through to our tax makers a hundred years ago. In this century, we have confirmed, the hard way, that the British in 1816 were right.

2. Taxes, whatever the format, must not be excessive.

The Founders and the men of the Enlightenment, condemned taxes that were "excessive." Unfortunately, they did not define the term, but they did explain the consequences. Montesquieu, who relied on history for his judgments, said excessive taxation resulted in "extraordinary means of oppression." Now, that's worth thinking about. What he seems to be telling us, is that human nature rebels against excessive taxation. It may be a violent revolt; it may be emigration to avoid tax; it may be evasion or fraud of some sort--but it is an iron law of history you cannot legislate against human nature. When a government does, in the tax field, it has to resort to "extraordinary means of oppression." But Montesquieu does not end there; for the inevitable consequence was, "the country is ruined."

The best definition of excessive comes from a leader of the British House of Commons at mid-18th Century, following the excise tax revolts against Sir Robert Walpole. The government had to do a lot of thinking about what had happened, and Henry Fox summed up the wisdom learned with this observation:

> All governments must have a regard not only for what the people are <u>able</u> to pay, but what they are <u>willing</u> to pay, and the manner in which they are willing to pay, without being provoked to a rebellion.

3. Most important, the tax system as a whole, must be moderate.

There is an ancient Asian proverb, "It is not the heavy taxed realm that executes great deeds, but the moderately taxed one." This is consistent with the Greek doctrine of the "golden mean," propounded by Aristotle. Virtue is the middle ground between extremes. Tax policy should follow a moderate course in all respects: tax rates, surveillance, privacy, punishments, even equality. It is, in my opinion, no virtue to exempt any citizen from some tax. In the New Testament, even the widow paid her mite. In the Roman Republic, the taxes of widows and orphans, however small, were set aside for the cavalry. Taxes were paid with pride, and love of one's country.

Tax rates should pass the smell test, and not reek of plunder against any minority class of citizens, like our estate taxes which today confiscate over half the accumulated (and taxed) wealth of the rich. No wonder they take flight and leave, for patriotism, like it or not, is soluble in taxes. Not even a half-starved crow will sit around to be shot at.

Intrusions should show some respect for privacy and due process. Photographing everything in every bank account is looked upon by other Western societies with horror, like something out of Orwell's <u>1984</u>.

Our savage punishment of tax sinners is not only out of step with Western Civilization, it was condemned by the great writers of the Enlightenment. Not only Montesquieu, but William Blackstone in his <u>Commentaries</u>, and Adam Smith in <u>The Wealth of Nations</u>. They all condemned making tax evasion a felony. The tax evader, said Adam Smith, was--

> In every respect, an excellent citizen, had not the laws of his country made a crime which Nature never meant to be so. In those corrupt governments where there is at least a general suspicion of much unnecessary expense, and great misapplication of the public revenue, the laws which guard it are little respected.

Montesquieu and Blackstone in one voice, both said, you must not treat tax offenders as villains.

4. There is no single form of tax Nirvana.

Around 1750, the famous British Poet, Alexander Pope, gave us this wise couplet:

> Whoever hopes a faultless tax to see,
> hopes what ne'er was, is not, and ne'er will be.

Reliance upon any single form of taxation has not worked well in history. Alexander Hamilton saw this and he pushed hard at the Convention to give Congress broad authority to tax in any number of ways. He argued this point in The Federalist to overcome the popular view that the federal government should only be able to tax imports. His argument was sound. He said that if great revenues are needed, as they will be at certain times of emergency, then a single tax will become excessive and this will injure commerce and foster evasion with the high tax rates that will be necessary. Better to have the power to tax all kinds of sources, not just one source, so the rates can be moderate.

Historical examples are easy to find. The Spanish Empire and later the super-Dutch empire both went into decline because of heavy excise taxes that crippled trade. The Netherlands, the superpower of the 17th Century, was unable to compete with lower priced, and lower taxed British goods. An English diplomat in Holland wrote home: "When in a tavern, a certain dish of fish is eaten with the usual sauce, about 30 several excises are paid." Said another English writer, "Should we in England be obliged to pay the taxes that are here imposed, there would be rebellion upon rebellion." As British merchants underpriced Dutch goods, Leiden was a desolate town, its once flourishing cloth industry in a depression. The linen industry of Haarlem had similarly shrunk. As a modern Dutch historian has observed about the decline of the super-Dutch, "Taxation meant the strangling of trade."

The British eclipsed both the Spanish and the Netherlands in world markets, supporting the government with a broad range of taxes on all aspects of commerce and wealth. The tax philosophy of Britain's rise to superpower status was to avoid a single primary tax, which, in the words of one British tax writer 200 years ago, "ought to be most sedulously avoided."

The wisdom of Hamilton has been proven by our reliance on a single, primary tax to carry most of the country's revenue needs: it has fostered evasion and hurt commerce just as he predicted. There is no single tax Nirvana, if history is to be a guide. Such schemes have had disasterous results in the past.

What should be done? Should the present income tax be abolished? Yes--definitely so. It has been misused; the American taxpayers have been abused; they are fed up with it and want a real change. A flat income tax has merit as long as it is moderate, as indirect as possible, and as long as the Orwellian powers of the tax man are rooted out. We may not be able to "Subdue" the tax monster as the British did in 1816, but we must tame the beast before the faith of the people in federal taxation can be restored.

What about a national sales tax? A VAT? A GST like Canada, or some other form of tax on commerce. All these forms of taxation are indirect, and conform to the best tax wisdom of the past 2500 years. The Greeks, Romans, the Enlightenment, the Founders, all would favor such taxes. They have history on their side, as long as they are not too excessive or extensive as was the excise with Spain and The Netherlands.

What else? We need to explore other tax ideas, even novel or ideas that may appear crackpot. We want a tax that conforms to and does not buck the wisdom of the past. This story from Henry Ford's search for a safer car, may have some merit in our search for better ways to tax:

Henry Ford wanted to protect lives and injuries from shattered auto glass. He asked the world's glass experts to make unbreakable glass for his new models. The world's glass experts said it couldn't be done. They knew too many reasons why it couldn't be done. Henry Ford said to his aides, "Bring me eager your fellows who do not know the reasons why unbreakable glass cannot be made. Give the problem to ambitious young fellows who think nothing is impossible." He got the unbreakable glass.

America needs a new tax invention, something that might be possible with our modern technology and be compatible with the temper of a free people. In our search for a new tax system every idea and plan to replace the income tax, must be measured and tested against these four criteria of a bad tax system, given to us by Adam Smith in The Wealth of Nations:

1. The tax must not foster a large bureaucracy.
2. The tax must not discourage enterprise, and thus deprive jobs from the multitude.
3. The tax must not encourage evasion--legal or illegal.
4. The tax must not put taxpayers through odious and vexation examinations by the tax gatherer.

Add to Adam Smith's four signs of a bad tax system, the four positive factors set forth in this treatise:

1. A permanent tax system should be as indirect as possible.

2. The tax must not be excessive; i.e., not only what the people are able to pay, but what they are willing to pay.

3. The system as a whole must be moderate: no savage punishments; no totalitarian intrusions and surveillance; uniform and equal rates.

4. No reliance on a single form of tax--taxes should cover a broad range of the national wealth and commerce.

If we measure our current tax system by the above eight principles, it fails miserably. It might be necessary, if we are to have a good tax system, to give the problem to ambitious young fellows (and gals) who think nothing is impossible.

Chairman ARCHER. Thank you.

You have piqued my interest to read every word in your book. Perhaps every Member of the Committee might be encouraged to do so.

Dr. Payne.

STATEMENT OF JAMES L. PAYNE, PH.D., AUTHOR OF "COSTLY RETURNS; THE BURDENS OF THE U.S. TAX SYSTEM"

Mr. JAMES PAYNE. Thank you, Mr. Chairman.

I agree with what Mr. Hancock said this morning about these being historic hearings that you are having, because down through the years, at least the last 20 or 30 years, there has been surprisingly little attention given by this Committee in particular, and Congress in general, to the real costs and burdens, and problems, and destructiveness of the tax system.

I think we have got to look at these problems before we go too far into tracing out which reform we want to have. One aspect that I will mention is the total overhead cost of running the tax system. Apparently there are some Members of this Committee that still believe it is minuscule. I notice in the questioning of the Mobil representative this morning that there are people that feel this cost is trivial. I don't think anybody that has looked at these numbers can say that anymore.

In the figures I have put together, the compliance cost is only one component—there are costs associated with enforcement, collection and litigation, and disincentive to production. If you add these together in 1985, as I did, they amounted to $363 billion. I have updated this estimate to 1993, the latest year for which the figures are available, and I get $593 billion. That is the figure that Fortune magazine has that was mentioned this morning.

Another way to express the conclusion of this research is to say that the marginal overhead cost of raising $1 through the Federal tax system is 65 cents. If you are going to fund, let's say, a $100 million dam with Federal tax money, the true social cost of that $100 million dam is $165 million because of the overhead cost of collecting the money.

Well, what should we do about it? As I say, I don't think we should rush right away into major reforms. I think there are a large number of simple reforms we can do to test, frankly, Congress' sincerity here in turning around the direction that the tax system has gone. Until now, the premise in Washington has been, really, to get the money from taxpayers, to squeeze taxpayers, and the question of the work that this implied, and all the other types of degradations: This has been left to one side.

For example, one reform that I suggest concerns paid informers. A lot of people don't even know we have paid informers, whereby every American is encouraged with cash rewards to inform on every other American about tax transgressions. This is a system that no other democratic country has. They seem to run their income tax systems without it. It makes us, as far as I can see, unique in the democratic world.

This hasn't been raised; it hasn't been debated. I think eliminating paid informers is one move that this Committee could do to indicate its sincerity to clean up a Tax Code that has gotten Americans so angry over the years.

Thank you.

[The prepared statement follows:]

Statement of James L. Payne prepared for the House Ways and Means Committee hearings on Replacing the Federal Income Tax, June 6, 1995.

The members of this committee are to be congratulated for holding this precedent-setting hearing, looking into what is wrong with the current tax system. Washington has been a city where people concentrate on giving out money, and they have tended to downplay the sacrifices associated with collecting it.

This bias has meant that tax committees have overlooked studies detailing the waste and injury of the income tax system. Instead, they directed their energies into "reforms" to squeeze more money out of taxpayers. This process has resulted in a staggeringly complex tax system, one that imposes great economic, moral, and social costs on the nation.

In my book on the burdens of the income tax system, Costly Returns, I have calculated these costs. As a way of illustrating their magnitude, let me focus on just one, the compliance cost. This is the time spent by businesses and individuals in learning about the tax code, keeping records, making computations, and filling out forms and supporting documents.

The most comprehensive study we have of this cost was undertaken by the Arthur D. Little Company in 1985. This study found that businesses and individuals spent 5.4 billion hours of work complying with federal tax law. This corresponded to 2.9 million people--the entire labor force of Indiana--working full time all year long. The economic cost of this labor came to $159.4 billion.

That was ten years ago. Since that time, the tax law has grown more complex and more taxpaying entities have become subject to it. For 1995, I calculate that the total time businesses and individuals spend on tax compliance work has risen to 10.2 billion hours. This amounts to 5.5 million workers working all year--the equivalent of the entire work forces of Indiana, Iowa, and Maine.

This number is just the compliance burden. The income tax system involves a host of other costs, including those associated with enforcement (audits, demand notices), forced collections (levies, liens, seizures), and tax litigation. In addition, there is the inefficiency caused by the disincentives to production, and the economic waste of tax avoidance and evasion. When all of these costs are added together, I found that in 1985 they amounted to $363 billion. Updated to 1993, the figure is $593 billion. To express this finding another way, the marginal overhead cost of raising one dollar through the federal tax system is 65 cents.

The Road to Reform

These figures reinforce Chairman Archer's contention that the income tax is extremely destructive. However, I believe it is premature to attempt to substitute another tax arrangement for the present one.

The problem is that large numbers of Americans, both citizens and policy makers, are not fully aware of the failings of the current system. They still believe the income tax is working rather well. The main reason for this lack of understanding is the bias I alluded to earlier: Washington's culture of spending has suppressed the unflattering facts about the income tax.

Take the matter of statistics on the overhead costs of the tax system. The number I just gave--that tax system overhead costs are 65 cents on the dollar--is a sober, middle-of-the-road calculation based on respected sources. Nevertheless, most people find it incredible, too large to be believable. Why? Because no one has ever compiled it before. This committee, for example, with all its professional and expert staff members, has never attempted to estimate the overhead cost of the U. S. income tax system. Nor has the GAO. Nor has the Treasury. This, when you stop to think about it, is an astonishing gap: hundreds of Washington experts responsible for the U. S. income tax system who do not know, and have not even bothered to ask, what damage the tax system is doing to the country!

With policy makers ignoring the costs of the tax system, it's not surprising that the general public doesn't know about them either. Reporters, political science professors, and the man in the street accept the IRS's claim that operating the federal income tax system costs "less than one percent" of the tax money collected. No wonder they disbelieve when they hear that the real figure is 65 percent.

This is just one example of how the down side of the income tax system has been obscured, leaving the public seriously misinformed. This lack of information makes it inadvisable to attempt to replace the income tax system. An attempted reform at the present moment would probably result in complex tax

legislation that adds a federal consumption tax without getting rid of the income tax.

To replace the income tax, the first step should be to inform the American people about it, to drag this monster out from under the rock where big spenders have hidden it, and let the daylight shine upon it. The best way to do this, I believe, is to attempt to reform some of its most objectionable features. This is the way to call attention to its underlying flaws.

Among dozens of possibilities, let me suggest three reforms which would bring to public notice some of the grave failings of the current system:

1. Require that IRS demand notices have an accuracy rate of at least 99 percent. The IRS currently sends out 3-6 million computer-generated demand notices each year. They accuse the taxpayer of not paying the right amount of taxes, and threaten forcible collection action if a satisfactory response is not received. These notices generate enormous anxiety among taxpayers, since the IRS is threatening citizens with financial ruin.

Tax practitioners know, and studies confirm, that a high proportion of these demand notices are erroneous. A GAO study found an error rate of 47 percent; a Gallup survey indicated 69 percent. In other words, the coercive power of the state is being brought against citizens in error millions of times each year! Most Americans have no idea about this error rate. Indeed, there are tax committee staff members who are unaware of it.

IRS officials will probably argue that if they concerned themselves with accuracy, this would reduce the number of demand notices they could send out. The "scattergun" approach is necessary, they say, to "provide presence," that is, to maintain the public anxiety on which the income tax depends.

Shouldn't we have a debate on this matter, and openly decide whether we approve of this system of false accusations?

2. Abolish paid informers. Another quietly-hidden feature of the current system is the practice of offering cash rewards to those who inform on possible tax evaders. The reward program encourages children to inform on their parents, husbands to inform against their wives, and so on. In prompting Americans to betray other loyalties, this program has been increasingly successful. In 1961, 4,401 people informed; by 1989, the number had nearly tripled, to 11,754.

Enforcement officials will make the case that encouraging citizens to spy on each other heightens the "fear factor" on which the income tax depends. They have a point: an income tax works best if every person fears that Big Brother is constantly watching him. But the question must be asked: How far are we willing to compromise liberty, privacy, and decency to uphold the income tax? When the Soviet Union had this system of fostering state interests by rewarding citizens to spy on each other, we called it the Evil Empire. I should also note that no other civilized country allows this practice. An American Bar Association survey of 16 other democratic states found that none had statutes corresponding to our section 7623 of the tax code empowering officials to pay cash rewards to tax informers.

3. Abolish the individual estimated tax and quarterly tax payments. The tax code is laden with provisions that place a huge compliance burden on taxpayers in order to obtain a slight revenue gain for the Treasury. The reason these destructive provisions keep getting approved is that, up until now, congressmen and tax officials have not placed any value on taxpayer time and trouble. They only look at the income stream coming into the Treasury.

The individual estimated tax is a typical example. By forcing millions of self-employed workers to try to calculate their income in advance, and then forcing them to make quarterly payments during the year, the Treasury ends up benefitting from the interest on the earlier payments. But this arrangement costs taxpayers dearly in time and frustration. In addition, it forces them to deal with the IRS four times a year instead of just once. Many taxpayers object to this irritating "choke chain," and simply refuse to comply; many others run afoul of some aspect of the regulations. As a result, the estimated tax generates over five million penalties a year--many of which are protested, which leads to still more complications and more frustration.

A Congress that cared about serving taxpayers, instead of simply squeezing them, would long ago have abandoned the individual estimated tax. Raising this issue would be a good way to find out, before we again plunge down the road of major tax reform, whether Congress now has its heart in the right place.

Appendix: Estimate of the Federal tax compliance burden for 1995

For complete citations of sources mentioned, and further details, refer to James L. Payne, Costly Returns; The Burdens of the U. S. Tax System (San Francisco, ICS Press, 1993). (Hereinafter CS)

The starting-point of the estimate is the 1985 finding of the Arthur D. Little study, 5.4 billion hours for business and individual compliance combined (CS, p.21), adapted as follows:

1. The methodology of the Little study--which was financed and supervised by the IRS--was biased toward understating the compliance burden: missing data was entered as zero; seemingly "high" figures were discarded, and so on (See CS pp. 20-23). To control for this bias we can compare the Little results on individual compliance burden with other studies of individual compliance burden, all of which show a higher burden than the Little study:

AD Little, 1985	1.813 billion hours
Slemrod, 1982 (CS, p.23)	2.13 billion hours
Slemrod, 1989 (CS, p. 155)	3.00 billion hours
Collins, 1987 (CS, p. 23)	2.02 billion hours

The average of the Selmrod 1982 and Collins 1987 figures, 2.08 billion hours, gives a fair estimate of the true individual compliance cost in 1985. This means that the Little study figure is .87 of the true value (1.813/2.08).

Therefore, to obtain an unbiased estimate of the entire compliance cost in 1985 (individual and business), one needs to multiply the Little figure (5.427 billion) by 1/.87, giving 6.2 billion hours.

2. The total number of taxpaying units affected by compliance costs is indexed by the total number of tax returns filed. This went from 178 million in 1985 to 207 million in 1993 (IRS Annual Reports). This is a 2% increase per year, or a 20% increase 1985 to 1995.

3. Slemrod's two comparable studies on individual tax compliance burden found that between 1982 and 1989, hours spent per taxpayer increased 26 percent. This figure probably understates the increase in business compliance burdens, but we shall use it to estimate the overall growth of compliance burdens of businesses and individuals. This figure indicates a 3.7 percent increase per year in the compliance burden for a taxpaying unit (26%/7). Hence the estimated increase for the years (1985-1995) is 37% (10 x 3.7).

Hence, to estimate the tax compliance burden in 1995 we multiply the figure for 1985 (corrected) times the increase in the number of taxpaying units, times the increase in burden per taxpaying unit, thus:

1995 compliance burden =

(6.2 billion hours) x (1.20) x (1.37) = 10.2 billion hours

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Chairman ARCHER. Thank you, Dr. Payne.

The last witness is Dr. Raboy.

STATEMENT OF DAVID G. RABOY, PH.D., CHIEF ECONOMIC CONSULTANT, PATTON BOGGS, L.L.P.

Mr. RABOY. Thank you, Mr. Chairman.

As you know, I was originally on the competitiveness panel, and I am a bit out of my element with respect to compliance so I will stick to my original topic, which is to discuss one of the aspects of tax reform that may affect competitiveness, and that is the question of border tax adjustments.

Under the GATT or the successor WTO, there is a system of border tax adjustments which attempts to harmonize the cross-border applications of national tax systems. The GATT includes a destination principle where goods are to be taxed in the country in which they are consumed rather than in the country in which they are produced. The result is that so-called indirect taxes like the VAT can be rebated on exports and levied on imports, whereas so-called direct taxes like income taxes or corporate profits taxes are not eligible for border tax adjustments.

I believe there is no qualitative difference in the incidence of direct and indirect taxes, so to me the GATT distinction is unjustified. Nonetheless, it remains after the Uruguay round and therefore must be a factor in deciding what form tax revision ought to take.

As compared to our trading partners, the United States relies primarily on nonborder adjustable direct taxes. More important, although many of the tax reform proposals before us now have qualitatively similar tax bases, under WTO rules, some would be eligible for border tax adjustments and some wouldn't. The crucial question is whether it matters if we have a border adjustable system.

In the old days many observers believed that our trade problems existed in large part because our exports were subject to double taxation while our competitors' exports escaped taxation, at least partially, both at home and at the U.S. Customs frontier. Then the pendulum swung in the other direction and it was argued, primarily because of floating exchange rates, that border adjustments were irrelevant. I think the truth lies somewhere in between.

First, I think the proper focus for policymakers is not necessarily the nominal trade balance but rather the real costs, the relative costs that determine the individual decisions of consumers, exporting companies, and companies competing with imports. Taxes are real costs just as surely as wages, raw inputs, energy or anything else, and if taxes distort decisions whether to purchase domestic goods or imports, to export or to sell in the U.S. market, or whether investments should flow to the trade sector rather than other sectors, then both the external and internal sectors of the economy suffer.

The tax system should not be an implicit regulator of world trade. Policymakers should strive to create tax systems that are neutral, that don't distort these costs.

Let me bore you with a little economic theory. Economists agree that if you could construct an ideal VAT on an origin basis, then at equilibrium it would be trade neutral. They may not tell you the

real economic effects on trading sectors that may occur on the way to this equilibrium.

These same economists tell you that at equilibrium, an ideal VAT based on a destination principle is also trade neutral, and not surprisingly in this idealized world, a switch from an origin- to a destination-based system would also be neutral. But even in this idealized world, the switch from an origin to a destination system, which we would consider here, can produce some substantial trade flow changes during the adjustment period. Exports will increase and imports will decrease.

Further, since taxes are real costs and not just nominal costs or illusory costs, these trade effects cannot be wiped out solely by nominal exchange rate movements. The magnitude of these effects is indeterminant as is their duration, and as such I would not argue that these effects, themselves, justify a tax overhaul.

But if we are going to consider tax reform for other sound policy reasons, then we ought to adopt the destination principle and enjoy the shortrun trade benefits.

In addition, given our proclivity to run trade deficits, a destination-based tax by definition has a larger tax base and therefore you can have a lower rate and get the same amount of revenue.

I would like to address a fairly thorny political issue within the consumption tax debate: Income distribution and how you remedy it. It is common wisdom that remedial measures may be necessary to address perceived regressivity in a consumption system, and the choices include exemption or zero rating of certain goods.

Many economists have argued that such tax preferences are inefficient ways to achieve progressivity and they would prefer income credits or direct spending outside of a comsumption tax system. But I would argue that there is a compelling international argument to try to find a way, other than exemptions, to deal with regressivity.

Many of the items frequently listed for exemption or zero rating do not enter international trade. These include food, housing, medical services and education. As a result, preferential treatment of these goods drives a tax wedge between trade-intensive and non-trade-intensive sectors.

VAT preferences could conceivably cause investment to flow away from industries that compete with imports or produce exports, and a contraction in our trade sector could result. This, of course, would be opposite of the competitive effect we would like to see from consumption-based tax reform.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF DAVID G. RABOY
PATTON BOGGS

My name is David G. Raboy and I am the Chief Economic Consultant to the Washington, D.C. law firm of Patton Boggs, L.L.P. I am pleased to testify today on the international economic implications of a tax reform that would substitute a Value-Added Tax (VAT) for existing business taxes. It is not uncommon for there to be a divergence in views between academic economists and one class of economic actors whose actions economists attempt to study -- business people. It is, of course, somewhat of an irony in our academic era; with its belief that business people act in their own self-interest and basically know what they are doing; that on some issues business people and academic economists can apparently hold radically different views for long periods of time on the effects of policies.

One of the policy issues where it is claimed that business people and those that study their decisions are most at odds is the effect of a VAT (or more correctly the substitution of a VAT for existing business taxes) on "competitiveness." The existence of this issue, of course, can be blamed on the GATT (The General Agreement on Tariffs and Trade), which allows a system of border tax adjustments. Such adjustments are allowed on "indirect taxes" (sales taxes, VATs, excise taxes, and the like), but not on "direct" taxes (income taxes, payroll taxes, and other taxes on income flows). Given a choice of adopting the "origin" principle, where taxes are levied on goods in countries where they are produced, or the "destination" principle, where taxes are levied on goods in the country in which they are consumed; the GATT adopted the destination principle. Indirect taxes like the VAT, which are applied *directly* to goods, are levied on imports and rebated on exports while direct taxes like the corporate income tax, which may *indirectly* enter the price of goods, are not applied to imports and not rebated on exports.

Since the U.S. has relied on origin-based direct taxes with no border adjustments, and the rest of the world is more heavily dependent on indirect taxes with border adjustments, many business people in trade-intensive sectors have argued for transformation of the U.S. tax system, despite the protestations of academic economists, many of whom claim that such a transformation will not affect trade. Mainstream economic theory is based on the foundation that economic actors are "rational", i.e., they behave in predictable ways that represent their self-interest, based on available information. It is, therefore, a bit troubling to face the specter of so many rational, profit-maximizing business people blindly pursuing policies that apparently will not achieve their intended goals. But, maybe, the gulf is not as wide as some economists claim.

My testimony will attempt to reconcile the divergent views on the trade implications of VATs, and to determine what the economic literature actually says about VATs, other taxes, and international "competitiveness." The interaction of several issues will prove crucial: 1) the choice of an origin- or destination- based tax system; 2) the incidence of a VAT as compared to other business taxes; and 3) the effects of the international monetary system.

II. How Should We Judge Competitiveness?

A threshold issue concerns the proper gauge to evaluate the trade implications of tax policy. While many focus on the trade balance, I will argue that a barometer that focuses on real costs is of more use.

Relative Prices and International Trade

The classical theory of trade states that countries trade because they are different. They are endowed with different levels of natural resources, labor of differing qualities and costs, capital, and other factors of production; or there are differences in consumer tastes. Because they are different, countries face different trade-offs in the types and quantities of goods and services they can produce, given their differing resources. In one country a class of goods may be *relatively* less costly than in another country, therefore, "comparative advantages" may exist.

The classical theory holds that by engaging in trade with one another, countries can exploit others' efficiency and better themselves. As they begin to trade the relative prices of the goods entering trade in each country will change, due to increased demand for each country's export, until relative prices are equalized somewhere between the initial pre-trade levels. At this "equilibrium" each country will be economically better off than it was before because there will have been "gains from trade." The faith that is required is that the free market will sort out the

best solution. Therefore countries are best served if prices of goods entering international trade are not distorted by government policies. But not just any prices -- *relative* prices. One of these countries could have higher *absolute* costs for products entering trade and the other still could benefit from trade. The relative prices that are of importance are expressed as opportunity costs -- what must be given up in terms of one thing to produce another thing.

Trade theory has come a long way in the past two decades. Whereas the classical theory held that trade stemmed from differences in countries, the rather embarrassing observation was made that almost identical countries still traded, that countries might export essentially the same good to each other (two-way trade), and that other occurrences could not be explained by the classical theory. Rather than jettisoning classical theory, however, new trade theorists added to it by developing notions of economies of scale in production (in order to be efficient it might not make sense, given the market, to have twenty countries producing wide-body aircraft or super-computers), and imperfect competition. These concepts, when added to the classical concept of comparative advantage, do fairly well in explaining trade in the modern world. Whereas some of the new trade theory questioned the efficacy of free trade, and most economists would grant that interference is warranted under certain situations, the dominant view of the new trade theorists is that, in general, the additional explanations of trade patterns enhance rather than diminish the potential gains from trade. Therefore, it is still appropriate to judge government policy as to its effects on relative prices.

As a general principle, then, policies that artificially distort the *relative* prices of traded goods diminish economic efficiency by lessening the gains from trade. There are both internal and external relative prices to be considered. Economists define the "terms of trade" as the *external* price of exports of a country, divided by the external price of the goods that the country imports. A country is better off when the external price of exports rises relative to imports; that is, when the terms of trade improve; because obviously it can buy more with the same volume of exports -- what it sells in international markets has increased in value.

The terms of trade are not, however, the only relative prices that matter to policymakers. It is well known in the literature, for instance, that there are two countervailing effects of a tariff. There is an efficiency loss from a distortion of the internal prices facing consumers and producers after application of the tariff which disturbs the allocation of resources, and there is an improvement in the terms of trade which benefits the country. For a "small" country, one which has insufficient market share to influence world prices, by definition *no* trade policy can effect the terms of trade. But policies *will* influence internal relative prices and force consumers and producers into decisions they otherwise would not make, thus distorting the allocation of resources and lessening economic efficiency.

Therefore, this testimony will use as its gauge of the effects of policy, changes in both internal relative prices and the terms of trade from those that would prevail under free trade. The relevant question will be whether a VAT, or a VAT/other-tax-substitution, alters the internal or external relative prices of traded goods from those that would have prevailed under free trade.

Why Not the Current Account?

The current account, popularly known as the trade balance, is one component of the international accounts of a country. It is defined as the difference between the value of exports and imports plus other more minor government and nongovernment transactions. The current account is measured in nominal units of a nation's currency.

The second basic account is the capital account which is essentially the net of capital inflows and outflows (both private and public). Capital outflows include government currency reserves and other assets, and private assets such as stocks and bonds issued by foreign companies and governments. Capital inflows are basically official foreign government purchases of home country assets and private purchases of domestic assets by foreigners.

These two accounts comprise the balance of payments, which is simply an accounting identity which reflects all monetary inflows and outflows. By definition this identity must always be in balance; that is, any deficit in the trade balance must be made up by a capital inflow of equal magnitude. The excess of imports over exports must be paid for by borrowing money from foreign entities in one form or another. Since the balance of payments must always balance, it also defines the demand for a nation's currency when exchange rates are free to float.

Because U.S. assets and goods must be purchased with dollars, exports and capital inflows constitute the demand for dollars. Similarly, imports plus capital outflows define the supply.

The best way to illustrate that the current account is not a good gauge for policy is to take an issue that everyone can agree on, and compare the analysis of that issue with respect to the current account or relative prices. Everybody can agree that tariffs distort trade. All economists agree that tariffs artificially distort the internal relative prices facing consumers and producers and therefore change the allocation of resources from what would exist under free trade. All economists also agree that if a country is relatively large, a tariff will change the external terms of trade. Further, there is virtually universal agreement among academic economists that, except in rare situations, tariffs make the world less efficient and less well off, and therefore tariff increases are generally opposed.

So in an era of floating exchange rates, *all else held constant*, what happens to the nominally denominated current account if one country increases its tariffs? *Absolutely nothing. Nothing can change the trade balance* unless it also changes the capital account because the decrease in import demand will cause a dollar appreciation unless capital outflows increase. The trade balance, the current account, is merely an accounting mechanism that measures items in nominal terms. There is no necessary correspondence between it and changes in the real economy, the allocation of resources, or economic efficiency. Tariffs are *real* costs, involving the extraction of real resources. The effects of this extraction cannot be masked by changes in strictly nominal phenomena, such as the movement in nominal exchange rates. For this reason, the effects of tax and trade policies on real relative prices are the preferred analysis route.

Of course, the trade balance will continue to be a politically explosive issue. It is the most publicly accessible image of our trading relationships, and has become politically tied to such issues as the "export of jobs," and some general feelings concerning our standing in the world. Therefore, following an analysis of the effects of VATs on relative prices, the current account will have to be revisited.

III. Origin- Versus Destination-Based Taxes

Much of the debate on the trade effects of a VAT concerns the prospect of substituting a VAT for other "taxes on business," including the corporate income tax and the employer portion of payroll taxes. The first issue that must be considered is whether the choice of an origin- or destination-based system has any trade implications.

The Methodology

The standard methodology used to investigate the effects on relative prices of a VAT involves a general equilibrium model where all results are reported after the world has fully adapted to a tax change, and no mention is made of what happens during the period of adjustment. It makes a crucial assumption that the country being studied is relatively small; that is, its world market share is sufficiently small that it has no power to affect the world prices of traded goods. By definition, therefore, nothing the country does in terms of policy changes can influence the external terms of trade, but tax changes can affect the internal relative prices of traded goods facing domestic producers and consumers. These relative prices are what are tested, at equilibrium, for the effects of VATs or other taxes.

It also assumes that the test country, and the rest of the world, produces three goods. The first good produced by the country is consumed domestically, but also can be exported (exportable). The second domestically produced and consumed good competes with imports from the rest of the world (importables). The final good is produced and consumed domestically and is neither exported nor does it face potential import competition (non-traded).

For equilibrium to occur in these models, three conditions must be satisfied. First, the domestic seller of the exportable good must be receiving the same return, after-tax, in both the home market and the external market. Obviously, if this were not the case, sellers would divert sales to where the after-tax returns were higher, and the positive or negative change in domestic supply in the home market would cause the domestic price to adjust until after-tax prices were equalized in the home and external markets. By definition, the world price is fixed, so that the domestic price of the exportable would be the price that changes to make sellers indifferent between the domestic and external markets. Second, the price of the domestically produced importable good, including tax, cannot be any different than the price of the import, including

tax. Otherwise consumers would shift to the cheaper version until demand changes caused the domestic price to adjust to restore equilibrium. Third, domestic supply of the non-traded good must equal demand for there to be equilibrium.

There is one final assumption that these models make. To isolate the relative price effects of tax changes and allow changes in producer or consumer income to be ignored, it is assumed that all tax revenue is distributed to consumers and/or producers in a non-distorting way that makes them whole for any additional tax liability. Thus, relative price changes, which alter incentives and therefore change economic behavior, are the only subjects of the analysis.

Assume that initially the home (small) country has no tax system. It is irrelevant what the rest of the world has because it is assumed that world prices are given and fixed regardless, but it causes no problem to state that the rest of the world has destination-based VATs. In the initial, free-trade equilibrium, the world price of imports into the home country and, therefore, also of the domestically produced importable is 10. The world price of the good that is exported is 15. If follows that both the internal and external relative price of exportables (exports) to importables (imports) is 1.5.

Origin-Based Taxes

This example will show that there is no change, at equilibrium, in any relative prices when a country with no prior tax system imposes an origin-based tax. An origin-based tax applies to exportables consumed domestically, actual exports, importables produced and consumed domestically, but not to imports. Therefore, in the home country that imposes an origin-based VAT levied at 10 percent, a seller of exportables is constrained in world markets by the world price of 15. Thus at equilibrium, in order to sell into the world market, his return must be reduced to about 13.64 so that after the tax is levied, the seller can meet the world price. Of course, the same price applies to exportables consumed domestically so arbitrage will result in an equilibrium where the return to the seller is also 13.64 and consumers pay an after-tax price of 15. Because there is no tax on imports, they continue to enter the home market at 10, so domestic sellers of importables, at equilibrium, will have reduced their pre-tax price to about 9.09, in order to remain competitive with imports.

There is no change in the relative price facing consumers because exportables still cost 15 and imports and importables still cost 10. Similarly, there is no change in the relative price facing producers because sellers receive 13.64 for exports and 9.09 for importables, leaving the ratio of returns unchanged. For both consumers and producers, the relative price ratio of exports (exportables) to importables remains 1.5 .

Because at equilibrium, none of the relative prices facing consumers or producers have changed after the imposition of the origin-based VAT, the opportunity cost at equilibrium of producing exportables (in terms of foregone importables) is exactly the same as before the imposition of the tax, so there is no incentive to alter the pattern of trade. In other words, the VAT is entirely neutral in its long-run effects on trade.

Destination-Based Taxes

What if the country had imposed, instead, a destination-based tax at the same 10 percent rate? This example shows that, as in the case with the imposition of an origin-based tax, the imposition of a destination-based tax would cause no change in relative prices, compared to the no-tax scenario. Looking strictly at the outcome *at equilibrium* the following would be true. Exporters would be charging and receiving 15 per unit on the world market because the tax would be rebated. Because sellers must make the same return in the home and external markets, the VAT on exportables would be passed forward so that the after-tax price facing consumers would be 16.5 and sellers would receive 15. The world price of imports is still 10, but now the VAT would apply at the border, so consumers would face an after-tax price of 11. Domestic sellers of importables would also receive 10 so that the after-tax price is 11.

What are the relative prices of traded goods at equilibrium under the destination-based tax? For consumers, exportables cost 16.5 and imports (importables) 11. The relative price is still 1.5. Of course, since the sellers of exportables and importables are receiving returns equal to world prices, the sellers' relative price also remains at 1.5. Thus, under both the origin and destination-based VATs, the relative prices of traded goods *at equilibrium* are exactly those that prevail under free trade. Both versions are trade-neutral.

The Switch

What happens if a country decides to substitute a theoretically ideal destination-based VAT for an existing ideal origin-based one? This is the central question relevant to the trade-effects debate. Under the assumptions of the models reported here, it is obvious that the move from a system that is neutral to another that is also neutral results in no long-run trade effects, *at equilibrium.* But simply viewing the equilibrium result does not provide the whole picture. What it does say is that if policy makers decide, for whatever reason, to move to destination-based ideal taxes, they need not concern themselves with a deteriorated trade situation. There are, however, some potentially significant short-run benefits that would accrue to industry sectors that engage in international trade.

The process of moving from the origin-based system to the destination-based one involves some short-run changes in levels of exports and imports. In order to see this, we must look at the "first-order" changes in relative prices; that is, the prices that prevail the instant after the tax change is implemented, before sellers have changed their prices. Then we can predict how behavior will change in the interim period before equilibrium is restored.

Under the origin-based tax, producers of exports (exportables) were charging 15 on the world market but, because of the tax, only receiving 13.64 in private return. The instant after the destination-based tax goes into effect, exporters will receive rebates for the tax, so the private return will increase to 15. In the first order, exportables consumed domestically are still sold to consumers at 15, but sellers are receiving 13.64 because of the tax. Clearly, there is an incentive for sellers to shift from domestic sales to exports. Also, since returns have gone up for the producers of exports (exportables), investment may flow to that sector.

To the producers of importables, *initially* nothing has changed. By definition, they have not changed their price and the tax is still the same. Therefore the first-order relative price of exports to importables for sellers has increased to 1.65. This change in relative prices subsequently provokes changes in behavior which restore equilibrium to the relative price level dictated by world prices over which the country has no influence. One of the changes has already been described. Exports will increase due to the higher returns to exports relative to sales of exportables domestically. As the supply of exportables decreases, the price will be bid up by consumers until the pre-tax price equals the world price and exporters are indifferent between selling domestically or exporting.

Similarly, consumers will find imports more expensive due to the imposition of the border tax that previously only applied to domestically produced importables. Thus the demand for importables produced domestically will increase relative to imports and the pre-tax price of importables will rise. This, of course, increases the short-run profits of importable sellers and encourages the commitment of resources to that sector. The pre-tax price will increase to the world price at which point consumers will be indifferent between imports and importables.

When all the adjustments have been made, the relative price of exports (exportables) to imports (importables) will once again be 1.5 for both sellers and consumers. Trade-neutrality will be restored and there will be no influences on relative prices that deviate from those that would exist under free trade. But along the way several things will have occurred to a greater or lesser extent: profits to exporters and sellers of importables will have increased by some amount, new resources will probably have flowed to the trade sector of the economy, exports will have increased by some amount, imports will have decreased by some amount, and there will have been exchange rate changes. The magnitude of these effects is uncertain, as is their duration, but from the standpoint of a business person involved in a trade-intensive sector, the results are positive.

Of course, the existence of short-run positive trade effects in and of itself is no reason to change a tax system, given the uncertainty of the trade effects and the administrative and compliance costs associated with the tax change. But there are many other reasons to overhaul the existing tax system and replace it with a more economically efficient one. If policy makers engage in tax reform, they ought to base the new system on a destination principle so that, in addition to the economic benefits that justify the change in the first place, some short-run trade effects are enjoyed. Since ultimately both ideal origin and destination based systems are trade neutral, the tax change ought to include the switch to a destination system so as to benefit the traded goods sector in the short-run.

IV. VATs and Other Business Taxes

Incidence

The short-term trade effects that result from shifting from an origin- to a destination-based tax will only occur if the new tax has a similar incidence to the one it is replacing. I have argued previously that the incidence of existing business taxes must be *qualitatively* similar to that of a VAT. The reasoning goes like this. At root, a VAT, regardless of its form (credit, subtraction, addition), is a tax on a company's value added. This in turn is equal to the sum of payments to the factors of production: wages and benefits to labor; and interest, dividends, and capital gains to capital.

Business taxes today include the corporate income tax, payroll taxes, and the individual income tax for non-corporate business. Regardless of the interminable debate on the incidence of the corporate income tax, there are theoretical similarities between its base, and the capital portion of value-added. Most important, the corporate income tax is a tax on the competitive return to equity capital and therefore is a component of variable cost. As such, the corporate income tax is not dissimilar from *ad valorem* taxes which also shift a firm's cost curves. Clearly payroll taxes are also similar to the labor component of a VAT.

Although there are obvious differences; interest is not taxed to corporations but to individuals, non-wage compensation escapes taxation; the aggregate bases of business taxes today add up to a value-added base with a great deal of preferential treatment. A basic tenet of public finance economics is that the initial point of taxation does not determine a tax's incidence. Our general belief is that taxes with identical bases, regardless of the point of taxation, must have the same incidence. Thus it is difficult to rationalize that a VAT, with a *qualitatively* similar tax base to the existing hodgepodge of business taxes, would not also have a qualitatively similar incidence. As long as the incidence is similar, the short-term trade benefits just described will occur.

Other Relative Price Effects

There are other aspects of a VAT/business tax substitution that may affect comparative advantage. In classical trade theory, one explanation of comparative advantage that is frequently cited is relative factor intensity, which in turn can be traced to relative factor cost. Some economists have argued that replacing the corporate income tax with a VAT would significantly lower the cost of capital in the United States.

V. Tax Preferences and Long-Run Trade Effects

In the last sections, the role of non-traded goods was ignored. The economic literature concludes, however, that a VAT will have *adverse* trade effects if preferential tax treatment; such as exemptions, zero-rating, or a lower tax rate; is afforded to non-traded goods. Since many of the goods in existing VAT systems that receive preferential treatment do not enter international trade, the analysis of preferential treatment must include consideration of the trade effects.

The intuition is straight-forward. Consider an example where non-tradeables are zero-rated. If a VAT applies to traded goods but not to non-traded goods, the relative prices of exportables to non-tradeables and importables to non-tradeables would increase. Having the tax apply to tradeable but not to non-tradeables introduces a tax wedge between the two sectors. Either the cost to consumers of importables and exportables relative to non-tradeables has increased and/or the returns to businesses of importables/exportables relative to non-tradeables have decreased. In either case the result is a reduction of consumption of tradeables relative to non-tradeables and/or a relative decrease in investment flowing to the tradeable sector. Strictly because of a tax-induced relative price change, the tradeable-goods sector will contract.

This is a serious issue for policy makers when you think of the types of goods that don't enter international trade. Examples include housing, medical care, education, many types of food sold for home consumption, and other goods. The standard proposals to exempt or zero-rate housing, food, medical care, and welfare activities would apply to non-traded goods.

Preferential treatment for some goods and services as a remedy for perceived regressivity has been criticized on a number of grounds. It is generally agreed that exemption, zero-rating, or lower rates are extremely inefficient and costly ways to redress regressivity; and that it is

preferable to seek remedies outside the VAT system through income tax credits or transfers. It is also apparent that preferential treatment causes economic inefficiency by distorting consumer and producer choices across industries. Now a third and compelling reason has been added to oppose narrowing of the VAT base. The effect will be a *long-term* deterioration of a nation's trading position.

VI. The VAT, The Current Account, and Exchange Rates

Throughout this testimony, the role of economic efficiency and tax policy has been stressed. It has been argued that the proper gauge for tax policy as it effects trade should be the relative prices of traded goods, and that the point of comparison should be the relative prices that would obtain under free trade. Further, these relative prices are *real* prices and the tax effects *real* as well. Taxes represent extractions of real resources just as surely as energy costs or labor costs. Purely nominal phenomena, like exchange rates, cannot mask fundamental real changes in costs.

This would seem fairly obvious in the case of other costs facing businesses. What would be the effect of a discovery by one country of a process to manufacture steel with half the electricity previously required? That country's steel industry would certainly enjoy an enhancement of its competitive position because the cost of producing steel relative to other domestic goods would drop as would the real costs of producing steel domestically relative to foreign produced steel. All else held constant, the comparative advantage (or disadvantage) of steel production would change. It would be a strange conclusion indeed if this innovation was completely nullified by exchange rate changes resulting from an increase in demand for the country's steel.

Taxes on output are no different from a cost stand point than per unit electricity costs. Taxes can only be remitted if steel is sold, and the returns foregone to pay the tax. It is as if a certain level of physical production is transferred to the government. This is not a monetary phenomenon. To argue otherwise is to assume that the entire economy is suffering from money illusion.

Policymakers will continue to focus on the trade balance where exchange rates do matter. And thus the statement that is currently in vogue -- that tax policy cannot affect the current account -- must be investigated. My conclusion is that it would be very difficult to predict the effects on the trade balance from a VAT/other tax substitution. First, the view that such a change would not affect the trade balance is predicated on the belief or assumption that tax changes do not affect international capital flows. Second, this view is also dependent on the notion that exchange rates are primarily a function of traditional trade and capital flows whereas the reality is that exchange rates are more influenced by asset trades than by traditional trade flows. This means that the change in the expectations of currency traders following (or in anticipation of) a tax change will be more influential to exchange rates than currency demand changes associated directly with exports and imports.

"All Else Constant"

First, we must be clear about what is meant by the statement that tax policy cannot affect the current account. It is based on the balance of payments accounting identity that essentially states:

EXPORTS - IMPORTS = CAPITAL OUTFLOWS - CAPITAL INFLOWS

The statement that tax policy (or tariff policy for that matter) can't effect the trade balance is predicated on the assumption of *ceterus paribus* -- all else held constant. In this case, the "all else" that is being held constant is capital flows. Not surprisingly, if the right hand side of the equation, net capital flows, is held constant, then there can be no change in the left hand side. The balance of payments is set in nominal units of currency. So, for example, if a tax change increased the demand for exports, *ceterus paribus*, the dollar must appreciate to restore the left hand side to the same nominal position as previously.

Capital Flows

It is conceivable that the "all else held constant" assumption is of less use here for policy makers than with respect to most other economic issues. It may be very difficult to find things to hold constant because of the complex interactions of taxes and international investment decisions. There is a thriving literature on the effects of tax policy on international capital flows that runs the gamut of "no effects" to "large effects." And the various levels of effects feed through diverse conduits such as deficit reduction or tax-induced changes in savings and investment, all of which would directly affect net capital flows.

The point here is not to argue who is right or who is wrong. It is merely to illustrate that there are several paths by which a VAT can affect capital flows, and therefore the exchange rate. But possibly more important to the determination of exchange rates than actual changes in domestic savings due to tax changes are *perceived* effects ir the eyes of foreign-exchange traders. In fact, the perception of fiscal and monetary policy to currency traders may be the dominant force in exchange rate determination in this regard.

Expectations and Exchange Rates

If exchange rates were primarily influenced by changes in the demand for imports and exports, then a VAT change which affected trading patterns would have a predictable effect on exchange rates. But exchange rate determination is much more complicated, relating primarily to the actions of traders who view foreign exchange as an asset to be traded in its own right. Foreign exchange trading world-wide grew from $200 billion per day in 1986 to $500 billion in 1989. This growth cannot be explained by differences in merchandise trade or capital flows associated with investment in tangible assets. In fact, these latter transactions may account for only 5 to 10 percent of foreign exchange trading.

The overwhelming majority of foreign-exchange transactions are done by investors who view foreign exchange, itself, as an asset. Foreign exchange assets primarily take the form of liquid interest-bearing instruments, and are therefore a component of net capital flows in the balance of payments. Foreign exchange determination is driven by people who hold foreign-exchange as assets, and their transactions are dependent on their expectations. These expectations could easily change in anticipation of a major tax change but it is difficult to predict the net effect on exchange rates. Anybody who feels confident predicting what the expectations of foreign exchange traders would be following the announcement of a major tax reform including a VAT deserves the Nobel Prize in economics (or to be drummed out of the profession, I am not sure which).

Look at all the countervailing items that could affect a trader's perceptions. If the trader perceives that the demand for exports is going to increase and/or the demand for imports is going to drop, he or she may predict a dollar appreciation. But if part of the VAT is used for deficit reduction, he or she may anticipate a dollar depreciation due to decreased U.S. borrowing. Similarly, if he or she anticipates that tax reform is going to lead to greater domestic saving, a dollar depreciation prediction may seem appropriate. But if the expectation is for increased capital inflows due to better investment opportunities, an appreciation may be the better prediction. The sum of all of the fiscal policy ramifications of the VAT/other-tax substitution will determine the expectations of the traders that buy foreign bonds and have more to do with exchange rates than the buyers and sellers of real goods and services. And we haven't even discussed monetary policy!

Monetary Policy

It is well known that domestic monetary policy, not just central bank exchange activity, exerts a primary influence on exchange rate motion. In fact, the *expectation* of monetary changes affects current and forward exchange rates.

What monetary policy might accompany, or be expected to accompany, a major tax reform including the addition of a VAT? The conventional wisdom is that the Fed would accommodate the VAT by increasing the money supply, even when a VAT is used to replace other taxes. Thus, against the expectation of an increased demand for exports (and all the possible countervailing effects involving capital flows) we have an expansion, anticipated or real, of the money supply to accommodate a supply-shock in the amount of *the tax rate times the*

entire domestic economy, many multiplies of any conceivable change in the demand for exports. An anticipated increase in the money supply, of course, exerts downward pressure on the dollar.

The point is that all of the potential effects of fiscal and monetary policy will combine to influence the expectations of foreign exchange investors. In all likelihood, these investors are far more important to exchange rate determination than the buyers of sellers of exports and imports, and their expectations more important than the direct effects on exchange rates from increases in domestic saving, or from reductions in the Federal deficit. Since the expectational effects on exchange rates contain so many countervailing forces, it would probably not be wise to base one's predictions on the effects of a VAT on the current account on an "all else held constant" assumption.

What's the Answer?

Professor Carl Shoup pointed out that the notion that exchange rate changes would wipe out any tax-induced cost effects was not new. He referred to the 1953 Tinbergen Report to the European Community of Coal and Steel. This report, set against a controversy as to whether to adopt a destination or origin based sales tax, presented the "equivalence theorem" which stated the view that tax-induced trade effects would be eliminated by floating exchange rates. Shoup notes that the equivalence theorem was challenged contemporaneously, primarily along the lines noted in this testimony.

Everything that goes around comes around. So if a policymaker views the current account as the proper target to judge tax policy, what is he or she to make of the claim that a VAT-based tax reform cannot affect the current account because of exchange rate adjustments? The last word belongs, appropriately, to Shoup:

> Accordingly, the only tenable position in our present state of knowledge is to assume that the destination and origin principles are neither equivalent nor wholly disequivalent (to coin a word), and that a move from the origin principle to the destination principle will probably increase exports and decrease imports somewhat, but not by as much as the tax rate alone might indicate...This statement may not be of much help in designing tax policy, but it at least avoids the errors inherent in taking either of the extreme positions.

VII. Conclusions

This testimony has considered various aspects of the debate concerning the trade effects of a substitution of a VAT for other business taxes in light of both the economic literature and putative gulf between the beliefs of a wide range of business people and academic economists. I have argued that tax policy should be judged in terms of distortions in the relative prices of traded goods, rather than nominal changes in the trade balance. This is based on the view that undistorted relative prices provide the greatest possibility for gains from trade.

Based on my reading of literature, I believe the following conclusions are warranted: 1) at equilibrium, both an origin and a destination-based VAT are neutral in their effects on the relative prices of traded goods; 2) switching from a pure origin-based VAT to a pure destination-based VAT would cause exports to increase in the short run and imports to decrease. At equilibrium, however, relative prices would return to the neutrality position that existed under free trade; 3) if preferential VAT treatment is afforded classes of goods and services to redress regressivity, the most likely affected goods will be those that do not enter international trade. The results of zero-ratings, exemptions, or preferential tax rates for non-traded goods will be a contraction of the traded goods sector, and a worsening of the U.S. terms of trade (an adverse distortion of relative prices); 4) although a VAT is neutral with respect to relative prices, taxes that may be replaced by the VAT may distort the relative prices of traded goods through artificial distortions of factor costs, and intertemporal distortions. Therefore, at least in the short run, a VAT/other-tax substitution may remove some existing distortions in the relative prices of traded goods; and 5) the effects of the VAT/other-tax substitution on the current account are unpredictable, due to the overwhelming influence on capital flows of foreign-exchange traders, whose expectations will be influenced by countervailing aspects of tax policy as well as by monetary policy. The view that exchange rate appreciations will wipe-out any demand influences on exports or imports is based on a narrow assumption unsustainable in real international financial markets.

Chairman ARCHER. I want to thank each member of this panel for excellent presentations and would like to inquire—Dr. Raboy, we heard from two other witnesses that border adjustability really doesn't affect trade balances and you have taken sort of a middle ground position in saying that it can have an impact on trade balances. I wish I had had time to ask the other witnesses because I honestly cannot understand in a commonsense way how if you can sell your product at a reduced price, that that does not give you an advantage.

If you have lower labor rates than another country and as a result your product is priced below what that product can be manufactured for in another country, does that not have an effect on your trade balance?

Mr. RABOY. Absolutely.

Chairman ARCHER. If you can remove the expense of government, is that not the equivalent of reducing labor expenses that are built into the price of the product?

Mr. RABOY. I think it is.

Chairman ARCHER. Why is it that if you reduce the price of the product by reducing one category of expense, which is the cost of government, that it is different and offset by exchange rates compared to if you had a lower wage rate and thereby had a lower price on your product?

Mr. RABOY. Mr. Chairman, we are in complete agreement. Taxes are real costs, just like having a higher wage rate, a higher electricity cost, or an increase in the cost of steel. To me it is illogical to believe that purely monetary phenomenon like exchange rates can mask real effects on the economy like taxes or wage rates or the cost of electricity.

I think that people focus on an accounting identity in our balance-of-payment system that states that the demand and supply of money have to be equal at all times, and that is true. Then they make another leap that says tax policy may affect the demand for exports and imports but it can't have any effect on the way we invest overseas or here. By definition, if you hold one side of the ledger constant, you can't change the other side.

So their argument is that nothing can change the trade balance unless you affect capital flows. In reality, what happens is exchange rates are extremely complex. There are billions and billions of dollars of exchange trade. Only 5 to 10 percent of that trade is associated with transactions we know as merchandise trade or even long-term investments. What really determines exchange rates is what the guys trading these exchange bonds think.

I certainly would not want to predict how they would react to a major tax overhaul. There are enormous countervailing effects on the policy side, on the capital flow side and on the monetary policy side. I think the best assumption is, since we know that taxes are real effects, they have to affect trading decisions.

Chairman ARCHER. Let me further pursue this question of border adjustability with you. As long as we have an income-based tax, whether it be a flat tax or a very complex one as we have today, how can that possibly be legally border adjustable under the now WTO, for this reason?

I may be in a business that produces widgets and I may have 1 year where I don't pay any taxes because I don't have any income. I have got a break-even business. Do I get to deduct the flat tax percentage from the price of that product when it is shipped overseas? How do I determine what I am able to remove from the price of my product as long as it is in any way income-based from a tax standpoint? Do I have to submit my tax return to the Customs Department and then determine what percentage is going to be removed from the price of that product when it is sold overseas? If my product is in competition with another widget producer in the United States who may have large taxable income and more profits, is the waiver at the border or the adjustment going to be the same? How does that work?

Mr. RABOY. There are two issues. One is economical: Is there an economic difference between two taxes that have identical bases, like an Armey flat tax versus a VAT?

The second is an administrative question. In order for a tax to be border adjustable under the GATT, you have to be able to identify the tax component of the good and take it out of taxable amounts. You can do this with a subtraction method value-added tax. You can do it with a credit invoice value-added tax. You cannot do it with the Hall-Rabushka type of flat tax where income taxes are paid at one level and profits taxes are paid at essentially the other.

Even if we disagreed with the GATT distinctions, nonetheless they constitute the GATT rules that came out of the Uruguay round and we are stuck with it.

Chairman ARCHER. Even if that could be changed by force majeure of the United States of America, you would still have the complexity as to the amount of tax on that item based on what your income happened to be in a particular year, and would you use last year's income tax return, whereas this year you might not have any income at all that is taxable.

To me, it seems like it would not be workable. Yet, there seems to be doubt in the mind of other witnesses as to whether it might be border adjustable.

Let me move on to two other things. Dr. Hall, you mentioned a flat tax and then you mentioned a pure income tax. What is the difference between a flat tax and a pure income tax?

Mr. HALL. Essentially it has to do with the taxation of capital income at the individual level. The flat tax essentially takes investment income and taxes it at the source, unlike the current income tax. Essentially it gets into a tax base itself. How do you calculate your taxes? Is it a cash flow or accrued income? That is the point.

Are you taking your total receipts and subtracting off all purchases or are you trying to in fact match income, what dollar was earned using what dollar of expenses? And therein lies the problem.

Chairman ARCHER. What is a pure income tax, in your mind?

Mr. HALL. I am not sure I can answer that concisely right now.

Chairman ARCHER. You used the term.

Mr. HALL. I think what I was attempting to point out was a properly administered income tax that did not treat differentially any type of capital income and also adjusted for all of the effects

that inflation has on the timing issues associated with an income tax, an accrued income tax base.

Chairman ARCHER. Finally, I want to ask the difference between Dr. Payne's analysis of the cost of compliance and your analysis of the cost of compliance, Dr. Hall, and Fortune's, which gets up to almost $600 billion. He is at $300-and-some-odd billion and you are $136 billion, I believe you said. What are the differences?

Mr. HALL. It is fairly easy to explain. Mine are strictly financial costs, strictly dollar outlays for paperwork burden. As I understand it, Dr. Payne includes a great deal of other types of costs. Mine is simply filling out tax forms, understanding the law, getting legal advice, that type of thing; none of the litigation, none of the opportunity costs, simply financial costs.

For the entire Federal tax system, I estimate $200 billion and for the income tax alone, $140 billion. I think Dr. Payne's analysis is a correct way. We have just concentrated strictly on financial costs because they can be easily demonstrated and are high enough——

Chairman ARCHER. Would you argue with Fortune's estimate?

Mr. HALL. I believe Fortune got their estimate from Dr. Payne.

Chairman ARCHER. Would you argue with that?

Mr. HALL. No.

Chairman ARCHER. So we can assume if you consider all aspects of administration, compliance, litigation, every aspect of maintaining this method of raising revenue, that it is legitimate to say that it is a cost of $592 billion per year?

Dr. PAYNE. Yes. The biggest component there is what the previous panel was talking about, the marginal excess burden. This is the lost production owing to people not working, not investing because they are deterred by the tax system.

Chairman ARCHER. How would you quantify that element?

Dr. PAYNE. I took—this was the figure in the Ballard, Chovin and Wiley study, the 1985 American Economic Review study. The marginal cost for them was 33.2 percent and the average cost was, I think, 23 percent.

Chairman ARCHER. But what dollar amount figure would that be in the $592 billion?

Dr. PAYNE. Just about half of it.

Chairman ARCHER. Thank you very much.

Mr. Gibbons.

Mr. GIBBONS. Mr. Chairman, I was waiting for someone else to be here. I want to thank Dr. Raboy. I am appreciative of his input.

Dr. Hall, I was listening to your testimony. You said there were three principal types of taxes that were being considered here and then you mentioned a business transfer tax. I think you may be calling my value-added tax proposal a business transfer tax. I have a simple subtraction method value-added tax.

Mr. HALL. I did not mean to imply that. I talk about the flat tax, U.S.A. tax and the retail sales tax. I call the flat tax and U.S.A. tax a direct tax and the value-added tax a retail sales tax.

Mr. GIBBONS. You seem to assume that in a value-added tax you have to have different rates.

Mr. HALL. No, sir. I said that is the major source of complexity.

Mr. GIBBONS. I agree with you. That is all the questions I have.

Chairman ARCHER. Mr. Hancock will inquire and also will temporarily preside over the hearing.

Mr. HANCOCK [presiding]. Thank you, Mr. Chairman.

Dr. Adams, I have read your book and in fact I recommended it to a lot of people. I am also glad to point out that I am glad that you believe in the capitalistic system because I tried to buy 200 copies and you wouldn't give me a big enough discount and I couldn't afford it. Maybe if we could get the tax change, I could buy enough copies to send to the Missouri State Legislature.

I didn't realize until I read your book that the scribes that Christ ran out of the temple were the tax collectors. I didn't know that until I read your book. I never had thought about it. I thought they were just keeping records. I didn't realize that those were the tax collectors.

One of my staffers pointed out after he read the book, which I recommended that he do, and your book about the dynasties and the power of the tax collector ruining dynasties, monarchies, he pointed out they have just recently started telling the Queen of England that she has to start paying income taxes now. If they had been doing that all along, we might have had a different situation there.

The present tax law—I kind of like your idea about burning tax records—you know, dead men tell no tales; burn the tax records. If it wasn't for the computer systems that we have now, we couldn't have a tax law like we have. We would be the world's largest bookkeeper if it weren't for computers. There aren't enough man-hours around to keep records if it weren't for computers.

With that, how do you get rid of it? Is it possible to do what the Chairman said, pull it out by the roots and start over?

Mr. ADAMS. I think he is right. In fact, using your reference to ancient Egypt, some people asked me for a comparable tax system; I say go back to Egypt. The scribes even counted the eggs in the pigeon nests and went into the houses of the housewives and tried to check and see if they were using free drippings from their cooking.

I think that while we may think that our computers and our high technology creates a fairly monstrous tax bureau, I think the scribes of Egypt were everywhere, inspecting and snooping and recording.

I am reminded of Adam Smith in "Wealth of Nations." He gave the four signs of a bad tax system. We got all four. The first one he said is a large, cumbersome bureaucracy to administer the tax law. That is bad.

The second thing that he said about a bad tax system is it discourages enterprise and denies jobs to the multitude. It is interesting that he was concerned with jobs.

The third factor of a bad system is it encourages evasion.

And fourth, he said it puts the taxpayer through odious and vexatious examinations by the taxman. Of course, there is the audit.

You can't find many redeeming factors in the tax system that we have in comparing it to the historical past and to the great minds that created our country.

Mr. HANCOCK. You mentioned the Mayan empire went down the tube because they felt they were being overtaxed and disappeared into the jungle.

Mr. ADAMS. One of the great taxmen in America said that, James Eustice, a professor at NYU. That is probably just his guess, but it may be true.

Mr. HANCOCK. Certain people in this country now that are even giving up their citizenship—I don't approve of it and I know we are liable to hear some comments on it—but giving up their citizenship to where they can move their assets out of this country. We have people moving between States now, quite a lot of it in fact, to reduce their tax burdens. Isn't that kind of parallel with what your historical evaluation——

Mr. ADAMS. One point is that many historians believe that more people emigrated to America from Europe to avoid Europe's hated tax system than for any other reason.

One of the things in my book I am proud of, is an old front page of a brochure in 1630 in Amsterdam advertising for passage to New Amsterdam, which is New York, and the title in Dutch is "Freedom." If you read the pamphlet in Dutch, which my Dutch friends have read for me, it was "freedom from taxes."

So there was a great immigration. Now you see it going the other way. One of the points that I have made, remember little sayings, I would say that patriotism is soluble in taxes. Think about that. That might explain why people do leave and why people did come here; because America was a great tax haven. That is what built this country.

Mr. HANCOCK. Thank you.

Mr. Rangel.

Mr. RANGEL. Some would say America still is a great tax haven.

Mr. ADAMS. Say that again?

Mr. RANGEL. Some would say America still is a great tax haven.

Mr. ADAMS. A lot of people say that and there is truth in it.

Mr. RANGEL. Notwithstanding the Chairman's comment that people leave the United States to avoid taxes, that shouldn't influence anybody to change the tax system, do you think?

Mr. ADAMS. It depends on the exodus. If it is the last one to leave, turn out the lights——

Mr. RANGEL. The Chairman referred to a specific number of people—are you familiar with the case the Chairman referred to? Campbell Soup—a dozen people that made several billions of dollars, they have moved to the Bahamas. It is a crummy thing to do, and he certainly doesn't support it, but I don't believe that we should even think about changing our system to accommodate a group of people that think so little of the United States that they would leave.

If the exodus was the kind that you referred to in your book that would cause people to leave their native country, that is different. You haven't seen any exodus from the United States based on the unfairness of this system, have you?

Mr. ADAMS. I think professionally we do from time to time, but not mass exodus.

Mr. RANGEL. Substantial?

Mr. ADAMS. There are a number of people that leave for any reason.

Mr. RANGEL. You have found a number of people sufficient to record that because of the unfairness of the tax system as they see it they would leave the United States?

Mr. ADAMS. I had a little talk with former IRS Commissioner Shirley Peterson, an IRS Commissioner, now in private practice, and I asked her, had the IRS ever made a study on the number of Americans who were leaving to avoid taxes? And she said, No, we have never made a study. But she said, Since I have been in private practice, I sure have got a number of inquiries. I will have to leave you with that.

Mr. RANGEL. Not to worry. I am not going anywhere. Thank you. It is a very good book.

Thank you, Mr. Chairman.

Mr. HANCOCK. Mr. Johnson.

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

Dr. Hall, you talked about multiple rates concerning sales tax. What do you mean by that?

Mr. HALL. For example, you would have a zero rate on food and a positive rate on golf balls and golf clubs.

Mr. JOHNSON OF TEXAS. You are presuming that a sales tax or any kind of consumption tax would have variable rates or——

Mr. HALL. No. I am not assuming that at all. I meant to point out that for any indirect tax, of which a retail sales tax or VAT taxes are, multiple rates are the key source of complexity to those systems.

Mr. JOHNSON. But if you had a single rate on everything——

Mr. HALL. Then the complexity part would be diminished.

Mr. JOHNSON. And that is uniformity, and I think Mr. Adams talks about uniformity in his book, too, to some degree.

How would you view the continuation of various Federal excise taxes in the context of a flat tax proposal, since both are essentially a consumption tax?

Mr. HALL. I think a good case could be made that if in fact the flat tax is administratively simpler, that all Federal taxes should be rolled into one tax system. That would dramatically simplify——

Mr. JOHNSON OF TEXAS. You are saying if a flat tax were imposed, you would do away with all other taxes?

Mr. HALL. Yes.

Mr. JOHNSON OF TEXAS. All of them?

Mr. HALL. Yes.

Mr. JOHNSON OF TEXAS. Mr. Adams, you did talk about uniformity in your book. You know, this morning we heard some comments about a police state, the Gestapo-like tactics of our IRS, which makes it I guess one of the reasons it falls into those four bad categories you spoke about, a tax to evade, so to speak.

What do you mean by uniformity?

Mr. ADAMS. I remember when Mr. Rabushka and I guess Mr. Hall wrote the article in the Wall Street Journal about 12 or 13 years ago. I think the first article that they wrote they didn't use the word flat tax but used the word uniform rate tax. I always thought that was the correct name. I don't like the name flat be-

cause it is a dead word. I like the word uniform because the Constitution says taxes are supposed to be uniform.

When that case came up before the Supreme Court, it was considered to be the leading case of the year and the Supreme Court dismissed it as a one liner. The major law reviews and the major leading tax scholars in America thought that the real issue of graduated rates was whether or not they violate the uniformity command in the Constitution. I think they do.

I think the Supreme Court has the last word on it, but I think they made a mistake there like they made a mistake on segregation because they made uniformity the same for everybody. If you go back to the Convention that was drafting the Constitution, the first draft said the taxes would be common to all, and then they said "uniform and equal." They ended up with "uniform."

What they were trying to do was to prevent America from having a tax system that was then existing in France when there were all kinds of exemptions and immunities and privileges. They wanted this to be a country in which the rates were uniform and common to all.

We have breached that only because the Court let us do it. I think the Court let us do it because at the turn of the century, we were seduced by the philosophy of socialism. Nobody was ever seduced by communism. That came by rape. But socialism has been a seductive idea and it is dead now. We spent a whole century proving it was a dumb idea.

Mr. JOHNSON OF TEXAS. Kind of like a flat tax? I think you are right when you say that the income tax is the mother of all taxes, and I appreciate that comment.

Thank you, Mr. Chairman.

Mr. HANCOCK [presiding]. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

Dr. Raboy, is that proper pronunciation? Would you pronounce it for me?

Mr. RABOY. Raboy. Actually, three different family members pronounce it different ways.

Ms. DUNN. Do they? I don't feel so bad. Thank you.

I wanted to ask you a couple questions having to do with trade. I am on the Trade Subcommittee, and I would like to know your impression of how well our current tax system is suited to the goals that we have in trade and economic policy for the United States.

Mr. RABOY. Well, I don't think it is very well suited at all for a large variety of reasons. I think there is an inherent bias in our Tax Code against capital investment, productive investment, and that by definition has to hurt our trading situation.

I think it is unfortunate that the rest of the world has adopted border adjustable consumption taxes as their primary form of revenue, and the United States hasn't. Now, that is not to say that the imposition of a consumption tax on a border adjustable basis is a panacea for trade. But simply, it harmonizes our system. It means that the rules are fair, they are predictable, and trade thrives in that type of a situation.

Ms. DUNN. What sorts of changes in tax policy would you see our adopting that would encourage greater exports?

Mr. RABOY. I think that any of the tax proposals before this Committee that eliminate the double taxation of savings and investment income will by definition increase the productivity of our export sector and lead to greater competitiveness on the part of the export sector.

I also believe that we should adopt the destination principle. We should not forgo that opportunity. The switch from an origin-based system to a destination-based system will cause exports to increase somewhat in the short run.

One final cautionary note is that when we are considering adopting a consumption-based system, there are many who believe that there should be various exemptions for food, housing and education and those sorts of things, to address perceived or real regressivity. And I think it is important that regressivity be addressed.

I would simply encourage that it be done outside of the VAT system. Because otherwise you will create a privileged sector that doesn't enter into international trade, primarily housing, education, and medical care. They will become tax-preferred entities. As a result, investment will flow into those sectors, rather than into the export sector or the sector that competes directly with exports. That could do us some damage.

Ms. DUNN. OK, great. Thank you.

I would like to ask the panel to answer a couple of questions I encountered when I was talking with constituents from my district. One is that the consumption-based tax would unfairly hit senior citizens who had been through their income-producing years, paid their income taxes, had planned for their future and now they are on mixed incomes, then they are faced with a large, 15 or 17 percent, whatever it is, sales tax on products they buy.

What would we do under this tax system or what should we do under this tax system to protect people like that? Anybody who cares to answer.

Mr. HALL. Well, it is essentially a tradeoff between—essentially what you are talking about are key transitional issues, and no matter what system we adopt, you are going have these transitional issues. And they are going to, at least in the short term, create complexities.

Under the flat tax, just as an example, though, the couple you described may or may not have any tax liability at all. The retail sales tax would affect them, and if you choose to exempt them in some fashion, then you are going to just simply create more complexity. However, you know, this is an equity-complexity tradeoff.

The U.S.A. tax system has essentially addressed this question in its preliminary transition rules, and once again it is an equity versus complexity tradeoff.

Ms. DUNN. OK. Anybody else care to answer that one?

And then, Dr. Hall, could you please explain to me, I have been in and out of this hearing all day, how you handle—once again, please explain how you handle mortgage interest on home ownership so that we could continue some policy of encouraging home ownership?

Mr. HALL. Well, I think part of the problem is that we are in fact encouraging home ownership over and above other types of invest-

ment. And that may be an interesting policy matter, but it is in fact a tax distortion.

The question, the real question is once again a transition question. People have bought their homes with the knowledge that they will have this interest deduction, and if you are taking it away from them or you remove it from the tax system entirely, then that will have an immediate impact on the net worth of their home. And that could cause problems.

As a simple matter, simply the financial aspect of losing the home interest deduction, if you lower the tax rate enough, you simply buy them out. Their tax bill is lower, even without the home interest deduction.

Ms. DUNN. Anybody else care to comment on any of those questions?

Thank you.

Mr. HANCOCK. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Dr. Raboy, I wonder if you could comment on something that Dr. Hufbauer touched on in his testimony. And I think he had one viewpoint on this. If we fail to adopt a border tax, what impact would you anticipate that will have on exchange rates?

Mr. RABOY. If we fail to?

Mr. ENGLISH. Yes.

Mr. RABOY. Again, I think that the effect on exchange rates is indeterminative. It would be almost impossible to predict it, because in order to answer that question, I have to put myself in the mind of an exchange trader. What is important is not what happens to the actual amounts of goods and services crossing the border, but what is going to go on in his mind. Because what goes on in his mind affects 80 to 90 percent of the foreign exchange trade.

So if we do nothing, then what the exchange trader is going to look at is the other components of the tax system, and he is going to ask himself, How is that going to affect investment in this country versus overseas? How is that going to affect what the Fed decides to do to the money supply? So I hate to punt on that one, but I am not sure I could give you a prediction.

Mr. ENGLISH. No, I appreciate it.

Dr. Hufbauer also testified—and I would like to read a portion of his testimony and get your comment—the fundamental reason for border tax adjustments is neither to alter the Nation's trade balance, nor to find a substitute for exchange rate adjustments. The fundamental reason for border tax adjustments is to deal with the burden on sectors that are more heavily taxed under the new system than the old.

Any TBA system will impose higher taxes on many business firms than the current corporate income tax, both because some firms pay little or no tax under the current present complicated system and because under some TBA systems, a larger portion of wage taxes will be paid at the corporate level.

I wonder if you would either concur or dissent from that and comment on it. And what sectors do you think would be adversely impacted under the new tax system?

Mr. RABOY. OK. Well, as a general rule, if you go to a consumption-based tax system, then companies that are more capital intensive clearly benefit relative to the situation they were in before.

Mr. ENGLISH. That would include steel, energy?

Mr. RABOY. Yes.

Mr. ENGLISH. Heavy manufacturing?

Mr. RABOY. Petrochemicals, all those industries.

Now, having said that, though, I believe that these countries are currently in a situation of bias. In other words, the Tax Code is biased against capital-intensive industries. So by going to a border adjustable or even a nonborder adjustable consumption tax, essentially what you are establishing is neutrality, so that firms are neither benefited nor harmed if they choose to use labor or use capital.

Mr. ENGLISH. Thank you.

Dr. Hall, Dr. Boskin in his testimony spoke to the complexity issue as it applied to the U.S.A. tax, indicating that it would be a more complex tax than some other alternatives because of the need to track assets. Would you care to comment on that?

Mr. HALL. Yes. Well, that is in fact true. Under the—essentially what, if I could contrast the flat tax with the U.S.A. tax——

Mr. ENGLISH. Please do.

Mr. HALL. The reason the flat tax is administratively simpler is because it goes under what is called a prepayment approach. It taxes all income immediately, and then—at the individual level. It taxes all wage and income immediately, and then never taxes any income earned on savings and investment. So capital gains, interest income, dividends are never taxed at the individual level. So there is no reason to have to track all those assets because you have prepaid.

Under the U.S.A. tax system, you tax wages and nonwage income, and by so doing—and also, and the key feature of what U.S.A. stands for, you have the unlimited savings allowance.

So because of the unlimited savings allowance, you in fact have to document what you have saved—you in effect have to prove your net saving for the year, and by undertaking that exercise, there is a greater complexity.

Mr. ENGLISH. Dr. Hall, one thing that leapt out about your testimony as I reviewed it is where you talk about the compliance costs to small U.S. corporations with assets of $1 million or less. And that as a group, these small corporations have had to pay a minimum of $382 in compliance costs for every $100 they paid in the income tax.

Could you get a little bit into the methodology for calculating that, and how solid an estimate is that? It is a stunning figure.

Mr. HALL. Yes, it is. Essentially it is very simple. It is an IRS figure that—and all I simply did was apply a labor cost figure to what the IRS calculates, which is an hourly burden. If you take essentially the hour—the time cost burden of complying with form 1120, which is the corporate income tax form, and you multiply it by a labor cost of $39 a hour, roughly speaking, or I guess for 1991 it was somewhat less than that, and you simply multiply that figure by the number of corporations that have $1 million in assets or less, you come up with a figure of roughly $15 billion.

Well, you can also track through IRS records what those companies paid in income tax and it was roughly $4 billion. So we have a compliance cost to tax paid ratio of roughly 382 percent.

Mr. ENGLISH. Thank you.

And I would like to thank all of the panelists. This has been very enlightening.

Thank you, Mr. Chairman.

Mr. HANCOCK. Mr. Gibbons, would you like to inquire?

Let me express my appreciation to the panel. It has been very informative. We appreciate the conciseness of your remarks and the directness in answering the questions that the Committee has asked.

The Committee stands in recess until 10 o'clock tomorrow.

[Whereupon, at 3:11 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, June 7, 1995.]

REPLACING THE FEDERAL INCOME TAX

WEDNESDAY, JUNE 7, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The Committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

Chairman ARCHER. The Committee will come to order. I would like to ask our guests and staff and press to please take seats so we may commence.

This morning we are continuing the second day of hearings on replacements for the current income tax system, and we of course will have another full day of hearings tomorrow.

[The opening statements follow:]

OPENING STATEMENT OF HON. BILL ARCHER

Today we hold the second of 3 days of hearings on replacing completely our current tax system. Yesterday we heard from several witnesses about the problems of our current system and some broad guidelines for framing a replacement. Today we will hear from the administration its position on fundamental tax reform. We will also have presented two of the major replacement alternatives, the value-added tax, which will be advocated by the distinguished Ranking Democrat on the Committee, Sam Gibbons, and the U.S.A. tax which is advocated by Senators Domenici and Nunn.

OPENING STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, thank you for calling this series of hearings on one of the most critical economic policy issues facing our Nation.

The current Federal income tax imposes huge costs on the American people. The time and money spent complying with Federal tax requirements is staggering. An IRS-commissioned study completed in 1985 concluded that the 5.4 billion hours of work expended by taxpayers for filing business and individual returns amounted to 24.4 percent of income tax revenues—a sum of $159 billion.

More recently, economists Robert Hall—who we'll hear from tomorrow—and Alvin Rabushka have estimated that direct compliance costs—both in filing and in buying expert advice—exceed $100 billion. Direct planning costs exceed $35 billion and revenue lost to the Treasury because of tax evasion exceeds $100 billion.

Economists widely believe that there are five desirable characteristics of any tax system: Economic efficiency, administrative simplicity, flexibility, political responsibility and fairness. Our current system scores low marks in each of these areas.

While today's witnesses support different ways to reform our Tax Code, it is important that we recognize the great degree of agreement—near unanimity—on the need to fundamentally overhaul the current system.

Again, Mr. Chairman, thank you for calling this series of hearings. I look forward to hearing from our distinguished guests and to moving forward to improve the system for all taxpayers.

Chairman ARCHER. We commence this morning with a representative from the Treasury, Assistant Secretary for Tax Policy, Les Samuels, who will be our first witness.

Les, if you would like to proceed. We are not going to strictly hold you to it, but as you know, if you can keep your oral presentation to within 5 minutes, we would appreciate it; and you of course can submit your entire written statement for the record. If you feel constrained that you have to go beyond 5 minutes, then certainly we will be pleased to accommodate that. You may proceed.

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY ERIC TODER, DEPUTY ASSISTANT SECRETARY

Mr. SAMUELS. Mr. Chairman, I would first like to introduce Deputy Assistant Secretary Eric Toder, who is accompanying me today, and I do have a longer written statement for the record, and I would like to summarize it.

Chairman ARCHER. Welcome, Mr. Toder.

Mr. TODER. Thank you.

Mr. SAMUELS. Mr. Chairman, at the outset I want to congratulate you for calling this very important hearing. Frustration with our tax system is unacceptably high. We are committed to working with Congress to address this serious problem. An excellent way to improve our tax system is to consider alternatives. Thus, I am pleased to discuss today proposals for fundamental tax reform.

Several plans have been introduced that would replace all or part of the income tax and payroll taxes with a tax on consumption. These reform proposals originate in part from frustration with the complexity of our existing system and concerns about our national savings rate.

The most important reason to consider replacing the income tax with a consumption tax is the change could increase savings and capital formation, and thereby raise our standard of living in the long run. Depending on how it is designed, a consumption tax could also improve economic efficiency and simplify the tax system.

Regardless of how they are collected, consumption taxes have one element in common—they tax income only when it is spent on consumer goods and services, or in other words, they exempt income from new saving from tax.

The proposals that are currently under discussion include Representative Armey's and Senator Specter's plans to adopt a two-part rate consumption tax in place of the current corporate and personal income taxes. Representative Gibbons has proposed a subtraction method VAT in place of the corporate income tax, the payroll tax, and most of the individual income tax. Senators Nunn and Domenici propose to replace the individual and corporate income taxes with two consumption taxes: A flat rate tax on businesses and a progressive rate individual consumed income tax. In addition, Mr. Chairman, you have indicated that you would replace the present income tax with a national retail sales tax or a VAT.

As with all tax proposals, these reform ideas should be carefully evaluated according to their ability to achieve fundamental tax policy objectives—fairness, efficiency, and simplicity.

Reforms should also include rules to reduce windfall gains and unexpected losses during the period of transition to a new system. Consumption tax proposals, in particular, may require special transition rules to prevent taxing consumption from previously taxed income, which could impose severe tax burdens on elderly Americans. In this regard, I would note that when many economists talk about an ideal consumption tax, they postulate that in order to obtain maximum efficiency, all existing wealth would be taxed as part of a transition to a new system.

Also, it is widely acknowledged that consumption tax proposals will need special rules for certain sectors, such as financial services businesses. Another issue is coordination with State and local governments which depend heavily on retail sales taxes for revenues.

The current Federal income tax promotes widely held social and economic goals, such as home ownership, private charitable giving, and provision of medical insurance by employers. We expect that a new consumption tax would still promote social and economic goals. But continued use of the tax system for these purposes would greatly lessen the possibilities for simplification and tax rate reduction from replacing our current system with a broad-based consumption tax.

Moving from one system to another would be complex and costly and would create both intended and unintended winners and losers. It would also change asset values, and the levels of prices and wages.

Mr. Chairman, we recognize that the current U.S. income tax system has many defects, and we welcome discussion on how to reform it. But radical changes to the tax system involve major costs and risks. Replacing the entire income tax system with a consumption tax would be a grand experiment of applying theory to a practical application that no other country in the world has chosen to undertake. Proponents of these plans must, therefore, overcome a significant hurdle—they must show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

I will briefly comment on four issues: Distributional effects, effects on saving, costs of compliance, and the treatment of existing wealth.

A consumption tax would typically place a higher burden on low- and middle-income families than an income tax with the same rate structure. In this regard, eliminating the tax on income from new capital benefits high-income families because they receive the bulk of capital income.

Chart 1 we have up on the board shows the distributional effect of replacing the revenue of corporate and personal income taxes, including the earned income tax, with a broad-based consumption tax with no exemptions and a revenue neutral flat rate of 14.5 percent. This baseline proposal is the simplest and most regressive form of consumption tax. It would increase Federal taxes for families in the first four income quintiles and cut taxes for families in the highest income quintile.

There are, of course, a number of ways to make consumption taxes less regressive or even progressive. European countries reduce the regressivity of value-added taxes by exempting specific goods and services or taxing them at lower rates. This approach does not make the VAT much less regressive, however, because the tax relief from exempting specific goods and services is not directly targeted to low-income families.

Consumption taxes that are collected wholly or in part from individuals can be more easily made progressive than those collected solely from businesses. This can be achieved by providing standard deductions for low-income families or graduated rates.

Chart 2, that we are just putting on the board now, illustrates the effect of including a standard deduction and personal exemption in a general consumption tax. It shows the distributional effect of replacing the individual and corporate income tax with a modified flat tax. This has a standard deduction of $24,700 for joint returns and a $5,000 personal exemption. The revenue neutral flat rate is 22.9 percent.

Under this version of the flat tax, the aggregate aftertax income for the top quintile would still be 1.6 percent higher than under current law, a net tax cut, and the aggregate aftertax income for the group of families in the first four income quintiles would still be 1 to 2.2 percent lower than under current law, a net tax increase.

Chart 3 compares the progressivity of the current Federal system with the modified flat tax I just described. It shows that current law is progressive—effective rates rise with each income quintile. The modified flat tax is progressive through the fourth income quintile. Compared to present law, the effective tax rate decreases from 24.5 to 16.4 percent for families in the top 1 percent of the income distribution. This decrease in tax burden occurs because under the flat tax proposal, income from new savings and investment is not taxed.

Addressing regressivity is a key challenge in designing a consumption tax that will not add burdens to low- and middle-income families. Thus, in analyzing any of the proposals, the first question to be asked—is it fair? Compared to the current system, who will be the winners and the losers?

Consumption taxes will not tax the return to new savings and investment. An income tax does tax this return and thereby discourages savings and investment to some degree. Consequently, one might expect that replacing the income tax with a consumption tax would encourage domestic saving and capital formation.

The national savings rate in the United States has declined in the eighties compared to the previous three decades, due to a decline in private saving and increases in the Federal budget deficit. We consider the low rate of U.S. savings to be a very serious concern. But we must ask ourselves how much the proposals under public discussion would help. The decline in savings does not appear directly related to changes in tax policy. Marginal tax rates were lowered substantially during the eighties and new saving incentives were introduced, but the overall private savings still fell.

How much would substituting a consumption tax for the income tax boost total private savings? If the aftertax rate of return on

savings goes up, individuals may increase saving for future consumption. Most statistical research by economists, however, finds that the effect of increasing the rate of return on savings is small or negligible.

Our current income tax includes incentives for employers to provide retirement savings plans for all of their employees—including low-income employees. The incentives for employers to establish retirement plans would be weakened under a consumption tax.

Simplification of the tax system is a very important goal of many tax reform proposals. We strongly support this goal. A simpler tax system would lower compliance costs for taxpayers and administration costs for the government.

One source of complexity in our current income tax, the measurement of capital income, would be largely absent under a consumption tax. Three other important sources of complexity—provisions to distribute the tax burden equitably, rules to measure the consumption component of business income properly, and the provisions that use the tax system to advance certain social and economic policies—would continue under any consumption tax.

For example, suppose it is desirable to have a consumption tax that continues to promote home ownership. Because consumption taxes, unlike income tax, would exempt interest income from tax, continuing to allow a deduction for mortgage interest paid would encourage homeowners to incur additional borrowings beyond their financing needs. Rules to prevent this type of tax arbitrage would be complex and difficult to enforce.

Some commentators have suggested that a switch from the present income tax to a simpler consumption tax would promote compliance from the underground economy. This benefit may be easily overstated. The reporting of income and sales from illegal activities is unlikely to be affected by changes in the tax system. Incentives for not reporting income or sales from informal activities would also remain under a consumption tax.

A very significant issue in converting to a consumption tax system is deciding how to treat the return to wealth that was accumulated out of aftertax income under the income tax. For example, without a transition rule for past savings, a retiree who accumulated $100,000 in savings out of aftertax income before the imposition of a consumption tax would be taxed on withdrawals from that account that are for consumption.

An exemption for existing wealth may be desirable to relieve the tax burden on individuals with accumulated savings, many of whom are elderly. However, it would also require higher tax rates on wage income and reduce much of the gain in economic efficiency that are predicted from a consumption tax. In this respect, transition rules are not merely an inconsequential technical issue. How existing wealth is treated during the transition could have material economic effects.

We are not at this time convinced that the case for completely replacing the income tax with a consumption tax is compelling. The most frequently cited economic benefit of such a change, an increase in private savings, is uncertain and could be small. Savings incentives within the existing income tax can increase savings without replacing the entire system.

The fairness of replacing the income tax with a consumption tax is also a concern. Moving to a flat rate consumption tax would increase the tax burden on low-income and lower the tax burden on high-income families. Efforts to improve the progressivity of consumption tax proposals would result in complexity. In addition, the effects of switching to a consumption tax on wage and price levels, interest rates, and the value of existing assets, including homes, is uncertain.

In examining consumption tax proposals, it is inappropriate to compare a theoretically ideal consumption tax and the income tax system in place today. Instead, we should analyze a consumption tax that is likely to emerge from the political process. Exclusions would be made under a consumption tax, and those exclusions would reduce the economic benefits of the proposals and increase complexity.

We commend efforts to develop consumption tax proposals that are progressive and revenue neutral. We are concerned, however, that such a consumption tax could be excessively complex.

Mr. Chairman, we look forward to working with the Congress on improving our system. We believe that greater weight should be given to simplification in evaluating tax reform proposals than has been given in the past. A simpler tax system would lower compliance costs for taxpayers and administration costs for the government. We will give serious consideration to proposals that would meet the tax policy objectives set forth in my testimony—proposals that would simplify the tax system and improve economic incentives without sacrificing revenue or fairness.

While the debate is in process, simplification should also be given greater weight in evaluating changes to our existing tax system. Last year, the House of Representatives passed the Simplification and Technical Corrections Act. We ask the Committee to consider this legislation.

Mr. Chairman, that concludes my remarks and I would be pleased to answer any questions you or Members of the Committee may have.

[The prepared statement follows:]

Mr. Chairman and Members of the Committee:

Introduction

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

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

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

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

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

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

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

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

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

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

Background

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

What is a consumption tax?

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

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

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

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

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

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

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

Options for taxing consumption

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

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

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

2. Value-added tax. Most countries that have a national consumption tax administer it as a credit-invoice VAT. Under this system, businesses are liable for VAT on their sales, but

receive a credit against their tax liabilities for VAT paid on inputs purchased from other businesses. Credit-invoice VATs in effect in other countries tax imports and exempt exports. They achieve this result by not taxing export sales, while allowing exporters a credit for all purchased inputs, and effectively imposing tax on goods purchased from other countries by not allowing their costs to be creditable.

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

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

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

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

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

Distributional effects of replacing the income tax with a consumption tax

Replacing the income tax with a flat-rate consumption tax

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

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

Table 1 shows the distributional effect of replacing the revenue of the corporate and personal income taxes (including the earned income tax credit) with a general consumption tax with no exemptions (such as a broad-based VAT or national RST).[2] The revenue-neutral rate of 14.5 percent used for these calculations assumes that the tax is imposed on all consumption in the economy, including consumption services supplied by the government and non-profit sectors, which would probably be exempt from a VAT or RST. In practice, therefore, the rate that would be required under a broad-based VAT or RST would probably be much higher.[3]

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

In this analysis, the burden of the consumption tax is distributed to taxpayers according to components of current income. But individuals may base current expenditures on their expectation of future income as well as on current income. For example, college students who earn very little while they are in school might, nevertheless, have high current consumption expenditures if they are able to borrow against the expectation that they will have high incomes in the future. In such cases, annual income understates economic well-being. Annual income may overstate economic well-being in a year when a family receives income from a transitory source, such as a large bonus. For these reasons, some economists argue that lifetime income is a better measure of an individual's long-term economic well-being than annual income. Our analyses, however, do not distribute tax burdens according to lifetime income because future earnings are uncertain, and even if future earnings were known, lifetime income would be difficult to measure with accuracy. In addition, lifetime income is an inappropriate measure of current well-being if individuals are unable to smooth their consumption over their lifetime by borrowing and saving. For example, if the college students mentioned above are not able to borrow against their uncertain future earnings, it may be inappropriate for the tax system to view

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

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

[4]These results are illustrated in Chart 1.

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

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

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

(1996 Income Levels)

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

Department of the Treasury
Office of Tax Analysis

March 7, 1995

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

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

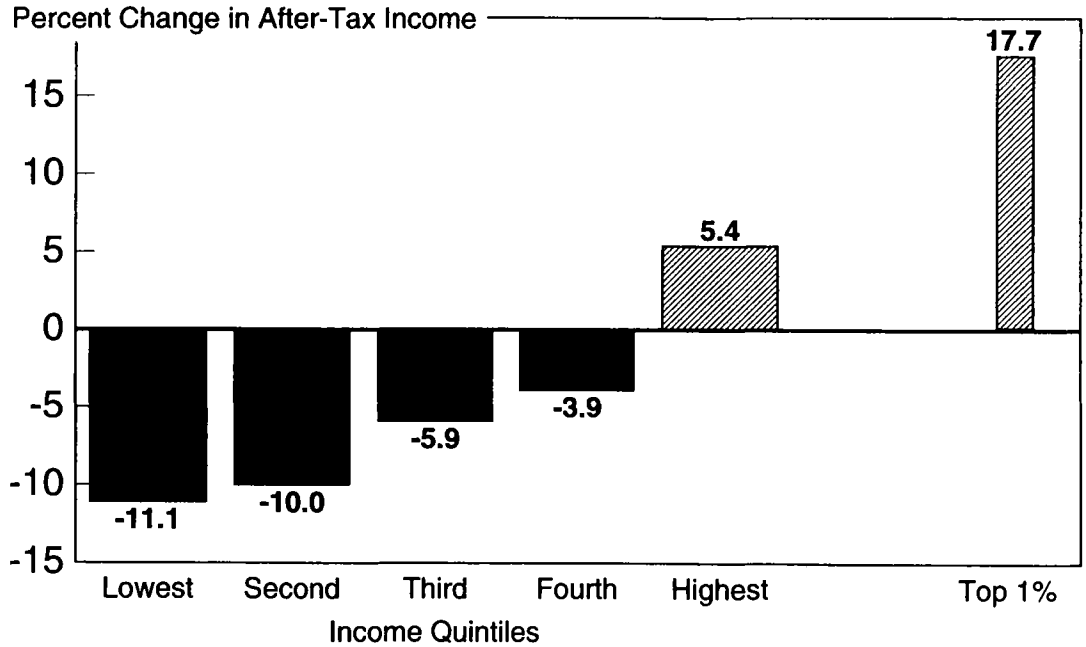
(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors; the corporate income tax by capital income generally; payroll taxes (employer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

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

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

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

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



Source: Department of the Treasury (see Table 1 for details)

them as well-off currently.[7] Nevertheless, some studies show that distributing a general consumption tax to families according to their estimated lifetime income makes the tax appear to be less regressive.

Addressing the regressivity of a consumption tax

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

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

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

Table 3 compares the progressivity of the current Federal tax system together with the revenue-neutral, stylized flat tax described above. The last two columns in the table show taxes

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

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

[9]These results are illustrated in Chart 2.

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

(1996 Income Levels)

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

Department of the Treasury / Office of Tax Analysis — March 7, 1995

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

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

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

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

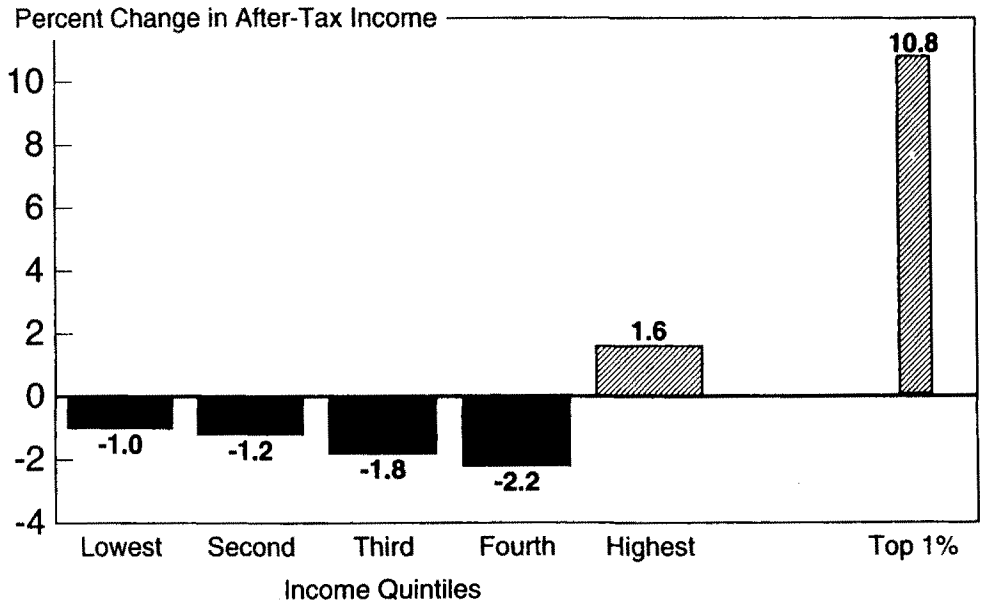
(5) The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.

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

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

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,436

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



Source: Department of the Treasury (see Table 2 for details)

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

(1996 Income Levels)

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

Department of the Treasury
Office of Tax Analysis

June 5, 1995

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

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

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

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

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

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

While Treasury has not completed a study of the distributional effect of the Nunn-Domenici consumption tax, their proposal was designed to achieve progressivity through graduated rates under the individual consumed income tax. A top statutory individual tax rate of 40 percent, together with the loss of a deduction for labor costs under the 11 percent business tax, means that consumed labor income in excess of $24,000 (for joint filers) would be taxed at an effective rate of 46.6 percent under the Nunn-Domenici proposal. With the family living allowance and personal and dependent exemptions, a family of four would pay income tax at an effective rate of 46.6 percent on consumed labor income in excess of $41,600.

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

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

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

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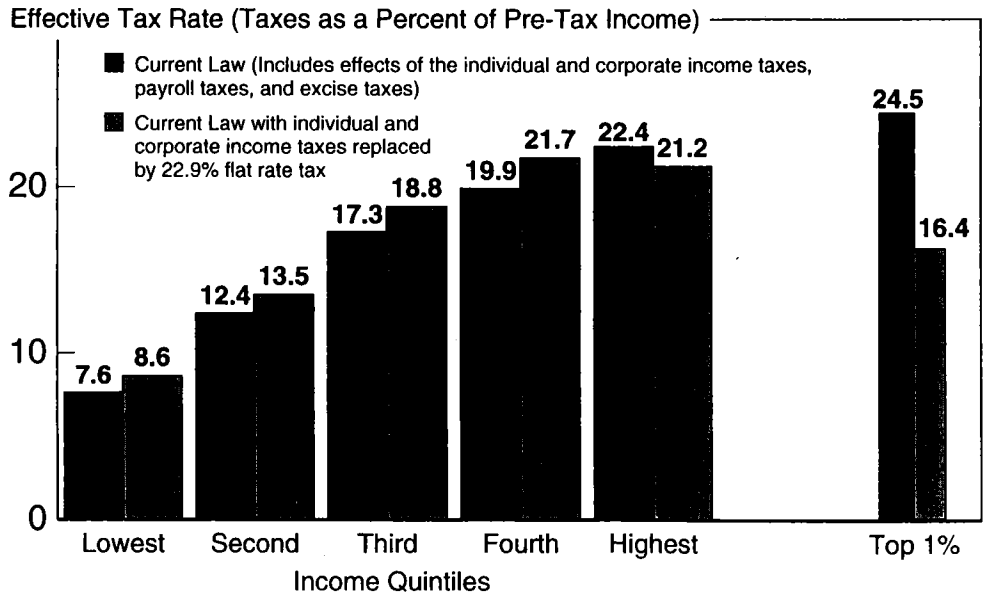
[10] These results are illustrated in Chart 3.

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



Source: Department of the Treasury

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

Saving and investment[12]

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

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

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

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

Source: Department of Commerce, Bureau of Economic Analysis

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table 7. Average Net National Saving Rates for Selected Countries

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

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

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

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

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

Source: Organization for Economic Cooperation and Development

2. Tax policy and private saving. Two effects from substituting a consumption tax for the income tax could boost total private saving. Economic theory suggests that if the after-tax rate of return on savings goes up, individuals would increase saving to consume more in the future since the "price" of future consumption in terms of foregone current consumption is lower. However, most empirical studies find that the effect of increasing the rate of return on the level of saving would be quite small.[15] In addition, some people are "savers," while others consume essentially all their income. Shifting the overall burden of taxes from saver to consumer households can increase aggregate private saving, but it would also result in an increased concentration of private wealth.

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

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

be likely to respond to direct tax incentives. The incentive to establish retirement plans would be much weaker under a consumption tax.

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

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

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

Prices and wages

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

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

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[16]Under U.S. tax rules, corporate income tax is imposed on the return to equity-financed capital used in the United States regardless of who owns it, whereas the individual income tax is imposed on the return to capital owned by U.S. residents regardless of where it is used. (U.S. corporations are taxed on their worldwide income, but receive a tax credit for foreign income taxes paid. The residual U.S. tax rate on active foreign-source income of U.S. corporations, after accounting for foreign taxes, is generally quite low.) Eliminating the corporate tax would be expected to increase domestic investment more than saving, because it would reduce the cost of capital to both U.S. corporations and foreign corporations investing in the United States by much more than it would increase the after-tax return to U.S. savers. In contrast, eliminating the individual income tax would be expected to increase saving more than domestic investment because it would increase the after-tax return to U.S. personal saving invested both in the United States and abroad, but, with internationally-linked capital markets, would not provide a relative advantage to capital invested in the United States.

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

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

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

Asset values

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

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

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

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

Tax-exempt interest rates would be expected to rise in response to a switch to a consumption tax because, under most consumption tax proposals, tax-exempt bonds would no longer be favored relative to taxable bonds. Consequently, existing holders of long-term municipal bonds would suffer a capital loss.

Under the current income tax, investment in owner occupied housing is substantially tax favored compared to other forms of investment. These advantages include allowing deductions for certain homeownership costs, such as mortgage interest and property taxes, even though housing produces no taxable income. Under most consumption tax proposals, housing would lose its relative advantage over other forms of investment. The switch to a consumption tax

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

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

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

would affect housing most directly through the repeal of the mortgage interest deduction and corresponding elimination of the tax on interest income. Consequently, the cost of both debt and equity capital invested in housing would increase.[22] The loss of preferential treatment means that the consumption benefits from housing would rise relative to the returns from other investment. This would lower the price of existing housing and substantially reduce the number of new homes that are built.[23] In the absence of special transition rules or a continuation of tax preferences, housing values could fall considerably in the short run. Over time, the housing stock would be expected to decline, and the resulting scarcity of homes would push the prices of existing houses back towards their initial level.

Economic efficiency

1. Allocation of capital.

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

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

2. Taxation of existing wealth.

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

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

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

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

reduce, and could entirely eliminate, the gains in economic efficiency that many economists expect from the switch.[25]

3. Labor supply.

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

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

4. Consumption-saving choice.

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

International trade

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

To see how a refund or exemption for exports under a consumption tax and the imposition of the tax on imports (called border tax adjustments), in fact, amount to neither a subsidy for domestic exports nor a penalty on imported goods, consider a very simple example. Imagine that both New York and New Jersey produce apples for consumption within the state and for "export" to neighboring states. Assume a competitive market for apples sets the price per bushel at $5.00. Now imagine that New York adopts a broad-based, 10 percent VAT that exempts exports and is imposed on imports. The price of apples produced and bought in New York would be expected to rise to $5.50. Since the New Jersey apples that are trucked into New York are subject to the 10 percent VAT, they would also sell for $5.50 per bushel. Imports into New York would, therefore, not be penalized relative to domestic produce. Over

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

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

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

the border, New Jersey apples would still sell for $5.00 per bushel, as would imported New York apples that are exempt from New York's VAT. The exemption for exports, therefore, results in no subsidy for New York's exports.[28]

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

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

Although border tax adjustments under a consumption tax are generally considered to have no long-run affect on the balance of trade, it should be noted that some types of consumption taxes are accepted as border-adjustable under the General Agreement on Tariffs and Trade (GATT), and others are not. Indirect taxes, such as credit-invoice VATs used in most other countries, are border-adjustable under the GATT. Consumption taxes collected wholly or in part from individuals, such as a consumed income tax and a flat-rate tax of the type proposed by Representative Armey and Senator Specter, are unlikely to be refundable under the GATT. Although a broad-based, single-rate subtraction method VAT is economically equivalent to a similarly broad-based credit-invoice VAT, a GATT ruling would consider other factors. Whether a subtraction method VAT would survive a GATT challenge is an untested issue.[30,31]

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

Special treatment may be appropriate for specific business sectors under those forms of tax that are collected at least in part from businesses. High administrative and compliance costs relative to revenue collected may justify special treatment for certain sectors and for small businesses. Special rules are required for taxing goods and services with hard-to-measure tax

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

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

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

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

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

bases, such as financial services.[33] The tax base for these services is not explicitly separated from other charges, and it is difficult to apportion the benefit from financial services to those who receive them. For example, the charge for intermediation services provided by banks is included in the difference between the interest rates charged to borrowers and paid on deposits. That difference also includes the return to equity-holders. Moreover, it is difficult to allocate the intermediation charge to a specific savings account or loan.

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

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

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

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

Simplicity

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

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

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

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

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

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

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

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

Distribution of the tax burden

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

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

Many consumption tax proposals, such as those of Gibbons, Armey, and Nunn and Domenici, offer large standard deductions and exemptions for dependents in order to relieve

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

Measuring consumption

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

Promoting social and economic goals

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

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

The underground economy

The underground economy consists of illegal activities and those which are "informal," but not illegal. A suggested benefit of a consumption tax system is that it may promote greater compliance with the tax laws from those presently operating in the underground economy. Some

commentators have suggested that a consumption tax collected at the business level would enable tax to be imposed on income of the underground economy, particularly the informal sector, that is untaxed under the current individual income tax.

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

Coordination with State and local sales taxes

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

Transition to a consumption tax and the tax on existing wealth

The most significant issue in converting from an income to a consumption tax system is deciding how to treat the return to wealth that was accumulated out of after-tax income under the income tax. The return to new saving and investment would be exempt under a consumption tax, but without an explicit exemption for old wealth, the return to and withdrawals from the stock of existing assets that are not reinvested will be taxed. For example, imposing a Federal VAT would automatically tax all withdrawals from existing savings that are used for consumption -- even if those savings were accumulated out of after-tax income. A full or partial exemption for current wealth might be desired to relieve the tax burden on individuals with accumulated savings, many of whom are elderly. But such an exemption would reduce the taxes paid by the holders of wealth, making the tax less progressive. In addition, economists believe that a tax on existing wealth would not distort taxpayer behavior, and that this non-distorting wealth tax is the source of much of the gain in economic efficiency predicted to result from a switch to a consumption tax. Consequently, an exemption for all existing wealth would effectively convert the tax into a tax on wage income alone, requiring higher tax rates on wages. The effect would be to reduce significantly, and possibly completely eliminate, the gains in economic efficiency that some economists expect from a consumption tax.[37]

To illustrate the magnitude of this problem, consider the value of current household wealth. The total wealth of U.S. households is estimated at about $23 trillion.[38] Much of this wealth is in the form of assets, such as pensions and unrealized capital gains, which have not yet been taxed. Excluding housing, the basis of private assets in the United States could be as much as $10 trillion. Rules governing the treatment of consumption financed by existing wealth

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

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

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

during the period of transition to the new tax will determine to what extent this significant amount of previously taxed savings is subject to the consumption tax. In this case, transition rules are not merely an inconsequential technical issue; how existing wealth is treated during the transition could have material economic effects.

Transition rules could be designed to relieve completely the tax burden on savers who have already paid income taxes on their savings and would otherwise be taxed again when those savings were spent under a consumed income tax. For example, without a transition rule for past savings, a retiree who accumulated $100,000 in a savings account out of after-tax income before the imposition of a consumption tax would be taxed on withdrawals from that account that are for consumption expenditures. A transition rule could allow savings that were accumulated under the income tax to be segregated from "new" savings and deducted from income. This rule would treat the $100,000 as tax-paid savings and would enable the retiree to make tax-free withdrawals from the savings account. It is difficult, however, to design rules that differentiate between individuals who reduce their accumulated savings in order to consume, and individuals who only rearrange assets among accounts. Allowing tax-free withdrawals from past savings, for example, would enable any individual with accumulated wealth to gain a tax deduction simply by transferring old assets into "new" savings accounts. Such a rule would enable a millionaire living off the interest on her accumulated assets, for example, to receive the equivalent of tax-free interest income -- a substantial benefit compared with current law.[39] The Nunn-Domenici plan includes detailed rules that would prevent the taxation of most previously-taxed savings while prohibiting taxpayers from generating savings deductions out of existing savings. While these rules would largely prevent the imposition of unfair burdens on elderly households, they would add to the complexity and costs of the tax system and would result in lower economic benefits than if the return to accumulated assets were subject to tax.

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

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

Conclusion

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

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

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

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

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

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

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

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

Chairman ARCHER. Thank you, Mr. Secretary. Obviously there are going to be many questions and colloquies with you by Members of the Committee. I would like to commence just by asking you, for the purpose of establishing a predicate of the discussion on your charts, are the distributional tables that you use as the basis of these charts based on the old family economic income distributional concept that was discarded by the Joint Committee in the last Congress as being inappropriate, such as the imputing of income for the ownership of one's home and a number of other arbitrary and subjective numbers?

Or have you changed it in the way that the Joint Tax Committee, under the previous Majority, in the last year changed theirs?

Mr. SAMUELS. Mr. Chairman, the distributional analysis has been done according to the traditional method that Treasury has used since the end of the Ford administration, which includes family economic income.

Chairman ARCHER. So the answer is that you have not changed your standard, whereas the Joint Committee, under the previous Majority, in the last Congress, recognized that it was inaccurate and changed it.

Yours is the same, correct?

Mr. TODER. Our standard is the same, Mr. Chairman.

Chairman ARCHER. OK. Thank you very much.

Now, have you considered the impact of reduction in interest rates and increased value of the dollar in benefiting every American in the determination of these comparisons in these charts?

For example, if one who wishes to buy a home, particularly a first-time home purchaser, is able to buy that home at interest rates that are 1 or 2 percent lower over the long term, isn't that a massive reduction in the price of that home? And have you taken any of that into account?

Mr. SAMUELS. Mr. Chairman, let me just say that the economic benefits that are discussed in the context of moving to a consumption tax as set forth in our testimony are uncertain. So we have not taken any economic benefits or detriments, because there will be—there are possibilities of significant changes, as I said, in wages, prices, and asset values; and we haven't taken those into account either way. Either way, we haven't taken them into account, because I don't think at this point there is on—there can be a reasonable prediction as to what those might be.

Mr. TODER. Let me just add, we believe that interest rates are set primarily on the world economy, and it is very unlikely that interest rates would fall very much. Americans would still be taxed the same on their interest at home and overseas, and foreign lenders would still not be basically taxed on the interest they receive from lending to the United States.

The consequence, we believe, is that aftertax interest costs of housing would rise significantly from changing to a consumption tax, and that the value of existing housing equity would fall substantially.

Chairman ARCHER. Well, I sort of operate off of the basis of what my colleague from Georgia says is common sense, and maybe that doesn't fit into the ivory tower. But common sense tells me that if you have zero tax on savings, you are going to have more savings.

If you have more savings, interest rates are going to go down. If you don't tax income production in the United States to foreign investments, more money is going to flood into the United States, which will increase the amount of savings and investment capital in the United States. And I think, if I am not incorrect, that money, as you say, on a worldwide basis is a fungible commodity, and that is going to relate directly to market forces. And if you have more savings coming into the United States, more demand, more interest in people putting them in here, the price of money is going to go down in the United States.

Now, maybe that is too common sense for an ivory tower, but it seems pretty clear to me that interest rates are going to go down dramatically if you can convert to a consumption tax; and then, in addition, as Mr. Gibbons has articulated so well over the years, if you can remove the price of government as an expense of a product and thereby reduce its price in the world marketplace, you are going to sell more American products, which in turn is going to give you a lower trade deficit, which in turn is going to stabilize the value of the dollar and give people more purchasing power for their dollars in the United States.

Now, that is not ivory tower; that is just kind of the Archer rule of common sense. The important point is, whether I am right or whether I am wrong, that is not being considered in these charts.

Now, finally let me ask you this, Mr. Samuels. I appreciate your support of our effort to get into this evaluation of the current system and what we might do to replace it, and we welcome you aboard in that process.

I am curious as to when you will have a proposal for us that we can look at as to what you think is the appropriate way to replace the current Income Tax Code.

Mr. SAMUELS. Mr. Chairman, we are evaluating these proposals that have been made, and we are also evaluating how one might change the existing system to make it better, and that is the process that we are going through.

In looking at the proposals that are on the table, one of the interesting things to me in considering them is that they are all idealized proposals. I actually haven't kind of thought about them as being ivory tower; I have kind of talked to my colleagues when they explained them to me as kind of being on another planet, because they assume an idealized system; and I think that—as a practical person, I don't think they will ever actually be adopted through the political system.

For example, the idealized consumption tax system assumes, as I mentioned in my testimony, in obtaining the efficiencies that people hope to get out of them, that there will be a tax on existing wealth in the transition; and I think that would be a very hard objective to obtain in designing a practical system, and I think that is a serious problem.

So what we are trying to do is evaluate all of these proposals, understand where the real pitfalls are. This is like peeling an onion, there are whole layers of issues, and we think at the end of the day, based on what we know, that the proponents of these have a very high burden that the projected benefits will, in fact, occur. And so, therefore, we think that at the same time we should be

carefully and seriously looking at what we can do to our existing system to make it simpler and easier for taxpayers; and so that is what we are doing.

Chairman ARCHER. I am not sure what your answer is to my question. My question is, When will you have a proposal that we can look at in comparison to these other proposals?

Mr. SAMUELS. Mr. Chairman, at this point we aren't making a proposal. What we are saying is that we have looked at these proposals and consumption taxes—proposals to replace the entire income tax with a consumption tax, and we see very serious questions that need to be answered. So we are not in the position to propose a new system that would completely replace the income tax, and we think that you should be making comparisons and evaluating these, and hopefully, out of this debate will emerge a consensus about how to make our existing system simpler and easier for taxpayers to understand, while maintaining fairness and raising the same amount of money; and we think that is the way the process should move forward.

Chairman ARCHER. Well, it seems very difficult to get a precise answer from you, but I will say that we are not just considering consumption taxes. We are considering a flat tax. The proposal that Congressman Armey has made, and a number of other proposals, and we would welcome——

Mr. SAMUELS. Mr. Chairman——

Chairman ARCHER. We would welcome a proposal from the administration. You have tremendous resources through the IRS and through your own Treasury Department, resources that are of a far greater magnitude than we have up here at the Congress. And inasmuch as you applaud this effort and you think something should be done, we would like to have your proposal in the mix so that we can look at it.

And so I will ask you again, will you submit a proposal, and, if so, when?

Mr. SAMUELS. Mr. Chairman, we are looking at these proposals; we have spent a great deal of time—I am sure you can tell by reading our testimony—in listing the criteria by which these consumption tax proposals should be evaluated.

I would add, the Armey flat tax proposal is a consumption tax. When you talk to the economists through your hearings, if you ask them, they will tell you it is a consumption tax proposal.

We think that the right way to go through this process is to evaluate variations of the proposals and try to understand how they might come out of the political process and compare it to our existing system as it might be improved.

Chairman ARCHER. I know. You have said that. You have said that several times. But do you not have any original ideas of your own?

Mr. SAMUELS. Mr. Chairman, I think if you read our testimony, you will see that we have spent a great deal of time analyzing the proposals to try to make sure that everyone understands what the problems are.

Chairman ARCHER. That is still not responsive to my question. You are talking about analyzing other people's proposals. I am ask-

ing you whether you have an original proposal of your own and when we might be able to receive it?

Mr. SAMUELS. Mr. Chairman, over the years, the Treasury Department has set forth analytical frameworks for all of the proposals that this Committee is discussing today. The Treasury Department in 1977 put out an analysis of proposals; in 1984 the Treasury Department put out analytical proposals. I don't think that we are scratching around for some ideas that haven't been thought of before. I think if you talked to the people who have been doing the research on the tax system and alternative tax systems, that you will see variations on the theme and the pros and cons of the variations, and that is what we are suggesting.

Chairman ARCHER. But which ones do you support? Let me see if I can get at this in a different way, because I am not getting a responsive answer to my question. I am getting the continued response of, well, we want to examine all of the various alternatives that have been submitted by somebody else, that we have a framework whereby we can evaluate those, and I really, I really, hope in fairness you will not respond that way to me again, because I would like something a little more precise. So let me try another way to get at it.

If we had no tax system today to generate the money to pay the Federal Government's bills, if we were starting from scratch, would you adopt as the best way to raise money the current Federal income tax system? That should be easily answered yes or no.

Mr. SAMUELS. The current Federal income tax system? No.

Chairman ARCHER. All right. In that event, and if you had the challenge, which is what we are accepting here today, to try to look, from scratch, at a system that would be the best for the United States for the raising of the money to pay the bills, what would it be, in your opinion; and if you don't have it for me today to answer that, could you have it for me in 1, 2, 3, or 6 months?

Mr. SAMUELS. Mr. Chairman, I think that at this point in time that you ask what is the ideal, as opposed to what in fact will actually happen——

Chairman ARCHER. No, I am asking you for a proposal to help us make something happen. And certainly you have got ideas down there; you have got all kinds of, as you say, framework and background and resources of a gigantic magnitude. Would you let us know what you think is the most appropriate way for us to raise money to pay the government's bills; and if so—and either yes or no—will you or will you not? If the answer is yes, then in what timeframe might we expect to hear from you?

Mr. SAMUELS. Mr. Chairman, we are in the position, as you can tell from our testimony, of saying that we should be analyzing——

Chairman ARCHER. No, no, no. I just said, please don't give me that answer again. Answer me specifically whether you will have a proposal for us that you believe is the appropriate way, the best way, for us to raise the revenue to pay the government's bills, yes or no; and second, if the answer is yes, in what timeframe?

Mr. SAMUELS. Mr. Chairman——

Chairman ARCHER. I mean, it is very simple. Will you or will you not have a proposal?

Mr. SAMUELS. I think that——

Chairman ARCHER. You can say "not in my lifetime, no." It is a very simple question. Either you will or you won't.

Mr. SAMUELS. I really think that it is a way of looking at this that we at this point have determined is not the path that we are going to follow.

Chairman ARCHER. So you will not have a proposal for us; you will sit on the sidelines and criticize every proposal that is introduced. Whether it be by Mr. Gibbons or by Senators Nunn and Domenici or whether it be a proposal ultimately specified by me, you will sit and you will target those and you will criticize, but you will not come forward with a proposal of your own.

Mr. SAMUELS. I don't actually think that is what we are doing. We are not going to sit by and just criticize proposals. We are going to try to tell you what the pros and cons of various proposals are, and what we think——

Chairman ARCHER. You know, I don't want to belabor this. You will not have a proposal for us. That is what you are saying; is that correct?

Mr. SAMUELS. What I have said is that—explained to you how we are going to participate in the process at this point in time.

Chairman ARCHER. No, no, no. It is a simple thing. Will you have a proposal or will you not have a proposal? It is very simple, a yes or no answer.

Mr. SAMUELS. Mr. Chairman, we are here to discuss the pros and cons of these various——

Chairman ARCHER. That is not responsive. I mean, the administration has a wonderful computer programming system that must be embedded in the minds of every Representative that appears before the Congress, and it is to pattern their answers in the way that you have patterned your answer, but it is not responsive.

Just say, no, you are not going to have one and then we can go on.

Mr. SAMUELS. But I think that that isn't really the point of this.

Chairman ARCHER. That is my question. That is the point of the question.

Mr. SAMUELS. I think that the point is that there are various ideas for how to design an income tax system. They have been around—they have been around now for quite a while, and I think it is an excellent idea to review our current system and the alternatives that have been put on the table.

Chairman ARCHER. Which one do you like?

Mr. SAMUELS. I think——

Chairman ARCHER. Which one do you support of the various alternatives? And if you don't support one of them, will you modify one and make that proposal to the Congress?

Mr. SAMUELS. I think that given the——

Chairman ARCHER. Well, clearly you are programmed not to give a definitive answer to the Congress, and I accept it. I know you are put personally in a very difficult position. But it is very, very clear that the administration has instructed you that you are not to give us a specific proposal that will be the administration's idea of how we can better raise money. So we then have to, as in Medicare—where we face the same thing—we have to move forward with our responsibility to do what is right for the people of this country.

Mr. Gibbons.

Mr. GIBBONS. Mr. Archer, I think you did an excellent job of cross-examining the witness. Maybe they could use you out in the O.J. trial.

Let me say, I have read Mr. Samuel's statement, I have discussed it with him. He gives a good analytical analysis of what the problems are. I don't necessarily agree with all of his conclusions in his statement, wherever you can find a conclusion, but I don't have any questions at this time. I would like to get on, so I can get down there and talk a little while.

Chairman ARCHER. Well, we are going to be very interested, because you at least are willing to come forward with a specific proposal and defend it.

Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

Mr. Secretary, you have cited three criteria that should be employed in evaluating alternatives to the existing Tax Code—namely, fairness, simplicity, and efficiency. Does the existing Tax Code, in your estimation, meet any of those criteria?

Mr. SAMUELS. Mr. Crane, I think that to start, the existing Tax Code does not meet the criteria of simplicity. I think we have got ourselves in a situation where the complexity of the Code has obviously resulted in enormous resentment and frustration among taxpayers, and we need to do something about it. So on that score, I think the simplicity criteria is not met and needs to be addressed.

With respect to fairness, I think when you look at the progressivity nature of the system, I think that—in very general terms, I think it is a fair system.

With respect to efficiency, I think that the system could be significantly improved. I think that when you look at the number of the incentives in the system, which give rise to complexity, that you have to wonder at the end of the day how much those incentives actually achieve their goal. So I think that we need—we have a lot of work to do with our existing system.

Mr. CRANE. Now, when you talk about the fairness question, you cite progressivity as evidence of the fairness in the system. Do you think it is perfect as it exists right now? For example, on your chart over here, the top 1 percent of taxpayers are paying 24.5 percent of the total taxes; is that not correct?

Mr. SAMUELS. That is correct.

Mr. TODER. Excuse me. They are paying 24.5 percent of their income in taxes.

Mr. CRANE. All right.

Mr. TODER. They are not paying 24.5 percent of taxes.

Mr. CRANE. All right, they are paying 24.5 percent of their total income in taxes. The bottom 20 percent are currently paying 7 percent?

Mr. TODER. 7.6.

Mr. CRANE. 7.6. That kind of spread is evidence of fairness in your judgment?

Mr. SAMUELS. I think that when you look at the issue of fairness, you should look at who is best able to bear the burden of taxes for running our government, and I think when you start with that premise, you look at those who have total command on resources

as the best measure of a taxpayer's ability to pay tax, and I think that that type of progressivity, roughly speaking, is an appropriate measure.

Mr. CRANE. But is it ideal as it exists right now?

Mr. SAMUELS. It is hard to say anything is ideal. I think that is a reasonable—that is a reasonable——

Mr. CRANE. Well, let me ask this question hypothetically. Personal income, that top 1 percent of the taxpayers could probably pay 30 percent of all of the taxes, right?

Mr. TODER. I think——

Mr. CRANE. They would have a better standard of living than the bottom 20 percent?

Mr. TODER. Yes.

Mr. CRANE. Yes?

Mr. TODER. You are asking if the top 1 percent have a better standard of living than the bottom 20 percent?

Mr. CRANE. If their taxes were raised to say 30 percent of total taxes that we are taking in, they would still have a better standard of living than the bottom 20 percent of taxpayers, right?

Mr. TODER. That is correct.

Mr. CRANE. So that would even be preferable to the existing system in your estimation?

Mr. TODER. No, I don't think Mr. Samuels was saying that. I think what he is saying is that it is appropriate for people in the higher income brackets to pay a higher percentage of their income tax.

Mr. CRANE. To be sure, I got that.

Mr. TODER. I don't think he said that any level——

Mr. CRANE. Well, then, let me ask this question quickly before time runs out. If they paid 16.5 percent of total revenue out of their personal income, and the bottom 20 percent paid 8.6 percent, that would be unfair; is that your estimation?

Mr. SAMUELS. Mr. Crane, I think that the question is if you wanted to raise the same amount of revenue that we are—pick a target and apply this progressivity to it, the existing revenue that we are raising, I don't see how one could design a system that would take the numbers that you used and raise the revenue that we need. Somebody is going to have to——

Mr. CRANE. Well, except on your chart over here, you are raising the same amount under this consumption tax approach as you are raising under the existing tax structure.

Mr. SAMUELS. Right.

Mr. CRANE. But you are saying under the consumption tax, that the top 1 percent of taxpayers would be reduced in their total payment from 24.5 percent of the total to 16.4 percent of the total. And I am asking, is that evidence of unfairness?

Mr. SAMUELS. I think what would be—give me great cause for concern is the fact that the top 1 percent, who have the effective rate of 16.4 percent, are paying less as an effective rate than the people in the third and fourth and most of the fifth quintile. So you compare them to the people in the second—I am sorry, the third quintile, who are paying 18.8 percent of their income as an effective rate. Why is the top 1 percent—as a matter of judging the fairness, should they be paying less than the people in the——

Mr. CRANE. Because you are comparing 1 percent of the population with 20 percent of the population.

Mr. TODER. No. We are talking about the taxes as a percentage of their income, not their share of taxes. So it would say if somebody had $200,000 of income, they would pay $32,000 in tax at a 16 percent rate, and if somebody had $50,000 of income, they would pay $9,000 in tax at an 18 percent rate. That is the comparison that we are making here.

Mr. CRANE. All right. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

Mr. Samuels, having read your testimony and then listening to your responses to the Chairman, I wind up, I think, much in the same position as my friend from Florida. It is difficult to ask you any questions, because I think I know what the answer is going to be.

But you need to understand the level of frustration for us, and I mean on a bipartisan basis. When you respond to the Chairman that you are not going to criticize, you are just going to examine the pluses and minuses of the various proposals that are going to come before us, I shook my head at that point and went to the dictionary; and "criticize," on page 308 of the Webster's Ninth New Collegiate Dictionary, says: criticize, number one, to consider the merits and demerits of and judge accordingly, to evaluate.

That is what I thought criticism was, and you said you are not going to do that, you are just going to examine the pluses and minuses of various proposals.

You know, when you use the retiree example and the need for transition rules, maybe some of us here don't have a long enough memory to recall what we did in the 1986 tax bill to folks who were retiring without a transition rule on a retroactive measure which destroyed people's plans, based upon the belief that government would do what government said it was going to do and then didn't. And I think that was just part of the ground swell that has led us here today. And, frankly, people sitting at this table were part of that, OK?

So when you come in and preach to us about the need not to deal with theory, but to deal with the real world, and when you presume to tell us what is going to come out of the congressional process and that you know it is not going to be what we are talking about, frankly, I will stack up what we say we are going to do with this new Majority in comparison to what we do with your administration, Mr. Samuels.

It is a little galling to have you tell us you know we are not going to do what we say we are going to do, especially when you have seen that the fundamental changes that are proposed are being proposed on a bipartisan basis, that there is a level of frustration here that transcends the partisan question.

So when you find us talking to you, or Mr. Gibbons simply throwing up his hands saying, I don't have any questions for this person, you need to know that it is based upon a frustration with the recent past in trying to deal with the present system.

And when you sit and give us testimony that you know we are not going to deliver what we think we are going to deliver—which

argues to me that we start with the bolder concept since you have now told us it is going to get whittled back—but then that your request is for something far less than kind of basic rethinking, you know we are going to get less than that even, if, in fact, you are correct; and when you tell us that you are shooting for fairness, efficiency, and simplicity, that is awfully close to fairness, simplicity, and growth, which was the whole pursuit of the eighties in terms of the Tax Code. And so it is very difficult for me to sit here and listen to this administration, first of all, tell us what we are going to do in the legislative process, but not offer any alternative.

The Reagan administration during that period, Treasury offered Treasury one and Treasury two, which were fairly bold flat tax concepts, which at least showed they were thinking about the issue. They were willing to engage.

You have told us you are not willing to engage in fundamental tax proposals. But that is nothing new; you weren't willing to engage on the budget, you didn't engage on welfare, you haven't engaged on reform in the health system, you are not engaged in the Medicare reform, so, gee, what is new, you are not engaged in tax proposals either.

So you sit back and criticize. You tell us the pluses and the minuses of the ideas that we are offering, which obviously are theoretical because they are not in place. But, Mr. Samuels, if you and your President really want to participate in an area that needs fundamental change, you are going to have to participate. Sitting back on some higher level and offering criticisms of the work product that we are going to be presenting and telling us that we are not going to be able to accomplish what we are trying to accomplish isn't worth very much.

You occupy an important position. The Chairman has said that you have enormous resources on hand. You are cheating the American people by not participating in a very active and aggressive way.

Chairman ARCHER. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Archer. I think sometimes things can be looked at differently. Mr. Thomas and I were both here in 1988 and there was Treasury one and Treasury two. But I do remember Secretary Baker sat down there day in and day out as we did tax reform and he did exactly what you suggest, Mr. Samuels, you were going to do. He very definitely told us the pros and cons of the various things that we were looking at, the various votes that we took and how we moved forward in tax reform. And I think that over the years that has been the relationship of the Congress with the Treasury.

In fact, I am quite sure Mr. Archer is very committed to this consumer tax, as Mr. Armey is very committed to the flat tax; and I think every one of us at this table and on the other side in the Senate knows that the system right now is very complicated and needs reform. So I am quite sure, Mr. Samuels, that you will be right there telling us what would happen if we did certain things; and I am totally convinced that the Congress, no matter who is in the Majority, will do exactly what they want.

So I think what is happening here this morning is just a difference in semantics for how we look at things.

Yesterday——

Mr. THOMAS. Will the gentlewoman yield just very briefly on that point?

Mrs. KENNELLY. Sure.

Mr. THOMAS. I think it is telling, because I think you are accurate in that—but I think it is ironic that you used Secretary of the Treasury James Baker as the example who sat down with us day after day and talked about the changes. We asked for Secretary of the Treasury Rubin to come, but they chose not to send the Secretary of the Treasury, they sent someone else. So when Les Samuels is going to be sitting there, compare that with the previous commitment of the Secretary of the Treasury sitting there and working out the details. I thank the gentlewoman for yielding.

Mrs. KENNELLY. Mr. Samuels, yesterday Dr. Kotlikoff was here from Boston University and he testified that he thought since the Treasury and the IRS had made such advances in electronics, that there could be a card that every family could have, that as they bought consumer goods would tally their tax and then when April 15 came the IRS could figure out what taxes these people owed or if they were going to get a refund.

Could you tell me, knowing what you know now about the IRS and the Treasury, is this something that is possible, and if possible, could this really happen in the near future, or would this be something that would take huge changes in the system to bring this about?

Mr. SAMUELS. Mrs. Kennelly, we have been spending a lot of time thinking about modernization of the IRS and enhancing their computer capability. As you know, they have a long-term program—tax systems modernization that they have been requesting funding, so that they can do a much better job, and seeing the problems that they are having in getting that funding. And I would hope that Congress would respond and properly fund them so that they are able to not only collect the taxes, but provide better service to taxpayers. That is a fundamental part of that proposal.

Mrs. KENNELLY. So you think this was a practical proposal?

Mr. SAMUELS. No. I think that that type of proposal would need an enormous amount of work, and a very significant commitment of resources, including financial resources, to have basically the capability to try to make it work.

I am not familiar with the details of that particular idea, and I would be happy to consider it. We have thought about cards in other contexts and have run up against various administrative problems, so I just—I would want to know more about the proposal before I would be able to make any judgment.

Mrs. KENNELLY. Thank you, Mr. Samuels.

Quickly, in your written statement, you talked about taxation of existing wealth, and I agree with you. I think one of the things we have to look at as we look at a new tax system, or the possibility of a new tax system, is what happens in transition. As we know, the older members of our society have a great deal of the wealth at this present time in the form of savings. And yet if we leave that in place as we transfer it into a new system, it would mean the rates would have to be higher for the working individuals.

Mr. SAMUELS. Right. And, in fact, if you don't tax existing wealth, you effectively have—you have turned the consumption tax into a wage tax. That is, if you talk to the economists, that is what you have.

Mrs. KENNELLY. So as a policy, you would say you would have to tax existing wealth in savings?

Mr. SAMUELS. I think the economists and Mr. Toder here can comment on it. They all assume that in order to get the efficiencies in talking about a consumption tax that you would, in fact, tax existing wealth. We think that would raise very serious problems.

Mrs. KENNELLY. Because it would be aftertax dollars?

Mr. SAMUELS. Yes.

Chairman ARCHER. The gentlelady's time has expired.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Samuels, do you believe that there is a lot of public dissatisfaction under the present Tax Code?

Mr. SAMUELS. Mr. Bunning, absolutely, yes.

Mr. BUNNING. Do you believe also, then, that the burden of proof should be placed on those who defend the current tax system rather than on those who want to change it? In other words, if you think that there is a public upheaval occurring in this country about the Tax Code, those who want to defend it ought to be able to defend it and those who want to change it ought to be the ones that are encouraged to get the job done, that is my followup on Chairman Archer's questioning of you.

Why wouldn't the administration, recognizing the public dissatisfaction with the Tax Code, come forward with a proposal to do just that?

Mr. SAMUELS. Mr. Bunning, I think that when you look at the dissatisfaction with the tax system, which we agree is there, when you—and I saw a recent poll that was quite interesting, it asked about dissatisfaction with the tax system, and a majority said, yes, they were dissatisfied, they would like to have substantial, fundamental reform.

Mr. BUNNING. They want a fair Code.

Mr. SAMUELS. And they also said that—a majority of those people also said, one, they want a progressive income tax and, two, they wanted to maintain itemized tax deductions.

Mr. BUNNING. I have never ever heard anybody say they want a progressive income tax. In fact, just the opposite. I have seen polls that say we don't want an income tax, period.

Mr. SAMUELS. I am just telling you the poll I saw. It is interesting to see. There are different polls. This was a poll that was just taken that I saw, and that was, because people in some ways they like kind of the basics of our current income tax system in the sense that it is a progressive income tax and provides——

Mr. BUNNING. That must be a Treasury poll, because I have never seen that anywhere public.

Mr. SAMUELS. No, it was not a Treasury poll. They also like certain incentives in the income tax, like home mortgage deductions, charitable contributions, pension, the pension system.

Mr. BUNNING. Only if the current type of system is continued. In other words, if everybody is treated fairly and we take out all deductions and all exemptions, then everybody seems to be OK, you can do whatever you want so long as the public sees that it is fundamentally fair.

Let me ask you, if I asked the question across the country do you think the United States should do away with the IRS, what kind of response do you think I would get?

Mr. SAMUELS. Well, since no one likes paying taxes, I haven't found anybody that likes to pay taxes, when you ask whether they would like to get rid of the IRS, I think most people would say I would like to live in a country where there are no taxes collected, and one doesn't have to deal with any tax administration. The IRS, obviously, they have a very difficult job administering the laws that are written by Congress. That is a tough job.

Mr. BUNNING. You realize the tax system currently is a voluntary tax system.

Mr. SAMUELS. It is, and we should be extremely proud of it. And that part of it, the voluntary nature of the system is something that is, I think, a tradition here in this country. On the other hand——

Mr. BUNNING. Mr. Samuels, let me just get to the point I am trying to make. Are you defending the current system? That seems to be the case based on your testimony.

Mr. SAMUELS. I don't think I am defending the current system. What I have said that we simplify, I said we need to simplify our existing system.

Mr. BUNNING. Can I quote you at different functions that you have gone to where you have defended the current tax system, in other words, you have said if somebody wants to change this system, they better have a good reason for doing it because this is the system that is in place, even if it is bad?

Mr. SAMUELS. No, I haven't said that.

Let me just say in my testimony today, as I said, I think that the proponents of changing the entire system, that is getting rid of the entire income tax, the individual income tax and the corporate income tax have a high hurdle to meet, and the comparison is what can we do to our existing system to make it better. There are a number of things that we could do to our existing system that would relieve burdens on taxpayers.

Mr. BUNNING. Mr. Samuels, if we don't change the current system, the compliance or the voluntary part of it eventually will be severely eroded and that is what is happening presently. Voluntary compliance is eroding and the voluntary system will fall apart if we don't change and make it more simple for people to comply. Thank you.

Chairman ARCHER. Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Samuels, in your testimony you stated that you are concerned that any consumption tax Congress may enact could be excessively complex.

Do you seriously believe that a new consumption tax would be as complex as the current system?

Mr. SAMUELS. Mr. Herger, I think it depends on the form of a consumption tax. I think when you look at the proposals that Senators Nunn and Domenici have set forth, and by the way, I commend them for their proposal, it is detailed. They spent an enormous amount of time thinking about how to make their system work, and when you look at that system I think you have to conclude in evaluating it that one of the serious questions is its complexity, and you could wind up in a system where you are basically collecting the consumption tax at the individual level, that you could wind up with a more complicated system because you have to keep track not only of your consumption, but the way you keep track of it is you look at your income, then deduct from it your net savings, and calculating your net savings is a brandnew calculation that taxpayers now don't have to do.

You don't have to keep a balance sheet now, thank goodness. We have a complicated enough system as it is. Under a consumed income tax system you would have to keep some kind of balance sheet, and Senators Nunn and Domenici have tried to minimize that burden in their proposal, and they have spent a lot of time at it, but it is still a new level of calculations in determining your net savings the taxpayers have to make that they don't have to make now, and we think that that additional computation would lead some to think that it is more complicated than the existing system.

Mr. HERGER. So much of the complexity of our tax law today is because of the years and years of additions and underbrush, if you would, of refinements. Wouldn't doing away with that also do away with all that underbrush and at least in a new system we would be starting new and would not be nearly as complex as the system we currently have? I mean, what you describe sounds very simplistic compared to what we go through today.

Mr. SAMUELS. I think that the——

Mr. HERGER. In comparison.

Mr. SAMUELS. Right. The issue is when we are talking about consumption taxes, and I think one of the things that we hope we could add to the discussion is trying to explain what, in fact, people mean when they talk about the consumption tax.

I am sure you will have other witnesses, along with economists, as you go through these hearings that will also provide that information. It is a theoretical model, and moving from that model to our very complicated and sophisticated economy, we have the largest economy in the world. We have the most complex economy in the world, and as you think about starting over with a brandnew tax system, you are going to run into a whole series of issues, like these transition issues of how to deal with the taxation of existing wealth under a consumption tax. Under a consumption tax, if you don't have a transition rule, people who have earned money under the income tax system and paid taxes have now saved money in aftertax dollars. They have their $100,000 in the bank and they are retired and now they are dissaving because they are spending some of their savings in their retirement.

To move just cold turkey into a consumption tax, they will pay consumption tax when they spend down their savings. They will be taxed twice on their efforts, and that is, I think, a very serious question as to how to deal with that issue.

Mr. HERGER. My time is almost up, please excuse me, but you are now referring, as I understand it, to a transition period which obviously we will have in any type of change we make, but it is a transition period that we will work through, I think the point is. I don't know how we could have a system that is more complex as is perceived by the American public, the American taxpayer, than what we have now.

I share the concerns of those who have questioned before me on the fact that we seem to see a trend now with the administration. We had Secretary Shalala who was here on the Medicare bankruptcy. No suggestions from the administration, no plans.

We see you here representing the administration again on taxes, again no plan, no timetable when, if ever, we will have a plan. I believe that if there is a reason for the American public perceiving the President as being irrelevant, it is precisely because of this. We aren't seeing any plans, we are not seeing any leadership, and I think this is regrettable. I believe the American public deserves much more than what we are seeing. Thank you.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Thank you. Mr. Samuels, I think the frustration with the present system is bipartisan, and I hope that the response can be accordingly. I think the question is whether we are going to use that frustration in part for political purposes or if we are going to respond to it. I hope we respond to it. So let me just ask you, because I think, in a sense, the issue is clear, and that is whether we are going to undertake major reforms in the present system or discard it and essentially totally replace it.

The answer may not be simple. I don't think it is, but the issue is clear. I think that essentially your position today is one of reforming the present system or your preference or your tendency rather than totally replacing it. Is that a fair characterization?

Mr. SAMUELS. Mr. Levin, I think that that is a fair characterization in the sense that we are concerned about the consequences of trying to apply a model that no other country in the world has adopted to the most complex and largest economy of the world, and we think that there are significant things that you could do with the existing system that would go a long way to satisfying or trying to meet and reduce taxpayer frustration.

Mr. LEVIN. All right. In answer to Mr. Crane you said on complexity it is much too complex; it needs improvement.

Mr. SAMUELS. Absolutely.

Mr. LEVIN. You gave it a decent grade on fairness, but also a somewhat poor grade on efficiency.

Mr. SAMUELS. Right.

Mr. LEVIN. So now the question becomes whether you have some proposals relating to complexity and inefficiency. In your testimony, you referred to the Technical Corrections Act of last year. Will you have some proposals relating to complexity and efficiency?

Mr. SAMUELS. Mr. Levin, we are actively working on those proposals and the types of things that we are considering are issues of trying to—we have asked people about what they don't like about the system, and for example the so-called Pease and Personal Exemption Phaseout is something that people find excessively com-

plex, so I think one ought to kind of look to see about how one would eliminate that.

The individual AMT is too complicated, needs to be reformed. We have—as an example, we have 3 million people filing AMT forms and only 300,000 people pay the AMT. There is no reason why we need to have all those people filing forms that don't owe AMT.

Mr. LEVIN. So I think, then, is your answer that you may not be coming up with a totally new system in terms of a proposal, but you are going to be proposing some major reforms in the present system?

Mr. SAMUELS. We are going to be proposing what we believe will have a material benefit on the simplification front.

Mr. LEVIN. OK. When do you think that will happen?

Mr. SAMUELS. We are working on it. We have a series of ideas. I don't have a timetable as to when they are going to be released, but we are working on some actively, and I think one set is going to be released relatively soon.

Mr. LEVIN. All right.

Chairman Archer, I think, is perhaps interested in the answer to that. You are going to be coming forth with some proposals.

Let me ask you, yesterday we heard testimony that the cost of compliance was $202 billion. Mr. Hall suggested that the annual cost is based on 5.1 billion hours of work. Is that at all in the ballpark, do you think?

Mr. TODER. We have not looked very closely at that. From what people have advised me, that number, we think, is too high, but we would be happy to supply you with an analysis of it.

Mr. LEVIN. So whatever the number is today, it is too high, the compliance; is that correct?

Mr. TODER. Absolutely.

Mr. LEVIN. And so there is a basis for frustration among the public?

Mr. TODER. That is correct.

Mr. LEVIN. And the administration intends to present some specific proposals that relate to complexity as well as efficiency?

Mr. SAMUELS. Correct.

Mr. LEVIN. Will you in the next week or month, if possible, give us some kind of a timetable as to when those proposals will be presented?

Mr. SAMUELS. Sure.

Mr. LEVIN. You will?

Mr. SAMUELS. Yes.

[The information was not received at the time of printing.]

Mr. LEVIN. OK. Thank you. My time is up.

Chairman ARCHER. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Samuels, we have kind of had a basic philosophy on taxation that the best tax is a tax with as broad a base as possible and as low a rate as possible. Would you concur in that thinking?

Mr. SAMUELS. I think that that is an objective that we should try to achieve.

Mr. HANCOCK. I said yesterday I didn't think this ever would happen in my lifetime, that we would really be holding hearings considering elimination of the income tax. I would like to see it

done and as quickly as possible, but under those circumstances, even though we realize it is going to be a slow process, we are going to be extremely deliberate. We are talking about major, major changes in the way we finance the Federal Government.

Would Treasury or anybody consider an absolute total moratorium on any changes whatsoever in the income tax laws and regulations, just leave it the way it is so that the public could understand what they are dealing with? I mean, would Treasury even consider it or would the administration even consider making that recommendation to the Congress until we can work out something better?

Mr. SAMUELS. Mr. Hancock, I think we believe that we should be giving simplification greater weight in all legislation that is currently under consideration. That is a serious issue right now. We all know people are frustrated, and I think that we should all, in considering legislation and regulations, give simplification a much greater weight.

On the regulatory side, we have recently announced a proposal that we have asked comments on where small businesses will be able to decide whether they want to be a corporation or a partnership by checking a box to get rid of all the difficulties of deciding whether an unincorporated entity is a corporation or a partnership. So we have been—we are committed in our regulatory process to simplification.

On the legislative side, I would urge the Committee to take simplification into account and give it a much stronger weight than it has in the past because of the frustration the taxpayers have. We know we have a system that is too complex, and it is tilting. It is tilting over. There is no doubt about it. So I would hope that that would be the case, and I think that—when you talk to tax practitioners, one of the things that they say is that the constant change of the tax law is one of the things that, for them, is the most frustrating, that they get to understand something and then the law is changed. So the idea to slow down the change in tax law, I think, is a valuable one.

Mr. HANCOCK. In my business career, in my life, you know, I have lived through several simplifications, and it got so simple that I can't figure it out.

What I am asking you is would the administration and would the Treasury recommend to the administration or somebody that we just leave it alone at least for a couple of years so the practitioners and the businesspeople and the people that are planning the estates would know what they are dealing with. I mean, a 5-year moratorium or a 4-year moratorium or something because you can do something 1 day and then find out they have already made a regulation that messed it up. I am not talking about simplification. I am just talking about saying, look, leave it the way it is until we can work out something, a major change, would Treasury recommend that?

Mr. SAMUELS. Mr. Hancock, what we would recommend is that as Congress is considering legislation that they give simplification a greater weight and in the meantime, while they are considering this, there are some things that I think Congress could do to simplify the existing system, so I think that would be how I would do

it. I think the system now is so complex and there are so many problems I think there are some things that could be done. I wouldn't want to wait 4 or 5 years while everybody has to live with——

Mr. HANCOCK. Here again, when I hear Treasury and Internal Revenue talk about simplifying something, I get nervous. I get real nervous.

Quite frankly, I think there are a lot of people out there who think don't try to simplify it again, just don't change it at all for a while. I mean just leave it alone for a while. We have got a depreciation schedule now. Let us live with that one; don't hit us with a different one next month. Anyway.

Mr. SAMUELS. I think, as I say, we have said before, we think that constant change to the tax law is a serious problem in terms of the issue of complexity and frustration, so I would think that given all the frustration that is out there that we ought to give significant weight, much more weight than we have in the past to simplification in considering tax law proposals.

Chairman ARCHER. Mr. Hancock, your time has expired.

Mr. Camp.

Mr. HANCOCK. Thank you.

Mr. CAMP. Thank you, Mr. Chairman.

Mr. Samuels, in your opening statement you state that frustration with the current tax system is unacceptably high, and you also say that this frustration is a serious problem, and I think in response to one of the questions from Mr. Bunning, who asked you if there was a lot of dissatisfaction with the current system, you responded absolutely in testimony today.

Are those all fair characterizations of what you think about our current tax system? Yes or no?

Mr. SAMUELS. That is my view of how taxpayers are reacting to today's tax system.

Mr. CAMP. Would some of those causes be—in response to Mr. Levin, you mentioned the complexity, the inefficiency, the equitability of the system, complexity, even the audit process, the fact that small business people literally have to hire a professional in order to prepare your returns, would all those be some of the reasons that you make the statements you do about the frustration with our current system?

Mr. SAMUELS. I think that there are a variety of factors in the frustration. One is the sheer complexity of the system. It is interesting, about over 70 percent of taxpayers claim the standard deduction, but about half the taxpayers go to professional preparers.

Obviously, you know, if you have half the taxpayers going to professional preparers it is because they are intimidated by the system. They don't think it works very well.

I also think that there is a sense among some that they are frustrated with the system because they feel that there are some taxpayers, very wealthy taxpayers, big companies who aren't paying their fair share because of loopholes and so forth, so that they are frustrated about that as well, so I think it is a variety of problems.

Mr. CAMP. Do you think the taxpayers are satisfied with IRS audit procedures?

Mr. SAMUELS. I don't——

Mr. CAMP. I know obviously you have thought about this issue if you have testified that taxpayers are frustrated with the system. Do you think they are?

Mr. SAMUELS. I think that the IRS has been given—has a very difficult job of administering this complicated system, and I think that we—my personal view is that we should be proud of all of the employees who are doing a difficult and, to some extent, unwelcome task under difficult circumstances, and I think that they are trying to do their best, and I think that, obviously, no one likes——

Mr. CAMP. Do you think the procedures in themselves are such that they would cause taxpayers to be unduly frustrated with the system, the fact that there are reach backs, the fact that they may be audited and their audit is approved and then a few years later the IRS issues a regulation and changes that procedure. Do you think that might cause some problem?

Mr. SAMUELS. Actually, I think if you look at—one of the issues that has been discussed is actually the decline in audits by the IRS over the years so that the audit rate has gone down, so it is hard to engage in that question. There are very, very few——

Mr. CAMP. Let me move on to something we do agree on. We do agree there is a growing dissatisfaction with the current income tax system. Wouldn't it then seem proper to consider an alternative system, given that huge amount of frustration?

Mr. SAMUELS. I think we should consider alternative systems and consider how we could make the existing system substantially better.

Mr. CAMP. I know you mention in your testimony that the consumption tax, your concern is that it may be regressive.

Mr. SAMUELS. That is correct.

Mr. CAMP. OK. Would you suggest exempting some specific items?

Mr. SAMUELS. No, no, absolutely we have not said that. We think that as one tries to deal with regressivity, that is, if you look to the Europeans that have VATs, that is one of the ways that they try to deal with regressivity is by providing exemptions for specific items or having different rates, and I think that their experience is that when they do that, that introduces complexity into the system and also it doesn't do that much to address the problem of regressivity because if you exempt an item, you exempt it for all taxpayers, not just the low-income taxpayers.

Mr. CAMP. So you would not advocate exempting certain goods and services or changing rates?

Mr. SAMUELS. Absolutely not.

Mr. CAMP. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Samuels, thank you for your testimony today.

Chairman ARCHER. Mr. Cardin, could I ask you to suspend just a moment? Please don't take this out of his time.

For the benefit of everyone and their schedules today, we plan to take a break between 1 and 2. We will not be in the hearing room between 1 and 2. You may proceed.

Mr. CARDIN. Thank you, Mr. Chairman.

In response to some of the questions that have been raised by my Republican colleagues, I think it would be premature and perhaps irresponsible for either the Republican leadership or the administration to come forward with a specific proposal to change our current tax structure, knowing the sensitivity of the markets and the fact that riding here from Baltimore this morning the stock exchange reached an all-time high.

I am not so sure it would be a good idea to put out there a specific proposal, particularly when we haven't had the Committee hearings necessary in order to try to formulate some national consensus as to which way we should move.

Mr. Chairman, I have been very complimentary of the fact that we are holding these hearings. I think we need to hear about the current tax structure and various proposals that are under development, but I think it would be premature for the administration to come down on a side of this debate, and I am glad to see that you are here participating with us.

I happen to believe that it is time to radically change our tax structure and believe that we need to move from an income-based tax to a consumption-based tax.

Mr. Samuels, I would appreciate some of your thoughts here. I think many of us have been fixed on the income tax because in our college classes we learned that if we believe that ability to pay should be one factor in collecting taxes, the income tax is the easiest way to get at that, but it seems to me as we look at the evolution of the current income tax here in the United States, we find that it has become so complex and that the progressivity of it has been compromised to such a point that perhaps we could work with consumption-based tax and accomplish the same progressiveness as we do under the current income tax structure. I point out the fact that many of us are concerned about the current use of the income tax or concerned about the savings ratios in this country which are at a historically low level.

In just the last 12 years we have seen that the savings ratios in this country have dipped about 50 percent. We are close to what it was in 1929, which should alarm all of us. From the international competitiveness standpoint, a consumption tax makes our companies more competitive internationally because it is border adjustable. My question to you is that you have raised the three standards which I agree with—efficiency, fairness, and simplification. They are very important factors.

You have acknowledged the fact that the current structure is less than simple and has some shortcomings as to efficiency. As far as fairness, couldn't we construct a consumption-based tax that brings out fairness through use of low-income or modest-income tax credits or perhaps combining it with some modified income tax for higher incomes?

Couldn't we construct such a tax structure that, in fact, could meet your definition of fairness using consumption rather than income?

Mr. SAMUELS. Mr. Cardin, I think that it is theoretically possible to design such a system, and I just would mention that you were talking about the nature. You said, well, we would have a consumption tax and then also some kind of income tax.

Mr. CARDIN. Well, maybe a modified tax, but certainly not——

Mr. SAMUELS. Some kind of modified tax, and I think that is what Senators Nunn and Domenici have tried to achieve with their proposal is to try to deal with the progressivity issue. I think that when you—we are very concerned about the savings rate. It is abysmally low and needs to be increased, and I think the issue is how much can tax policy affect the increase in the savings rate, and I think that when you look at the evidence that the economists have generated through their studies, it is unfortunate because thinking as a logical matter, well, if you reduce taxes or you increase the aftertax rate of return on savings, savings should go up.

I wish that were the case, but when you look at the economic studies that have been done, they don't have evidence that there would be more than a small or negligible change. And so the question is do you want to change the entire system for something where the economists have been working for years, we don't have extraordinarily good evidence that it will work, and you think about all the disruptions that will occur to the economy and to people in terms of the prices and wages, the prices of goods, the value of assets, all of those things you have to think about as a cost of going to a new system.

Mr. CARDIN. These are very valid questions and ones which I hope we will examine as we determine which way we want to move on our tax structure. We have two competing thoughts out there, a flat tax versus a consumption-based tax. I hope we gel around the consumption-based tax.

Obviously, as we move toward dealing with the issues of fairness, we will be introducing complexity. There is no question about it. There is that tradeoff. But it seems to me there is also a balance here, and we could reach a better balance using a model of a consumption-based tax than we can our current income tax and I would welcome your thoughts as we move through these mazes as to how we can try to accomplish all of these goals. Once again, I appreciate your presence here today. Thank you, Mr. Chairman.

Mr. CRANE [presiding]. Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman.

Mr. Samuels, you just said that a consumption tax would have an impact on the value of assets, on wages, and on goods, but in your initial testimony you and Mr. Toder said that it may not have any effect on savings or interest rates. How do you square those two views, that it could have profound impact on the economy, but won't do the kind of things that we think it might do for the economy?

Mr. TODER. Yes, Mr. Zimmer, we believe that people hold very different kinds of assets, and we believe depending on what your asset position is, whether you are invested in houses or corporate equities or bonds, your wealth would be substantially altered or could be substantially altered by changing the tax system.

It will affect the different returns on different kinds of investments in a very big way. The point that I believe that Mr. Samuels was making is the main overall effect is that the aftertax rate of return to saving will go up because we will no longer be taxing the return to new saving. We think as a theoretical matter that it would raise the rate of saving.

However, when we look at all the studies that have been done by the OECD, by many economists, we don't really find very much evidence that aftertax rates of return affect saving very much, so while we do believe it will have many different effects across industries and across people depending on people's circumstances, we don't believe that the overall effect on the economy will be very large in the long run. I think there will be adjustment costs which will be very significant.

Mr. ZIMMER. You have also said that a consumption tax won't reduce interest rates because interest rates are set by the international market in debt securities. That is interesting because——

Mr. TODER. We believe they will come down a little bit, but not very much.

Mr. ZIMMER. OK, good. How much?

Mr. TODER. I can't give you a precise figure, but——

Mr. ZIMMER. The reason I raised this is because your boss, Secretary Rubin, sat in the chair where you are and told us that the reason why U.S. interest rates declined over the first part of the Clinton administration, and even before that, was because of the policies of the Clinton administration, and so I wouldn't ask you to contradict Secretary Rubin, but do you believe that international factors are much more important than domestic fiscal policy on domestic interest rates?

Mr. TODER. We believe both have an effect. We also believe that changing the Federal deficit would have a much bigger effect on the national saving rate than changing the tax system, and so we think there was a much bigger effect from deficit reduction.

Mr. ZIMMER. I think we are in agreement that reducing the deficit would, in fact, lower interest rates, which is why we are pushing forward for a balanced budget. Other than balancing the budget, could you name any other steps that you believe would either increase the savings rate or reduce interest rates?

Mr. SAMUELS. Mr. Zimmer, we think that targeted savings proposals through the pension system may increase savings. The House-passed tax bill has some new incentives for IRAs, the President's budget has new incentives for IRAs that are somewhat different than what the House passed, so we think that those are the types of savings proposals that we ought to be thinking about, how to make the pension system simpler so not so much money is spent on administration, and more of that money can be kept in the pension system and investment, but those are the types of things that we think would be helpful for the tax system to do, but we shouldn't expect the tax system is going to solve our low savings rate.

It is very interesting, and it is actually kind of distressing that our trading partners, it is just not the United States whose savings rate has gone down. Our major trading partners' savings rates have gone down. We have been kind of the leading edge, but the OECD has done a report and shows that our trading partners' savings rates have gone down, and Japan who has the highest savings rate, they have the lowest consumption taxes. Their consumption taxes are quite low. So I wish I could, from my position, I wish I could figure out some important ways that tax policy could make a real significant contribution to increasing savings, but when you

look at the experience here in the United States and look at the experience of other countries, there seem to be so many different factors that tax policy is not going to drive increases in savings rates in the way that we hope they would. We are frustrated about it, too, and think that this is an extraordinarily serious problem for the country.

Mr. ZIMMER. One final question. Do you believe that the IRA proposals that the President has made and those that are in the House bill will or will not increase savings rates in the aggregate?

Mr. SAMUELS. We think that there are differences between the proposals.

Mr. ZIMMER. Well, the President's.

Mr. SAMUELS. We think the President's proposals will have a positive effect on savings of middle-income Americans to whom it is targeted. We developed those proposals to give people a choice to kind of feed into the existing IRA system that people understand and know and so we think that it will be a positive contribution to improving the savings rate. But we also, I think, all have to realize that it is not going to solve our national problem. It is a step, but we shouldn't assume that it is going to solve the problem.

Mr. ZIMMER. Thank you.

Mr. CRANE. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. Mr. Samuels, I can only give you one example of how the tax policy affects savings, and that is mine. I save all year to pay my tax liability on August 15. I save past the April 15 deadline with an extension to pay those taxes.

I find it interesting you changed within an hour's time from when Chairman Archer asked are you going to come forth with any type of proposals to when Mr. Levin asked you the same question. Now, which one of those answers did I misunderstand or understand?

Mr. SAMUELS. Mr. Collins, I explained to Mr. Levin, who said we have some proposals to simplify the existing system. I mentioned in my testimony the Simplification and Technical Corrections Act which the House passed last year, which we asked, we think that that is an important bill. It will improve the current system.

Mr. COLLINS. I did understand, then, you are coming back with some type of proposal for simplification?

Mr. SAMUELS. We are working on simplification ideas, and we will be coming up with simplification proposals for our existing system.

Mr. COLLINS. I find it of interest, too, that you have compassion for a taxpayer who has accumulated, as you put it, wealth. Do you not have compassion for those taxpayers who leave an estate that you tax? This wealth is an aftertax accumulation of wealth, is it not true?

Mr. SAMUELS. Our estate tax depends on the composition of a decedent's estate. Some assets in the estate, for example, assets that have unrealized capital gains are taxed not on the capital gains, but on the estate tax.

Mr. COLLINS. Assets in an estate are accumulated after tax. You have compassion one way, but you lose the compassion the other.

Mr. SAMUELS. No, I wouldn't agree with that, Mr. Collins.

Mr. COLLINS. You don't agree with many things anyway. That brings me to the next point that you say you are willing to work with the Congress, but every time I see you sitting across on that side you are countering anything that is proposed, changes that this side of the aisle proposes. You are over there countering those measures, but yet you are willing to work with the Congress. So I am not surprised that you have a difference of opinion on the last question.

Is it not true that we already have two systems of taxation; one is income and the other is consumption?

Mr. SAMUELS. Mr. Collins, actually our current income tax system is a hybrid of an income tax and a consumption tax system. We already have elements of a consumption tax in our existing system, and those elements are our pension system, where we give people a deduction for contributions to their pensions or their IRAs, and in addition we, the way we treat residential housing, owner-occupied housing is similar to a consumption tax system.

Mr. COLLINS. How about excise tax, motor fuel tax and taxes of that nature?

Mr. TODER. We have those taxes, but they account for a very small proportion of total Federal revenues. Other countries' consumption taxes account for a larger proportion of their total revenues. I think the consumption tax at the State and local level are more important.

Mr. COLLINS. We do have the two systems at the Federal level, too, but you mention intimidation. You know, the IRS is the most intimidating agency that I hear complaints about from my constituency. Have you felt intimidated by the threat of abolishing the IRS?

Mr. SAMUELS. No, sir.

Mr. COLLINS. Let me just ask you this. When I hear the question asked to constituents do they favor revamping the current system, very few say, yes, but when you ask about a flat tax versus a consumption tax, usually it is split about 50-50, but if you mention at all abolishing the IRS, it is usually unanimous. The intimidation is real among people.

Have you ever been audited?

Mr. SAMUELS. Yes, sir.

Mr. COLLINS. You have. Did you feel intimidated then?

Mr. SAMUELS. One, I would say, never likes to go through that experience.

Mr. COLLINS. The answer is, yes, with the intimidation? Well, I am glad you were intimidated at one time or another.

Thank you, Mr. Samuels.

Chairman ARCHER. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman, and thank you, Mr. Samuels, and Mr. Toder, for your testimony today. I think as you have heard today and as we heard yesterday, there seems to be a broad consensus on the Ways and Means Committee on both sides of the aisle that the tax system that exists is broken. It is badly broken and it needs to be fixed, and I, yesterday, commended the Chairman and I do again today for bringing forth these hearings to talk seriously about how that might be done.

Let me see if I understand where you are relative to that same proposition. First of all, I understand you to say that you agree that the present system is broken and needs to be fixed, and so you are certainly in agreement about that. You also say to move from the income tax to a consumption tax and do what the Chairman said yesterday which is to pull this system up by the roots and throw it away so that it won't come back is, in your view, a very radical fix.

You mention that you see such a change as a major risk and we could incur major costs as a result of it. Then you go on to say nobody really knows what would happen if we made such a change and there is no other country that has ever done it, and so forth. The difficulty with that is how is it that we could ever make radical changes, then, in the system, given the fact that there will never be enough information or we will never know enough about the future to be able to say with certainty that there won't be some negative and perhaps some unintended consequences.

Could I first get you to comment on that.

Mr. SAMUELS. Mr. Payne, I think that when we think about dealing with a major change that we should do our best and use our best judgment in trying to evaluate what the benefits and the risks and the disruption to the economy might be. I think in this particular context we think that if you look at the evidence of what the benefits are going to be based on the economic research in terms of increasing the savings rate and when you talk to the economists who have thought a lot about this about what these different systems inherently mean—in other words, when people talk about a consumption tax and try to decide what efficiencies might arise from a consumption tax—they talk about a model, and that model includes a broad base. Everything is taxed, and you would tax existing wealth in order to get the efficiencies that they would hope to achieve in a consumption tax, and I think that those kinds of assumptions that if you went forward with them would carry significant risks of plunging into the unknown.

I think we would be very careful with plunging into the unknown.

Mr. PAYNE. I think we should be careful about plunging into the unknown, but would you say that there is an acceptable way to move into the unknown? As you have already mentioned, we have a hybrid system. I noticed from the information given to us by Joint Tax that compared to countries in the OECD, presently our general consumption taxes are 7.6 percent of all of our tax revenues, whereas the other nations are in excess of 17 percent, meaning that other countries have adopted more consumption taxes than we have.

Would it make sense for us to be moving more in that direction? That then could be a test, if you will, to provide some of these answers so that if we don't make the transition immediately or in a radical way, as you said, but if we begin to look at a way to make that transition over a longer period of time, would that be an acceptable way to proceed?

Mr. SAMUELS. I think it is hard to answer the question without exactly having a proposal, but the fact is the statistics that you referred to, all of our major trading partners use different taxes.

They all have kind of a mixed system. They all rely on the income tax for an important part of their revenues, and they also all rely to a different extent on consumption taxes.

And they also, I would say, if you look at the list, it is another interesting fact that Japan and the United States, that have the lowest consumption taxes as a percentage of the taxes raised, also raise as a percentage of GDP less than our other trading partners, so everybody has a different system that they have evolved which kind of—they have applied what they think is important for their society. And look at the G–7, the United States and Japan are at the bottom in terms of percentages of tax that we take out of our GDP and our other trading partners take a greater percentage and they tend to rely more on consumption taxes.

Mr. PAYNE. But let me just say if, in fact, we can't make the radical change are you saying that perhaps we shouldn't be making any kind of an incremental change either?

Mr. SAMUELS. No, I am not saying that. I think when you evaluate these proposals that you need to kind of—it is helpful to look on the experience of other countries and how their systems evolved and what their composition of taxes are, and it seems to me that if you wanted your suggestion of increasing the percent of consumption tax that we look to as a revenue source, that is an idea worth considering, but you would have to decide how you were going to get there and how you would do it and whether it would be worth it.

Mr. PAYNE. So while you can't support a revolution in the tax system, you might look at an evolution where we would move incrementally to a different kind of system over a period of time, testing as we go what the impact would be on the economy and then making that transition as smoothly as possible?

Mr. SAMUELS. What we have said is we will consider serious proposals that will simplify the system and improve economic incentives without sacrificing revenue or fairness. That is how we would look at that, absolutely.

Mr. PAYNE. Thank you very much.

Mr. CRANE. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I want to address the issue of fairness because I think that it is fundamental, the fundamental issue when we are looking at overhauling our tax system, so I want to explore that just a little bit with you. You mentioned that your criteria for fairness is based on one's ability to pay; is that correct?

Mr. TODER. Yes.

Mr. SAMUELS. Yes.

Mr. ENSIGN. In your previous comments if somebody makes, let's just throw out a couple of numbers here, if somebody makes $1 million a year, is it not true that their ability to pay a 90 percent tax rate would be much greater than somebody's ability to pay a 10 percent tax rate that only makes $20,000 a year? I mean, that is a true statement.

Mr. TODER. Well, certainly——

Mr. ENSIGN. Is that a true statement?

Mr. TODER. That is a true statement.

Mr. ENSIGN. OK, OK.

Mr. TODER. We are not endorsing 90 percent tax rates.

Mr. ENSIGN. Let me go further with this. Based on your definition, that would be fair.

Mr. TODER. No, no, we would say that a person with $1 million has a greater ability to pay tax than a person who makes $20,000.

Mr. ENSIGN. You said that was one of your criteria for fairness.

Mr. TODER. But that doesn't mean that that person has a greater ability to pay a particular tax rate.

Mr. ENSIGN. You said that our current system is fair because of the progressivity. What determines that fairness? In other words, if we have 39.6 at the top, is that high enough? Should we go to 90 percent for somebody who makes $1 million a year? At what point is it fair is my point.

Let me address this another way. If you have two farmers that are farming fields, and farmer A over here produces x amount of crops and farmer B over here produces y amount of crops and the person over here works twice as hard as the person over there, should we tax at a higher rate farmer B that worked twice as hard as farmer A and produced twice as much crop?

Now, his ability to pay is greater, but should he be taxed on his crops at a higher rate because he worked harder? Aren't you, in fact, punishing someone for working harder? Don't our current tax rates, based on progressivity, punish people for working harder and producing more?

Mr. TODER. Mr. Ensign, it is clear that any tax system which, even if it is a flat tax system, which causes people to pay more taxes if their income is higher is going to have some adverse effect on incentives to work. That would also be true.

Mr. ENSIGN. Not if it is at the same rate. In other words, if I produce 100 bushels and somebody else produces 10 bushels, I pay 10 and they pay one. Yes, I am paying more bushels, but I am paying the same rate, so I have the same incentive to make more, more and more, but if I make 100 bushels, somebody makes 10 and they pay 1 and I pay 40, that is where the unfairness to me comes in. It would seem the only fairness is when people pay the same rate.

Mr. TODER. I suppose you can make that definition of fairness, and that is——

Mr. ENSIGN. Well, where do you come up with your definition of "fairness"? You said it was one's ability to pay, and I just pointed out to you that, by that definition, you could have somebody paying a 90 percent tax rate and that would be fair. So where do you come up with your definition for "fairness"?

Mr. TODER. We believe as general matter, and this has been discussed in many writings of economists going back to John Stuart Mill in the 19th century, that people who have higher incomes can afford to pay a higher percentage.

Mr. ENSIGN. They may be able to afford it, but is it right? I mean, we are talking about fairness here. Is it fair? Is it right?

Mr. TODER. The question really is, do you want to tax somebody on the bread and milk for their kids by taxing——

Mr. ENSIGN. Is not socialism based on redistribution of wealth? Is not that what the whole system of socialism and Marxism is about, that it doesn't matter how hard you work, we are going to

take all of your money and we are going to redistribute it to make everybody equal? That is not the system the United States was set up on. We are set up on capitalism to reward somebody for working hard.

Progressivity punishes people for working hard. It is one step closer to socialism.

Mr. SAMUELS. Mr. Ensign, I think that our progressive income tax system, if you look back over the years—it has many faults now and needs to be revised, but it has served this country well. In times of national need and emergency and wars, our income tax system was able to raise funds for this country, for the government, to satisfy needs of the society. And I think that if you look back over the years to the beginning of the income tax——

Mr. ENSIGN. You are skirting the issue of fairness. I mean——

Mr. SAMUELS. You asked about a progressive income tax.

Mr. ENSIGN. No. I asked you where your definition of "fairness" came from, and you haven't answered that, just like you didn't answer Chairman Archer. Where does your definition come from for "fairness"? What are your criteria to determine what is fair and what is not? You haven't answered that, and I guess you are not going to answer that.

Thank you, Mr. Chairman.

Mr. CRANE [presiding]. Mr. Portman.

Mr. PORTMAN. I thank the Chairman and thank the witnesses for coming today. I have read your testimony before the hearing and listened patiently today to the questions and answers and to your remarks; and I guess my view is that, in fact, your testimony is "criticism" more in the common usage than the usage that Mr. Thomas found in Webster's, and that is that it is mostly con and not much pro. And I guess what I would hope we could do over the next several months, now that Chairman Archer and Ranking Member Gibbons and others have begun this great debate, is to hear a more objective analysis.

I think we all need to go into this with our options open. I think the biases need to be put aside, and I would hope that—particularly with regard to various consumption tax proposals, that you all could give us a more balanced analysis.

With regard to the three criteria use of fairness, efficiency, and simplicity we have discussed today, I think we disagree on efficiency. I would hope that you could go back and look at some of the testimony from our hearing yesterday on the savings and investment on going to a consumption-based tax. I think you are wrong, frankly, but I may be wrong. You may be right.

Maybe it is not going to affect interest rates. It certainly runs counter to common sense and some of the testimony we have heard from the economists. But I won't get into that.

Simplicity, I think it is plain from your testimony and others' and the other analyses we have heard that the current system needs to be vastly revamped, that either a flat tax system or something closer to a VAT would be simpler for most Americans and most American businesses.

Let me focus on fairness again, following up on my colleague from Nevada's questions.

Again, when I look at your testimony, you say in your oral statement that addressing regressivity is one of the great challenges of a consumption tax system, and I like that, because you are at least saying, it is a challenge, it is not something that can't be addressed. I look at your testimony and you mostly point out the problems from a regressive or progressive standpoint. You talk about the fact that some European countries tax certain goods more than others through their VAT. You also mention the possibility of standard deductions for low-income families and so on, and in fact your charts reflect your certain assumptions with regard to that, which is why this chart is just based on assumptions, which is fine. But one could lower or raise those deductions and change the assumptions and the bars would all change.

But from your experience from other countries, in addition to the European experience, would taxing certain goods more than others address some of what you consider to be the challenges of regressivity in a consumption tax system?

Mr. TODER. Mr. Portman, I think the difficulty with addressing this by taxing goods, some goods more than others, is that there are very few goods in the economy that aren't consumed by everybody. So if you exempt food because you want to help low-income families, as many of our States do and many European countries do, you exempt a lot of the consumption of high-income families—all of us eat—and you end up having to raise tax rates on everything else to fund the same revenue. So if you want to address the progressivity issue, it is much easier to do so by collecting some of the tax from individuals as opposed to collecting it from businesses; that is, to have some mechanism to differentiate among individuals.

The Armey flat tax does that to a degree, because it taxes wages at the individual level, and the Nunn-Domenici tax does that more completely and also has progressive rates. But as we have testified, having that kind of a system is more complicated.

Mr. PORTMAN. But, Mr. Toder, within the context of a consumption tax, are you aware of any other countries that have a progressive element other than the higher VAT taxes or other excise-type taxes on goods?

Mr. TODER. No——

Mr. PORTMAN. Take your rates in your testimony, as an example. Are you referring to some sort of an income tax that would be concurrent with a consumption tax?

Mr. TODER. That is correct.

No, actually, I am referring to a way of collecting the consumption tax. I mean Dr. Kotlikoff suggested electronic filing, which was mentioned here as a way to try to measure the total consumption.

Mr. PORTMAN. But the measurement of income as a part of that would be needed in order to meet your standard of progressivity; is that correct? In other words, you could have an annual aggregate consumption tax through the use of the technology that Mrs. Kennelly and others have talked about, but you would still need to address the issue of income?

Mr. TODER. Well, you wouldn't need to measure people's income, you would actually measure people's consumption by taking their

income and letting them deduct their saving. But you would have to collect it from individuals. I think that is the distinction.

Mr. PORTMAN. Are there any other examples of countries where consumption tax has a progressivity element?

Mr. TODER. As far as I am aware, what other countries have done is that they have used other taxes to bring progressivity into their system. So they have a flat rate consumption tax with some exemptions, and then they have income tax systems along with that.

Mr. PORTMAN. Any comments, Mr. Samuels?

Mr. SAMUELS. I think that is generally the way our trading partners have—who have been using value-added taxes have tried to deal with the issue of regressivity. They have a mixed system, and then they deal with that——

Mr. PORTMAN. On the income side.

Mr. SAMUELS. On the income tax side.

Mr. PORTMAN. Thank you, Mr. Chairman.

Mr. CRANE. Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Mr. Samuels, you know the House of Representatives is led by a man who declared himself to be a radical, and so you have to take in context what has happened to you here today. I want to ask you some simple questions.

Are you aware that the U.S. Government has three branches?

Mr. SAMUELS. Yes, sir.

Mr. MCDERMOTT. And one of the branches is the legislative branch covered under article I of the Constitution; you are aware of that?

Mr. SAMUELS. Yes.

Mr. MCDERMOTT. And as I understand article I, section 7, it gives to the House of Representatives the responsibility for authoring all tax bills; is that correct?

Mr. SAMUELS. That is correct.

Mr. MCDERMOTT. Were you invited up today as the Assistant Secretary of the Treasury to make a proposal from the administration or to comment on proposals which are before this Committee?

Mr. SAMUELS. I believe I was invited to make comments on proposals.

Mr. MCDERMOTT. So you were sandbagged. You were asked to come up here. I wouldn't make you comment on that, but it seems to me that the Majority here today has taken unfair advantage of you, putting you in a position where you are asked to come up and comment on proposals and then they demand that you make a proposal. That is not fair. I think that you ought to take the advice of the Revolutionary War, which is to hold your fire until you see the whites of their eyes.

Are you aware of any agreement between the House and Senate on this proposal or that proposal, either flat tax or a consumption tax?

Mr. SAMUELS. No, sir.

Mr. MCDERMOTT. You have heard another proposal from Mr. Hancock today to do absolutely nothing, just to hold steady, so we have another proposal here on the table today. So you have at least three proposals floating around; is that correct?

Mr. SAMUELS. There are many proposals floating around, yes.

Mr. MCDERMOTT. And according to the Constitution, all bills have to pass both Houses, House and Senate, and be sent to the President for his judgment, and at that point, you will make a recommendation to him about whether it is a good bill or a bad bill; is that correct?

Mr. SAMUELS. That is correct, Mr. McDermott.

Mr. MCDERMOTT. You might, of course, be willing to participate in the process of the groups drawing proposals up here, but you are not up here to force one on us, are you?

Mr. SAMUELS. No, sir.

Mr. MCDERMOTT. You would never see that as your role?

Mr. SAMUELS. No, sir.

Mr. MCDERMOTT. Let me ask you another question, because I do have another question.

There is a recent GAO report, June 1995, that indicated that the estimated amount of taxes not voluntarily paid has held steady at about 17 percent of the total Federal income tax due to the IRS. In 1992 that is estimated to be about $127 billion. And the largest component of noncompliance appears to be that people do not report all taxable income on their tax returns. Now, is there any proposal that is before this Committee, as far as you know, that will tighten up compliance and force people to report all of their income?

Mr. SAMUELS. Mr. McDermott, I am aware of that report, and that that is a problem that is kind of well-known and long standing; and I am not aware of any proposal that, at this point, is before this Committee on that issue.

Mr. MCDERMOTT. Are you aware of any proposal that is being proposed by—to this Committee that would make the noncompliance worse? I mean, you are looking at these proposals, are they going to be tighter in terms of getting taxes owed to the Federal Government, or are they going to be more easily evaded?

Mr. SAMUELS. Mr. McDermott, I think it depends on the type of proposal. For example, if the proposal is to replace the current system with a retail sales tax, that is one where one worries about compliance, because there is only one taxing point. And if you miss that point, you have lost all of the revenues. So we are, in looking at these proposals, we are trying to evaluate the compliance issues associated with them, and that is, I think, the one that we would have at this point the most concern about.

Mr. MCDERMOTT. So you are talking, in that sense, about a consumption tax, about a VAT or that kind of tax where it all is collected at one point or another.

Mr. SAMUELS. A retail sales tax.

Mr. MCDERMOTT. A retail sales tax, not the VAT?

Mr. SAMUELS. Right.

Mr. MCDERMOTT. The VAT, you think, is more efficient in terms of the ability to collect the tax, because there are more places where you can pick it up?

Mr. SAMUELS. I think from the compliance point of view, the VAT has kind of this built-in safeguard that you have to report your purchases to get the credit. And I think—my understanding is that the experience of European countries that have both VATs and in-

come taxes is when they introduce the VAT, their income taxes went up, because people were paying more attention to their purchases and sales.

Now, obviously, you can try to avoid the VAT by not reporting your purchases or your sales. That is a problem you have to watch out for. But it is, I think—a VAT, I think people feel, would have this safeguard for compliance and the tradeoff, of course, is that it is more complex, because you have more people who are paying the tax.

Mr. MCDERMOTT. Is there any proposal being made before this Committee that will not have rules and regulations?

Mr. SAMUELS. Mr. McDermott, I think all of these proposals will have rules and regulations.

Mr. MCDERMOTT. So it is a myth to tell people that we are going to pass a bill that will allow you to compute your taxes on a postcard and that will be the end of it, no problem, just take a postcard and you will be all done?

Mr. SAMUELS. Mr. McDermott, I think all of these proposals are more complicated than that.

Mr. MCDERMOTT. Thank you.

Mr. CRANE. Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. And Mr. Chairman, my personal view of the Presidency is that this is not supposed to be a ministerial position, but it should be a leadership position. And the President of the United States and his agencies that are subject to his direction ought to be coming up with visions for this country. As a result, I believe that Treasury, in coalition with the Presidency, ought to have a proposal for a good replacement tax system.

So I think that—regardless of what you have been invited up here to testify on, Mr. Samuels—I think that you leave the country without leadership by not proposing some strong system that is simple, that is fair, that would replace our current income tax system, which everybody agrees lacks totally in common sense, fairness, and simplicity.

I would just ask you, since apparently while I was gone at a press conference you did state to Mr. Levin that you will come up with some proposed changes to the current income tax system. My only question to you would be, how do you intend to handle the informal or underground income problem?

Mr. SAMUELS. That is a difficult problem that all systems face. Under today's conditions the underground economy is a problem. But I would note that there are kind of two parts to the underground economy. There is the illegal part of it, which I don't think will change under a new system, that part of the economy is going to remain out of the system.

The informal part of the underground economy would be someone who is engaged in activities that are not reported or are underreported. I don't think, as we have said in our testimony, that you are going to make major inroads in that area, and I think it is unfortunate. And the reason is that if you have a consumption tax, the people who are in the informal economy, to the extent that they are dealing directly with persons who are not businesses, they can just as well go and say to you, I will paint your house and I

won't charge you tax. That will be as possible under a consumption tax as it is now; there is no difference.

The issue where you could have some impact on the informal economy is when you are dealing with taxable businesses, and in a value-added context, the business wants to have an invoice so that the way you could get some extra compliance from the informal economy in a consumption tax system is through those transactions. But again, even there, some businesses will say, I won't report my purchases or my sales, so you don't necessarily solve the problem of an underground economy.

I think if you talk to tax administrators from countries that have consumption taxes, they will explain that issue, that they have a problem with their underground economy, as well, even though they have a consumption—obviously, it is not a full consumption tax; no country has a full consumption tax, but it is not their only tax. But the countries that have a consumption tax will tell you of the problems that they have with compliance.

So it is a vexing problem, and I think information reporting is a way of trying to improve that problem.

The GAO report that Mr. McDermott referred to I think had some suggestions of how to deal with it. It is a problem that deserves attention and I think that taxpayers who are paying are playing by the rules and paying what they should. They are the ones who are suffering because the underground economy isn't paying their share.

Ms. DUNN. Do you believe, then, Mr. Samuels, that the underground economy is simply one of those problems that can't be solved?

Mr. SAMUELS. I would never, I would never give up. I am always an optimist. But it is a difficult, it is a difficult situation; and I think, for example, dealing with illegal activities is extraordinarily difficult, and we basically have to rely on our law enforcement efforts to try to deal with that.

Ms. DUNN. Thank you.

Mr. CRANE. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Secretary Samuels, in your view, is a consumed income tax, like the U.S.A. tax, border adjustable under GATT?

Mr. SAMUELS. Mr. English, we have looked at that and have written a letter to Senators Nunn and Domenici on that, and we concluded that we don't know.

Mr. ENGLISH. OK. Well, that is a direct answer, and——

Mr. SAMUELS. And we would be happy to share——

Mr. ENGLISH. I would like a copy of that.

[The information was not received at the time of printing.]

Mr. SAMUELS. It is a complicated issue, and the so-called subtraction method VATs are GATT-legal, and there is uncertainty about a subtraction method.

Mr. ENGLISH. And that would have to be, I believe, decided by an administrative procedure under GATT?

Mr. TODER. That is correct.

Mr. ENGLISH. OK. I would like to explore the equity issue that a couple of my colleagues raised.

I noticed in your analysis of the progressivity of a couple of different proposals, particularly the consumption tax proposal, the usual distributional tables. I wonder if your analysis takes into account the secondary effects of tax changes, Mr. Secretary? In other words, are you simply looking at what immediate effect someone sees on their tax bill; or are you also taking into account the probable economic consequences and changes in economic activity? For example, for someone in the lowest quintile, although they might not see an actual immediate tax break, they might experience greater economic opportunity, a greater likelihood of getting a job, and the other things that flow from economic growth. Does your analysis take that into account?

Mr. SAMUELS. Mr. English, our analysis takes into account all Federal taxes.

Mr. TODER. Our analysis is somewhere in between the two things you said. We look at more than what is on an individual's tax return.

Mr. ENGLISH. OK.

Mr. TODER. For example, we believe, and I think any economist will tell you, that businesses don't pay taxes, that people do; and so we allocate taxes collected from businesses to people. And many of these proposals change the way taxes are collected from businesses, and so we look at how those tax changes would affect people's incomes. That is part of their tax burden.

Mr. ENGLISH. But as I understand it from your answer, you don't take into account all of the effects, including secondary effects, from tax changes. And you don't take into account behavioral changes, you don't take into account likely impacts on the economy and the spinoff effects that are going to occur that do really affect individuals.

You have offered an incomplete analysis here, but one consistent with the sorts of distributional analyses that are common in Washington; is that fair to say?

Mr. TODER. Well, we—let's put it this way. We are not—don't have any great expectation that these changes in the economy—and as we have testified, as Mr. Samuels has testified on the effects of aftertax returns to saving—will have any material or significant or predictable effect on economic growth. If you believe the economy will grow, you would have to—obviously, people will be somewhat better off than is shown in the tables.

Mr. ENGLISH. So your position is that tax changes of this sort don't affect economic growth?

I also understand, and I assume this is the administration's view, that tax changes don't affect the savings rate. Is that accurate?

Mr. TODER. We believe there would be a modest improvement in the savings rate.

Mr. ENGLISH. OK. Could you envision any tax change that would lower the cost of capital without making the Tax Code less progressive under your analysis?

Mr. TODER. I believe that we could change—there have been many proposals that have been made. For example, there was a Treasury report in 1992 on integrating the corporate and individual income taxes. That idea has been floated a number of times.

People have not responded to it very enthusiastically. But I believe—and it costs money.

But I believe one can develop proposals; to change the mix of taxation on businesses, if they are appropriately financed, could lower the cost of capital.

Mr. ENGLISH. Thank you, Mr. Chairman. Let me just say, I avoided in my questioning what the gentleman from Washington characterized as sandbagging our witness, but I would like to say for the record that I am also deeply disappointed that we have not been given guidance by the Clinton administration on what they would like to see in an alternative tax system in the form of a specific.

It was clear from the testimony that Secretary Samuels—you weren't here to offer that, and that the administration apparently is not developing a proposal; and I intend to send to Secretary Rubin—and I hope you will take this back to him—a formal request that they do so, which I believe is entirely appropriate.

Thank you, Mr. Secretary.

Chairman ARCHER [presiding]. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

I too subscribe to the Archer rule of common sense, and after listening to the testimony here today by the administration, it is obvious that we are not going to have any leadership out of the White House on this issue either.

You know, as a freshman on this Committee, I have sat here in amazement and listened through the first 5 months when you punted on Medicare and punted on balancing the budget. As a matter of fact, the President's budget had deficits as far as the eye could see, he has threatened to veto the rescissions package, and now he's offering no suggestions to help us overhaul the Tax Code and come up with a new system.

You know, being a farmboy from Nebraska, I wonder what all of you are doing over there. Frankly, there is no leadership at all.

I heard you answer Mr. Cardin's question that you are going to offer a proposal. Do you have any idea when that might come out? You have been very careful in your words, and I know that you have been told to not say anything specific. Will you have it this month or next month?

Mr. SAMUELS. Mr. Christensen, what we said is we are working on simplification proposals of the existing system and we are working on that. We are considering options, and I don't have a timetable for when we will make them public.

Mr. CHRISTENSEN. OK. Let's say that you were simplifying the current system. Precisely how do you plan to simplify the current system? What are some suggestions that you have looked at?

Mr. SAMUELS. Well, here are the types of things that we are looking at. For example, the alternative minimum tax system for individuals needs to be reviewed. Right now, you have about 3 million individuals who have to file forms that don't pay AMT. Only about 300,000 individuals pay AMT. So you have 3 million people filing forms and only 300,000 people actually pay it.

We think that we should be looking at that area to see whether we can simplify the system. We think we should try to figure out

how to expand the number of people using 1040EZs and 1040As, that that would be a useful thing for today's system.

We think that we should look at the definition of "dependent," because it is somewhat complicated, to see whether there are any simplification things that we can do there.

We have a series of those types of proposals that we are considering and evaluating.

Mr. CHRISTENSEN. Is the administration spending more time in this area of looking at simplifying the current Code, or do you think the administration is looking at the ideas that the Congress is exploring in terms of revamping the whole system and moving to a consumption-based tax that both the Ranking Member, Mr. Gibbons, and the Chairman are looking at, or the flat tax that has been floated out there by Mr. Armey and others?

I hear more from your testimony that you are looking at trying to fix a bad tire rather than put a new tire on.

Mr. SAMUELS. Mr. Christensen, we have been spending a substantial amount of time evaluating the proposals that have been made—the flat tax proposal, that consumption tax proposal we have looked at and we are continuing to look at. We are looking at the proposal by Senators Nunn and Domenici. So we are spending a very significant amount of time on those proposals, and if you look at our testimonies and you see the analysis that we have done and the simulations that we have done to try to understand how these proposals will work, who are the winners and who are the losers, you can see that we are spending a very significant amount of time on those proposals.

Mr. CHRISTENSEN. I will look forward to the President and his administration taking a stand and coming out with their specific recommendation, rather than being a reactionary, irrelevant part of the process. I hope that you will join the Republican Majority and help us change what has been a very complex, cumbersome, bureaucratic tax system. I appreciate your help on this.

Chairman ARCHER. Is there any Member who has not inquired, who wishes to inquire?

Mr. Samuels, thank you for spending so much time with us today and responding to some very difficult inquiries. One thing that was not mentioned today is that it is estimated that there will be 40 million Americans who will have a confrontation with the IRS this year: 40 million Americans. Now, some of those will be very small. But each of them will get a letter from the IRS, and when an individual citizen gets a letter from the IRS, it is not a very pleasant experience.

Interestingly enough, it is estimated that over 50 percent of those confrontations will be won by the taxpayer, and yet what I hear you saying, that what you want to come to this Committee with at some point in time is a further tinkering around the edges, as we have done over and over and over again for the last 20 years, and still have a system that puts us in the position that we are in today.

What are you going to do, for example, for a head of household? That is a fairly basic thing for people under this tax system. The IRS has to ask 42 specific questions of an inquirer before they can

give a definitive answer as to whether you are or are not a head of household.

I think inherent in the fabric of this income tax is an impossibility of fixing it, and so I really would hope that when you go back and you talk to Secretary Rubin, and perhaps to the President, that you will urge them to come forward with some sort of broad recommendation that we can consider; and we will give full consideration to it, because we are looking for answers. And you have the capability, I think, to give us a lot of good suggestions as to what answers might be the best for this country to put us ahead in the global marketplace, to put us ahead in capital savings and investment and productivity and better real jobs for all Americans.

So again I want to thank you very much for coming today, and I am sure it won't be the last time that we will see you before the Committee.

Thank you, Mr. Toder, as well.

Mr. TODER. Thank you, Mr. Chairman.

Chairman ARCHER. Our next witness is our colleague, Chris Cox.

Chris, we are happy to have you before the Committee, and know that you will feel welcome; and we would encourage you under our Committee rules, and probably those of your Committee too, to try to limit your oral presentation to 5 minutes or less, and anything that is more extensive will be submitted for the record and accepted in the record.

So welcome, and you may proceed.

STATEMENT OF HON. CHRISTOPHER COX, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. COX. Thank you very much. I will be pleased to do so.

Chairman ARCHER. If you will suspend for just 1 second, Chris.

Our colleague, Sam Gibbons, was due to testify today; and because of the way the time has worked out, he will be testifying tomorrow, and we will have a greater opportunity to spend the time in developing his recommendations.

So Chris, you may proceed now.

Mr. COX. Chairman Archer, I am here to congratulate you on your vision and courage in proposing not simply to reform, but to replace, the income tax. I am here as the Chairman of the Republican Policy Committee because this is the most pure issue of policy that our Congress will have the opportunity to debate. And I am here because the national debate that you have ignited is of such enormous importance that I am certain it will eclipse even such issues as term limits or the flat tax itself.

For a brief time in my career, I taught Federal income tax, as you know, at Harvard University; and I became as familiar as a teacher might become with 8 volumes of IRS Code and regulations and 14,700 pages and another 200,000 pages of decisions and interpretations that ordinarily accompany our Code, and I was apprised that ignorance of the law is no excuse.

I was once on a television show with Fred Goldberg, who was then our Commissioner of the Internal Revenue Service; and I had the opportunity to ask him, do you use an accountant to help you prepare your income taxes? And I confessed that I did with mine, and he said, yes.

What kind of a system have we got?

What we have learned in the history of the income tax since it was first made possible in 1913 is that the Federal Government simply cannot be trusted with the power to wield this intrusive, destructive, wasteful and counterproductive tax. Our Founding Fathers wisely prevented against an income tax in the Constitution itself. It took a constitutional amendment to permit what has developed into the most invasive and hated interference of the Federal Government in the lives of ordinary citizens. Not only the Founding Fathers, but the authors and the sponsors of the 16th amendment itself would be horrified to learn what we have permitted their income tax to become. Even its sponsors assured the Nation that a system such as ours today would be unthinkable.

The Chairman of the Ways and Means Committee, Representative Payne of New York, who sponsored the bill, supported it, voted for it, and managed it on the floor, supported the 16th amendment because he believed the country should have an income tax only in time of war. I now quote from his floor remarks.

> As to general policy of an income tax, I am utterly opposed to it. I believe, with Gladstone, that it tends to make us a Nation of liars. It is the most easily concealed of any tax, the most difficult of enforcement, and the hardest to collect. It is, in a word, a tax upon honest men and an exemption of the income of rascals.
>
> I hope,

he added,

> that if the Constitution is amended—

and remember, he sponsored the amendment, supported it on the floor and managed it—

> I hope that if the Constitution is amended in this way, the time will not come when the American people will ever want to enact an income tax except in time of war.

That was the Chairman of the Ways and Means Committee.

How about the Democrats? As for the leading Democratic sponsor, Representative Clark of Missouri, he offered his support for the constitutional amendment in the context of the income tax bill they were then debating. It had an exemption of $5,000, which meant that nobody who made that income paid any income tax at all.

I have adjusted these figures so you can understand what it was like to hear that debate on the floor; I have adjusted the figures for inflation.

I do not believe, he said, that $82,000 per individual exemption is too much. I certainly would increase it. And for this reason: $82,000 is not an unreasonable amount for a man to support a family on or educate his children, $99,000 would not be an unreasonable amount, $115,000 would not be an unreasonable amount. But I say that when a man's net income rises above $1.65 million per year, it does not make any difference to him practically whether you take 1 percent, 2 percent, and so on.

It is easy to see why the income tax law was passed. Everyone believed someone else would pay. As recently as the eve of Pearl Harbor, only one in every seven Americans was required even to file an income tax return. The last time we had a Republican Chairman of Ways and Means was 1954. The Federal tax burden on the average American family then was one-tenth of what it is today. But today, in the late 20th century, each of you here and

each of your constituents pays several hundred percent more in taxes than your mother and father. In fact, today, over 95 percent of all taxpayers who are forced to file income tax returns are people who were promised by the sponsors of the 16th amendment that they would never be taxed at all.

Mr. Chairman, in your other responsibilities in this Committee you are looking at major spending programs. And I urge you as you go about your business of cutting spending to think of this not as an exercise in rationing pain and scarcity, but rather an exercise in making possible the kind of America that my parents knew, that I had when I was a child, as recently as the fifties.

At that time, the average American family making the average American income paid an income tax rate of 2 percent. They paid a mortgage—on their 30-year mortgage, they paid an interest rate of 4 percent, because the government then balanced its budget, had a surplus in an era of low taxes. The FICA tax rate was 1.5 percent. All of this is possible if we are willing to reduce the size and scope of government, and hand-in-hand with that exercise goes your effort to not just reform, but replace the income tax.

I will now close, because I see the red light is on. Within the memory of some of the people in our audience, on July 5, 86 years ago, Congressman McCall, a Republican from Massachusetts, looked into the future, into our own day, and he asked a troubling question about the constitutional amendment that the House voted to approve later that day. Why, he asked, drag every governmental power to Washington? So that a vast, centralized government may devour the States and individual liberty as well? I say this amendment should be more carefully considered than it has yet to be considered.

In the intervening decades, the American people have had ample opportunity to consider the income tax and they have found it wanting. It has become everything that Congressman McCall feared. It now deserves to die.

I wish you Godspeed in your efforts in igniting this debate. I thank you, Mr. Chairman.

[The prepared statement follows:]

CHRISTOPHER COX
CALIFORNIA

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COMMITTEE ON GOVERNMENT OPERATIONS
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CAPITAL MARKETS

JUNE 7, 1995

STATEMENT OF REP. CHRISTOPHER COX
CHAIRMAN, REPUBLICAN POLICY COMMITTEE

BEFORE THE COMMITTEE ON WAYS AND MEANS
ON ABOLISHING THE FEDERAL INCOME TAX

Chairman Archer, I appear here today to congratulate you on your vision and courage in proposing not simply to "reform," but to replace the income tax. I appear as the Chairman of the Policy Committee, because this is the most pure issue of policy that our Congress will have the opportunity to debate. And I'm here because the national debate that you've ignited is of such enormous importance that I am certain it will eventually eclipse even such issues as term limits or the flat tax itself.

For a brief time in my career, I taught federal income tax at Harvard University, and I became as familiar as a teacher might become with eight volumes of the Internal Revenue Code, and Regulations comprising 14,700 pages, and another 200,000 pages of decisions and interpretations that ordinarily accompany the Code. As a taxpayer, not to mention as a teacher, I was also daunted by the knowledge that, in the government's view, "ignorance of the law is no excuse."

I was once on a television show with Fred Goldberg, who was then our Commissioner of Internal Revenue. I had the opportunity to ask him: "Do you use an accountant to help you prepare your income taxes?" I confessed that I did with mine. He admitted that he, too, needed an accountant to figure his tax liability. When even the IRS Commissioner needs help to do his income tax, what kind of a system have we got?

What we have learned in the history of the income tax, since it was first made possible by the ratification of the 16th Amendment in 1913, is that the federal government simply cannot be trusted with the power to wield this intrusive, destructive, wasteful, and counterproductive tax. Our Founding Fathers wisely prevented against an income tax in the Constitution itself. It took a Constitutional Amendment to permit what has developed into the most invasive and hated interference of the federal government in the lives of ordinary citizens.

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Not only the Founding Fathers, but the authors and sponsors of the 16th Amendment itself, would be horrified to learn what we have permitted the income tax to become. Even the amendment's sponsors assured the nation that a system such as ours today would be unthinkable. Like many of his Republican colleagues, Rep. Sereno Payne of New York, the Chairman of the Ways and Means Committee--who sponsored the 16th Amendment, supported it, voted for it, and managed it on the floor--supported it only because he believed the country should have the option of an income tax in time of war.

I now quote from his floor remarks:

> As to the general policy of the income tax, I am utterly opposed to it. I believe with Gladstone that it tends to make a nation of liars; I believe it is the most easily concealed of any tax that can be laid, the most difficult of enforcement, and the hardest to collect; that it is, in a word, a tax upon the income of honest men and an exemption, to a greater or lesser extent, of the income of the rascals; and so I am opposed to any income tax whatever in time of peace. . . . I hope that if the Constitution is amended in this way the time will not come when the American people will ever want to enact an income tax except in time of war.

That was the Chairman of the Ways and Means Committee, the chief Republican supporter of the income tax amendment. How about the Democrats? As for the leading Democratic sponsor, Minority Leader Champ Clark of Missouri, he offered his support for the Constitutional Amendment in the context of the income tax bill that was then being debated. The bill contained a $5,000 exemption, meaning that nobody who earned this amount paid any income tax at all. I've adjusted these figures for inflation, so you can understand what it was like to hear Rep. Clark's remarks on the floor:

> I do not believe that the $82,000 exemption is too much. . . . I certainly would increase it rather than diminish it, and for this reason: $82,000 is not an unreasonable amount for a man to support a family on and educate his children; $99,000 would not be an unreasonable amount; $115,000 would not be an unreasonable amount. But I say that when a man's net income rises above $1.65 million a year it does not make any difference to him, practically, whether you take one percent, two percent, five percent, or 25 percent.

It is easy to see why the income tax law was passed. Everyone believed someone else would pay. As recently as the eve of Pearl Harbor, only one in every seven Americans was even required to file an income tax return. The last time we had a Republican Chairman of Ways and Means--1954--the federal tax burden on the average American family was one-tenth of what it is today.

But today, in the late 20th century, each of you here and each of your constituents pays several hundred percent more in income taxes than your mother and father. Today, over 95% of all taxpayers who are forced to file income tax returns are people who were promised by the sponsors of the 16th Amendment they would never be taxed at all.

Mr. Chairman, in your other responsibilities on this Committee, you are looking at major spending programs. As you go about the business of cutting spending in these huge federal programs, I urge you to keep this in mind: Cutting spending and reducing the size of government should not be an exercise in rationing pain and scarcity. Rather, it should be done in order to return the benefits of freedom to every individual citizen. Because of the twin evils of the income tax and the endlessly expanding welfare state, middle America now bears a much greater government burden that when I was a child. It need not be that way.

When I was a child, in the 1950s, government did not consume 40 percent of our gross domestic product, but half that. As a result, the average American family, making the average national income, paid an income tax rate of just two percent. The average family of my parents' generation could afford a three-bedroom home, even though the norm was that only one spouse had to work. They paid only four percent interest on their 30-year mortgage. Their FICA tax rate was one and a half percent. All of this was possible because--despite such extravagances as the Korean War, the G.I. Bill, and the Marshall Plan--the federal budget was balanced in a low-tax environment.

That kind of freedom and opportunity is again possible in our future. But it will only become reality if we are actually willing to reduce the size of government, and only if we recognize that the income tax, in the American context, is an experiment that has been tried and has miserably failed.

On July 12, eighty-six years ago--within the memory of some of the people in our audience--Congressman Samuel McCall, a Republican from Massachusetts, looked into the future, and asked a troubling question about the Constitutional amendment that the House voted to approve later that day:

> Why drag every governmental power to Washington so that a vast, centralized government may devour the states and the liberty of individuals as well? I say this Amendment should be more carefully considered than it has yet been considered.

In the intervening decades, the American people have had ample opportunity to consider the income tax, and they have found it sorely wanting. It has become exactly what Congressman McCall feared. It deserves to die. I wish you Godspeed in your efforts, Mr. Chairman.

Chairman ARCHER. Thank you, Congressman Cox, for really putting what we are about here in historical perspective. I think it is very, very good for us to look back and to see the history of what has occurred.

We had a witness here yesterday who said that 1 page of history is worth 200 pages of logic, so I thank you for your presentation today.

Mr. Thomas.

Mr. THOMAS. Thank you very much, Mr. Chairman. I too want to thank you, Chris, not just for your testimony, but your leadership in a number of areas, not the least of which is the whole tax question. Having seen it as a payer, a user and a teacher, you have probably walked around it in more facets than most of us.

You perhaps caught just a bit of the administration's testimony before you began. What we will be looking for is guidance from any number of people who want to help us in choosing from the bipartisan alternatives that are in front of us, and I would hope as Chairman of the Policy Committee of the Republican Conference that there will be a dialog carried out, not necessarily to pick a winner, but to at least indicate the general support in the direction that we are going.

What I found most ironic about Under Secretary Samuel's testimony was an unwillingness to look at where we are today and where we may be tomorrow. When you phrase the question, do you want to get rid of the income tax and also the Internal Revenue Service at the same time, a number of people would be tempted to say yes. But when you say, as a bonus, you will also get rid of the payroll tax on the employer, that you will harmonize the tax structure for trade with other countries, and that you will stop punishing savings and investment and really support accumulation of wealth all at the same time, some of us find it difficult to find people dragging their feet.

When you are out talking to your constituents, do you find anybody able to muster an argument in favor of the current system or in favor of the current system with minor changes, or even in favor of the current system with major changes?

What do you find out there?

Mr. COX. I find my constituents are not just tempted by the thought of abolishing the income tax and the IRS, they are delirious about the possibility. But frankly, because this debate is just now getting underway because of the leadership of the Chairman of the Ways and Means Committee, what I find chiefly among my constituents is that they were not aware that it was thinkable. They are used to thinking of Washington as a calcified place where nothing changes, and even though they are utterly convinced of the illogic of the system, the wastefulness of it, of the enormous costs which they are very familiar with, even if they haven't seen in the studies, they know in their own lives, their own businesses what it means.

The compliance costs, they didn't think that we were smart enough here in Washington to understand that. And now that this debate is underway and people realize that it is possible not just to tinker with the income tax, but to get rid of it, I think you have got a tiger by the tail here.

Mr. THOMAS. Well, I looked forward to this moment as a Member of the Taxwriting Committee, but I honestly thought it was going to take a change in the Majority control of the House to bring it about, and lo and behold, that is the case.

We look forward to your continued input, not just as a Member who understands the system, but as someone who is in an extremely important position to assist us in making choices among the very attractive alternatives that we will be looking at. I thank you very much for your participation.

Chairman ARCHER. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Cox. No questions.

Chairman ARCHER. Does anyone else wish to inquire?

Mr. Hancock.

Mr. HANCOCK. Yes.

Mr. Cox, what type of law or kind of law did you practice in the private sector before you came into the Congress?

Mr. COX. General business law.

Mr. HANCOCK. I understand that you were heavily involved, though, in the creation of capital—of venture capital, helping businesses get started?

Mr. COX. That is exactly my specialty. I did capital formation.

Mr. HANCOCK. OK. Under these circumstances, your business was primarily to create jobs, to start new businesses or to emerge businesses to where we could create jobs, and make us more able to compete on a worldwide basis and what have you through this type of structure.

How much of your time would you say percentagewise with one of your clients was spent in the idea of how you developed jobs, or how you can do it from within the Tax Code, and to be able to keep enough of the capital to expand the business? What percentage of your time was spent on that part of starting a business, say?

Mr. COX. Probably a third to a half. I tried to make my specialty the business side, the venture capital, the initial public offering, how to start up your company, how to expand your market, go through financing and so on. But the tax side of it was sufficiently important and dominating in many cases that when eventually I was asked to teach Federal income tax at Harvard Business School, it was based on the experience I had gained allegedly in a nontax area. But I didn't have to do too much prep work in order to teach an introductory course in Federal income tax because of that.

I tried to teach a course called "Tax Factors in Business Decisions" which—the notion that students in business school should learn that you make a business decision and only take tax factors into account, but you don't make decisions for tax reasons. It became increasingly hard to convince people, given the big numbers they were looking at with taxes, that that made sense.

Mr. HANCOCK. Did you ever have a client that made the decision to establish his business outside of the United States because of the tax structure in the United States?

Mr. COX. I never counseled anybody who did that, but I did have clients who already had established operations overseas, in many cases, who take advantage of the lower tax, lack of capital gains taxes and so on.

Mr. HANCOCK. You never had a situation where, following your counsel, that organization made the decision without your counsel, though, to go to a foreign country to establish their business?

Mr. COX. I did not, but I was counseling mostly startup companies and so on that hadn't gotten to the point yet where they had an operation to pick up and move.

Mr. HANCOCK. But you know of a lot of cases where that has happened?

Mr. COX. I am well aware that people move jobs to other countries on a routine basis in order to avoid the tax burden that is relatively higher here in the United States.

Mr. HANCOCK. Thank you very much. I really appreciate your testimony, and I appreciate the work that you have done here in the Congress. Thank you.

Chairman ARCHER. Congressman Neal.

Mr. NEAL. Thank you. Chris, you made reference to 4 percent interest rates. What kind of deficit reduction could you think would be necessary to get us to 4 percent interest rates again?

Mr. COX. Well, in those days we found that the Congress was able to support such extravagances as the Korean war, the Marshall plan, GI bill, all with a balanced budget, a surplus budget in a low tax rate environment.

It is extraordinary to think how we have failed, in comparison. I believe if we were to do the same, that is to say, operate at a surplus to take on those major responsibilities of which we were capable, but none of those of which we were not capable, that we would find ourselves in that same zero inflation environment that would permit 4 percent interest rates on 30-year mortgages.

Mr. NEAL. The interest rate on my home is 8 percent after all these years. If there is any suggestion that you could have that is going to bring interest rates down and I am not aware of any ideas in the current marketplace, could you share that with us?

Mr. COX. Roughly speaking, you are paying an inflation premium on top of the 4 percent rate that your parents paid.

Mr. NEAL. Thank you.

Thanks, Mr. Chairman.

Chairman ARCHER. Chris, would it not also have a major impact on interest rates if you had a zero tax on savings and investment? And if you were able to completely abolish the income tax, would you not have a far greater influx of interest in investment by foreigners in this country which would once again put more money available for loan purposes? And under the law of supply and demand, because money is fungible, and fungible worldwide today, if there were far more money available for loaning in the United States, would that in itself not drive the interest rates down?

Mr. COX. That is exactly what it would do. Today we have an abysmal 3.9 percent savings rate. That is woeful compared to the rate at which Americans used to save and invest when I was a child, when my parents were working in the fifties.

Interest—interest rates are one measure of the cost of capital. The price of money will, like the price of any commodity, go down as the supply goes up. If we can supply more savings, more investment capital in the system, necessarily, we will drive down interest rates at the same time. And of course, if you relieve our American

system right now of the burdensome tax on savings and investment, you will have exactly that result.

Chairman ARCHER. Thank you.

Ms. Dunn, did you wish to inquire?

Ms. DUNN. I did want to. Thank you, Mr. Chairman.

Chris, I remember last year when a group of us was putting together the Contract With America your frustrations in not being able to include in that proposal the repeal of the 16th amendment. And I just wanted to tell you that I can understand your satisfaction now, sitting here, realizing that the impossible is now occurring; and Chairman Archer has put on the agenda for discussion this major, major change in public policy.

Chairman Archer asked earlier today a question of the Treasury Assistant Secretary, who was not forthcoming with us, as to the administration's proposal for a replacement Tax Code. He said, If you could design the most appropriate way to raise the money to pay the government's bills, what would your proposal be? Are you in a position now to make a proposal to us for a new Tax Code to replace the income tax?

Mr. COX. What you replace the income tax with is of vital importance. Obviously, if we don't have an income tax any longer, we are immediately in the realm of consumption tax. Many economists, if not most economists, tell us that that is a step in the right direction, that that is an improvement, and I would dare say that that is something upon which economists who would consider themselves of liberal stripe agree upon with economists who consider themselves to be conservative or supply siders.

But what kind of a consumption tax and precisely how one implements it is very, very important. There are details here that I can't possibly cover in 5 minutes or 30 seconds or however long I am permitted to respond to the question, that if tweaked, could change the fairness of the system, the advocacy of the system, the cost of enforcement of the system and so on. And that is what these hearings are all about.

I concluded my formal remarks with a quote from Congressman McCall saying that when they passed the 16th amendment, they did it in a 4-hour debate, that they didn't spend enough time thinking about what they were up to. I hope we don't make that mistake. I know we will not.

I think what Chairman Archer has done is started a national debate that will probably last more than 1 year, probably more than 2 years. It will take some time for us to flush this out. The important thing is that today, yesterday, you began this, and this is a historic course. I just want to be sure that as we start at the front end of this process, everyone recognizes just how significant this is in the history of our country.

Ms. DUNN. Thank you.

Chairman ARCHER. Mr. Zimmer.

Mr. ZIMMER. Congressman Cox, I would like to know, at what point do you want to repeal the 16th amendment? While we are still debating tax alternatives? Because I would assume that by repealing the 16th amendment, then you take the flat tax off the table, and you take the Nunn-Domenici tax bill off the table, because they would not be constitutional any longer.

Is that your understanding as well?

Mr. COX. Yes. There are two things that one must consider in passing a constitutional amendment affecting taxes. One is that it will make possible whatever tax system you have in mind at the moment, and that is of course the milieu in which the 16th amendment first was adopted.

Second, you have to try to project what subsequent Congresses might do with the power that you have given or the power that you have subtracted. And so I believe we have to be just as sober about repealing the 16th amendment as we are when we passed the balanced budget amendment, as we are when we consider any amendment to the Constitution. As a practical matter, it will take multiple years to ratify.

In order to get us an income tax in the first place, we had about an 18-year period from the commencement of the debate in the late 19th century until final ratification by the last State in 1913. I hope it doesn't take us 18 years from the date of this hearing to get a result, but it will take as a practical matter something more than a year or two; and I think that is ample time for us to flesh out the whole debate and consider whether we have an acceptable alternative in the form of a consumption tax to substitute for today's income tax.

Mr. ZIMMER. As I understand it, one of the reasons the 16th amendment was enacted was because of some fairly cryptic language in the Constitution, as it was originally drafted, limiting the ability of Congress to impose direct taxes without allocating them among the States according to population. That is the best I can recall the language.

What does that prohibition mean and would any tax, nonincome tax that you would foresee require some kind of modification of that proscription?

Mr. COX. I don't think so. The Supreme Court ruled that the—I find, by the way, the language to be unambiguous in the Constitution.

Mr. ZIMMER. What is the direct——

Mr. COX. The Supreme Court so held, the Court at that time held that, in consistency with the language in the Constitution, any tax levied by the Congress must either be a capitation tax—that is, a head tax, if it were to be a direct tax on individuals rather than on transactions—or the proceeds of the tax would have to be apportioned among the several States. So you couldn't tax money from New Jersey, which would be a donor State, and give a net benefit to California. That was what was meant by the original constitutional provision.

I think it remains unambiguous. It has never been the subject of a lot of constitutional debate or discussion beyond those decisions.

So I think if you repeal the 16th amendment, what you are left with is the Federal capacity to tax transactions.

There was a corporation income tax that was found to be constitutional that antedated the 16th amendment because it was a franchise tax on the privilege of being a corporation. So sales tax, for example, which is one of the things that you are considering, all other manner of transaction taxes, even a VAT, although I don't

favor it, all of these things would likely be squarely within the constitutional power to tax that the framers, the Founding Fathers, conferred upon Congress to begin with in article I.

Mr. ZIMMER. Would it be possible to include deductions and exemptions as means of assuring progressivity in a consumption tax, a sales tax-based system, or VAT tax system, under the proscription of the original Constitution?

Mr. COX. Yes. In my view, that is straightforward, in the same fashion that now we make a legislative judgment that we are not in State *x* going to levy a sales tax on groceries or on rent——

Mr. ZIMMER. Or on people earning less than $10,000 a year?

Mr. COX. Well, no. Once you frame it as an income tax, I think you are going to get, at the very least, into a gray area. The whole point here is to tax transactions rather than to tax people on the basis of their incomes. That is why the language of the 16th amendment was incomes from whatever source derived.

Mr. ZIMMER. Thank you.

Chairman ARCHER. Mr. Portman, and then hopefully we are going to recess at 1 o'clock.

Mr. PORTMAN. Thank you, Mr. Chairman.

Briefly Chris, thanks for all of your work on this. And I found that last dialog fascinating; one of my questions was how much of the progressive/regressive concerns that were expressed by Mr. Samuels earlier could be addressed by not having the 16th amendment; and I think that is something we need to look into, because part of the response to my earlier questions to him I think were along the lines of having almost a concurrent system to have some income-based system in order to deal with what he considers the unfairness of the system.

You have the experience of also working in the White House Counsel's office; I believe you were there during part of the formulation of tax policy from that, independent of Pennsylvania Avenue, and then you went into the private sector and got involved with tax-motivated business decisionmaking, and then taught tax, so you are a glutton for punishment. You have a good background to talk about this.

I didn't want to have you leave here without pushing you a little bit further, therefore, on your views as to the future. Without getting into a lot of detail, in response to Jennifer Dunn's comment, you indicated that you would indeed support movement away from an income tax and therefore to a consumption tax system of some kind, the details being more difficult. You then mentioned briefly that a VAT tax wasn't necessarily your favorite or preferred option.

Are you leaning more toward, then, a retail sales-type tax, or what other ideas do you have, generally speaking, at this point as to where we might move?

Mr. COX. I would like to address two things that you raised: First, the kind of consumption tax that might operate best and what I think might be its features; and second, the notion, based on my experience with Mr. Zimmer, of repealing the 16th amendment and analyzing what powers would remain for the Federal Government.

The only reason I think it is necessary for us to address the 16th amendment at all in the form of a repeal is that I don't know that

the American people are willing to have this Congress pass a big new national tax right on top of the income tax they have already suffered through, even if some Congress promises them, don't worry, we will reduce the income tax burden so that this big new tax we are visiting upon you will be not so bad.

Because we have seen the history. I quoted to you from the original debates in Congress, when it was proposed that they tax only millionaires. Now we know 95 percent of all taxpayers fall below the line that that original Congress intended to exempt. That is to say, they have to file now, and it was intended that they should not. So it was for that reason that I think, as a political matter, we would be wise to consider, if we are going to pass a big new tax of some sort, simultaneously to promise to the American people in a binding way that we mean it, we are not kidding, we are going to take away the income tax. You don't have to trust us on this, we have taken away our power to levy, as to how best to structure the consumption tax.

The opportunity is to have a broad-based tax and therefore a very low rate. The opportunity simultaneously is to have it be efficient in collection so that the burden on individuals is taken away. You don't have to do all of that paperwork, you don't have to think about April 15 all year long. The government is not intruding into your life, and you are not going to go to jail because your shoebox was out of order.

By the way, in the constitutional debates in the House, I noticed that the sponsor said, nobody will ever go to jail. People opposed to it said, you are going to go to the penitentiary if you don't have the right papers and the government is going to snoop around and so on; and people said, that is ridiculous. But of course that is exactly the way the IRS operates today. So that is the benefit of that tax.

The problems that this Committee are going to have to address in a sales tax include noncompliance. Will people cheat, will they be able to—will we stimulate somehow the underground economy? The basic precept of a consumption tax is, you get rid of the underground economy which is flourishing under the income tax because you tax transactions that are unavoidable. Structured properly, it seems to me some kind of transaction tax, modified sales tax, maybe sales tax just like we have right now would achieve that.

You also need to make sure that it is procompetitive, that it stimulates all of the things that we as Members of Congress want to stimulate both in the economy, work, savings, investment, and so on.

Those would be my criteria, and I suspect they would be yours as well.

Mr. PORTMAN. Thank you.

Chairman ARCHER. Thank you for an excellent presentation. The Committee will stand in recess until 2 o'clock.

[Whereupon, the Committee recessed, to reconvene at 2 p.m. the same day.]

Chairman ARCHER. The Committee will come to order. Jon Christensen and I are here, and that is great quality. While we may lack in numbers up here, we have the quality to speak to at least the panelists at the beginning.

Gentlemen, welcome to the Committee. I apologize to you for the delay in how long you have had to wait today. It really was pretty much beyond our control, but we are delighted to have you with us and we are looking forward to hearing your comments on the VAT.

Cliff Massa, would you like to proceed.

STATEMENT OF CLIFF MASSA III, PARTNER, PATTON BOGGS, L.L.P.

Mr. MASSA. Thank you, Mr. Chairman, and Member of the Committee. My remarks are going to emphasize three points, on which there is more detail in my written statement. The first, just as a taxpayer and observer, we have an opportunity to perhaps try to establish some principles on which to build a tax reform package.

Second, that whatever we do, a single-rate tax should be applied to all economic value added as the most sensible base on which we can build a new tax system, one that differs dramatically, by the way, from VATs around the world. Third, my observation that the subtraction method tax is the way to proceed.

As to principles, it seems to me that if we are really going to contemplate starting from scratch, perhaps we could agree on a few basic things. Perhaps, one, that the government's general revenue system is there solely for the purpose of raising revenue; second, that it ought not be used to try to achieve particular purposes, economic, social, good, bad, or to penalize or encourage particular activities; third, that we finally integrate our tax system with those of our trading partners; fourth, that we develop a system that has the maximum amount of simplicity, but also the maximum efficiency so that we can eliminate a lot of wasted planning and compliance time and get the maximum part of the base covered. Finally, let's try to address any regressivity of the system outside the system.

Granted, those proposals, those principles can be agreed with, disagreed with, but they are ones that kind of appeal to me, and on the basis of those principles it seems to me that economic value added in its most generic sense provides this country with the best, most neutral, least distortive tax base we can come to.

I want to emphasize by this that I am not talking about VATs in the sense that most of us understand them. Systems in other countries in Europe, Canada, Mexico, which I think my colleague, Dr. Cnossen, may be able to comment more on than I am able to, are probably the worst possible models to deal with. I am going to suggest that economic value added in its most generic sense is, in fact, the best system to work with.

By that, I understand value added to be the amount that each business adds to the production of goods and services as they move through the economy. In essence, as long as a business is selling goods and services for more than it pays for its inputs from other companies, it is adding value.

Looked at another way, what it is using is its labor services, the services of its employees, and its capital services, the services of its lenders and its owners, to turn inputs into more valuable outputs. If that is the sum and substance of value added, which is what I understand it to be, it seems to me that that is as close to perfection in a tax base as we can come.

It is going to treat labor and capital or more accurately the payments for labor services and the payments for capital services the same way. It treats debt and equity the same way. It treats all businesses the same way. It treats foreign and domestic producers the same way.

There were some concerns this morning expressed by Treasury that we may not be able to reach an ideal system. Well, perhaps not, but it certainly seems to me that we ought to start there. If we are going to wipe away a rather complex system, let's try to reach for the ideal, and I think value added in its economic sense is the ideal.

Let me focus on the subtraction method value-added tax, which is what I was asked to deal with particularly. There is a different method that is used in other countries. It is known as the credit method whereby each transaction has a tax notation on the invoice. You add up your tax amounts, subtract the tax amounts on your purchase invoices, and you pay the difference.

My colleague, Alan Schenk, will go into much more detail on that. The subtraction method to me is a little simpler, although the economics are the same. Every business aggregates its sales receipts for goods and services, subtracts its purchases of goods and services, and pays a tax on the difference, which is equal to its value added. It is interesting that all the tax proposals that are put forth at the moment rely to some degree or another on a tax on value added and particularly on a subtraction method—Mr. Gibbons' proposal, the U.S.A. tax, the business portion of it from Senators Nunn and Domenici, former Senators Danforth and Boren's business activities tax. While it may be a little controversial, I will argue that the flat tax is essentially the same thing. It just taxes value added in two pieces. The subtraction method, I think, is viewed favorably by the proponents because it is viewed as being inflexible, meaning you cannot with ease try to tax different goods and services with different rates, putting different preferences and penalties into place.

Some people will argue that is a detriment, that the credit method is more flexible and you can do more things with the system. I would argue that the subtraction method being inflexible is a principal reason that it ought to be considered in this country. If we want to keep a single rate applied to every business activity, which I personally would find desirable, then the subtraction method is the best way to go. I would be glad to comment in a lot more detail when time permits. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF CLIFF MASSA III

TO THE

COMMITTEE ON WAYS AND MEANS

"The Subtraction Method Value-Added Tax"

June 7, 1995

This statement discusses the concepts and mechanics of a ***subtraction method value-added tax***. To provide a context, section I presents five principles for the Committee's consideration as a foundation on which a new tax system could be constructed. Section II describes "value-added" and how it differs significantly from "profit" on which the business income tax is based. Section III covers the subtraction method in more detail. An *Appendix* provides additional details and commentary.

I. SUGGESTED PRINCIPLES FOR TAX REFORM

When federal tax policy is debated, two principal issues should be addressed. One is the "how much" issue -- do we tax ourselves sufficiently? The other is the "in what ways" issue -- do we tax ourselves intelligently? Recent national tax debates have focused heavily on *how much*, with little serious attention being given to *in what ways*. Our political process may never produce a lasting consensus about what percentage of gross domestic product should be claimed by the government in taxes. However, a consensus may be forming on the need to change the ways in which the federal government generates the taxes that we are willing to pay and to do so in the most efficient manner.

The early stages of the growing tax reform debate have produced a willingness on the part of many groups and policy makers to put a wide range of possibilities on the table. Such proposals and the growing public and press attention to the subject strongly suggest that the time for fundamental tax reform is approaching.

Given this opportunity, is my hope that we will step back from a contentious bout of slogans and themes long enough to make a considered judgment about some basic principles under which we can tax ourselves *intelligently*. If we develop such a context in which to work, the result may be both better and longer lasting. My recommendation that the Committee consider adoption of a subtraction method value-added tax is based on several factors, including the following five principles.

1. The role of the federal government's basic tax structure should be to generate the desired level of revenue -- nothing more. Efforts to achieve economic, political and social objectives through the income tax are inefficient, wasteful, blunt and complicating instruments.

2. The tax structure should impose minimal distortions on the economic decisions made by millions of individuals and businesses every day. Any tax imposes a drag on private sector activities as the price for the governmental services that we require. But this unavoidable impact should not be aggravated by a general revenue system which encourages, discourages, penalizes, rewards or otherwise artificially influences particular actions of consumers, investors and business managers.

3. The tax system should be able to be integrated with the systems of our trading partners. We are long past the time when the our tax system should have been reformed to allow *border adjustments* that reflect the increasing trade in goods and services across international borders and the increasing flows of capital investments across the same borders.

4. The tax system should combine maximum simplicity with maximum efficiency. Enormous amounts of money and of the time of very talented minds are expended annually in planning for and complying with federal tax laws. Also, there is a sizable underground economy that evades taxes, thereby raising taxes on everyone else. The tax system should be simple enough to eliminate extensive planning and compliance costs while also thorough enough to enable an efficient Internal Revenue Service to apply it to the maximum possible percentage of the tax base.

5. "Regressivity" should be addressed directly, not by distorting the tax system itself. There may never be a consensus about the economic "incidence" of particular taxes, but economists and others have reached a general consensus that efforts to offset regressivity should be *targeted to the intended households* through direct spending programs or tax rebates. Offsets within the tax system itself -- particularly within value-added and sales tax systems -- are exceedingly wasteful.

II. ECONOMIC "VALUE-ADDED" AS A TAX BASE

A general tax structure which can be implemented under these principles is a tax that applies to *economic value-added.* Interestingly, there is already a substantial level of agreement that value-added is the best tax base on which to build. Although not widely recognized, all of the major tax reform packages introduced in Congress or described in detail by Members of Congress rely on a system that taxes economic value-added. Included are (i) the new tax structures within the packages by Rep. Gibbons and by former Senators Danforth and Boren, (ii) the sales tax recommendation of the Cato Institute and Senator Lugar, (iii) the business portion of the *USA Tax* package by Senators Nunn and Domenici and (iv) the flat tax recommended by Rep. Armey and others. Perhaps this represents an emerging consensus which will enable us to focus more attention on the mechanics and details of a tax system with less disagreement about what the proper tax base is.

A. A Tax on "Value-Added" vs. a VAT

The term "value-added tax" may have become a proper noun in the minds of many people. "VAT" almost certainly has acquired that status. The use of either term is generally intended to suggest a specific tax structure like those in place in Europe, Canada, Mexico and most industrialized nations. That structure applies multiple tax rates, exemptions and other preferences to the sales of goods and services in the economy, with invoices listing a VAT amount for each sales transaction.

However, *this does not describe what value-added is;* it only describes a familiar means for computing taxes on a portion of value-added. In fact, most VATs in other countries are the worst possible models for a tax system that applies to value-added. The VAT's reputation for complexity and economic distortions is well deserved. Those who heap scorn on VATs do so with considerable justification. If a VAT were the only option for tax reform, I would hope we stay where we are.

But the widespread dissatisfaction with VATs as they are used in other countries is *not* grounds for opposing all value-added tax systems. I urge Members of the Committee to step back from the slogans and rhetoric and to consider what value-added really is.

B. The Basics of Value-Added

"Value-added" is what each business entity contributes to the economy as it does its part to move goods and services through the various stages of production and distribution and to the ultimate consumer. As long a company is selling its goods and services to its customers for more than it pays to purchase inputs from its suppliers, the company is producing value-added. By applying a tax to the value created by each business entity, the system is actually reaching the total value of goods and services consumed in the economy. What the retail sales tax does at the last stage, a value-added tax does in increments at every stage along the way.

To be more precise, value-added for a given company equals what that company pays to its providers of labor services and to its providers of capital services for the use of those services in converting "inputs" into more valuable "outputs." For example, when a company purchases inputs of raw materials, component parts and various goods and services from other companies, it does so with the intention of converting them into its own goods or services for sale to its customers. This conversion is accomplished by applying the company's available labor services -- *i.e.*, the work of its employees -- and the company's capital services -- *i.e.*, the use of assets acquired with its lenders' debt and its owners' equity -- to process, assemble, rebuild, move, market or in other ways make its own goods and services more valuable to its customers than the sum of the purchased parts.

Therefore, when you strip the system down to its basics, a tax on value-added is applied to the compensation that the company provides for both labor services and capital services. That means that the tax base is equal to the sum of (i) wages, salaries and benefits of all kinds for employees, plus (ii) retained earnings, dividends and interest for owners and creditors. This illustrates why value-added is

so widely regarded as a sensible, neutral and efficient tax base for a general revenue system. It taxes both labor and capital or, more accurately, the payments made for both labor services and capital services. It does so in proportion to how much of either is used by a company.

This also illustrates why the flat tax is a tax on economic value-added. The flat tax applies to the payments made for labor services (wages, salaries, pension payouts) at the individual level and to payments made for capital services (interest, profits) and for some labor services (fringe benefits) at the business level. The mechanics are different and the numbers of taxpayers are radically different, but the tax base is economic value-added in both systems.

C. Contrasting "Value-Added" With "Profit"

The value-added concept is simple to explain and easy to understand, *provided that* income tax concepts are set aside. For businesses, the income tax applies to profits for the years. "Profit" (whether distributed or retained) is a payment for capital services, so profit is an element of value-added. However, it is only one such element. Interest paid to lenders is another payment for capital services. Payments for labor services (including wages, salaries and all benefits) comprise the other element of value-added. Therefore, a company can still add value to the economy, even when it is not profitable. Labor and borrowed capital (if any) are still at work converting "inputs" into more valuable "outputs" even though the owners may be losing money (although a company which continuously pays more money to suppliers, employees and lenders than is coming in from sales will not stay in business long). But while a business activity continues, losses alone do not result in zero value-added tax liability. They merely reduce the value-added attributable to labor and to assets financed by debt capital.

A related issue is the fact that any company's value-adding activities can be negative for a period of time. If the company pays more for inputs than it receives for outputs during a particular accounting period, it has consumed more value-added than it has generated. Such temporary periods of "negative value-added" occur when a company engages in significant expansion programs such as major purchases of machinery and equipment or inventory accumulations. These purchases significantly increase the sales receipts of the company's suppliers that created the value-added represented by the equipment, inventory and other inputs. To prevent double taxation of the same value-added, the company with negative value-added for the period must be given a prompt refund equal to the tax rate multiplied by the negative amount.[1] Then, the system as a whole is taxing the net value-added in the economy for the period. A company's periods of negative value-added will be followed by periods in which its value-added is rather high, because its increased sales exceed its reduced level of purchases by considerable amounts.

III. THE SUBTRACTION METHOD

A. The Alternatives for Computing a Value-added Tax

There are two methods for computing a company's value-added and three ways to compute its value-added tax liability.

1. Subtraction Method

A simple way to measure value-added for any given period is to determine the excess of a company's gross receipts from the sale of its goods and services over its purchases of goods and services from other businesses. This is the basic "subtraction method," so named for the simple arithmetic process that it uses. The tax rate is them applied to the base. In a sense, the subtraction method computes value-added only when it is realized in a sale to customers. The subtraction method is often called a "period tax" or "books of account" tax because it can be computed for a given period using basic sales and purchases information from the company's books.

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[1] An alternative is an indefinite carry forward of the "negative value-added," plus interest. However, this does not recognize either the cash flow implications to the company or possible perpetual carry forwards of exporters because of the border adjustment rules.

2. Addition Method

A less simple but perhaps more fully descriptive method requires identifying and then adding together the component parts of value-added for the company. Value-added is created by the company's own labor services and capital services. so value-added for the period is computed as the sum of (i) wages, salaries and benefits paid to employees, plus (ii) interest paid to creditors, plus (iii) profits (either paid or retained) for the owners. The tax rate is then applied to the total. This is called the "addition method," for the obvious reason. Although in use in two states, this method is sufficiently difficult that it is not under serious consideration at the federal level, so it is not discussed further in this statement. Under this system most of the value-added is computed without regard to sales because wages, salaries, benefits and interest are incurred without regard to the timing of sales.

3. Credit Method

Often called a third method for computing value-added, the "invoice and credit method" is perhaps more accurately described as a third method for computing the tax liability itself. This method (called the "credit method" hereafter) requires the company to compute a tax amount for each sale and then record that amount on its invoice or sales receipt given to another business. The company then aggregates the tax amounts on its sales receipts to compute a tentative liability. It also aggregates the tax amounts on its purchase receipts to compute the tax attributable to what it has bought. By subtracting its purchases' tax notations from its sales' tax notations (*i.e.*, by crediting its taxes on purchase invoices against its taxes on sales invoices), the company computes its liability for the period. The credit method is often called a "transactions" tax because the rate is applied to each sales transaction.

In essence, the credit method is a variation of the basic subtraction method. The subtraction method subtracts gross purchases (P) from gross sales (S) and multiplies the balance times the tax rate (TR) to produce tax liability, so that Tax = (S - P)TR. The credit method multiplies each sale and each purchase by the tax rate and then subtracts taxes on gross purchases from taxes on gross sales to produce tax liability, so that Tax = (S)TR - (P)TR. The mathematical results under each method are the same because (S - P)TR = (S)TR - (P)TR.

B. The Merits of the Subtraction Method Versus the Credit Method

Even though the credit method and the subtraction method are substantively identical, conventional wisdom has long held that the credit method is preferable. This is due at least in part to the fact that the credit method is well known because it is used in VATs in Europe and elsewhere. Also, the credit method is generally perceived as being more flexible, easier to enforce and more visible than the subtraction method. The proponents of the major proposals in this country have chosen the subtraction method value-added tax as the preferred approach for the United States. Two basic reasons support this choice -- (i) it offers the best means for keeping the tax simple and neutral and (ii) it is readily adaptable to the accounting and bookkeeping practices already in place for the income tax, public disclosure and basic business needs.

1. Simplicity

The subtraction method is the simplest means for computing the tax because it stems from a very basic concept. By computing the excess of gross sales receipts over gross business purchases, a company can readily determine the taxable amount to which the tax rate is applied. The subtraction method is also gaining favor because it is generally perceived as being incapable of handling multiple tax rates and other complexities. Commentators believe that the accounting difficulties of tracking categories of sales and purchases for purposes of applying different rates and other rules make the subtraction method incompatible with such complexities. In contrast, the credit method is widely regarded as being flexible enough to allow multiple tax rates and various preferential rules to be imposed. The credit method can impose a categorization process on the seller which allows different tax rates to be applied to sales invoices for different categories of goods and services. This, in turn, allows both the seller and the buyer to keep track of the gross amount of tax attributable to each transaction. The subtraction method would require both the seller and buyer to categorize each sale or purchase on their books as being in one rate class or another and then apply the appropriate rates to the aggregate amounts in each category for each accounting period.

This difference in flexibility alone is sufficient reason to adopt the subtraction method. If the "inflexibility" of the subtraction method helps to assure that a value-added tax in the United States will apply a single rate to all businesses without imposing biases or distortions on the economy, then that is an invaluable advantage to this approach.

2. Familiarity

The subtraction method also allows a company to use its most basic financial data -- gross sales and purchases -- when computing the tax amount. With far fewer accounting rules than are imposed either for generally accepted accounting principles ("GAAP") or for income tax rules, the subtraction method is relatively easy to implement. The credit method, on the other hand, would require a company to add to each sales invoice a line which states the amount of tax attributable to the sale. Then, when recording both its sales and its purchases, the company must create a new accounting category and place into that category the tax shown on each sales invoice and each purchase invoice. Although not fatal to a simple system, these steps would create some additional compliance requirements which the subtraction method would not impose.

The subtraction method's computations are also seen as being more familiar to U.S. businesses which are accustomed to the federal income tax where, simply stated, gross income minus deductions equals taxable income. Both financial and income tax accounting already require that companies record their aggregate receipts and expenses for a given accounting period. A subtraction method value-added tax would use the same basic data and procedure.

Conversely, relatively few U.S. businesses are already accustomed to tax systems that are computed and recorded on each sales invoice with a subsequent record of the tax amount. Retailers which pay state and local sales taxes have such familiarity. Manufacturers which are subject to the handful of federal excise taxes (such as on alcohol and tobacco products) and gasoline retailers have some familiarity with computations based on transactions, but these are generally based on quantities produced or sold rather than on invoice prices. So, in a sense, the American business tax "culture" is much better attuned to the subtraction method than it is to the credit method.

C. Brief Comparison to a Sales Tax

While a subtraction method value-added tax and a retail sales tax apply to the same theoretical base, the sales tax concept presents the unnecessary risk of missing all of the value-added represented by (i) the "underground economy" which sells goods and services to consumers without reporting such sales and (ii) the banking and insurance industries which are unable to identify the actual fee that is charged as part of each loan payment or insurance premium paid by consumers. When a consumer purchase is not taxable, *all* of the value-added in the goods or services are exempt. A value-added tax will at least apply to that portion created by honest businesses that are in the system.

Also, some system must be devised to prevent the "cascading" effect of taxing sales of goods and services that are used by a business in the production of its own goods and services. Exempting goods that will be resold is not sufficient. Goods and services that a business purchases to use when producing its own goods and services cannot be subject to the sales tax because their value will be taxable again at a later stage. To avoid such cascading will place a significant burden on the seller to distinguish between types of customers. Consider this issue as it affects sales of goods and services by airlines, utility companies, computer and software dealers, hotels, gasoline retailers and lawyers -- just to name a very few. The value-added tax avoids these complexities completely because a business purchaser is able to deduct the cost of its purchases when computing its own tax liability.

APPENDIX

A. The Economic Effects of a Value-Added Tax

A value-added tax is neutral in its impact on a number of economic decisions which are distorted by the current hodge-podge of federal tax systems. For example, a value-added tax does not distinguish between the use of labor services or capital services. It applies equally to payments for both in whatever proportion each is used. Thus, the decision to use either more employees or more capital to transform inputs into more valuable outputs would be driven by factors other than the value-added tax. Similarly, whether a company decides to finance its operations through debt or equity is irrelevant under the value-added tax. Interest and profits *both* are in the base and are taxed at the same rate.

A value-added tax does not distinguish between the sectors of the economy. The value-added that is created by the service sectors and the value-added that is created by manufacturers are subjected to the same rules and tax rate. Also, a value-added tax is indifferent to the origin of goods and services as long as they are purchased or consumed within the taxing country's borders. A value-added tax system eliminates the advantages currently enjoyed by foreign companies which sell in the United States while paying little of the existing income tax and none of the payroll tax on the value of their imports.

A value-added tax also treats all entities the same, regardless of the form of the business organization involved -- whether C corporations, S corporations, partnerships and sole proprietorships. These labels are irrelevant under a value-added tax system.

B. Who Bears the Burden of a Value-Added Tax?

Economic theorists will probably never settle the argument about who bears the ultimate burden or "incidence" of a value-added tax. The traditional view is that such taxes are fully passed forward to consumers in the form of higher prices. The theory is that a value-added tax can be passed along by businesses because the full cost of purchases (including taxes) is recovered when it sells its goods and services. This assumes that markets are completely inelastic, meaning that consumers will buy the same quantities of goods and services at the higher prices as they bought at lower prices before the value-added tax was enacted. In such an inelastic market, any business would be foolish *not* to pass along the value-added tax costs to its customers. But does this differ from the situations involving other taxes -- or any other costs -- paid by businesses? In other words, if markets are completely inelastic, wouldn't businesses also fully pass forward the costs of all taxes? Does the label "value-added tax" insulate this tax from consumer resistance to price increases?

The alternative economic view does not conclude that a value-added tax (or any other "consumption tax") is not passed forward to consumers. In fact, as a net addition to current taxes, a value-added probably would be passed forward to some degree. Rather, the alternative view concludes that there is no qualitative difference between the incidence of a value-added tax and that of any other business tax. The burden will be shared in part by labor, in part by owners and in part by consumers. Market forces will determine how large each part is, and mere labels will not dictate a result.

C. Inflationary Effect of a Value-Added Tax

Given the traditional view that a value-added tax is fully passed forward in higher prices, the conventional wisdom is that enactment of such a tax will have an inflationary effect. However, there is no way of predicting with certainty what effect a value-added tax will have on inflation, just as there is no certainty in predicting how other tax reforms, tax decreases or tax increases will affect inflation. That probably depends primarily on the Federal Reserve Board's response to such changes. A serious evaluation of the effects on prices and on inflation of the introduction of VATs in 35 countries was undertaken by Alan Tait at the International Monetary Fund. Tait's research found that there was little or no effect on the price index in 22 of the countries, that an acceleration of inflation followed the new tax in six countries and that a shift in prices followed in the other seven. Even though inflation did occur in a few of the countries, Tait noted that other factors -- such as government monetary and fiscal policies, the use of the new tax revenues and advance commentaries and expectations by policy makers and the public -- explain more about inflation trends than the introduction of a value-added tax. His

study is strong support for the argument that a broad-based business tax alone does not accelerate the rate of inflation, particularly when it replaces other taxes.

D. The Value-Added Tax Applies Equally to Labor Services and to Capital Services

One persistent criticism of a value-added tax is that it taxes only labor, because machinery and equipment costs are fully deducted in the year incurred while employee compensation (including all wages, salaries and benefits costs) is not deducted at all. In fact, a value-added tax applies equally to labor and to capital. More accurately, it applies equally to payments for labor services and to payments for capital services. When a company purchases machinery and equipment, it must be allowed to remove the costs of such assets from its value-added base because *the costs of such assets have been taxable to the producers of those assets*. Not allowing a deduction for these costs would result in double taxation of the same value-added.

What is generally overlooked is that the purchase (or lease) of more and/or better machines requires the use of more debt capital or more equity capital -- or probably both -- to fund the purchase or lease. When this happens, the capital services component of the value-added base will be much higher than otherwise would otherwise be the case. Interest costs will rise and profits must rise to pay the lenders and owners for the use of more of their capital (as well as to repay the lenders their capital itself). While there is a one-time reduction in value-added as the costs of machines are deducted, the capital services portion of the value-added base will be significantly increased for several years.

E. Regressivity

VATs in Europe, Canada and other countries generally either exclude sales of food, housing and medical care from the system (using a zero rate of tax) or impose a much lower rate of tax on sellers of these and other "necessities." Conventional wisdom is that such exclusions and preferences are necessary to offset the perceived "regressivity" of a value-added tax, based on the traditional view that it will always be passed forward to consumers in the form of higher prices whereas other taxes are not.

But the usual approaches to addressing regressivity are ill-advised *even if the traditional incidence analysis is correct*. Preferential treatment of necessities is wasteful, minimally effective and distortive. When exclusions or preferential rates apply to sellers of food, medical care and housing, they apply to *all* sellers and to *all* of their sales. As a result, a huge portion of the anti-regressivity "benefits" are wasted on middle and upper income households which buy more quantities -- and more expensive -- food, medical care and housing. Furthermore, such exclusions can reduce the tax base by 30 percent or more, which requires raising the tax rate on all other business sectors (whose products and services low income households also buy) to cover the revenue loss. This process destroys neutrality among business sectors, distorts economic decisions and creates a system that is very complex and costly to administer.

Perhaps this is explains the trend in other countries to reduce or eliminate the use of such preferential rates for "necessities." The New Zealand tax enacted in 1986 (and widely regarded as a model broadly-based VAT system) uses only one rate and applies it to all businesses. Even the EC countries which introduced the use of multiple rates are trying to lessen the number of rates and the categories of activities.

The better approach is to tax all businesses on value-added at a single rate which maximizes the efficiencies of the system and prevents distortions among industries. Then, a portion of the revenues that would otherwise be lost through exclusions or preferential rates can provide income and payroll tax reductions, refundable tax credits and/or income support programs that benefit only those households which are the intended beneficiaries of such assistance.

F. "Visibility" of a Value-Added Tax

Conventional wisdom holds that a value-added tax is a "hidden" or "invisible" tax and, therefore, its rates are very easy to increase. The theory is that voters will not notice a value-added tax, making it quite painless for government to raise the rate at will. Much of the commentary on the flat tax and the sale tax emphasizes a need to make taxes almost painfully visible. Whether visibility is *politically important* to restrain the size of government or not is debatable. If it is, there is no mechanical reason why each retail sales receipt cannot say "includes XX% value-added tax."

G. How the Subtraction Method Value-Added Tax Works

The Taxpayers. The value-added tax base should include the value-added by every "business" in the economy, without regard to the legal form of the entity. Profit motive and profitability are irrelevant for value-added tax purposes. All that is important is that the entity has added value to the economy through the production and sale of goods and services.

The Taxable Amount. For purposes of a subtraction method value-added tax, the "taxable amount" is simply the excess of receipts from sales of goods and services in the United States over purchases of goods and services *(i.e.*, raw materials, machinery, energy, intangibles, accounting services, pencils, *etc.)* used by the company to produce its output. A company does not have to grapple with the income tax concepts of inventory capitalization, depreciation, bad debt reserves, intangibles amortization, *etc.* These concepts are not needed in the value-added tax context. The specific tax liability is computed by applying the tax rate to the taxable amount.

Exports. Any value-added tax attributable to exported goods and services must be removed or rebated. Otherwise, the value that is created and taxable in this country would be taxable again in the destination country if that country imposes a similar tax -- and all of our major trading partners do. The simple approach under the subtraction method is to exclude export sales from gross receipts while deducting all purchases relating to the exports, thus allowing the exporter to recover the full amount of value-added tax attributable to the goods and services which it purchased as inputs for its exports. For a company which sells exports exclusively, its sales receipts for the purposes of a value-added tax will always be zero. For a company which is primarily but not exclusively an exporter, its includible receipts will be low. When there is an excess of input purchases over sales receipts, producing a "negative value-added," a refund equal to the tax rate multiplied by the negative amount is necessary.

Imported goods. The value of imported goods and services must be included in the value-added tax base to ensure that all of the economic value that is added to goods and services before they arrive in this country is taxable identically to the value-added in domestic goods and services. Because there is an identifiable entry point for imported property, the importer can be subjected to the value-added tax system by computing its value-added at the time the import enters the United States. The amount of value-added for an imported item can be defined as the total amount which the domestic purchaser pays to acquire the item and to get it to the United States (including transportation and insurance fees). Whether we collect a check at the border or simply add the amount of taxable value-added to the importer's value-added tax return is an administrative choice. Alternatively, business importers can be denied a business purchase deduction equal to those costs.

Imported services. In contrast to imported property, imported services have no "entry point" where it is possible to either impose the tax or make a record that can be cross-checked later. Telecommunications, financial services, professional services and others move electronically and via the mails and couriers with no visible border crossings. International transportation services provided to passengers and goods are also difficult to track. Nonetheless, any value-added tax in the United States can and should be applied to all foreign services. One option is to ignore such services for border adjustment purposes and then deny the importer a value-added tax deduction for the costs of the services. This would include the value of the services in the tax base without the need to monitor flows of such services across the U.S. border.

Financial intermediation services. Financial service companies add value to the economy when they serve as intermediaries to the actual parties of financial transactions, such are between depositors and lenders or among those are pooling their insurable risks. This financial intermediation has value which customers are willing to pay for, either directly or indirectly. The value of such financial intermediation must be identified for value-added tax purposes. However, because no explicit fee is charged, financial intermediation services are routinely excluded from VATs around the world due to the perceived inability to determine "value-added" on each specific transaction such as a monthly loan payment or insurance premium payment. One advantage of the subtraction method is that the value-added need *not* be computed transaction-by-transaction. Instead, the bank can compute its implicit fees (which are part of the interest rate "spread," *etc.*) for each accounting period and take the aggregate amount into account along with its other receipts from sales of services.

Small businesses. Small businesses representatives often criticize value-added taxes as imposing significant burdens on small business, based on VATs in other countries. Under these

systems, small businesses -- indeed, *all* businesses -- are definitely subjected to burdensome record-keeping requirements which track the categories of goods and services they sell in order to properly compute the tax. The problem is not the concept of a value-added tax, but how VATs have been structured. Small businesses would not face the same burdens under a single rate subtraction method value-added tax in the United States. In fact, complying with such a value-added tax would probably be much easier for small businesses than complying with our current income and payroll taxes. Some proposals present mechanisms for providing targeted relief for small businesses under a value-added tax in the United States, primarily to lessen the administrative expenses of the government with very little loss of revenue. Whether this is desirable or acceptable in the context of *replacing* taxes currently paid by small businesses is questionable.

Real property. Real property is yet another market segment that is often considered to be too difficult by many VATs that exempt at least some real estate activities. Nevertheless, real estate activities *(i.e.*, buying, selling, and leasing of land, buildings and housing) should and can be included in the base of a value-added tax in the United States in one of two ways -- as an *operational asset* or as a *financial asset.* Real estate has some characteristics of both models. For example, some land and buildings are similar to the proverbial "widgets" because they are the products sold by home builders, commercial builders and developers. Both the seller/lessor and a business purchaser/lessee could reasonably treat such real estate transactions like any other sales of goods and services for value-added purposes. But some real estate transactions have more characteristics of the financial asset model. When financial services companies or developers hold land for future use, they could be engaged in investment activities rather than business activities currently. The approach for including real property sales in a value-added tax probably should be based on some compromises between precision and administrative simplicity.

Government and non-profit entities. Governmental entities add value to the economy when they engage in activities which, if carried on in the private sector, would be considered "business" activities. Such activities would include public utility services, medical services, postal services, mass transportation services and any other activities not involving the exercise of any essential government function. The value-added generated by these activities should be subject to the value-added tax in the same manner as the corresponding activities in the private sector. Many organizations which are exempt from the federal income tax also engage in value-adding activities that can be included in the tax base. The widely accepted social policy of exempting charitable and educational functions from most taxation may dictate that a value-added tax only be applied to those activities of the organization which produce unrelated business taxable income.

Other taxes. A value-added tax should be the federal government's general revenue source. Other taxes should not be allowed as deductions or credits, no matter what purpose such taxes achieve. The practical result of allowing certain types of taxes -- *e.g.*, sales taxes, excise taxes, other *indirect* taxes -- to be excluded from gross receipts or to be deducted when paid to a government will be an erosion of the federal tax base. All jurisdictions will be pressured by businesses to push as much of their own revenue base as possible through this loophole. To allow one or more taxes to be removed from the value-added tax base will sanction a superior status for such taxes by sanctioning that tax's first claim on *that* base.

H. Administrative and Compliance Issues

The difficulties of administration and compliance under a value-added tax are largely determined by the complexity of its underlying structure. A May 1993 IRS report concluded that the cost and difficulty of administering a value-added tax would be directly dependent on the complexity of the system and urged that "it is imperative to the interests of both taxpayers and the government that [such] legislation be kept as simple as possible." A series of varying tax rates, exemptions and preferences on sales of particular goods and services naturally requires more regulations and more complicated compliance procedures than would a single-rate value-added tax applied neutrally to all sectors of the economy. This, in turn, will generate major audit and litigation controversies. In addition to such potential controversies, businesses attempting to comply with all of the varying rates and exemptions would be required to establish procedures that identify those goods and services treated preferentially versus those that are not. Such administrative and compliance problems would be substantially reduced by enactment of a single rate value-added tax that applies neutrally to all business sectors. The Government Accounting Office estimates that a system with a single-rate and virtually no preferences would reduce audit costs by 30 to 50 percent, compared to one with multiple rates and exemptions

A single rate subtraction method value-added tax system should reduce the administration and compliance burdens of the current business tax system (if used as a substitute). Only two sets of basic data that most companies already keep for various reasons -- gross sales receipts and gross purchases of goods and services -- would be required. While certain categories may need to be identified rather than grouped with other sales and purchases (*e.g.*, exports, imports, interest), this should be a one-time change to bookkeeping procedures. Once these basic sales and purchases data are computed, a company's task would essentially be complete under a value-added tax system. It would merely apply the applicable tax rate to the base to determine liability. To this extent, a value-added tax would be relatively easy to comply with in comparison to the income tax or financial statements under GAAP rules because there would be far fewer adjustments and computations required .

Because the basic information required to compute value-added is readily available in the business community, maintaining records for use by IRS audit agents will be no more onerous than current practices. The suggestion that a credit method tax will enhance compliance compared to the subtraction method seems implausible. The notation of tax amounts on invoices does not assure that the seller is properly reporting its liability to the government. The possibility that an audit agent will look through thousands of sales invoices -- hundreds of thousands for large companies -- to add up tax amount is equally implausible. The Internal Revenue Service is far more likely to assess a company's accounting practices and to take statistical samples of invoices sampling during an audit.

Businesses should be allowed to use either the accrual or cash method for recording sales and purchases, based on the method currently used for their financial reporting. For accrual taxpayers, sales and purchases would be treated as occurring in the reporting period in which title passes or services are performed. For cash basis taxpayers, actual receipt or payment dates would determine the correct reporting period.

The tax would be computed, collected and paid for each "taxable period," which probably should be a calendar quarter or a quarter of whatever year is sensible for the business. If some companies have negative value for that period because their purchases exceed their sales, that negative amount must be taken out of the total tax base. Otherwise the system is exposing some value-added to double taxation -- once in the value-added tax bases of the companies which sold the goods and services to the "negative" company and again in that company's base. Therefore, taxpayers who have business purchases in excess of gross receipts for any period would be entitled to a refund from the Treasury equal to the value-added tax multiplied by the excess.

Chairman ARCHER. Thank you.
Dr. Cnossen.

STATEMENT OF SIJBREN CNOSSEN, PH.D., PROFESSOR OF ECONOMICS, ERASMUS UNIVERSITY, ROTTERDAM, THE NETHERLANDS

Mr. CNOSSEN. Mr. Chairman, distinguished Member of the Committee. I am a professor of tax law and economics at Erasmus University, Rotterdam. I have written widely on various consumption taxes and advised 17 countries on the design of their consumption tax system.

I am honored, Mr. Chairman, to discuss today proposals for broad-based consumption taxes, which are being considered by your Committee. In the U.S. debate five options of a broad-based consumption tax are under review: A national retail sales tax, a value-added tax, a business transfer tax—all indirect approaches to taxing consumption—and two direct approaches: A flat tax and a consumed income tax.

In my written testimony, I have reviewed the pros and cons of these alternatives in some detail, generally by applying the criteria that you, Mr. Chairman, recently announced. Specifically, I have tried to find an answer to the following questions: First, what is the most robust form of consumption tax?

In other words, which form permits the broadest possible base ensuring equal treatment and which form is least susceptible to erosion through the political system?

Second, which consumption tax is the most difficult to evade and avoid? Third, which consumption tax has the lowest operational costs? Fourth, what is the most neutral form of consumption tax?

Fifth, which consumption tax is best in freeing exports of tax, in line with your call for promoting competitiveness. And finally, which consumption tax interferes least with State retail sales taxes?

Mr. Chairman, an analysis of these questions has led me to the following conclusions: One, a national retail sales tax would not seem compatible with State retail sales taxes: Bases would be different, taxpayer resistance would be great, and such a tax would add substantial complexity.

Also, a retail sales tax is not very good in taxing services, in comprehensively excluding business inputs from taxation and by extension making sure exports leave the country completely free of tax.

Two, the value-added tax seems the most robust and neutral form of consumption tax. A sizable small business exemption—I would like to emphasize—of, say, $100,000 can eliminate most of the incompatibility with State retail sales taxes because most businesses filing for the Federal value-added tax would not have to file for State retail sales taxes and vice versa.

Such an exemption would cut in half the number of taxpayers that would have to be registered under a national retail sales tax. The number of taxpayers under a retail sales tax would be about 20 million; the number of taxpayers under my VAT with a generous small business exemption of $100,000 would be 10 million. Accordingly, it would make the VAT a much less intrusive tax.

Three, the business transfer tax appears compatible with State retail sales taxes. However, it is very vulnerable to erosion through the political system. In contrast to the value-added tax, there is no penalty on being exempt from tax. The tax on value added that is not taxed is lost forever. Hence, the business transfer tax would generate relentless political pressure to exempt "worthy" products and industries.

In my opinion, the system of freeing exports from tax under the business transfer tax would not be acceptable to the international trading community.

Four, the flat tax resembles the income tax, and any tax that resembles the income tax would soon become like an income tax, riddled with exemptions and provisions for special treatment. Like the income tax, the flat tax has difficulties distinguishing business income from labor income. As an origin-based tax, moreover, that includes exports in the tax base, it would face the same kind of cross border, intercompany transfer pricing issues as the current corporation tax.

Five, the consumed income tax is the most costly and intrusive form of consumption tax. In addition to keeping records of income, taxpayers would be obliged to keep and furnish records of savings.

Mr. Chairman, I must admit to a comparative advantage in the field of value-added taxation. Even after allowing for this, however, I believe that the value-added tax is the preferred form of consumption tax. The VAT has the broadest possible base and is less susceptible to political erosion than are the other options.

Also, the value-added tax is most neutral with respect to domestic economic activities as well as foreign trade. This is an important attribute of an acceptable tax in a highly competitive and interdependent world which leaves the optimal allocation of resources to the free play of market forces. The value-added tax probably is less evasion-prone and less costly to administer than the other forms of consumption tax. To a large extent the value-added tax can be made compatible with State retail sales taxes.

Mr. Chairman, if the United States were to give serious thought to adopting a value-added tax, it should be advised to stay clear of the mistakes and shortcomings of the European value-added taxes. In particular, it would be advisable to tax all goods and services with virtually no exemptions, to impose a single rate of tax and to provide for a generous small business exemption of $100,000, eliminating 60 percent of all potential taxpayers at a revenue cost of less than 3 percent.

In conclusion, Mr. Chairman, if a value-added tax were adopted, it is crucial to get it right the first time—by simplicity and structure in operation, stability and certainty in legislation and rulings, and convenience in payment arrangements.

A broadly based value-added tax with a single rate, virtually no exemptions and a generous small business exemption would promote the acceptability of the tax and keep initial and ongoing operational costs within reasonable bounds. Mr. Chairman, distinguished Members, I would be pleased to answer any questions, and thank you for permitting me to testify before this Committee.

[The prepared statement follows:]

WHAT KIND OF CONSUMPTION TAX
By Sijbren Cnossen[1]

Mr. Chairman, Distinguished Members of the House Ways and Means Committee:

For some time, the body politic, the business community, and the tax profession in the United States have been debating the desirability of introducing a broad-based consumption tax which is absent from the American federal tax system. Various options are being considered, ranging from *in rem* consumption taxes on transactions to a personal tax on aggregate individual consumption, akin to the individual income tax. I shall comment on these options, generally by applying the criteria that you, Mr. Chairman, have announced in the Committee's Advisory of May 11, 1995. More specifically, I shall try to find an answer to the following questions:

- What is the Most Robust Form of Consumption Tax?
- Which Consumption Tax is the Most Difficult to Evade and Avoid?
- Which Consumption Tax has the Lowest Operational Costs?
- What is the Most Neutral Form of Consumption Tax?
- Which Consumption Tax Permits the Most Unambiguous Border Tax Adjustments?
- Which Consumption Tax is Best for Capital Formation and International Competitiveness?
- Which Consumption Tax Interferes Least with State RSTs?

The answers to these questions lead me to the conclusion that the value-added tax (VAT) is the preferred form of consumption tax (CT). The VAT has the broadest base and is less susceptible to political erosion than are the other options. Also, the VAT is neutral with respect to domestic economic activities, as well as foreign trade. This is an important attribute of an "acceptable" tax in a highly competitive and interdependent world, which leaves the optimal allocation of resources to the free play of market forces. The VAT probably is less evasion-prone and less costly to administer than are the other forms of consumption tax. Finally, to a large extent, the VAT can be made compatible with state retail sales taxes.

1. What are the Choices?

Five options are being considered in the current debate. These options are: the retail sales tax (RST), the value-added tax (VAT), the business transfer tax (BTT), the flat tax (FT), and the consumed-income tax (CIT).

a. The RST purports to apply the tax only to sales made by retailers to final consumers. To confine the tax to consumer sales, registered businesses are permitted to make tax-free purchases upon the presentation of a tax registration certificate. The U.S. and Canada are (the only) two countries with an RST, because it is suitable for administration by subordinate levels of governments (states and counties) in a federation. The Nordic countries and Switzerland used to levy RSTs, but they switched to VATs.

b. Economically, the VAT is identical to the RST. It also taxes retail sales in full. Instead of collecting the full tax from the retailer, however, the VAT

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disburses the collection process throughout the entire production-distribution network. Retailers, who collect the full tax from consumers, remit the tax on their value added (the difference between sales and purchases) to the Treasury, but pay the remaining amount to their suppliers who, in turn, remit the tax on their value added, and so on. At each stage of the production-distribution process, the VAT-liability is determined by permitting registered businesses a credit for the tax on purchases of business inputs (raw materials, intermediate goods and services, as well as capital goods) against the tax on sales. The VAT is the most widely imposed CT in the industrialized and developing world. More than 100 countries now have this form of CT.

c. In principle, the BTT is identical to the VAT, but instead of allowing a credit for tax on purchases, the BTT permits businesses to deduct purchases of (taxable) inputs from sales, applying the rate to the difference. Again, the whole production-distribution network is involved in the collection process, but each stage is only concerned with its own tax liability. There is no accounting for the tax of other stages. No country has a BTT, but Michigan has some experience with this form of CT.

d. In its simplest form, the FT is a modification of the BTT. If, under the BTT, purchases are deducted from sales, what remains are wages (and salaries) and "profits" (a collective name for various "capital income" items rather than accounting profits, as usually understood). In addition to permitting a deduction for purchased business inputs, the FT also allows a deduction for wages. Subsequently, wages are taxed separately at the level of the individual recipient, permitting a basic exemption (and other deductions, if desired). This introduces an element of progressivity into the tax, even if the rate on the individual's remaining wage would be flat. "Profits" are taxed at the flat rate, without a basic consumption. No country has an FT or a tax that comes anywhere close to it.

e. The CIT is a fully personalized CT. At the individual level, the CIT taxes all income (a better word would be incomings), including the proceeds from all forms of borrowing, but permits a deduction for all forms of saving (including loan repayments). The remaining base -- aggregate individual consumption -- can subsequently be subjected to the same kind of rate structure as the individual income tax. In other words, the CIT, broadly and comprehensively defined, can be levied in accordance with ability-to-pay. No country has a CIT, although it is often pointed out that the current income tax is closer to a CIT than to a true "Haig-Simons" accretion type of income tax, mainly because retirement savings are treated on a CT basis.

If the income tax is to be replaced entirely, the new tax will need to raise some $735 billion revenue. This is a very tall order that would require a rate of more than 20 percent on aggregate consumption expenditures (assuming that three-fourths of those expenditures would in fact be taxable). More modest goals, such as reducing the income tax and/or the federal deficit, could be accomplished by a broad CT levied at a uniform rate of, say, 10 percent.

2. What is the Most Robust Form of Consumption Tax?

Neutrality and fairness require that the new CT should be able to include nearly all consumer goods and services in its base. Also, it should not be susceptible to political erosion. If "worthy" goods and services can easily be exempted, the CT would soon degenerate into an excise-type of levy. In short, robustness should be one of the characteristics of the new CT.

RSTs actually in use (or previously levied in the Nordic countries and Switzerland) have never been able to integrate the taxation of services with the taxation of goods. The reason probably is that RSTs must rely on end-use

exemptions to segregate business use from private use of services (which are more often of the mixed-use type than are goods). End-use exemptions are notoriously difficult to apply and monitor, because exempt services must be defined, identified by the retailer (impossible in many cases), and separately accounted for. Whatever the case, potentially taxable services outside distribution easily comprise one-half of GDP in industrialized countries. This is too large a portion of economic activity to be ignored under a CT if equal treatment and neutrality are taken seriously. Moreover, not being able to integrate services in the RST base is itself a source of considerable administrative complexity and ambiguity, since it then becomes necessary to devise arbitrary rules for separating the service element from the sale of a good whenever the two occur in combination.

In contrast, the VAT is the first CT that successfully unifies the treatment of services with that of goods. Unfortunately, some important categories (health care, education, banking, insurance) are usually left out of the base. Nevertheless, some 70 percent of consumer spending on services is taxed in countries that use the VAT, while very little of this spending is taxed in jurisdictions that adhere to the RST. The VAT easily segregates business use from private use of services. The type of service (or for that matter, the type of product) -- business or private -- does not have to be identified, nor the type of purchaser -- business or consumer. Moreover, the VAT always collects tax on taxable inputs, even if the service or the establishment performing the service are exempt. Hence, the rate can be lower, given the yield of the CT.

Obviously, the distinction between goods and services is not relevant under the BTT, FT and CIT which, as accounts-based forms of CT, directly tax value added, wages and "profits", or consumption.

The RST base and the VAT base are both susceptible to erosion through political favoritism. Exemptions achieve this under the RST; under the VAT, a zero rate has the same effect. Clearly, the experience in the few countries that have a zero rate for "basic necessities" (Canada, the United Kingdom, Ireland) is not favorable. Zero rates achieve nothing, but add greatly to administrative and compliance costs. Prior-stage tax must be refunded and small businesses eligible for exemption will still register voluntarily to get the refund.

The VAT has the advantage that it is difficult to exempt pre-retail stages of production and distribution. Since the tax credit on inputs would then not be available, cascading would occur which induces business to register anyway. This contrasts sharply with the BTT under which intermediate stages can easily be left out of the base since the succeeding stage would be permitted a deduction for its inputs anyway. This feature of the BTT would create relentless political pressure to exempt some "worthy" industry, sector, or product. The political system could also reduce the bases of the FT and the CIT, e.g. by allowing a deduction for mortgage interest, gifts, etc.

3. Which Consumption Tax is the Most Difficult to Evade and Avoid?

In terms of the ease with which taxes can be evaded and avoided, transactions-based CTs, such as the RST and the VAT, seem to have an advantage over accounts-based CTs, such as the BTT, FT, and CIT. Under the RST, however, the whole weight of the tax is put on one stage only, i.e. the retail stage where businesses are often small and accounts not always adequately maintained. Evasion is always for the full amount of the RST. In contrast, the multistage collection feature under the VAT gives the tax authorities a lien, as it were, on suppliers for the tax they collect from their customers, including retailers. The rationale for this arrangement is that taxable businesses are less likely to default on tax invoiced by their suppliers than on tax payable directly to the tax authorities.

Furthermore, under the VAT, each invoice exchanged between registered taxpayers represents an unequivocal agreement in respect of the gross tax liability payable by the buyer to the seller and by the latter to the tax authorities. The tax is

made visible each time a taxable transaction takes place. This "public declaration" of the tax liability is an important advantage of the VAT and the RST, if quoted separately. Obviously, its effect is stronger if, as under the VAT, the invoice is used as documentary evidence for the tax credit claimed by a registered buyer. This implies that the effect is weaker at the retail stage (in particular under the RST but also under the VAT) where sales are made to consumers and users who cannot claim credit for the tax invoiced to them.

Like the VAT, the BTT is also collected fractionally throughout the production-distribution process. Unlike the VAT, however, the tax is not calculated and quoted separately with respect to each transaction. There is no "lien" on suppliers for the tax payable in succeeding stages of production and distribution. No "public declaration" of the tax liability exists. The absence of a clearly defined audit trail, as under the VAT, weakens the BTT's fractional collection mechanism. In terms of compliance control and enforcement, the BTT, as well as the FT and the CIT, are akin to the (business) income tax. Since the tax liability is not based on transactions, evasion and avoidance, as under the income tax, would probably be greater than under transactions-based CTs. Moreover, the FT, like the income tax, has difficulties in distinguishing between income from business and from labor.

4. Which Consumption Tax has the Lowest Operational Costs?

Certainty and simplicity in tax design and operation are essential characteristics of an "acceptable" tax, because they minimize compliance and administrative costs. Overall, operational costs are a function of how well the tax base has been defined, how simple the rate structure is, the complexity of taxpayer obligations (computation, filing, record keeping), the extent of tax administrative requirements (accounting and tax collection, audit and enforcement), and the number of taxpayers.

RSTs and VATs, being transactions-based, generally require sales clerks, not accountants, to perform the tax computations. The VAT is somewhat more complicated than the RST, because in addition to tax on sales, credits for tax on purchases must be identified. Basically, however, only two spikes are needed: one on which all sale invoices are pinned and another one for all purchase invoices. The difference between the total VAT shown on all sale invoices and the total VAT shown on all purchase invoices must be computed and remitted to the Treasury (or refunded by it, if the amount is negative). More formally, under VAT, registered businesses must keep a record of purchases in addition to the record of sales which they also have to maintain under the RST. If the tax base is not comprehensive, RSTs require separate accounting for exempt items. VATs do not require separate accounting for zero-rated sales, but they do for tax on items (consumer goods bought through the business) for which the tax credit is denied.

BTTs, being accounts-based, generally require accountants, not sales clerks, to perform the tax computations. In terms of compliance, the BTT although simpler, is akin to a business income tax. Presumably, as under the VAT, records of sales and purchases must be kept. In the absence of invoices showing tax, it would be difficult to ascertain which purchases had been subject to tax. If value added would be determined on an annual basis (when the balance sheet and the profit and loss statement are drawn up), presumably some form of prepayment system would have to be devised. The BTT would require separate accounting for purchases (identified by supplier) from small-businesses, if exempted. Otherwise, value added would not be taxed comprehensively. Compliance costs for the FT would be higher than for the BTT, because the number of taxpayers would be much larger. The CIT, being a personalized tax like the income tax, probably would involve a similar level of compliance costs.

Administrative costs comprise mainly the cost of auditing taxpayer accounts. It is unlikely that audit costs, as a percentage of revenue, would differ very much between various CTs. In all cases, in-depth audits would have to be based on comprehensive accounts, such as balance sheets, profit and loss statements, and

bank accounts. VAT audits might be easier, because the tax on invoices provides a clear audit trail.

Overall compliance and administrative costs would also depend on the number of taxpayers. There are approximately 25 million separate business enterprises in the U.S. Under an RST, some 20 million businesses (retailers as well as wholesalers and manufacturers selling at retail) would have to be registered. Given a small-business exemption of, say, $100,000, the number of registrants under a VAT should not exceed 10 million (including voluntary registrants). The BTT would probably involve a larger number of taxpayers, because more small businesses would have to be taxed to ensure neutrality. The number of taxpayers under the FT and CIT would be much larger than under either of the other CTs, because, in addition to business entities, individuals earning employment income would have to be registered.

On the basis of a careful evaluation of various studies on the administrative and compliance costs of a hypothetical U.S. VAT (see, Tax Notes, June 20, 1994), I concluded that the administrative costs would be on the order of $100 per registrant and the compliance costs on the order of $500 per business. Hence, with 10 million registrants, total ongoing operational costs would be some $6 billion on an annual basis. (In comparison, the operational costs of the income tax are estimated at $75 billion.) The operational costs of other CTs likely would be higher. A federal RST would have more registrants, as would the FT and the CiT. Audit costs would be somewhat higher under the BTT, because there would be no presumptive record of tax-deductible purchases.

5. What is the Most Neutral Form of Consumption Tax?

Tax policy proceeds from the assumption that the market achieves the most efficient allocation of resources. This implies that CTs should not unintendedly interfere with producer and consumer choices. Specifically, it should make no difference for the CT-liability how often a product is traded before it reaches the consumer or whether its value is added earlier rather than later in the production-distribution process. Similarly, the CT-liability should be the same whether a product is manufactured with capital-intensive technology or labor-intensive technology. Also, CTs should not influence the form in which business is conducted. It should make no difference whether a product is made in the corporate or noncorporate sector, by integrated or specialized firms.

The RST does not score highly on the neutrality list. The main reason is that RSTs have difficulty distinguishing between producer goods (that should not be taxed) and consumer goods (that should be taxed). How does a registered trader know that a computer it supplies will be used for entertainment purposes at home (taxable), for resale (exempt), or as an (exempt) capital good for (taxable) hotel services? The inability to distinguish effectively between producer and consumer goods in practice means that many producer goods are taxed. This discourages capital-intensive production and, hence, economic growth. For similar reasons, RSTs are not very effective in taxing services, again distorting economic choices, particularly of consumers who will tend to buy more (untaxed) services relative to (taxed) goods.

The VAT scores much higher on neutrality grounds. Distinctions between producer and consumer goods and services --increasingly troublesome in sophisticated markets -- are unnecessary. Registered sellers, including retailers, are simply told to always charge tax, leaving it to buyers to obtain a tax credit if they are also registered (and placing the tax unequivocally on consumers who are not registered.) Consequently, the universal tax credit for registered businesses eliminates tax on producer goods more comprehensively than does the *ad hoc* exemption approach under RSTs. By way of exception, under VAT, financial services and insurance rendered to producers are saddled with an element of VAT on taxable inputs, because their output is usually exempted. (VATs have exempted financial services and insurance, because thus far it has been difficult to separate the nontaxable interest element of a transaction from its taxable administrative cost.)

In theory BTTs, which allow a deduction of taxable purchases from taxable sales, should be as neutral as the VAT. In practice, however, it would be difficult for registered businesses to ascertain with certainty whether or not purchases have been subject to BTT. Presumably, sellers would have to show some tax registration certificate to buyers, inviting similar identification issues (albeit reversed) as under RSTs. BTTs with comprehensive coverage would mitigate, but not eliminate, this problem, particularly if a sizeable small-business exemption is introduced. This issue would also arise under an FT, but not under a personalized CIT. These forms of CT, however, would have other neutrality problems, akin to those of the income tax.

6. Which Consumption Tax Permits the Most Unambiguous Border Tax Adjustments?

The neutrality criterion is also relevant for goods and services entering international trade. As is well known, such goods and services are nearly always taxed on a destination basis, that is, in the country where they are consumed rather than the country where they are produced. The destination principle is effected by relieving exports of domestic CT and levying CT on imports at the same rate as the CT on domestically produced goods and services. These border tax adjustments (BTAs) ensure that tax distortions, if any, are not placed in producer markets (producers are faced with world market prices, free of tax), but in consumer markets (where they are probably less harmful). Other things being equal, CTs on exports would undermine the competitive position of American firms in international markets. Similarly, undertaxation of imports would give foreign firms an unfair edge in U.S. markets.

Prima facie, RSTs do not require BTAs, because, as a rule, retailers do not import or export. (Exceptions arise with respect to occasional imports (and exports) by consumers.) Although exporters do not have to pay RST, their prices (and incomes) would be affected, however, by the tax imposed on producer goods which, as argued above, cannot be comprehensively excluded from the base. This should have a detrimental effect on international competitiveness. The RST, moreover, discriminates against domestically produced goods, because the price of those goods includes an element of tax on producer goods (in addition to the RST itself), while the price of goods imported from countries without an RST does not include that tax.

The VAT has fewer difficulties meeting the requirement of unambiguous BTAs. Tax levied in previous stages of production and distribution, being shown on purchase invoices, is simply rebated at the export stage. Moreover, imports are not favored, because domestically produced goods are not burdened with an element of tax on producer goods (except banking and insurance). However, the BTA-arrangements for the VAT cannot deal effectively with non-tangible services whose location of supply or purchase is difficult to determine. Most VATs provide a workable solution by taxing services mainly rendered to final consumers in the country of purchase, which in virtually all cases is also the country of destination. On the other hand, services exported by banks, insurance companies, professional services, advertising agencies, and similar enterprises, which are rendered mainly to business, are zero-rated. By deeming the location of the purchaser as the place of supply, imports of designated services are thus taxable in the hands of receiving businesses as though they had supplied them themselves.

Under the BTT, exports would be completely freed of tax if the tax rate, which must be uniform, is applied to the value of taxable inputs used in manufacturing exports, and the resulting amount is refunded. But this approach requires proof that the inputs have indeed been taxed as sales in previous stages of production and distribution. In contrast to the VAT, invoices do not provide the presumptively correct documentary evidence that this has indeed been the case. No doubt, this would invite objections from the trading partners of the U.S. These trading partners would also argue that the BTT is not a tax on products *per se* (but rather an accounts-based tax on value added) and hence not eligible for export rebate under GATT.

The FT is an origin-based tax. In other words, exports would be taxed and imports would be free of tax. Hence, the burden of the tax is on producers rather than consumers (who face world-market prices). Under the so-called equivalence theorem, exchange rate adjustments would cancel the effect of the origin-based tax on real trade, but in practice the effect would differ from one industry to another industry. An origin basis of taxation also means that exports have to be valued for FT purposes so that no value added domestically escapes the tax. This would raise problems reminiscent of the potential for manipulating cross-border intercompany prices under the corporation tax. The CIT is also an origin tax or a source tax, to use the terminology of the income tax.

7. Which Consumption Tax Is Best for Capital Formation and International Competitiveness?

In thinking about the effect of a CT on capital formation and international competitiveness, the comparison should not be between various forms of CT, but with the income tax.

In contrast to an income tax, a CT is neutral with respect to the choice whether to consume now or to save for future consumption. Although a CT reduces the absolute return to saving (that is, the amount of future consumption), the tax does not reduce the net rate of return to saving. A comprehensive income tax, on the other hand, reduces the net rate of return to saving, because both the amount saved and the interest earned on that amount are subject to tax. Therefore, if it is assumed that saving increases as the net rate of return on saving increases, a CT is superior to an income tax in promoting saving. By the same token, a CT does not tax (new) investment or, in contrast to an income tax, (current) capital income (if not consumed). On the basis of this reasoning, a CT should be better for capital formation than a pure income tax. In practice, of course, the outcome might not be so pronounced, because the current income tax also does not tax current (institutional) saving; in addition, it has various investment promotion allowances. Also, second-order effects on interest rates and other economic variables would have to be taken into account.

Furthermore, under a uniform CT, all consumer prices would rise exactly in proportion to the CT, thus leaving all relative prices unchanged. The imposition of a CT, therefore, does not involve a change in the allocation of resources and production incentives. Moreover, international competitiveness is not affected if proper BTAs are in place. In this connection, it should be pointed out that these BTAs, particularly under the VAT, are not a tariff-cum-export subsidy. On the contrary, BTAs under VATs (and the BTT) put internationally traded goods and services on the same footing as under RSTs. In practice, as argued above, internationally traded goods and services are treated more neutrally under the VAT than under the RST. BTAs are troublesome under BTTs.

This conclusion must be modified if the VAT, RST, or BTT were substituted for the income tax. As a tax on current consumption (of domestically produced and imported goods), the CT would dampen domestic demand. By contrast, income tax is an inducement to current consumption. Substituting the CT for the income tax, therefore, improves the trade balance. Over time, however, this effect would cancel itself out, because the accumulation of foreign reserves would lead to increased imports. In short, the CT would have a positive short-run effect on the trade balance, but no such effect would occur in the long run.

Other things being equal, international competitiveness would suffer under FTs and CITs, because the tax would not be rebated at export. Since world prices facing producers would not change, the CT on exports would be borne by them, exports would decline, the U.S. dollar would depreciate, and imports would become more expensive. In effect, the nonrebatable CT would be a protectionist import tariff violating the spirit of the GATT. Presumably, little would change if the FT or the CIT were substituted for the income tax which is also levied on an origin basis.

8. Which Tax Interferes Least with State Retail Sales Taxes?

An important consideration in weighing the pros and cons of various CTs would be their relationship to the RSTs which are levied by 45 states and the District of Columbia (as well as some 7,000 local governments). With some justification, states would consider the imposition of a federal CT an intrusion into their tax domain. Obviously, much would depend on the type of CT. Moreover, a CT which would replace (part of) the federal income tax would, it might be argued, leave states with more room to use their income taxes for revenue purposes.

A federal RST would score very low in terms of compatibility with state RSTs. It would have to be computed and paid by the same traders selling at retail (probably some 20 million) that now have to comply with the requirements for state (and local) RSTs. In addition, these businesses would have to account for federal RST charged on products and services exempt under state RSTs or vice versa. The incidence of the increase in compliance costs, like the incidence of the compliance costs of the RST itself, would be regressive: as a percentage of sales, they would bear more heavily on small businesses than on large businesses. Consumers would perceive the federal RST as a double tax on their purchases. One solution might be to merge the state RSTs with the federal RST, but this would require an unprecedented consensus on a nationwide harmonization of the various RST bases.

Prima facie, the VAT would run into the same problems. After all, being levied through the retail stage, it also would seem to involve double imposition and accounting for tax. However, the VAT can be so designed that most businesses would not have to account for tax on their sales. The answer lies in a generous small-business exemption which, in contrast to a similar exemption under RSTs, can be very substantial without serious loss of revenue. Thus, a small-business exemption under a federal VAT of, say, $100,000, would reduce the number of potentially registrable businesses from 25 million to some 10 million (including voluntary registrants). Only some 2.6 percent of potential revenue would be lost, because exempt businesses would still pay tax on inputs. As a result, most VAT-liable businesses would not be subject to state RSTs and most RST-liable businesses would not have to pay federal VAT.

As an accounts-based tax, the BTT would not be as visible as the RST and the VAT and hence might be expected to run into less opposition as a double tax on consumer purchases. Consumers might even perceive the BTT as a tax on business which, of course, it is not. Unlike the VAT, however, it could not incorporate a generous small-business exemption without jeopardizing the neutrality of the tax or proper BTAs. For similar reasons, the FT and the CIT should not run into much state opposition.

9. Rating Consumption Taxes

In the table below, I compare the various CTs on the basis of the characteristics and criteria discussed above. The rankings are from poor to excellent. The table does not provide a score for capital formation and international competitiveness, because I do not think that a clear-cut answer can be provided on these issues. Generally, saving is best promoted by reducing the deficit. Effects on international competitiveness are swamped by exchange rate considerations.

Form of CT	Robustness	Evasion Proof	Compl. and Admin. Costs	Neutrality	Border Tax Adjustable	Compatibility with State RSTs
RST	Fair	Fair	Fair	Fair	Fair	Poor
VAT	Good	Good	Good	Excel.	Excel.	Fair
BTT	Poor	Fair	Fair	Fair	Poor	Excel.
FT	Poor	Fair	Fair	Fair	Poor	Excel.
CIT	Poor	Fair	Poor	Fair	Poor	Excel.

The **RST** scores very low on compatibility with state RSTs. Also, it is not very good in taxing services, excluding producer goods and, by extension, providing correct BTAs.

The **VAT** is the most robust and neutral CT. Product and factor neutrality are important attributes of a CT in increasingly integrated and competitive world markets. A sizeable small-business exemption, not feasible under the RST, can eliminate the incompatibility with state RSTs and make the VAT less intrusive.

The **BTT** appears compatible with state RSTs. However, it is very vulnerable to political erosion. BTAs can easily become indeterminate and unacceptable to the international trading community.

The **FT** also is not as robust as either the RST or the VAT. As an origin-based tax, moreover, it does not score very highly on neutrality grounds. Proper treatment of international transactions is problematic.

The **CIT** is the most costly form of CT to administer and comply with. In addition to keeping records of income, taxpayers would be obliged to keep and furnish records of savings.

Taxation probably is a risk-averse business. Accordingly, it should be pointed out that there is much experience with RSTs and VATs, but none with the BTT, FT or CIT. I find the BTT very vulnerable from a political point of view. Transitional problems with the FT and the CIT should not be ignored. In the final analysis, much would depend on how much of the income tax would be replaced. Considerations regarding the distribution of the tax burden -- between rich and poor, young and old -- would also have to be brought into the picture.

To me, the real choice seems to be between the RST and the VAT. In making that choice, it must be borne in mind that the coverage of the RSTs (excluding capital goods) actually in use is little more than half that of most VATs, and that RST rates are on average only one-half to one-third of most VAT rates. Moreover, RSTs avoid the problems of hard-to-tax groups, such as service sectors, by simply excluding them from the base, just as they avoid the enforcement problems associated with higher rates by widely taxing capital goods. The conclusion is, therefore, that the VAT is a more robust form of CT: its administrative integrity seems easier to maintain as the demands on the inherent structural and technical capacity of the tax are increased in response to greater economic complexities and cross-border integration.

10. Do's and Don'ts of a VAT

If the U.S. were to give serious thought to adopting a VAT, it should be advised to avoid the mistakes of the European VATs (see the EU's Sixth Directive on Value-Added Tax). Specifically, the following mistakes should be avoided.

1. Tax all goods and services, with the fewest possible exceptions.

2. Impose a single rate of tax and confine the zero rate to exports. Generally, European VATs have two positive rates. These rate structures have been expensive to administer and comply with. They increase definitional problems, induce misreporting, necessitate additional recordkeeping, and require more intensive audit oversight. Moreover, multiple rates do not improve the burden distribution of the VAT.

3. Provide a generous small-business exemption, eliminating 60 percent of all potential taxpayers. Instead, VAT would be collected on their inputs only. Voluntary registration should be possible. In contrast, many European VATs try to tax even the smallest business, greatly adding to compliance and administrative costs.

4. Tax agriculture, subject to the small-business exemption. Taxation provides for much more even-handed treatment of food products. In contrast, the Sixth Directive exempts agriculture, but permits purchasers of agricultural products a presumptive tax credit for the tax paid in respect of farm inputs. Even-handed treatment is not achieved.

5. Tax real estate activities in full with the only exception of rents, rental values, and sales of residential property. The Sixth Directive exempts 'immovable property', but taxes newly created real estate. This has led to much confusion.

6. Try to find a way of taxing financial services and insurance, possibly on a cash-flow basis. The Sixth Directive exempts these services on administrative grounds, although exported services are subject to a zero rate.

7. Include non-profit organizations in the VAT-base, subject to a very generous exemption of, say, double the small-business exemption. The Sixth Directive generally exempts non-profit organizations on the ground that they do not have a 'profit motive' -- a criterion which in practice has proved to be unworkable.

8. Tax specified commercial-type of activities by subordinate levels of government, but refund the VAT on major investment goods, such as buildings, roads and bridges. The Sixth Directive exempts all government activities, thus distorting competitive conditions vis-à-vis the private sector.

9. Generally, do not tax secondhand goods, but apply the VAT to the margin of a few specified secondhand goods, e.g. cars.

10. Reduce compliance costs by basing VAT reporting as much as possible on existing accounting information, including the cash basis, if used. Also, permit quick methods for the calculation of the VAT on fringe benefits and items supplied through the business for personal use. Closely related businesses should be permitted to elect "nil consideration."

In conclusion, if a VAT is adopted, it is crucial to get it right the first time, by simplicity in structure and operation, stability and certainty in legislation and rulings, and convenience in payment arrangements. A broadly-based VAT with a single rate, the fewest possible exemptions, and a generous small-business exemption should promote the acceptability of the VAT, and keep initial and ongoing operating costs within reasonable bounds.

Chairman ARCHER. Thank you, Dr. Cnossen.

Professor Schenk, welcome, you may proceed.

STATEMENT OF ALAN SCHENK, PROFESSOR OF LAW, WAYNE STATE UNIVERSITY LAW SCHOOL, DETROIT, MICH.

Mr. SCHENK. Mr. Chairman, thank you very much for the invitation to appear before this Committee to discuss the value-added tax. Mr. Chairman and Members of the Committee, these hearings provide a unique opportunity to initiate a public debate on significant tax reform and the role of a value-added tax in that reform.

I will discuss the European and subtraction VATs and I will comment briefly on the Japanese tax which no one has mentioned, a modified European VAT that does not rely on invoices. I will look at the question of whether one form of VAT is better than the others.

Thomas Hobbes, back in his "Leviathan," suggested that it is more appropriate to tax individuals on what they withdraw from community resources in the way of a tax on consumption than on what they contribute to community resources by way of a tax on income.

Any value-added tax should be broadly based in order to simplify administration and compliance and prevent distortion of consumer choices. Otherwise, we will be repeating the mistakes of the past with our income taxes.

Congress should tax some services that are not taxed under many foreign value-added taxes, such as financial intermediation services and some services provided by government and nonprofit organizations in market transactions. Even the smallest businesses ultimately should be included in the value-added tax base. Exemptions are to be avoided.

If Congress wants to tailor taxes to individual economic circumstances of families through exemptions or other special provisions, this goal is better accomplished with an individualized income tax, not a tax on sales like a VAT.

I want to cover two major points about a VAT: One, the WTO rules and our balance of trade, and the other, how a VAT would operate with State and local retail sales taxes.

The U.S. taxation of imports and exports is circumscribed somewhat by our obligations under the WTO rules. The European VAT is considered an indirect tax that is border adjustable under these rules. A pure sales subtraction VAT is economically equivalent and therefore should be border adjustable. Our trading partners, however, may question the border adjustability of the Danforth-Boren and the Domenici-Nunn-Kerrey subtraction VATs but maybe not your tax, Mr. Gibbons, because the Senators grant credits against the VAT liability for a portion or all of the employer's share of the OASDI payroll tax. Additional research is needed on this issue.

The border adjustability of a subtraction tax may be jeopardized if Congress modifies the tax so that it resembles a tax on income rather than consumption. This is my concern about a subtraction VAT. It will be modified by Congress, and if it is modified too much, it may not be border adjustable.

You have heard a lot about whether VAT tax border adjustments improve balance of trade. I just want to make one point. The Japa-

nese VAT and the proposed subtraction VATs, except for Mr. Gibbons' subtraction VAT, have features that may actually result in a negative tax on exports, sometimes called a subsidy.

I want to say a few things about how a value-added tax could be operated alongside State and local sales taxes. The value-added tax appropriate for the United States ultimately may depend upon the kind of VAT that can operate alongside the existing variety of State and local retail sales taxes.

Most foreign countries employ VAT only as a Federal or local tax, not side by side with a second sales tax at another level of government. A European VAT that is separately stated on sales invoices looks like our retail sales taxes. The imposition of two different visible sales taxes on retail sales will create complexity at the checkout counter.

A European VAT can be modified to require that the tax be buried in retail prices and merchants can be required to post signs informing consumers of the tax rate included in the prices. The Japanese VAT that does not rely on tax reported on invoices also is an alternative worth considering.

Canada to our north has experience with a visible Federal European value-added tax operating alongside provincial sales taxes. Businesses complained about substantial compliance costs. Canadian consumers have voiced strong opposition, in part because of the sticker shock that results when two sales taxes are added at the cash register. A special committee on finance studied alternatives to the Canadian GST and recommended major changes in the GST that would bury the tax and move it closer to a Japanese consumption tax.

A subtraction VAT proposed by Mr. Gibbons and others is calculated on the results of operations for each tax period. By its nature it is buried in product prices. If the experience in Michigan with a State retail sales tax and a VAT calculated on period results and buried in product prices is any guide, then if Congress adopts a subtraction VAT and States continue to rely on transactional retail sales tax, businesses and consumers may not view these taxes as two sales taxes.

In the United States, States may object to a VAT imposed on sales and added at the cash register as an intrusion into their sales tax domain. If Congress adopts a subtraction VAT or a Japanese or a European VAT that is buried in retail prices, the State opposition may be more muted.

Let me just conclude with a couple of comments. If Congress decides to enact a tax on consumption to be collected by business, it should seriously consider a VAT. Except for concerns about the coexistence of a Federal VAT and State retail sales taxes, one form of VAT does not stand out as the best VAT to adopt. Because a Federal VAT must coexist with State and local retail sales taxes, there may be administrative and compliance reasons to prefer a VAT that is buried in the prices of taxable goods and services at least at the retail stage.

The administrative and compliance costs of a VAT are significant enough to dismiss the tax unless it replaces or substantially simplifies existing taxes or raises substantial revenue for other critical needs. If Congress decides to enact the European VAT, as a transi-

tion to the VAT, I urge you to look seriously at some of the attractive features of the Japanese consumption tax.

Thank you very much, and if I could add a personal note to you, Mr. Chairman. Thanks for holding these hearings. I teach a course in value-added tax, and so far most of the material has to be self-generated. Now, you have given me a lot of material, and I thank you.

[The prepared statement follows:]

Testimony Submitted by
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Professor of Law
Wayne State University Law School
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For
Committee on Ways and Means
U.S. House of Representatives

Hearings on Replacing the Federal Income Tax
June 7, 1995

Mr. Chairman, thank you for the invitation to appear before this committee to discuss the value-added tax. These hearings provide a unique opportunity to initiate a public debate on significant tax reform, and the role for a value added tax in that reform. If Congress needs substantial revenue for debt reduction, to finance programs, or to replace revenue from existing taxes, Congress should seriously consider a value-added tax.

There have been several proposals in the past few years to enact a federal VAT or national sales tax. They include Senator Hollings and Congressman Dingell's proposals for a European credit-invoice VAT, Congressman Gibbons, as well as former Senators Danforth and Boren, and Senators Domenici, Nunn and Kerrey's proposals for a sales-subtraction form of VAT, and Majority leader Armey and Senator Specter's adaptation of the Hall-Rabushka two part tax on a consumption base. Senator Lugar proposed a national sales tax to be administered by the states. I will discuss the credit-invoice and subtraction VATs, and comment briefly on the Japanese tax, a modified form of European VAT that does not rely on invoices.

The credit-invoice and subtraction VAT proposals tax the sales price of taxable goods and services and grant credits or deductions for purchases from outside suppliers. Tax liability therefore is based on value added at each stage. Under the European credit-invoice VAT, a business credits tax on purchases against tax on taxable sales to calculate tax due (a tax against tax calculation). Under a sales-subtraction VAT like the Danforth-Boren Business Activities Tax, a business multiplies the tax base (taxable sales less deductible purchases) by the tax rate to calculate tax due. The sum of the tax collected at all stages is equal to a tax on the retail prices of taxed goods and services sold to consumers. Appendix A contains an illustration of why these two forms of VAT and the retail sales tax are economic equivalents if they are imposed on the same base.

There are many issues raised by these proposals, especially the proposals to replace the corporate income tax and some of the OASDI payroll tax with a VAT. With the hearings at an early stage, I will concentrate on only a few of the issues. If Congress decides to replace the corporate income tax with a VAT, is one form of VAT better than the others?

I. Shifting From an Income Tax to a Tax on Value Added

Our major trading partners balance their tax systems by relying both on taxes collected at the source (income and payroll taxes) and taxes collected at the point of use of funds (consumption taxes -- mostly VATs). We rely very little on consumption taxes for federal revenue.

Thomas Hobbes, in Leviathan, suggested that with limited community resources, it is more appropriate to collect taxes on what individuals withdraw from community resources (taxes on consumption) rather than on what they contribute to those resources (taxes on returns to labor and capital, or income).

A switch from the corporate income tax to a VAT would represent a major shift in tax from a tax imposed only on profitable companies doing business in corporate form to a broader-based tax on sales measured by value added by all firms, whether or not the firms earn a profit. The economic implications may be

substantial. I will touch on only a few in the succeeding sections.

II. Scope of the Tax

A. Broadly define the base and minimize special treatment

A VAT should be broadly based in order to simplify administration and compliance and prevent distortion of consumer choices. The VAT base should include at least personal consumption expenditures. Unlike the familiar state retail sales taxes that are imposed mainly on retail sales of goods, a VAT should be imposed on services as well. Congress should tax some services that are not taxed under many foreign VATs. For example, a VAT should apply to financial intermediation services, real property transactions and, except for essential government services, services of units of government and non-profit organizations that are provided in market transactions. Politically, it may be easier to tax at least purchases by nonprofit organizations and government entities if the tax is a subtraction VAT included in product prices than if the tax is a separately-stated credit-invoice VAT listed on sales invoices.

Possible models for broadly-based European credit-invoice VATs are the ABA Tax Section VAT Committee's model VAT statute and the New Zealand Goods and Services Tax. The latter has been successful in taxing many transactions that are exempt elsewhere.

A VAT base can be altered by granting exemptions or zero rating to particular businesses (small business exemption), to particular sectors (governmental entities), or particular goods or services (education).

If sales are zero rated, they are completely free of tax. There is no tax on the sales and the seller can recover the tax paid on purchases. If Congress taxes international transactions under the destination principle (discussed later), exports will be zero rated.

If sales are exempt, there is no tax on the sales, but the seller can not recover tax paid on purchases attributable to the exempt sales. If government-provided services are exempt from VAT, the governmental entity bears tax on purchases but does not charge VAT on its services. Exemptions, however, may encourage vertical integration. For example, if education is exempt, a university that purchased stationery and forms from an outside printer before VAT becomes effective may establish a print shop in-house in order to avoid the new VAT on the purchases from the outside printer. Rules are needed to prevent this incentive to vertically integrate.

Exemptions also complicate the tax by requiring businesses to identify noncreditable tax on purchases attributable to exempt sales and by requiring line drawing between taxable and exempt transactions. The latter breeds litigation. Whether it chooses a credit-invoice or a subtraction VAT, Congress should minimize exemptions and zero rating.

If Congress wants to tailor taxes to economic circumstances of families, it is easier and more appropriate to accomplish this goal under an income tax, not a tax on sales like the VAT.

B. Businesses subject to tax

A person generally is subject to VAT on business activity. Who is a taxable person and what constitutes business activity? Congress should draw these lines broadly.

Most foreign VAT systems exempt small businesses from the tax, although the threshold for exemption varies substantially. At one extreme, only the smallest businesses and street vendors are exempt. Japan is at the other extreme. Assuming an exchange rate of 85 yen to the dollar, Japan totally or partially exempts businesses with annual sales up to about $600,000, and allows businesses with annual sales up to about $4.7 million to calculate tax liability under a simplified scheme. Only about 10 percent of Japanese businesses calculate tax liability under the normal statutory method.

U.S. experience with state and local retail sales taxes indicates that even the smallest businesses can be included in a sales tax base. The question of whether to grant any small business exemption requires a balancing of the administrative and compliance costs of granting exemption against the fairness and competitive inequities of exempting some businesses and taxing others.

What kind of activity is covered by the VAT? The trade or business, income-producing activity, and hobby distinctions under the income tax must be addressed under a VAT. Most VATs do not cover casual sales by individuals. Some high-priced casual sales, such as sales of planes, yachts, or real property, should be taxed. Rules must define the person who must file a return. For example, divisions of a single company may be required to file a single return or be permitted to file separately. Similar options may apply to businesses under common ownership or affiliated corporations.

A credit-invoice VAT generally handles exemptions better than a subtraction VAT. Revenue lost through an intermediate stage exemption under a credit-invoice VAT can be recovered at the next stage. The same generally does not occur under a subtraction VAT. If the revenue loss and complications caused by exemptions will result in Congress granting no exemptions or fewer exemptions under a subtraction VAT, a subtraction VAT may be better. If exemptions will be granted under either form, the credit-invoice VAT is preferable.

III. Balance of Trade Implications of a VAT

A. Apply the destination principle to international transactions

Congress can adopt either the origin or the destination principle to define the jurisdictional reach of a VAT. Except for House majority leader Armey's proposal (and possibly Senator Specter's as well), all of the proposals made recently are destination principle taxes. Under the destination principle, tax is imposed only on goods and services consumed in the United States. Imports are taxed and exports are relieved of tax. In contrast, under the origin principle, tax is imposed only on value added within the United States. Imports are not taxed and exports bear tax.

Other countries with VATs rely on the destination principle to tax international transactions. To place American companies in a comparable position, Congress should zero rate exports (and refund excess credits), so that the VAT does not enter into the sales prices of our exports. Congress should tax imports at the rate applicable to domestic sales. As discussed below, precise border tax adjustments may be easier with a European credit-invoice VAT than the proposed subtraction VATs or the Japanese Consumption tax in its present form.

International trade has become an increasingly important aspect of our domestic economy. The U.S. taxation of imports and exports is circumscribed somewhat by our obligations under the World Trade Organization rules (formerly the General Agreement on Tariffs and Trade, or GATT). Under these rules, a member country can rebate indirect taxes on export (but can not subsidize exports) and can impose on imports taxes no greater than those borne by domestically-produced items. A European credit-invoice VAT is considered an indirect tax that is border adjustable under these rules. Senator Hollings and Congressman Dingell's destination principle credit-invoice VATs comply with our obligations under these agreements.

A pure destination principle sales-subtraction VAT is economically equivalent to a credit-invoice VAT and therefore should be border adjustable. It should not matter what method is utilized to calculate tax liability on value added at each stage of production or distribution. Our trading partners, however, may question the border adjustability of the Danforth-Boren or the Domenici-Nunn-Kerrey subtraction VATs that grant credits against the VAT liability for a portion or all of the employer's share of

the OASDI payroll tax. If it is permissible to use VAT revenue to reduce payroll tax rates, as it should be, then the payroll tax credit feature in these proposals may be permissible. Additional research may be needed on this issue.

The border adjustability of a subtraction VAT may be jeopardized if Congress modifies a subtraction VAT so that it resembles a tax on income rather than consumption, such as by granting deductions for compensation paid.

B. Will border tax adjustments improve the balance of trade?

If Congress adopts a destination principle VAT to replace existing federal taxes included in export prices, the VAT may improve the U.S. balance of trade in the short term. The long term effects are less predictable.

If a VAT is introduced as an additional revenue source, the VAT will not alter the balance of trade. For example, assume that a vehicle, before VAT, sold for export at $15,000. With the introduction of a 10 percent VAT, the same vehicle will sell domestically for $16,500. If the vehicle is exported, there is no VAT on the sale and the vehicle will sell for the same $15,000 price it carried before the VAT was introduced.

If a VAT replaces a federal tax that is included in the price of American exports, the replacement should reduce the price of the exports. For example, assume that the VAT replaces the corporate income tax and assume further (it is not clear that this assumption is realistic) that the corporate income tax caused the price of the exported vehicle to increase from $14,500 to $15,000. The switch from the corporate income tax to a VAT should lower the export price of the vehicle to $14,500 and the export sales should increase. Even if these assumptions are correct, in the long run, the exchange rate of the U.S. dollar may adjust so that the vehicle will cost the equivalent of $15,000 in foreign markets. The exchange rate of the U.S. dollar is affected by many factors other than our balance of trade. It therefore is not clear if the increase in American exports prompted by a switch to a VAT will provide a long-term balance of trade advantage, or will be negated by an adjustment in the exchange rate.

The trade effects of a credit-invoice and subtraction VAT may be similar, but not necessarily the same. The difference results mainly from the fact that the proposed subtraction VATs allow deductions for purchases from exempt sellers (such as exempt small businesses). As a result, exports may bear negative tax to the extent that the exports contain purchased components or services that were exempt from VAT. The Japanese Consumption Tax provides treatment comparable to the subtraction VAT proposals.

IV. Coordination of a Federal VAT With State Sales Taxes

The VAT appropriate for the United States ultimately may depend upon the kind of VAT that can operate alongside the existing myriad of state and local retail sales taxes (RSTs). With any kind of federal VAT that operates with RSTs that are not harmonized, businesses face increased costs when they are subjected to different federal and state rules on the administration, audit, collection and assessment of the taxes. Government costs to administer the tax may increase as well.

Most foreign countries employ VAT only as a federal or a local tax, not side-by-side with a second sales tax at another level of government. This is one area where it is important to address European credit-invoice VATs and sales-subtraction VATs separately. The method of calculating VAT liability and the visibility of the VAT at the retail stage may be important.

A. Credit-invoice VAT and State Sales Taxes

A credit-invoice VAT that is separately stated on sales invoices looks like the more familiar RSTs. With a credit-invoice VAT, businesses must comply with two different sales taxes imposed on individual transactions. This will create complexity at the

check-out counter, especially if the seller does not use automated cash registers.

A credit-invoice VAT can be buried in selling prices, rather than separately stated on retail sales. The merchants could be required to post signs informing consumers of the tax rate included in the prices. If the VAT is buried in retail prices, consumers subjected to both taxes may not be confronted with sticker shock, but businesses still must calculate the VAT and RST on each transaction.

Japan has a credit method VAT that does not rely on invoices and that permits businesses to calculate tax from sales and purchase records for each tax period. The Japanese tax is an alternative worth considering.

Canada, with its Goods and Services Tax (GST), imposes a national credit-invoice VAT alongside provincial sales taxes (PSTs) imposed by all provinces except Alberta. Businesses subject to the GST and PST complain about the substantial compliance costs associated with the variety of sales taxes imposed on different tax bases and including different rules governing such obligations as the filing of returns and the submission to audits. Canadian consumers also have voiced strong opposition to the GST, in part because of the sticker shock resulting from the addition of two sales taxes at the cash register. While Quebec has harmonized (in large part) its sales tax with the federal GST, Quebec's provincial tax base and rules governing input credits differ somewhat from the federal GST rules.

In large part due to business and consumer opposition to the GST, a special Committee on Finance studied alternatives to the GST. The committee report recommended major changes in the GST, including a simplified system to allow taxpayers with annual revenue of Can. $200,000 or less (80% of the taxpayers) to report sales and purchases on a tax-inclusive basis. The tax could be buried in retail prices. It also urged the government to seek harmonization of the federal GST and provincial sales taxes. The recommended system would move closer to the Japanese Consumption Tax system.

No U.S. state opted to piggyback its state income tax on the federal income tax, even though, without charge, the IRS would have collected and remitted the state portion back to participating states. It therefore is unlikely that most or all of the states will give up their power to define their sales tax bases and hire their own agents in order to harmonize their RST with a federal VAT.

While it is possible for states to administer a harmonized federal-state sales tax or VAT (see Senator Lugar's proposal), the German experience with states (landers) administering the federal VAT suggests that the American states may seek to attract business by claiming that they are more lenient in administering the single harmonized tax.

B. Sales-Subtraction VATs and State Sales Taxes

Notwithstanding the advantages of a separately-stated, transactional credit-invoice VAT, an accounts-based subtraction VAT has one significant advantage over that kind of credit-invoice VAT. A sales-subtraction VAT, a period tax, is calculated on the results of operations for each tax period and is included in the prices of taxable goods and services.

Relying on the experience in Michigan with addition and subtraction forms of VAT, if Congress adopts a subtraction VAT (a period tax) and states continue to rely on transactional RSTs, businesses and consumers may not view these taxes as two sales taxes that require harmonization to reduce compliance burdens.

In the U.S., states may object to the credit-invoice VAT imposed on sales and added at the cash register as an intrusion into their sales tax domain. If Congress adopts a subtraction VAT (or a Japanese or even a credit-invoice form of VAT) that is buried in the retail prices of taxable goods and services, the state opposition may be more muted.

V. Administrative and Compliance Issues

Our piece of the global economy is complex. A tax on consumption will be complex, even if Congress keeps the base broad, imposes a single rate, and minimizes exemptions.

A. Single rate tax

A VAT should be imposed at a single positive rate, with a zero rate only for exports under a destination principle tax. Multiple rates increase administration and compliance costs. Businesses must identify sales that come within each rate group and have clerks trained and registers programmed for sales at different rates. The IRS also must verify the rate for reported sales.

A European credit-invoice VAT can accommodate multiple rates. With a subtraction VAT, it is difficult, if not impossible, to impose multiple rates.

B. Separately stated tax and the audit trail

A perceived advantage of a credit-invoice VAT is that the tax listed separately on each sales invoice provides an audit trail for the IRS to verify the seller's reported sales and the buyer's claimed input credits. The requirement for buyers to retain invoices to document claimed input credits is designed to encourage buyers to demand tax invoices from their suppliers. These invoices can be cross-checked with the suppliers' reported sales.

The "audit trail" advantage of a credit-invoice VAT may be overstated. The foreign experience indicates that taxpayers cheat under a credit-invoice VAT. The sales and purchase data required on VAT returns prepared under the Japanese CT or the proposed subtraction VATs can be verified by checking a business's sales and purchase invoices, even if VAT is not separately stated on the invoices.

There are other advantages if the VAT must be separately stated on sales invoices and purchasers can claim credit only for VAT listed on invoices. For example, businesses that are exempt from VAT or that sell exempt services can not list VAT on their sales invoices. Purchasers therefore can not claim input credits on these exempt transactions. The IRS auditor can verify allowable input credits by checking invoices on which VAT is listed. The Japanese CT and the proposed subtraction VATs allow credits or deductions for purchases from exempt small businesses. In part, this exception was made because it is so difficult to identify purchases from exempt small businesses under these VATs.

C. Accommodation to rate changes

A federal tax on consumption can be used as a tool to fine tune the economy. A change in the tax rate, coupled with consistent monetary policy, can encourage or discourage consumption. A credit-invoice VAT accommodates better than a subtraction VAT to rate changes.

A change in rate under a credit-invoice VAT will be reflected in prices and revenue immediately. A seller claims credit for the actual tax listed on purchase invoices, whether the purchase was taxed at the old or new rate. The goods or services acquired therefore are free of tax in the hands of that seller. Beginning on the effective date of the rate change, the seller will charge tax on sales at the new rate, whether a higher or lower rate. Buyers, including final consumers, should bear tax at the new rate.

With a subtraction VAT that is buried in product prices, there may be a time lag before the full effect of a rate change is phased in. If the tax rate is increased from five to 10 percent, the seller likely will include the new 10 percent rate in prices. Unless complicated rules are used to phase in the value of deductions for purchases, the rate hike may increase government revenue by only the value added after the effective date of the rate change. If the subtraction VAT is reduced from 10 to five percent, unless there are complicated rules to adjust the value of

deductions for purchases after the effective date that still may carry some of the old 10 percent rate, sellers may not reduce tax-inclusive prices charged on sales made immediately after the effective date to five percent. The tax revenue may reflect a five percent rate only on value added after the effective date.

D. Administrative and Compliance Costs

The General Accounting Office examined the cost of administering a European credit-invoice VAT with a single rate and minimal exemptions. The GAO report acknowledges that the addition of exemptions will substantially increase the costs. The GAO report estimates the administrative cost at between 1.22 and 1.83 billion annually, once the tax is fully phased in. The cost differential reflects different assumptions about the level of the small business exemption threshold and therefore the number of businesses that are included in the system. Based on these cost estimates, Congress should not enact a VAT unless it is to raise substantial revenue -- at least $100 - $150 billion annually.

The estimates of costs of complying with a credit-invoice VAT vary widely. The compliance costs depend on such factors as the number of returns required each year, the amount of information required to be filed or maintained, and the number of rates and items given special treatment. Estimates under a British study place compliance costs at 0.003% to 1.94% of taxable sales. These costs are offset in part by the cash flow benefits that accrue to firms that receive VAT from their customers before they must remit the tax to the government. It appears that compliance costs tend to be regressive, when measured as a percentage of sales, placing the heaviest burden on the smallest firms.

There is no reliable data available on the administrative and compliance costs of a subtraction method VAT. It is reasonable to assume that the compliance costs will be lower if businesses can take the data for the VAT returns from existing records of sales and purchases and the tax is not separately stated on invoices. The administrative costs may not change much, if at all.

In estimating the costs to administer or comply with a VAT, Congress should consider the savings that will result if existing federal taxes either are substantially simplified or replaced entirely.

The amount of VAT litigation and its attendant costs will depend in large part on the nature of the VAT base. If Congress grants exemptions and zero rating to particular sales or entities, it is predictable that there will be substantial litigation. In the United Kingdom, for example, Parliament created value added tax tribunals to handle anticipated disputes under their VAT that contained numerous exemptions and zero rating.

E. Tax issues that exist under the income tax arise under a VAT

Many issues that exist under the income tax apply under a VAT. For example, the definition of a taxable person and the proper reporting unit must be resolved under a VAT. A business can reduce its VAT liability by making purchases from outside suppliers but not by paying compensation to employees. It is necessary to make the familiar distinction between employees and independent contractors. To determine who is engaged in business, it may be necessary to make the income tax distinction among business under section 162, income-producing activities under section 212, and hobbies under section 183. Related party rules may be needed.

VI. Transition issues

A. Transition rules for purchases made between the dates the tax is enacted and becomes effective

The transition to a VAT could disrupt markets for business inputs as well as for consumer goods. If a VAT replaces the corporate tax and the purchase of capital goods qualifies for input

credit, then if a business can not recover the cost of capital goods under the expiring corporate tax, it may defer discretionary purchases until the VAT becomes effective.

If consumers anticipate that the introduction of the VAT will increase prices, they may accelerate purchases before the VAT becomes effective. This increased demand for goods and services may result in inflationary pressures that will increase when the VAT becomes effective.

B. Transition period needed to prepare for VAT

If Congress enacts a credit-invoice VAT, Congress should provide an effective date of approximately 18 months after the date the tax is adopted. The following represent some of the preparation work necessary to implement this VAT. Businesses must purchase new invoices to provide the data required for VAT purposes, train employees, and purchase or modify computerized cash registers and other record keeping equipment. The government must train personnel, issue guidance, educate businesses and consumers, the Federal Reserve must prepare to receive and process payments, and the IRS must purchase equipment and prepare to process and audit returns. The Customs Service must prepare for the collection of the tax at the borders and for the maintenance of records of export sales.

If Congress enacts a subtraction VAT that is broadly-based and that can rely on records already prepared by business, the required transition period may be somewhat less. The cash register adjustments and other preparations required to list VAT on sales invoices would not be necessary, but much of the training and education of employees of businesses and the government still must be done. The preparation required by the Federal Reserve, the Customs Office, and IRS under a credit-invoice VAT will exist under a subtraction VAT.

VII. Conclusion

If Congress decides to enact a tax on consumption to be collected by business, it should seriously consider a VAT. If a VAT replaces the corporate income tax, except for concerns about the co-existence of a federal VAT and state RSTs, one form of VAT does not stand out as the best VAT to adopt.

If Congress decides to add a VAT to the federal tax system, keep it simple and free from distorting and complicating exemptions or other special treatment. If it is necessary to reduce the regressive effects of a tax on consumption, Congress should do so outside the VAT system, such as through direct grant programs, cash rebates to low income households, or through the individual income tax that can be tailored to individual circumstances.

Congress should include as many businesses as possible in the tax system. It should apply the destination principle to tax imports and free exports from the tax. Make sure that the tax, whatever its form, is border adjustable. Do not adopt a VAT just to improve our competitive position in world markets in the long term. It is not clear that it will produce that result.

The European VAT should not be adopted just to achieve the benefits from its "audit trail." These benefits may have been overstated. Address transition issues and allow an adequate period for government and businesses to gear up for the tax.

In principle, a federal VAT should be separately stated and visible to consumers. However, if a federal VAT must co-exist with state and local retail sales taxes, there may be administrative and compliance reasons to prefer a VAT that is buried in the prices of taxable goods and services, at least at the retail stage. The goal can be accomplished with adjustments to a European credit-invoice VAT. The Japanese VAT or the subtraction VAT provides these results without any tinkering.

The European VAT handles rate changes better than a subtraction VAT. While the compliance costs of a subtraction VAT may be somewhat lower than a European credit-invoice VAT, the administrative and compliance costs of both are significant enough

to dismiss the tax unless it replaces existing taxes or raises substantial revenue for other critical needs.

If Congress decides to enact a European credit-invoice VAT, as a transition to the VAT, Congress should look seriously at the Japanese Consumption Tax, with its simplified method for smaller businesses, as the first stage of a credit-invoice VAT.

Appendix A

European Credit-Invoice VAT, the Sales-Subtraction VAT and the Retail Sales Tax

The following example is used to illustrate the European-style VAT, the subtraction VAT, and the retail sales tax.

Under the European-style credit-invoice VAT, a business's tax on purchases is credited against tax on taxable sales. Assume that a lumber mill sells lumber to a carpenter who fashions the lumber into tables and sells the tables to a retailer who resells them to consumers. Assume that the lumber mill sells the lumber for a pre-tax price of $1,000. With a 10 percent VAT, the mill would add $100 tax for a tax-inclusive price of $1,100. The carpenter sells the tables to a retailer for a pre-tax price of $5,000 (not including the $100 tax on the lumber). The carpenter adds $500 tax, for a tax-inclusive price of $5,500. The carpenter recoups the $100 tax on his purchases in calculating the tax that he remits to the government. The retailer sells the tables to consumers for a pre-tax price of $10,000. The retailer adds $1,000 tax, for a tax-inclusive price of $11,000, and recoups the $500 tax paid on her purchases. At each stage, tax is remitted only on value added by each business. This VAT is illustrated in Table 1.

Table 1

	Tax Liability of Each Seller	Tax Remitted to Government
Mill sale to carpenter		
Taxable sale $1,000 x 10%	$ 100	
Purchases 00	00	
Tax Payable by Mill	$ 100	$ 100
Carpenter sale to retailer		
Taxable sale $5,000[1] x 10%	$ 500	
Credit for tax on purchases	(100)	
Tax Payable by Carpenter	$ 400	400
Retailer sales to consumers		
Taxable sale $10,000[2] x 10%	$1,000	
Credit for tax on purchases	(500)	
Tax Payable by Retailer	$ 500	500
Total tax collected by government and paid by consumer		$1,000

Tax liability under a sales-subtraction VAT like the Danforth-Boren Business Activities Tax is calculated by multiplying the tax base (taxable sales less deductible purchases) by the tax rate. The data will be taken from company records and it therefore is more convenient to calculate the tax using tax-inclusive figures. To raise the same revenue as the above 10% rate applied to tax-exclusive data, the rate should be 9.0909%. In Table 2, the tax

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[1] The price would be $5,000 instead of $5,100 because the carpenter recovers the $100 tax on his taxable purchases.

[2] The pre-tax sales prices would total $10,000 because the carpenter would charge the retailer $5,000 + $500 tax, and the retailer would recover that $500 tax.

payable by each business, the revenue to the government, and the tax imposed on consumers are identical to the amounts listed under the European-style VAT in Table 1.

Table 2

	Tax Liability of Each Seller	Tax Remitted to Government
Mill sale to carpenter		
Taxable sale	$1,100	
Deduction for purchases	00	
Tax Base	$1,100	
Tax Rate	9.0909%	
Tax Payable by Mill	$ 100	$ 100
Carpenter sale to retailer		
Taxable sales	$5,500	
Deduction for purchases	$1,100	
Tax Base	$4,400	
Tax Rate	9.0909%	
Tax Payable by Carpenter	$ 400	400
Retailer sales to consumers		
Taxable sales	$11,000	
Deduction for purchases	(5,500)	
Tax Base	$ 5,500	
Tax Rate	9.0909%	
Tax Payable by Retailer	$ 500	500
Total tax collected by government and paid by consumer		$1,000

Under a federal retail sales tax, tax is collected only on sales to consumers. In the above example, the retailer will charge $1,000 tax on taxable sales of $10,000, producing the same revenue and the same tax-inclusive consumer prices as under the European VAT or the subtraction method VAT.

Chairman ARCHER. Thank you, Professor Schenk. I want to thank all of you. I am particularly grateful for your testimony, and I also must say because I think it is very much in line with my colleague and my friend Sam Gibbons, that I am very grateful to him because he has been plowing this ground for some time, and he understands the big picture and what is at stake, and I am hopeful that in some way or another we can reach a resolution of this issue that is going to help this country in years to come.

I am curious as to what differences there might be between you, Professor Schenk, and you, Dr. Cnossen, and whether those can be resolved.

Mr. SCHENK. Do you want to start, Sijbren?

Mr. CNOSSEN. Yes, Alan, no difficulty. I think I have come down, Mr. Chairman, fairly strongly in favor of the tax credit method, value-added tax. Professor Schenk has left the door open for a modified tax credit value-added tax with some elements of the subtraction method, which is currently imposed in Japan. I hope that sums it up reasonably well. So I guess we agree that a full subtraction method VAT probably would not be preferable.

In this respect we disagree with Cliff Massa. I think the Japanese value-added tax does well at the low rate of 3 percent that it is currently being levied. If you were thinking of a consumption tax that would replace the entire income tax, I guess you would have to impose it at a rate of some 20 percent. Aggregate consumption expenditure is $4.8 trillion. If for one reason or another about one-fourth of that expenditure is exempted, then you would have to tax the remaining expenditures at 20 percent to raise some $735 billion in revenue. That is a very high rate.

I believe that a high-rate subtraction method VAT would leave quite a bit of value added untaxed and would raise much stronger objections from your trading partners than the low-rate Japanese tax does. Although the rate is low, the Japanese tax nevertheless is a subsidy on exports and at the same time is an extra tax on imports. You didn't mention that, Alan, but I think you agree with that aspect as well. I think both features would be problematic.

Besides, I believe that the GATT arrangements for border tax adjustments require that taxes should be imposed on specific products to be eligible for rebate at the time of export. In other words, they should be transactions-based taxes, not accounts-based taxes as is the subtraction method, business transfer tax. Furthermore, it should be possible to calculate border tax adjustments unambiguously: There should be full certainty how much tax on exports has to be rebated and how much tax is imposed on imports, equivalent to the tax on domestically produced goods and services. Now, I would like to yield to Professor Schenk.

Chairman ARCHER. Professor Schenk.

Mr. SCHENK. Mr. Chairman, I don't think there is one right answer about the VAT. There are good and bad points of the subtraction method. There are good and bad points about the European style. I have one major concern about the subtraction method, and you are certainly in a better position than I to know how to evaluate this concern.

My concern is that your colleagues in the House and Senate will look at a tax that is based on sales minus purchases and think of

it—as they have been thinking about taxation in this country for decades—as a tax on income, and therefore be tempted to approach it that way and grant deductions, and enact other complications to the tax that would just destroy its nature.

Why do I say this? Because in Michigan we have experience with value-added taxes. We used to have a subtraction VAT and now we have an addition VAT. Think of the businesses that come in to the State legislature and would come in here. For example, a real estate construction company or a service company may claim that under an income tax there were years that they hired a lot of people, did not earn a profit, and did not have to pay any income tax.

Now, Congress is saying that even though we do not have any profit, but we are hiring employees, we have to pay a tax under this subtraction VAT. Michigan responded to this pressure by granting a special deduction for labor-intensive businesses. There were other special provisions like that that really changed the nature of the tax. That is my concern about the subtraction tax. If Congress could enact a pure subtraction tax, as Mr. Gibbons is trying to develop, I would not have those concerns. My question is whether or not that can get through Congress.

Chairman ARCHER. So basically what I hear you saying is that you have a degree of flexibility in your own mind that might accommodate what Dr. Cnossen is recommending as a viable alternative?

Mr. SCHENK. Yes.

Chairman ARCHER. Let me ask all of you, if I can, three quick questions. First, let me say as a foundationpiece for my own views that I personally will not support any consumption tax as an addition to the current income tax. It must be as a replacement for the entire income tax.

I just want to make that very clear. I have tried to over the months, but perhaps you need to restate these things. But having said that, if we are to move from the current income tax structure to a type of VAT, which all three of you propose, can we do that, in effect, cold turkey? And if not, why?

Mr. SCHENK. From which tax, Mr. Chairman? From the corporate income tax or from both?

Chairman ARCHER. From the corporate and personal income tax. Let's say, hypothetically, let those cease on December 31 and on January 1 go to one of your forms of value-added tax.

Mr. SCHENK. Speaking for myself, I think the transition issues would just be horrendous. I do not think that you can go cold turkey. I think if you announce today that the change will become effective December 31, you would probably have businesses defer purchases of capital goods, and you would have consumers stock up on consumer goods before the new tax goes into effect. I think you need a transition period.

Mr. MASSA. I am not sure, Mr. Chairman. It seems to me that either path, once you decide where we are going to end up, the path from here to there, whether long or short, is not going to please everybody. There are going to be dislocations. We have to decide is the end result worth the trip.

I am sure that if there is an extended transition period, this Committee will be busy like it has never been busy before with a

line of people, I would be included, I am sure, up here on behalf of people saying, but you have got to take this one into account and you have got to take that one into account.

As I recall the Canadians, as they began to move to the goods and services tax, at least were coming to a conclusion that cold turkey wasn't going to be any worse than anything else. I am not sure I have the answer for you, but I certainly wouldn't dismiss it out of hand because I am not sure that the answer cold turkey is going to be any worse than 3, 5, 7 years' worth of transition rules which actually increase complexity and increase costs in the process.

Chairman ARCHER. Dr. Cnossen.

Mr. CNOSSEN. Mr. Chairman, I think I would not like to be in the driver's seat—$735 billion in revenue, a rate of at least 20 percent in my view, possibly higher if Congress accepted some exemptions of the very broad base; enormous announcement effects; and very serious economic relocation issues, also because of the abolition of the income tax itself. These relocations of economic activity, economic decisions, and so forth, in my view, at a 20 percent rate consumption tax that would fully replace the income tax might be called dislocations.

Chairman ARCHER. So how would you do it?

Mr. CNOSSEN. I would phase it in. I would start with a value-added tax of 5 percent and reduce the income tax accordingly, Mr. Chairman, by the revenue that a broad-based consumption tax would yield, be it a national retail sales tax, a tax credit value-added tax, or a subtraction method value-added tax.

Chairman ARCHER. OK, thank you. On two other quick issues, what would you do about education and medical services?

Mr. CNOSSEN. I would tax them, Mr. Chairman, and I will explain why. I think there used to be a time when we thought that food should be exempted and now we know that the rich spend twice as much on food as the poor do and we also know that a consumption tax is not the appropriate tax to affect the income redistribution, or I should say try to impart some degree of progressivity to the tax system. Income distribution issues should be dealt with by the expenditure side of the budget.

I think that this argument also applies to medical services. Moreover, we have tremendous problems exempting medical services proper, because hospitals also do work for pharmaceutical companies in the form of research, and so forth, for which they want to be taxed in order to be able to get the tax credit on inputs. By and large, the same argument, perhaps to a somewhat lesser extent, applies to education.

Mr. MASSA. Every sale of goods and services in the economy, whether it is currently a tax-exempt organization or not, let's apply the system to it. Let the market sort out where the burdens go instead of trying to distinguish whether this business activity of selling education or selling medical care or selling legal services or selling food is worthy of not being taxed. Let's not start down that path. Let's put everything in the system. Let the market sort out where the burden goes, and then attempt to deal on a much more directed basis with the households that you conclude need some offsets to those effects.

Chairman ARCHER. In other words, there would be no tax-exempt entity?

Mr. MASSA. If they sold goods or services, I would recommend that they be in the system.

Chairman ARCHER. Well, is a State university selling a service?

Mr. MASSA. Arguably, they are selling services in exchange for tuition.

Chairman ARCHER. OK. Professor Schenk.

Mr. SCHENK. I would agree. My dean and president might not like it, but I think that it is very important not to distort consumption, and obviously you have problems even with that simple answer, and you raised one, Mr. Chairman. When somebody at my law school pays $5,000 a year tuition at the law school, he or she is not paying the full cost. The State is paying part of that cost, and so if you only tax the $5,000, you are not really taxing the full value. I think it should all be taxed whether it is the football game or it is the tuition.

Chairman ARCHER. All right. Then finally, do you have any concern about the problems in border areas in conjunction with Mexico or Canada, that if we convert our income tax completely to a value-added tax, will people simply go across the border and buy the products and services in a foreign country?

Mr. MASSA. Our two border countries currently have value-added taxes of their own, both Canada and Mexico. We are, in fact, the only major trading nation that does not have one. Perhaps the relative rates would make a difference, and Dr. Cnossen's experience in the European Community may help to answer that, but it would not seem to me to be either a large or an insurmountable problem.

If somebody decided that the Canadian tax rate was lower and I will buy it over there, we probably would end up with some kind of modest exemption on tourist-imported goods anyway, so it would not seem to me to be a major problem.

Mr. SCHENK. Mr. Chairman, I think it is a problem. It is a problem that Canada faced when it adopted a VAT and the United States did not have one. I live on the Detroit-Windsor border and people came over by the vanloads, and as a result the government had to do something in order to try to stem that flow.

Chairman ARCHER. Were they able to do so?

Mr. SCHENK. I must confess I forgot exactly what they did.

Chairman ARCHER. Dr. Cnossen.

Mr. CNOSSEN. Mr. Chairman, I think that cross-border shopping would not be a serious problem. You have a long contiguous border with Canada, but not really that many people are living along the border. If I go by European experience, politicians and businessmen make a lot of hay about cross-border shopping, but in fact the quantitative significance of it is very, very low.

Germans come and shop in Dutch towns even though the value-added tax is higher in Holland. The reasons are that parking facilities or movies are better, the cultural climate is freer, or whatever. Rate differentials do not significantly influence cross-border shopping in European countries, although in the European Community some 10 percent of the population lives along borders within 25 kilometers on either side.

Mr. SCHENK. Mr. Chairman, I remember what resolved the cross-border shopping problem. The exchange rate of the dollar in Canada versus the United States changed and therefore it was no longer profitable for Canadians to shop in the United States.

Chairman ARCHER. I see. I would like to explore your ideas of how we handle the regressivity argument, but I have already overused my time, so if I could get each of you to submit in writing, or if someone else wants to inquire about that, it would help the Committee a great deal to get specificity as to how you think we could best handle the regressivity argument.

[The following was subsequently received:]

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June 7, 1995

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

I very much appreciated the opportunity to testify before the Ways and Means Committee earlier today on the critical issue of choosing between various consumption tax alternatives. During my testimony, you asked that I provide the Committee additional materials concerning my views with respect to the potential regressivity of a consumption tax. I have examined this issue closely, and indeed, I published an article in Tax Notes in which I specifically addressed the regressivity issue. I thought it would be most efficient to provide you a copy of that article.

Once again, I appreciated the opportunity to testify, and I look forward to providing the Committee any additional information you may require to address this important issue.

Sincerely,

Sijbren Cnossen

Enclosure

Sijbren Cnossen is a professor in the economics faculty at Erasmus University, Rotterdam, the Netherlands. He has written widely on the value-added tax (VAT) and advised international organizations and several countries on the design and implementation of a VAT. This article is based on his testimony on consumption taxes and international competitiveness before the Committee on Ways and Means of the U.S. House of Representatives on June 20, 1991.

Professor Cnossen points out that a VAT is the most product-neutral and factor-neutral tax which exists. This is an important attribute of a "good" tax in a world that leaves the optimal allocation of resources to the free play of market forces. In theory, a VAT is equivalent to a national sales tax, a business transfer tax, or a uniform business tax of equal base and rate, but a VAT has greater feasibility and versatility. Also, it is more certain to be neutral and to effect correct border tax adjustments. He points out that the integrity of a VAT is safeguarded best if it is applied to all goods and services. Moreover, a single rate with no exemptions is strongly recommended. Professor Cnossen explains that a VAT is not a tariff-cum-export subsidy. Instead, the rebate at the export stage ensures that exporters are not disadvantaged vis-a-vis their foreign competitors. A VAT per se would have no favorable effect on the trade balance, but it is superior to an income tax in promoting saving, capital formation, and economic growth.

I. INTRODUCTION

In considering a consumption tax, such as a value-added tax (VAT), the United States is following the same pattern in tax development as many other countries in Europe and the rest of the world. Twenty-one of the 24 member countries of the Organization for Economic Co-operation and Development (OECD) have accepted the VAT as their main consumption tax. Recent converts to the VAT include Canada and Japan. The United States, Switzerland, and Australia are the only OECD countries that have not yet done so. Outside the OECD area, the VAT is levied by approximately 35 countries in Latin America, Asia, and Africa.

CONSUMPTION TAXES AND INTERNATIONAL COMPETITIVENESS: THE OECD EXPERIENCE

by Siljbren Cnossen

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The VAT was pioneered in the European Community (EC). From the beginning the EC has attached great importance to the VAT, because it is very successful in treating intra-community trade, as well as trade with third countries, according to the destination principle. A VAT enables precise identification and rebate of the tax on exports so that they can leave a country free of tax, while imports can be taxed on exactly the same footing as domestically produced commodities. Obviously, this form of neutrality is essential for the proper functioning of a common market. More generally, the border tax adjustments under a VAT are consonant with the tax provisions of the General Agreement on Tariffs and Trade (GATT).

In addition to being neutral with respect to foreign trade, a VAT does not distort domestic production and distribution. Thus, under a VAT, it makes no difference how often a product is traded before it reaches the consumer or whether its value is added earlier rather than later in the production-distribution process. A VAT is neutral regarding the production technique that a business adopts. In other words, it makes no difference for tax liability whether a product is manufactured with capital-intensive technology or labor-intensive technology. Also, a VAT is not influenced by the forms in which business is conducted. Other things being equal, the tax bill is the same whether a product is made in the corporate sector or by unincorporated businesses, or whether it is produced by integrated or specialized firms.

It will be appreciated that the VAT's neutrality with respect to domestic economic activities, as well as foreign trade, is an important attribute of a "good" tax in a highly competitive and interdependent world, which leaves the optimal allocation of resources to the free play of market forces.

II. APPROACHES TO TAXING 'VALUE ADDED'

The type of VAT used in the EC and nearly all other countries is a multistage, destination-based, net consumption VAT that includes all goods and services in its base (except those explicitly exempted). It covers retailers, and it permits registered firms a credit or "deduction" against the tax payable on their own sales for tax paid on their purchases from registered suppliers. For any tax reporting period, the net VAT liability is simply the difference between the total amount of VAT shown on all sale invoices and the total amount of VAT shown on all purchase invoices.

This method, which is used in all OECD countries, is called the indirect subtraction technique or tax credit method. Since the tax on sales must be stated on invoices to provide documentary evidence for the credit claimed by registered buyers, the tax credit technique is also referred to as the invoice method. It should be emphasized that the net consumption VAT is levied according to a cash flow (invoice) basis of accounting, instead of according to an accrual basis by which transactions are recorded in a firm's profit and loss account. Thus, under VAT, no correction needs to be made for a change in inventory value, and the tax paid on the purchase of capital goods is credited immediately against the VAT payable on sales.

Under a VAT, . . . the same value added is never taxed twice; that is, cumulative effects do not occur.

Under a VAT, the sum of a firm's purchases (the value added at earlier stages) and the value added by the firm itself equals, by definition, the value of the purchases (which have a full tax credit attached to them) by the next firm in the production-distribution process. As a result, the same value added is never taxed twice; that is, cumulative effects do not occur. Moreover, at the final retail stage, the sum of all values added throughout the process equals the consumer price, excluding tax. In other words, the total tax collected piecemeal under the

VAT from all stages of production and distribution is e· actly equal to a tax collected on the sale by the retaile to the final consumer or user: that is, a retail tax : national sales tax (NST).

The net VAT liability can also be ascertained by de ducting the aggregate value of purchases from the ag gregate value of sales and taxing the difference betwee them. This approach to computing value added is calle the direct subtraction technique or accounts method. i the United States, it is known as "the business transfe tax" (BTT) or "uniform business tax" (UBT). The BTT wa proposed by Sen. William V. Roth, Jr., R-Del., in 1986 Sen. Roth proposed using the revenues to make possibl· lower income tax rates, super saving accounts, and mor rapid depreciation allowances. A UBT bill was introduce. recently by Rep. Richard T. Schulze, R-Pa. Its revenues in turn, would be used to replace the corporation incom tax and the employer-paid portion of the FICA payroll tax

In industrial countries, services comprise up to 50 percent of national product, too large a portion of economic activity to be excluded from a broadly based consumption tax.

Finally, value added can be computed as the sum o factor rewards: wages, depreciation, interest, and ne profits. In the literature, this approach is referred to as the addition method. This approach is more complicatec than either of the subtraction methods, because it requires inventory accounting as well as adjustments fo investment income and capital goods purchases. Hence no country applies the addition method. However, Argentina and Israel apply this method to selected economic activities, such as banking, in which the value of inputs and outputs is difficult to measure.

III. DIFFERENCES BETWEEN A VAT AND AN NST

If a VAT is identical to an NST, why not collect the ful tax at the retail stage, that is, impose an NST? A VAT is preferred for four reasons: (i) potential coverage; (ii ability to distinguish producer goods from consume goods; (iii) ability to effect correct border tax adjustments and (iv) administrative feasibility.

First, NSTs are less effective in taxing services tha are rendered primarily by small business establishments Not taxing services means that services are favored ove goods. This distorts the economic choices of both consumers and producers, and it unnecessarily accentuates the regressive impact of the tax, because the demand fo services is generally more income-elastic than is the demand for goods. In industrial countries, services comprise up to 50 percent of national product, too large a portion of economic activity to be excluded from a broadly based consumption tax.

Second, NSTs have difficulty distinguishing between producer and consumer goods. How does a registerec firm know that a shovel it supplies tax free is not usec for (taxable) gardening purposes instead of as an (exempt) input for factory work? Who knows whether sugar is used to sweeten tea at home (taxable) or as an (exempt) ingredient for (taxable) bakery products? Similarly,

an NST has difficulty distinguishing taxable consumer services from exempt services rendered to business. A VAT has no such difficulty, because the seller is simply told always to charge tax, leaving it to the purchaser to obtain a tax credit if it also is a registered taxpayer.

Third, because NSTs are unable to distinguish effectively between producer and consumer goods, in practice many producer goods (e.g., fuel, office furniture, and computers) are taxed. This discourages capital-intensive production and, hence, economic growth. Also, it means that the NST enters into the cost of exports, with detrimental effects on international competitiveness. Similarly, because the price of domestic goods includes the NST on those goods and incorporates an element of tax on producer goods, whereas the price of goods imported from countries with a VAT that is rebated for exports does not, the NST artificially discriminates against domestic goods.

Fourth, a VAT is a more robust form of consumption tax. It disperses the collection process over the whole of industry and commerce. It transfers part of the burden of proof concerning tax liability to taxpayers (who must prove that they are entitled to the tax credit on purchases). It penalizes dishonesty more than does an NST, because every invoice throughout the production-distribution process is a "public declaration" with respect to tax liability.

IV. DIFFERENCES BETWEEN A VAT AND A UBT

If a VAT is identical to a UBT, why not collect the tax on the difference between the aggregate value of sales and the aggregate value of purchases, rather than as the difference between the tax on each of these two categories? The VAT is preferred for three reasons: (i) it is a more obvious and robust form of tax; (ii) it has fewer difficulties with exemptions and differentiated rates, if desired; and (iii) the border tax adjustments under VAT are more precise and sure to be accepted under GATT.

First, the VAT is a transactions-based tax, i.e., VAT is charged each time a product is sold or a service is rendered. The UBT, on the other hand, is an accounts-based tax under which the tax liability is calculated after, rather than at the time, sales are made. This means that the UBT is more of a hidden tax, that no "audit trail" is provided, and that the UBT is more susceptible to evasion. It is not true that the VAT requires separate business accounts. Both taxes have to be ascertained from records of sales and purchases, but only in the case of the VAT would the entries be backed up by tax invoices.

An exemption creates an arbitrary and indeterminable benefit for favored products. Once lost, the tax cannot be recouped.

Second, under the VAT, an exemption in the middle of the production-distribution process means that the tax on purchases cannot be passed on. As a result, the tax load on the affected product will ultimately be higher than in the absence of an exemption. This feature creates a strong inducement for business firms to register for VAT purposes. No such inducement exists under the UBT. An exemption creates an arbitrary and indeterminable benefit for favored products. Once lost, the tax cannot be

recouped. This means that the UBT will be subject to relentless political pressure to exempt certain products, activities, and sectors. Fairness and neutrality would suffer. Furthermore, a UBT cannot accommodate differentiated rates which, although not to be recommended, may be desired for technical reasons or to mitigate the regressive burden distribution of the tax.

Third, under the VAT, the accurate valuation of imports is of no great concern, because if less tax is paid due to undervaluation, there will be less tax to credit in the next stage. Under the UBT, on the other hand, valuation inaccuracies upon import do not simply wash out in succeeding stages. Similarly, under the VAT, the tax shown on purchase invoices is simply rebated at export. Under the UBT, on the other hand, there is no certainty that the inputs, which, incidentally, have to be valued accurately, have borne tax in stages prior to export. In short, border tax adjustments under a UBT are likely to be much less accurate than under the VAT. If so, they would invite objections from the trading partners of the United States.

Not surprisingly, no OECD country has a UBT. Until recently, the Finnish VAT had some features akin to a UBT, but these have now been abolished. Also, the Japanese VAT has an optional subtraction method, but it is confined to small firms. Obviously, the ments of a VAT versus a UBT must be viewed separately from the use of the proceeds. If desired, a VAT, like a UBT, can also be used to replace the corporate income tax and/or phase out the employer-paid portion of the FICA payroll tax.

V. DESIGN OF A VAT

The integrity of a VAT is safeguarded best if it is applied to *all* final goods and services. Taxing one commodity but not another distorts consumer choices and reduces the tax intake at a given rate, although some concessions must be made for social policy considerations and on administrative grounds.

A. Exemptions

No OECD country taxes free or governmentally subsidized services in the areas of health and education, nor does any OECD country tax social, charitable, or religious services. In the OECD, these "public interest activities" are exempted. This means that no credit is given to the "exempt organizations" for the tax they pay on purchases. Given the nature of the exempt services, which are rendered directly to consumers and which often are subsidized, distortions of consumer choices should be small. On the other hand, commercially provided education and health services generally are taxed.

A second group of activities exempted in the OECD includes financial transactions and insurance. There are various problems in trying to tax financial services. Should the tax be imposed on the full price—the interest—of the financial service, or should the tax be confined to the gross margin of the intermediary as measured by the difference between its loan revenue and its cost of borrowing? Because of these conceptual difficulties, as well as practical problems in measuring inputs and outputs, all OECD countries have opted for the exemption approach.

For similar reasons, OECD countries exempt all forms of life insurance from the VAT. Nonterm life insurance premiums, for instance, have a savings element that is difficult to separate from the portion attributable to the costs of administering the insurance scheme. Other

forms of insurance are also exempted, except in New Zealand, which taxes fire, general, and accident insurance premiums. To confine the tax to the gross margin, insurers are allowed a credit for the tax fraction of any indemnity payments. Nearly all countries zero rate financial and insurance services which are exported.

B. Real Estate

The treatment of real estate, that is, the lease and sale of land and the construction, lease, and sale of buildings, is one of the more complicated issues under the VAT. It warrants careful consideration. In most industrial countries, housing services, comprising rents and rental values of owner-occupied property, constitute 15 percent or more of total annual consumption expenditures. This is too large a portion of the potential tax base to be ignored under a VAT. Moreover, once an essential part of the tax base has been excluded, it becomes exceedingly difficult to recoup.

Nearly all countries in the OECD area tax building materials, as well as repair and maintenance services, at the standard rate. Logically, these materials and services, broadly interpreted as construction activities, add up to a new building. Most countries recognize this, and under their VATs, newly created buildings are subject to the standard rate as well. This means that a nonregistered individual who buys a new dwelling pays the full VAT on it. In effect, in that case, the VAT on new residential property is viewed as the capitalized value of the tax that would have been payable in respect of current housing services had the VAT been applicable to rents and imputed rental values. Basically, commercial buildings, which can be close substitutes, are accorded the same treatment. Potential cascading effects are eliminated by permitting commercial lessors to apply for registration and payment of VAT.

Countries that follow this approach also exempt the sale of real estate other than new buildings. This is logical, although it means that increases in the value of the stock of building services are not taxed, nor is a tax credit provided for decreases in that value. Taxing the transfer of (exempt) real estate would imply that a (presumptive) tax credit would have to be given for the tax, if any, paid on the earlier purchase of the property, a choice that no country has elected. Again, owners of industrial and commercial real estate could become registered taxpayers and receive the usual VAT treatment. The sale of their property then would be taxable, but any subsequent registered owner would be able to claim a tax credit if it, in turn, were to lease or sell the property to a registered taxpayer.

C. Small Traders and Farmers

Generally, small traders and farmers face relatively higher costs in complying with the obligations imposed under the VAT than do other taxpayers. Similarly, the tax administration's cost of enforcing the tax on them is relatively higher. For these and other reasons, most OECD countries with a VAT exclude small-scale traders and producers with an annual turnover below a specified amount (the "registration threshold") from the obligations to register, furnish returns, pay tax, and keep prescribed records. The VAT paid by small firms is confined to the tax invoiced to them by their registered suppliers. While small firms benefit from not being taxed on their own value added, they suffer from not being able to pass the VAT on to their customers, because, as nonregistered

users, they are not allowed to issue tax invoices. Also, they cannot obtain a refund when exporting their output or when purchasing expensive machinery. For these reasons, the small-firm exemption generally is optional.

The VAT treatment of farmers requires special attention. If taxed, farmers would have to comply with the usual VAT obligations. If they were exempted, however, although they would not incur compliance costs, they nonetheless would have to pay VAT on their inputs of feed, seed, fertilizer, equipment, and machinery for which credits cannot be provided. Because farmers are situated at the beginning of the production-distribution process, this element of tax would cascade down through the process. Clearly, therefore, a straightforward exemption of primary sectors, without compensatory measures, would be neither fair nor good social policy.

New Zealand, Sweden, and the United Kingdom treat farmers in the same manner as all other producers of taxable products, that is, they must comply with the same requirements for furnishing returns and making payments. Generally, modifications of these requirements can be obtained only under the small-firm exemption. Other OECD countries do not require farmers to register, and they compensate them for the tax borne on the purchases of VAT-liable inputs. In some countries, a purchaser of agricultural products receives a presumptive tax credit approximately equal to the tax borne by the farmer on his inputs. Obviously, the purchaser is expected to pass that benefit on to the farmer. In some other countries, the primary producer is taxed at a rate (different from the normal VAT rate) approximately equal to the rate of tax (expressed as a percentage of sales) he bears on his inputs. As a result, no tax needs to be paid nor a return furnished, but the farmer is able to invoice the tax to the purchaser of his products, who subsequently can take a credit for it. In all of these countries, the agricultural exemption is optional.

The most appropriate approach to the VAT treatment of farmers depends to a large extent on the size of production units.

The most appropriate approach to the VAT treatment of farmers depends to a large extent on the size of production units. Compared to most other OECD countries, in the United States, the agricultural sector is organized primarily as large production units. The only sensible VAT treatment of these units is registration and payment of tax, which would ensure that agricultural products bear a more even VAT burden than they would if they were exempted. The small-firm exemption would then apply to small production units.

D. Public Sector Bodies and Nonprofit Institutions

Under the VAT, public sector bodies may be either exempted or taxable. Obviously, it does not make sense to tax the Department of Defense, if for no other reason than that it would be impossible to value its services. On the other hand, a good case could be made for taxing telecommunications and the Postal Service, which charge for their services through telephone bills and the sale of postage stamps.

Under the VAT, public sector bodies must register for VAT purposes if they generate goods and services that

are used by or benefit businesses and individuals (except, of course, goods and services explicitly exempted by legislation) and for which a price is charged. In other countries, such chargeable services include all public utilities. Exempt, as well as taxable public sector bodies, always pay VAT on their purchases of taxable supplies, even if this means that they pay tax that is collected simultaneously by another government agency. This approach safeguards the VAT's integrity in that taxable suppliers need not distinguish between taxable and nontaxable goods and services, and consumers cannot find illegitimate access to untaxed supplies. Obviously, for exempt government agencies which are financed out of general revenue, there is no net budget effect, since both the VAT receipts and the appropriations to pay the VAT are higher. Usually, arrangements are made to compensate subordinate units of government for the increase in the cost of their purchases upon the introduction of the VAT.

The costs of VAT administration can be greatly reduced by introducing an appropriate small-firm exemption.

Broadly, nonprofit institutions and government entities are treated in a similar fashion; sales of goods and services that would be taxable if supplied by business are also taxable if supplied for a price by nonprofit institutions, for example, canteens and gift shops. However, the VAT is not applied to services that are supplied without compensation, for example, by churches and charitable institutions. After all, there is no basis on which to calculate the tax. Even if nonprofit institutions are not taxable on services rendered, their purchases are taxed on the ground that suppliers should not be required to differentiate their sales according to the end user.

E. Administrative Costs

The administrative litmus test of a "good" tax is its ease of collection and compliance. In OECD countries, administrative costs as a percentage of VAT revenue range from 0.35 percent in Sweden to 1.09 percent in Belgium. Measuring administrative costs in this way is misleading, because a simple rate change would affect the apparent efficiency of the VAT administration even though there would be little or no change in absolute costs. A better yardstick would be to measure administrative costs per registered trader or per tax office staff member. Although figures are difficult to compare properly, they clearly show that the cost of administering the broadly based, single rate New Zealand VAT is only a fraction of the cost of administering the U.K. VAT, which zero rates 40 percent of the potential tax base and has complicated schemes for real estate and small traders.

The costs of VAT administration can be greatly reduced by introducing an appropriate small-firm exemption. In 1985, approximately 60 percent of all agricultural and nonagricultural firms in the United States had business receipts of less than $25,000. These small firms accounted for less than one percent of total business receipts. Thus, exempting these firms would hardly affect tax revenues, but the number of taxable firms would be reduced from 20 million to 7.5 million. The costs of VAT

administration also can be reduced by applying a single rate, providing for less frequent returns, and by close integration with the administration of the federal income tax.

Although international data on administrative and compliance costs of the VAT must be treated with caution, it is clear that a VAT can be collected at a significantly lower average cost than can income taxes for a similar amount of revenue. Data on compliance costs are even more sketchy, but a simple rule of thumb (the ratio of VAT lawyers to income tax lawyers) indicates that VAT compliance costs are far lower than income tax compliance costs. In terms of administration and compliance, the VAT emerges rather well from a comparison with the income tax.

VI. THE REGRESSIVITY ISSUE

The most pointed criticism of a VAT is that its burden is distributed regressively with respect to income. Since consumption as a share of income falls as income rises, a VAT levied at a uniform rate falls more heavily on the poor than on the rich. While the criticism is valid, it is true only if VAT payments are expressed as a percentage of income. If, instead, consumption is used as the denominator, then, by definition, the impact would be proportional. The burden of a VAT levied at a uniform rate also would be largely proportional if the denominator were lifetime income rather than annual income, because many income recipients are only temporarily in lower-income brackets. They move into the middle- or upper-income brackets as their earnings increase. A lifetime income concept takes account of this phenomenon.

Whatever the case, in the political arena, the burden distribution of the VAT is usually measured against annual income. The question in this context is whether the regressivity issue should be addressed through the VAT itself or through other tax and expenditure measures. The VAT itself might be used to tax at a lower-than-standard rate (or even at a zero rate) essential consumer items that are disproportionately consumed by the poor and, conversely, to tax at a higher-than-standard rate luxury commodities that are disproportionately consumed by the rich. Corrections outside the VAT system might include higher income tax exemptions, lower basic rates, or increases in transfer payments to the poor.

Strong arguments have been advanced against the use of multiple rates under a VAT. Rate graduation is a very blunt and expensive instrument to mitigate regressivity.

However, strong arguments have been advanced against the use of multiple rates under a VAT. Rate graduation is a very blunt and expensive instrument to mitigate regressivity. As household budget expenditure surveys indicate, with rate graduation, the rich generally benefit twice as much as the poor in absolute amounts. This is because, for VAT purposes, it is nearly impossible to distinguish expensive higher-quality food products bought by the rich from less expensive ordinary food products purchased by the poor. If such a distinction is

not feasible, lower rates become less effective in mitigating the regressivity of the VAT. This is confirmed by the findings of four recent country studies, which indicate that the impact of a VAT does not differ significantly whether necessities are zero rated (as in the United Kingdom), taxed at a lower rate (as in the Netherlands), or taxed at the standard rate (as in Denmark and Norway).

Furthermore, the costs of administering a VAT are inevitably increased by a differentiated rate structure, because it brings in its train problems of delineating products and interpreting the rules regarding which rate should be applied. Even with careful design, anomalies cannot be avoided. Differentiated rates also involve a significant increase in compliance costs, particularly of small firms. Usually, it is not possible for them to keep separate accounts for the sales of differentially taxed products. The tax liability must then be determined by applying presumptive methods, an approach that increases the difficulty of monitoring the taxpayer's compliance. Also, there is evidence that the increase in compliance costs attributable to differentiated rates is distributed regressively with respect to income. Smaller firms with lower incomes bear proportionately more of the burden than do larger firms.

It should also be emphasized that, given the amount of revenue to be raised, applying a lower or zero rate to essential commodities means that the standard rate must be higher than it would be in the absence of rate differentiation. This higher standard rate would magnify the distortion of consumer and producer choices. This defect should be taken seriously because, as a rule, the severity of tax distortions increases progressively with the tax rate that causes them. It has also been shown that high *ad valorem* rates have detrimental effects on product quality. The higher the standard rate required to maintain revenue, the more serious are these effects.

Normally, the introduction of a VAT would be accompanied by a general price increase of some 0.7 percent for each percentage point of tax if its introduction were accommodated by the monetary authorities, as is ordinarily the case.

Similarly, increased rates make little sense. To the extent that they cover expenditures for drinking, smoking, and driving, increases in the related excises or user charges are indicated. Also, higher rates are difficult to enforce with respect to small high-value items, such as jewelry, perfume, and cameras, which easily can be smuggled in from abroad. In practice, the part of the VAT base that can be taxed at a higher rate is extremely small, at most five percent of total consumption expenditures. This is to be expected. As noted above, higher-income groups usually buy varieties of particular commodities that are more expensive than the varieties bought by lower-income groups, but it is nearly always impossible to distinguish between them in a way that is relevant for VAT purposes. The rich also spend proportionately more than the poor for foreign vacations and on education, but these expenditures either cannot be taxed or must be excluded on merit grounds. Overall, higher-than-standard

rates impart little progressivity to the distribution of the VAT burden.

Nonetheless, 15 of the 21 OECD countries with a VAT address the regressivity issue within the context of the VAT by applying one or more lower rates to essential items. However, this picture owes much to the situation in the original EC member states, which adopted the VAT in the late 1960s and early 1970s. These countries were concerned with staying as close as possible to the tax burden distribution of the previous turnover tax so as not to jeopardize the acceptance of a completely novel levy. (Lately, these countries have begun to reduce the number of VAT rates.) Not surprisingly, later converts to the VAT, not constrained by these considerations, adopted a uniform rate and adjusted the resultant regressive distribution of burden more effectively elsewhere in the tax and income transfer system.

In the United States, the regressivity of a VAT could be offset by (i) adjustments in food stamp payments and AFDC benefits to compensate low-income families with children, (ii) adjustments in Social Security benefits and SSI payments to compensate the elderly, (iii) the provision of a refundable vanishing VAT credit against personal income tax liability, and (iv) an increase in the earned income tax credit to compensate low-income workers. A highly imaginative approach would be to use part of the VAT revenues to reduce the payroll taxes that are highly regressive, distortionary, and which cannot be rebated on exports.

VII. EFFECTS ON PRICES, SAVING, AND CAPITAL FORMATION

An often-voiced concern in countries without a VAT is that the introduction of the tax would set in motion a spiral in which the tax, prices, and wages would feed on each other, i.e., a VAT would be inflationary. Normally, the introduction of a VAT would be accompanied by a general price increase of some 0.7 percent for each percentage point of tax if its introduction were accommodated by the monetary authorities, as is ordinarily the case. The crucial question, however, is whether this one-time increase would lead to further price escalations. Empirical evidence suggests that in 11 of the 13 OECD countries surveyed, considering all circumstances, the introduction of the VAT either had little or no effect on retail prices or simply resulted in a shift of the CPI trend line (one-time effect). The answer to the question raised above, therefore, almost categorically, is that VAT introduction does not lead to a price escalation spiral.

If approximately 70 to 80 percent of consumption expenditures would be taxed, a five-percent VAT would lead to a three- to four-percent increase in the CPI. In the absence of compensating wage adjustments, disposable incomes would be reduced correspondingly. It should be pointed out, however, that this reduction in take-home pay also would occur under an equal-yield increase in the personal income tax or in excise taxes.

A VAT is neutral with respect to the choice whether to consume now or to save for future consumption. Although a VAT reduces the absolute return on saving (that is, the amount of future consumption), the tax does not reduce the net rate of return on saving. In contrast, an income tax reduces the net rate of return on saving, because both the amount saved and the interest earned on that amount are subject to tax. Therefore, if it is assumed that saving increases as the net rate of return on saving

increases, a VAT is superior to an income tax in promoting capital formation and economic growth.

VIII. INTERNATIONAL COMPETITIVENESS

Since a VAT is levied on imports but rebated on exports, it is often contended that the tax promotes international competitiveness. The country's trading partners, the argument goes, "subsidize" exports to the United States and "discriminate" against imports from the United States. In a more sophisticated version of the argument, it is pointed out that since the United States relies relatively more heavily on income taxes, which are not rebatable under GATT, in terms of international trade, the country is disadvantaged *vis-a-vis* its trading partners, which collect relatively more revenue from indirect taxes less harmful to trade.

Emphatically, the argument that a VAT is a tariff-cum-export subsidy is wrong. However, there is some ground for assuming that the heavy reliance on income taxes hampers exports. In thinking about these two issues, it is useful to compare the international trade effects of a VAT on the one hand to its equivalent—the NST, and on the other hand to a substituting personal income tax. The latter comparison is appropriate if it is assumed that additional revenues must be raised through either a VAT or an income tax increase. Alternatively, the proceeds of a VAT could be used to lower the income tax.

It is well known that exports are not taxed under an NST because they do not constitute retail sales. For the same reason, imports are not taxed until sold at retail. Exactly the same happens under a VAT. Exports must be "detaxed" by rebating the tax collected in earlier stages of production and distribution so that exporters are not disadvantaged *vis-a-vis* their foreign competitors. Imports are taxed, but the tax that is imposed at the import stage under the VAT mechanism can be credited by the first taxable inland user, resulting in equivalent treatment *vis-a-vis* domestically produced goods. Under VAT, exports and imports end up bearing exactly the same tax as under an NST of equal rate.

The imposition of a VAT . . . does not involve a change in the allocation of resources, production incentives, or international competitiveness.

Under a uniform VAT, all consumer prices rise exactly in proportion to the VAT, thus leaving all relative prices unchanged. The imposition of a VAT, therefore, does not involve a change in the allocation of resources, production incentives, or international competitiveness. Indeed, contrary to popular belief, international competitiveness would suffer if the VAT would not be rebated at export. Since world prices facing producers would not change,

the VAT on exports would be borne by them, exports would decline, the U.S. dollar would depreciate, and imports would become more expensive. In effect, the nonrebatable portion of the VAT would be a protectionist import tariff violating the spirit, if not the letter, of the GATT.

This conclusion must be modified if the VAT were substituted for (an increase in) the personal income tax. As a tax on current consumption (of domestically produced and imported goods), the VAT would dampen domestic demand. By contrast, income tax is an inducement to current consumption and discourages saving because it taxes savings as well as income from savings. Substituting the VAT for (part of) the income tax, therefore, promotes saving and improves the trade balance. Over time, of course, this effect would cancel itself out, because the accumulation of foreign reserves would lead to increased imports. In short, the VAT would have a positive short-run effect on the trade balance, but no such effect would occur in the long run. What is plausible, however, is that compared to an income tax, a VAT is more conducive to promoting saving, capital formation, and economic growth.

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June 22, 1995

The Hon. Bill Archer
Chairman
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1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

During the Committee's June 7 hearing on tax reform, you asked me and the other members of the value-added tax panel to submit for the record our recommendations regarding regressivity offsets. This letter provides my comments on three issues -- (1) the nature of the regressivity problem of a value-added tax, (2) whether the tax system itself should be structured to address regressivity and (3) how the problem should be addressed outside the value-added tax.

My general conclusions are that regressivity is not a fundamentally different problem under a value-added tax than it is under any other tax paid by businesses and that any problem which does exist must be addressed *outside* the value-added tax system itself.

1. The Nature of "Regressivity" in a Value-Added Tax

All forms of taxes applied to economic value-added (*e.g.*, a retail sales tax, the European VAT, the subtraction method business activities tax) are widely assumed to be regressive. This is based on the belief that the tax burden is fully passed forward to the ultimate consumer who pays the tax as a part of the total cost of purchased goods and services. Lower income households generally consume larger portions of their incomes than do middle and upper income households, so the burden of the tax is believed to fall disproportionately on them.

Two fundamental questions need to be considered -- is the assumption correct, and is this result unique to the various taxes on value-added?

a. Is the tax fully passed forward?

I have long been troubled by the assumption that a tax on value-added is always fully passed forward to the consumer. This phrase -- "fully passed forward to the consumer" -- cannot mean simply that prices go up. Prices could rise by the full percentage of the tax rate, and sales certainly will continue to occur at the higher prices. Instead, "fully passed forward to the consumer" must mean that the full burden of the tax -- or the *economic incidence* of the tax -- falls on people in our role as consumers because we buy the same quantities of goods and services at the higher prices that we bought at the lower prices. If that occurs, the tax is fully passed forward because neither the profits of the sellers of goods and services nor the wages and salaries of the sellers' employees are reduced. But if consumers purchase somewhat lower quantities of the same goods and services at the higher prices, they are not bearing the full burden. Instead, as sales volumes fall, some portion of the burden of the tax is actually being paid by the business owners (because their profits also fall) or by employees (because wages are reduced or people are fired) or some combination of the two.

Both common sense and my experience as a partner in my own business tell me that *any* cost of doing business is included in prices to the maximum extent possible. When customers resist by buying fewer goods or by shifting to lower-priced goods, the business looks for ways to maximize its sales volume and profitability. A principal way is to scale back the price increase. In that case, the business owners bear a portion of that tax. Unless the market place is literate and can distinguish between taxes and other costs of operating a business, there is no apparent reason for concluding that a tax on value-added in any form is inherently more likely to be borne fully by consumers than is any other cost.

b. Is the pass forward unique to taxes on value-added?

If taxes on economic value-added are passed forward to some unknown degree from business to business, is this result unique to these taxes? Aren't the taxes that a business pays on its profits, payroll and property passed forward, too? What about the individual income tax that is paid by employees from their gross wages -- isn't this included to some degree in what the business collects from customers in order to pay gross amounts of wages and salaries?

Looked at another way, what would happen to market prices if all taxes paid out of business receipts (including income taxes on employees' wages) were suddenly repealed? Is it likely that businesses could sustain current price levels for an extended period of time? How long would it take for enterprising companies to begin reducing prices -- and to gain market shares -- while retaining their desired level of profitability after the expense of taxes

had been removed? I believe that the process would begin very quickly and would continue until a new level of equilibrium is found in all markets. If so, that is at least intuitive proof that current taxes paid by businesses are also included in prices to some significant degree.

My view is not that a tax on value-added would not be passed forward to consumers to the maximum extent possible. In fact, I believe that it would. Rather, my proposition is that a tax on value-added will be passed forward to the same degree that any tax or other cost of doing business is passed forward. This requires that the regressivity issue be assessed in terms of what effect, *if any,* will arise from the substitution of a tax on value-added for direct taxes on profits and/or payroll.

This also suggests that federal policy makers and others should not encourage the conventional wisdom about price increases following enactment of any of the taxes on value-added, unless the conventional widsom can be proven. A prolonged period of telling people that prices will go up when one tax is substituted for another is likely to encourage that initial reaction and to delay the efficient work of market forces that will sort out the longer-term effects of substituting one tax for another.

2. Addressing Regressivity Within a Tax on Value-Added

Even if a one-time increase in prices can be proven, efforts to offset regressivity should not become part of the value-added tax itself. One approach to lessening regressivity is to exclude the sales of food, medical care and housing from the gross receipts of businesses under the subtraction method tax. This is the equivalent of the zero rate under the credit method VAT, and it is the chief source of the problems presented by VATs in other countries (and by state and local sales taxes in this country). This approach is wasteful, inefficient and complicated.

First, such exclusions waste enormous amounts of foregone revenue on unintended beneficiaries. To provide the intended assistance for, perhaps, the 20 percent of households with the lowest incomes, exclusions also forego revenues from sales of food, medical care and housing to the other 80 percent. These middle and upper income households are very likely to buy more and higher priced necessities. So, to get the intended benefit to 20 percent of households, *at least four times as much revenue is lost from everyone else.*

Second, the exclusion of food, medical care and housing cuts the tax base dramatically. Based on national income accounts data, a 15 percent tax rate on a universal tax base must be increased to about 21 percent to recover the revenues lost because of the exclusions. Lower income households also purchase the goods and services that would now be taxable at the much higher rate. Thus, the already wasteful effort to provide a benefit to

such households becomes even more inefficient by taking back a large portion of the intended benefit.

Third, the preferential rules set the stage for complexities and controversies that will swirl around the definitions of "food" and "medical care" and "housing" and anything else that is left out. These are the source of numerous controversies in the countries in which they are used.

Fourth, many of the goods and services that would receive preferential treatment do not enter international trade. Housing, medical care and much of the food sector of the economy are purely domestic in nature. Absent the same tax burden as other sectors, these sectors will enjoy an artificial tax-induced cost advantage relative to export-intensive businesses and to those that compete with imports. This tax preference will encourage a shifting of resources to the untaxed sectors and away from trade-related sectors of the economy. Our trade-related sectors could contract, and competitiveness could deteriorate as an unintended but real consequence of the preferential treatment.

For these reasons, it is clear that a system which taxes value-added should not be shot full of multiple rates and preferences in an effort to deal with regressivity issues. All businesses should be taxable at the same rate on their business activities.

3. **Addressing Regressivity Outside of the Value-Added Tax System**

If it can be determined that a tax on value-added is certain to be passed forward to consumers to a greater degree than the taxes which it replaces, that issue should be addressed outside the value-added tax itself, for the reasons noted above. After quantifying the magnitude of the greater pass forward, the next step is to determine how much of this effect is offset by current government programs. A number of existing transfer payment and income support programs will be adjusted upward by their COLAs to reflect any price increases. These will include Social Security, military/government/railroad retiree pensions and various other specific benefits programs for certain employment categories and for food and housing support. Entitlement programs for medical care such as Medicare and Medicaid cover some additional portion of the effect, too.

To the extent that there is a price effect that is not offset by these programs, a direct transfer payment can be used. If the income tax is repealed, perhaps a simplified refundable credit based on household income (including government programs) and dependents can be fashioned. The current review in Congress of the earned income tax credit should provide a basis on which to construct any direct transfer payment mechanism that is necessary, based on total receipts of the household and the number of persons living there.

Summary

I urge the Committee to undertake first a serious assessment of the regressivity issue with a reconsideration of the "full pass forward" premise itself and then a reconsideration of how current taxes are passed on to consumers. Only after a problem is confirmed will it be possible to assess its magnitude, the ability of existing government programs to address it and the possible need for even more targeted relief.

Sincerely,

Cliff Massa III

Response by Alan Schenk to Chairman Archer's Request for Information on Regressivity

Mr. Chairman: You asked our panel to send you our comments on how to handle the regressivity issue under a value-added tax. I will quote in part from an article I wrote in 7 Virginia Tax Review 207, 270 (1987), where I wrote:

"Broad-based sales taxes are considered regressive because they impose a higher tax burden, as a percentage of income, on lower income groups (especially those below the poverty level) than on higher income groups.... [t]he regressivity of one tax may be accommodated by making adjustments in the progressive taxes if, as a result, the overall federal system possesses an acceptable degree of progressivity."

If Congress is concerned about the regressivity of a VAT, it should look both at the distribution of the VAT burden and the distribution of the benefits financed by the tax.

If a consumption tax like a VAT, that is collected by business, replaces all federal income taxes, there is little opportunity to make adjustments for regressivity under remaining progressive federal taxes. A VAT is not adaptable to differing economic situations of individuals or households.

If it is desirable to have a tax on consumption, it should be imposed on the broadest possible base in order to keep the tax neutral. The tax should not distort choices that consumers make about the products and services that they want to buy. It is undesirable to accommodate for regressivity within the VAT system, such as by granting exemption or zero rating to necessities like food, housing and medical care. These adjustments in the tax

base complicate the tax and grant benefits to high income households as well as the low income households that need targeting to resolve the regressivity issue.

If Congress retains the individual income tax or converts that tax to a progressive consumption tax like that proposed by Senators Domenici, Nunn & Kerrey, regressivity of the VAT could be addressed through credits like the earned income credit and increases in the standard deduction. Alternatively, the regressivity of a VAT could be accommodated through changes in direct grant programs to low income families, such as the food stamp program. Canada accommodates for regressivity by issuing a check quarterly to lower income households that were adversely affected by the introduction of the Canadian Goods and Services Tax. Unfortunately, Canada also complicates its tax by granting special treatment to food and other items.

Some economists claim that if a VAT or other tax on consumption is tested over a lifetime, the tax is not regressive. Even if the data supports this conclusion, this claim is not responsive to the problem. We historically have measured fairness of federal taxes, particularly the individual income tax, by using a year as the period of measurement. It seems inappropriate to use a different period of measurement to evaluate a consumption tax. As Dr. Carl Shoup wrote almost 50 years ago, a nation's "tax system must satisfy the deep, widespread feelings of the people as to what is fair." (Gen. Headquarters, Supreme Commander for Allied Powers, Tokyo, 1 Report on Japanese Taxation 17 (1949)). Ultimately, the question is whether the American public will view a VAT as a replacement tax, without any adjustment for the impact of the tax on low income households, as a "fair" tax.

Chairman ARCHER. Mr. Gibbons.

Mr. GIBBONS. First, I want to thank you, Mr. Chairman, for calling these witnesses and calling these hearings, and I want to thank the witnesses for their contribution that they have made to the whole understanding of taxation. I met and listened and read from each one of them and tried to profit by what they have thought.

I am familiar with the Canadian experience. I have talked to the Canadian taxwriters, and they suggest that the best transition is to go cold turkey, but don't write a law like their goods and services tax, write a law very similar to the one that I call my proposal, which is a simple subtraction method VAT. They think that their system as conceived was overly complicated. They also think that you ought to do it as a replacement tax, not as an add-on tax. I realize they were both adding on and replacing at the same time.

I think that is the experience that you have had in Europe, too, is you were adding on and inventing a tax system and you came up with a credit voucher system, subtraction system, and I think as you go through the evolution, Europe will sooner or later just go to a simple subtraction method VAT. That is what it looks like to me as you replace more and more of your income tax and your other systems of taxation with a value-added tax. That is the reason I try to just make the jump all at one time.

Now, I am concerned about the crediting at the border, the adjustment at the border. Under my system, the tax is embedded in the price of the goods and services. You don't have to keep displaying it on every individual voucher, but we could require it to be displayed on every voucher, although I think that would be a waste of time. It may make it difficult if we ever have to change the rate if we have it embedded in all those vouchers, too.

So tell me, what do you think is the danger of us getting in a trade squabble with our world trade partners if we go to the simple subtraction method of the tax? Would any of you want to fight that one?

Mr. SCHENK. I would be happy to start. As I said during my comments, Mr. Gibbons, it seems to me that if, in fact, Congress adopted your very broad-based sales subtraction VAT, it is economically equivalent to what the Europeans imposed. Therefore it would be a bit disingenuous if our trading partners said the Europeans can do it, anybody that follows the Europeans can do it, but you can't do it if you choose a different method of calculating the tax of value added.

Now, there are some concerns, and your colleagues in the Senate want to provide a payroll tax credit, not just repeal the payroll tax. The credit may be quite different when it comes to border adjustability. That is where we are going to get into trouble.

I am not saying that the answer is clear, but certainly our trading partners can argue that a payroll tax credit has the effect of not taxing some compensation. If you are really not taxing some compensation, maybe you are not taxing value added any longer. It then becomes an income tax and therefore not border adjustable. It really depends. Sorry for an academic answer.

Mr. GIBBONS. That is all right.

Mr. MASSA. The problem, the potential problem that Alan just raised, I think, needs to be emphasized is not related to the struc-

ture of the value-added tax. It is how an additional tax relates to it. I would hope that our trading partners are not disingenuous enough to say if we are taxing value added this way it is different than if we are taxing value added that way.

It is often observed that the credit method tax is a tax on products or on transactions and that the subtraction method is a tax on books of account or on the period. But I would recommend very strongly that you consider the fact that your tax and the subtraction method tax, in fact, compute a tax on the value of every good sold and every service sold. You simply accumulate it at the end of the period.

It doesn't seem to me that there is any fundamental difference, any difference except a mechanical one, so aside from the fact that perhaps our trading partners might not like our wising up and stepping into a border adjustable tax, I would hope we would not have real difficulty telling them that this is an apple and this is an apple, and we are going to treat them both the same way at the border.

Mr. CNOSSEN. Mr. Chairman, I have two very distinguished lawyers here on my left side, and it is the first time I hear two distinguished lawyers say that something which is economically equivalent is also legally equivalent. As I understand, lawyers go by what the law says and what the treaty says, and the GATT treaty or the WTO treaty says that the tax must be imposed on specific products and it must be possible to calculate the rebate unambiguously.

I would like to say here that income, of course, is also value added. Under the flat tax, value added is the sum of wages and capital income, and yet income taxes, under the General Agreement on Tariffs and Trade, are not rebatable at borders. We have agreed to this provision, even though revenues and value added are the same thing. So I would tend to be more pessimistic about the chances that border tax adjustments for a subtraction method VAT would be accepted without a fight.

I would like to add that the eligibility for export rebate also is in doubt because there is no presumptively correct record of the tax that has been paid in previous stages of production and distribution.

Mr. GIBBONS. Well, we could just, each voucher that would support the transactions, and there has to be vouchers somewhere, you know, people have some kind of record of what they did, you can simply put on each one of those vouchers, this includes x percent value-added tax. It would seem to me that would be the paper trail that you need. That is about all you really get with the European-style tax.

Mr. MASSA. It doesn't prove it has been paid.

Mr. GIBBONS. It doesn't prove it has been paid, that is right. I don't want to take any more time. Other Members ought to have more time. I have talked to these gentlemen so much over the years, I want to commend you again, though, each of you, for your thinking that has gone into all this, and I know that you realize I have stolen valuable material from you to include in my writings, and I thank you for it, and in my thinking, and so I will yield back the balance of my time.

Mr. SCHENK. Mr. Gibbons, could I make a personal comment.

Mr. GIBBONS. Certainly.

Mr. SCHENK. I testified before this Committee for the first time in 1970. I was the 17th witness out of 17, and it was a very long day for me and for all Members of the Committee, and at the end of the day there were only three Members left, and thank you, Mr. Gibbons, you were one of them.

Mr. GIBBONS. Well, thank you. Thank you. I sort of recall that. My memory gets a little dull going that far back, but thank you very much for remembering that.

Mr. COLLINS [presiding]. Thank you, Mr. Gibbons.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. Just a brief followup to Mr. Gibbons' questions. I have one specific issue as to services. Let's assume the proposed tax system is border adjustable. How would you deal with the imported services?

Mr. MASSA. Well, services are a good deal tougher to deal with because they are not tangible. They don't cross the border. They don't come through a customs point and say here it is, let's levy the tax. I believe what you will find in the various subtraction method proposals that are out there, a business importer of services is simply not allowed to deduct the services in computing value added and therefore they get into the base.

One of the areas on which more creative work needs to be done is telecommunications and professional services that are imported. There simply is no way to say, well, it crossed the border, therefore it goes into the base. The principal approach in the subtraction method is to say you do not treat it as a business purchase if you bought it from a foreign service supplier, therefore your own base is increased and the tax gets paid on it that way.

Mr. CNOSSEN. Services cannot be imported or exported. Services are not mentioned under the General Agreement on Tariffs and Trade, so what all value-added taxes do is make the recipient of a foreign service liable for reporting and paying the tax on the imported service, and eligible for the subsequent tax credit.

Mr. PORTMAN. Mr. Massa, I enjoyed reading your testimony, particularly your suggested principles for tax reform. In looking at them, it seems to me that they might apply equally, at least in most cases, to a national sales tax, and yet you come out strongly in favor of a VAT tax in your statement and your testimony.

Can you talk a little about that, the tax base of a national sales tax as an example as compared to the tax base of a VAT tax, and Professor Schenk and Dr. Cnossen, feel free to chime in.

Mr. MASSA. The tax base is the same, it is value added. It is the value of all goods and services consumed. The national sales tax simply applies at one stage to what a value-added tax does in increments along the way, so at least in theory the tax bases are the same.

There are some issues which sales tax proponents need to address and I think are addressing, one of which is if you miss a sale at the retail level, that entire tax base is gone. Therefore, in the underground economy which continues to operate, I assume, any goods and services that are sold when somebody is doing your roofing off the back of a truck or some such thing, that entire tax base is just missing. You miss it all.

Another major problem, certainly from the business perspective, is making sure that a business which buys goods and services for use in its own business doesn't pay the tax. That is a troubling issue that I think still has to be dealt with. The multistage value-added tax does not have those problems, and that is why I think it is a simpler system to deal with and more efficient than a sales tax, but in the ideal world they reach exactly the same conclusion.

Mr. PORTMAN. Professor Schenk, any thoughts on that?

Mr. SCHENK. Yes, Mr. Portman, what I would add is experience from Louisiana. Maybe Mr. McCrery could confirm this. Louisiana had a single stage retail sales tax, and many years ago they added a wholesale level to that tax and gave a credit to retailers so that it wasn't a double tax. The State estimated what the revenue should have been raised just by adding this wholesale tax. They were amazed that revenue went up dramatically more than they expected. Well, it is not surprising. What they found is that with a multistage tax, people subject to the retail sales tax who previously cheated, now paid the tax.

Mr. PORTMAN. So retail taxes, as well as wholesale taxes, were probably increased, and people were identifying the taxable amount at both levels?

Mr. SCHENK. Yes.

Mr. PORTMAN. Dr. Cnossen.

Mr. CNOSSEN. Yes, I think a retail sales tax would put too much weight on the weakest chain in the production distribution network. Moreover, I think a value-added tax, and I think that is an important feature, particularly in the United States, would enable you to exempt 15 out of 25 million businesses if you had a small firm exemption of $100,000 with a loss of revenue of only 3 percent; 2.6 percent, to be exact, to quote the GAO's report.

Of course, a retail sales tax, because the whole tax is collected at the retail stage, not at previous stages of production and distribution, could not accommodate that kind of exemption without very serious loss of revenue.

Mr. PORTMAN. Thank you, Mr. Chairman. Thank you gentlemen.

Mr. COLLINS. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

We are talking about primarily at this hearing about a total replacement of the income tax. Have you gentlemen ever given any thought to—or is there any credence in the possibilities of, for instance, a value-added tax replacing the income tax? You still got a whole bunch of other taxes, sales tax to replace the income tax.

You still got a whole bunch of other taxes built in, excise taxes, what have you. Would it be even feasible to consider replacing the entire tax structure of the U.S. Government with a value-added tax, giving them back every tax except a value-added tax or a sales tax?

Mr. MASSA. I think Mr. Gibbons certainly believes so because that is the thrust of his package. It would seem to me that setting aside for the moment the issues of how much money you are going to accumulate to put into or earmark for Social Security or the highway trust fund or anything else, I don't see any reason why things wouldn't get more and more efficient if we had one uniform

neutral tax that was the government's entire source of funding. Can it be done? I don't know, but in theory it certainly could.

Mr. HANCOCK. Is there any country that you know of that operates on that basis, even a small country?

Mr. MASSA. None that I know of.

Mr. CNOSSEN. No country has ever gone down the way that Chairman Archer is proposing, replacing the income tax by a value-added tax. If you did replace the whole tax system in the United States by a consumption tax, that probably would require a rate around 40 percent on all consumption expenditures.

I think that would raise very serious compliance and administrative problems, very serious taxpayer resistance; moreover, I guess we all know, intuitively know, that the higher the tax rate gets, the greater the distortions of the tax system become. That is why we have more than one tax, because we can keep the rates low and distortions generally are less than if we had one unique tax. Besides, there are other taxes, excises, and so forth, with which you want to achieve goals other than simply raising revenue.

Mr. HANCOCK. Thank you, sir.

Mr. COLLINS. Mr. Ford.

Mr. FORD. Thank you very much, Mr. Chairman. I will try to be very brief. Let me ask the members of this panel whether we should look at some of the other countries and whether they have an income tax as well as a VAT tax. Should we focus on changing the existing income tax system rather than change the whole Tax Code itself. If changing the system as we know it is advisable, should we implement a VAT tax with the subtraction method?

Mr. SCHENK. Well, Mr. Ford, it makes me a little nervous to go cold turkey, as the Chairman suggested, from one to the other. We have no experience, no country in the world has that kind of experience. As Professor Cnossen just pointed out, a balance of taxes is maybe one way to move so that some of the taxes are collected at the source on income and some of the taxes are collected at the point of consumption. I agree with you, we don't have experience.

Mr. FORD. So, when choosing a new tax system, you favor the VAT tax. But it is your opinion that we don't have the experience with this new system and we should gradually move into the area of a consumption tax or whatever new system that might be proposed.

Is that an accurate representation of your testimony?

Mr. SCHENK. Well, as I said in my testimony, I think that if Congress decides—and you know better than I—if Congress decides that it is valuable to impose a tax on consumption to be collected by business, then I would favor a value-added tax. I think that is the best tax to use. But it is that initial political judgment about which I have no judgment.

Mr. FORD. Could I hear from you, Mr. Massa?

Mr. MASSA. I would be perhaps a little less cautious and more concerned that if we put a new system in place and kept what we have, the odds are in a few years we would be talking about an even messier and more complex set of taxes.

I would encourage the Committee and your colleagues to at least consider the variable step of saying, we are going to change the entire system. If we find that the price is too high to pay to get from

here to there, then we won't do it. But rather than put in place a new system and leave some substantial portion of the income tax, I would hope we would try to find a bold way of saying, we really want to change the whole system, and let's do it. If we have to phase it in, fine; if we can do it cold turkey, fine.

Mr. FORD. But what would make the consumption tax so attractive? What makes it so attractive that you would proceed cold turkey without regard to unforeseen consequences of the VAT system?

Mr. MASSA. For me, again as a lay economist, it is that a value-added tax taxes payments for labor, services and payments for capital services; and by that I mean, wages, salaries and benefits on the one hand, profits and interest on the other. At the business level, they are all taxed once, all taxed at the same rate, so that businesses are no longer pushed and pulled between uses of labor and capital services. To me, it seems that that is a much more neutral, less distortive, more efficient tax system than sort of the various pieces we have got now.

Corporate income tax, I think it is generally agreed, is a tax on capital services. The individual income tax is a labor/service tax; it is also a capital tax, when you get capital gains, interest and dividends. We have the payroll tax that adds more taxes to labor/services. To a value-added tax, as I understand, it says we will tax returns to all factors of production, I think they are called, labor and capital once, and at the same rate; and that would be much better than what we do now.

Mr. FORD. Should we focus on exempting certain small businesses?

Mr. MASSA. I wouldn't exempt them—I share Professor Schenk's view—lest every law firm, accounting firm, doctor firm and everything else in the country all of a sudden breaks up, becomes a series of individual businesses. Dr. Cnossen's view about efficiency I understand, but I just think if you have a business level tax, every business ought to be in it unless there is some compelling reason to remove them.

[The following was subsequently received:]

Hearings on Replacing the Federal Income Tax
June 7, 1995

Response to Representative Ford's Request for Information on a Small Business Exemption

Mr. Ford. In many countries with VATs, small retailers do not maintain good records. Many of these countries also have a history of tax evasion at the retail stage. Typically, only a small percentage of the total value added in an economy is added by small businesses. It is not surprising that most countries with VATs grant exemption to small businesses with annual sales below a prescribed threshold. Taiwan, at one extreme, taxes even the smallest businesses, but these very small businesses are taxed under a different scheme administered by government auditors who visit these businesses. At the other extreme is the Japanese Consumption Tax (CT). I will assume an exchange rate of 85 yen to the dollar. Japan completely exempts businesses with annual taxable sales below about US$350,000. It partially exempts businesses with annual taxable sales below almost US$600,000. In addition, Japan provides a simplified scheme for businesses with annual sales below US$4.7 million. Only about 10 percent of Japanese businesses must use the regular method to calculate CT liability.

The states in the U.S. have been very successful in including small businesses in the retail sales tax (RST) bases. Small businesses keep records adequate to account for a broad-based federal VAT, although compliance by small retailers will become more complex if the VAT must be separately stated on sales invoices and the VAT will imposed on a base that differs from the RST bases. If Congress decides to enact a European-style VAT, I urge Congress to study the Japanese CT, a good first stage toward a European VAT that ultimately should cover all businesses, regardless of size.

Mr. FORD. I yield back.

Mr. COLLINS [presiding]. Mr. Ensign for a quick comment.

Mr. ENSIGN. Thank you, Mr. Chairman.

In the interests of time, I just want to make a quick comment and also I would like to receive your comments on regressivity as well. But you mentioned in hiding them in the price of goods, the taxes would be in the best interest of the States, helping get them onboard.

The one caution that I have on that is that one of the drawbacks to the VAT tax is that in the future it is easy to raise the VAT tax rate and if you hide that tax into the price of a good, at that point it is even easier and easier to hide tax increases. And as we are growing, the size and the scope of government over the last umpteen years, one of the reasons I think we now have a chance to downsize government is because people are sick of paying the amount of taxes, and that is a caution that I would add.

Thank you for the time, Mr. Chairman.

Mr. COLLINS. Thank you, Mr. Ensign.

We appreciate you gentlemen testifying before the Committee today. We excuse this panel and call the two gentlemen from the other end of the hall, Mr. Nunn and Mr. Domenici. Thank you, gentlemen.

We thank you two gentlemen for visiting with us at this end of the hall. We apologize. We have a vote on the floor and we understand that you have some votes coming up in just a few minutes. So we are going to go ahead. Mr. Domenici, would you like to lead off?

Senator DOMENICI. Mr. Chairman, I am going to let Senator Nunn lead off and follow him.

Mr. FORD. Mr. Chairman, let me say before the two Senators begin their testimony, I will have to leave the hearing because there is a vote on the floor. I will return, but I did not want my absence to be mistaken for rudeness.

Senator NUNN. We understand that better than anybody, you know.

Mr. COLLINS. It is a pleasure to welcome my colleague from Georgia to testify in front of the Committee.

STATEMENT OF HON. SAM NUNN, A U.S. SENATOR FROM THE STATE OF GEORGIA

Senator NUNN. You have taken over this Committee even sooner than I predicted.

Mr. COLLINS. We move fast.

Senator NUNN. I have just come from a hearing all morning on Bosnia and we have the President's and Senator Dole's terrorism bill on the floor, and now I am shifting to the IRS Code, and the only common denominator among those three subjects I think is terror. But I think all three probably fit in that category.

It is a pleasure to appear before the Ways and Means Committee as part of your hearings on tax reform, and I thank you and Chairman Archer, Congressman Gibbons and all of the Members for holding these hearings. Senator Domenici and I appreciate the opportunity to discuss our tax bill that we have introduced, which is

called the U.S.A. tax, which stands for unlimited savings allowance.

I would like to summarize my prepared remarks, and I would put the rest of my remarks in the record. We can't cover the whole subject today, and we know that, so I am just going to hit a few highlights. And then Senator Domenici is going to go into more detail on both the business and the individual side of the Tax Code.

The most important fundamental principle of the unlimited savings allowance proposal is the removal of the current bias in our Tax Code against the savings and investment that are the key to the higher living standards in this country in the future. In my view, higher savings lead to more investment, more investment means that we will have more productive American workers, the more productive our workers are, the more competitive we are in the international arena, and the more competitive we are in the international arena, the better jobs we have, and of course the better jobs we have, the higher income we have. So there is a direct connection between savings, more savings and higher income. If we can make that connection with the American people, I think we have got an excellent chance for real fundamental tax reform. If we don't make that connection, if people don't understand that, if they don't buy it, if they disagree with it, then I think it is going to be very hard to reform the Internal Revenue Code in a significant and fundamental way.

To efficiently use our time, Mr. Chairman, I am just going tc highlight four parts of our proposal that I think are very important, without getting into the details of the proposal, and then Senator Domenici will fill in the very large gaps here and have his own comments.

First, the question of fairness. I think that question has to be addressed. We have heard a lot about simplicity; we want our Code to be much simpler, and we think it is much simpler, but we do not want to withdraw the question of fairness in the process.

There are four main elements that we believe that make our U.S.A. tax on individuals fair: First, we retain progressive rates; second, we have a family living allowance that exempts from taxation the first several thousands of consumption for necessities. Everybody has to have certain necessities. We have added a family living allowance and, of course, we retained the individual exemptions. For a single person, the standard family deduction would be $4,000; for a married couple, it would be $7,000. The bottom line is for a family of four, if you have a family living allowance plus the current exemptions, they would pay no tax on the first $17,600 of income.

The third part of fairness, we retain certain key elements of the current Code. We enhance the earned income tax credit—we increase that; we think that is essential—and we retain the tax exempt status of certain safety net benefits.

Fourth, and most importantly, and we think this is fundamental and should be part of any tax proposal that comes forth into fruition as law, we have a new payroll tax credit to offset the most regressive part of the current Tax Code. This is a very significant and very important change. I will say more about that in a moment.

Finally, on the question of fairness, the U.S.A. tax system reflects a fundamentally different philosophy in that we do not focus on where the income comes from. We do not have different rates for wage income or dividends or capital gains. If our proposal is adopted, the debate about rich and poor on capital gains will be over because the wage earner will be able to save their money and defer taxes just as capital gains will be deferred if the gains are reinvested. So it will be the same principle.

Under the U.S.A. tax, the point is not where the income comes from, it is what you do with it, and we think that is very important.

The second point I would like to address is the payroll tax credit. Under the U.S.A. system, you would subtract from your income tax the amount withheld from your salary for the employee's share of the Social Security payroll tax or the FICA tax. Now, this is a tax credit; it is not a deduction. It credits directly against taxes. That would also be true of the employer; they would get a full 7.65 percent credit back against income taxes. We think this is a very important feature. It would reduce the regressive nature of the current payroll tax that is today the most regressive part of our tax system. There are literally millions of Americans today that pay more on FICA tax than they do on income tax, and these are primarily low-income working Americans.

The U.S.A. payroll tax would be refundable. Any worker with earned income can in effect subtract 7.65 percent, that is, the amount of the Medicare and the Social Security tax. Our proposal does not abolish the payroll tax or affect the operation of the Social Security system in any way. We know that revenue has to continue to come in; it will be collected as it is now, and the system would have just as much soundness as it does now.

Senator Domenici and I both believe that some of those fundamentals have to be addressed later, but not in terms of diminishing the revenue. So this is an important process for fairness. I think it will also eliminate one of the major impediments to people who have low skills, who now find themselves with a very large tax to the employer every time he hires a new individual. In effect, we have a tax on jobs in the name of the FICA tax that I think poses a tremendous problem to people with low income and low skills.

The third major point I want to make is the U.S.A. tax promotes U.S. competitiveness. This is very important. Our tax would put us on the same footing as our competitors. The U.S.A. business tax is territorial, meaning it applies to all sales on U.S. soil, no matter where the business is headquartered, and it is border adjustable.

Now, what that means is, we exclude, Mr. Chairman, from the tax base on business export sales. We do not include that in the tax base. Products made in America and exported would not be taxed. When a company, foreign- or U.S.-owned, manufactures abroad and sells in the American market, the company is subject to a new import tax, the same as if the factory were located in the United States. That is what we call border adjustability. Exports are excluded from the business tax and the business tax is added to imports, which means that foreign products sold in this market would have the same tax as American products made here. There would no longer be any incentive for a company to locate out of

America and export back into America because those goods would have the same tax.

Now, this is crucial because our share of economic output that is exported and imported has changed dramatically over the last 15, 20 years, yet the current Tax Code has not kept pace. In effect, this is what our competitors do. They have value-added tax for large parts of their revenue. They tax goods coming in and add to our products and then they rebate on taxes going out. We believe this is GATT-compliant, because it is very similar to what happens in Europe and what happens in Japan.

Fourth and finally, the one new deduction that we add into this Code is the deduction for human capital. That is a deduction for tuition expenses for postsecondary education, whether it is college, trade or vocational school or remedial education. Under the U.S.A. proposal, we provide a deduction for up to $2,000 per person for the taxpayer and for the dependents. We feel this is enormously important because we are addressing the capital side of the equation with our individual and business taxes; and we also think we ought to address the human capital side because the education and skills that our people have will have just as much effect on the future of our economy, if not more, than the actual savings and the investment.

Mr. Chairman, I won't even summarize because I know everyone is on a tight schedule today, but I would ask that my entire statement be put in the record, and I will turn it over to my colleague, Senator Domenici.

[The prepared statement follows:]

Prepared Statement of Senator Sam Nunn
Testimony before the Ways and Means Committee
June 7, 1995

Mr. Chairman, it is a pleasure to appear before the Ways and Means Committee as part of your hearings on tax reform for the 21st Century. Senator Domenici and I appreciate the opportunity to discuss S. 722, the USA Tax Act of 1995, with you and the other members of this distinguished Committee.

As you know, six weeks ago we introduced, along with Senators Kerrey and Bennett, the USA Tax Act of 1995, a comprehensive tax reform proposal that we believe represents the best way to achieve the goals we all share -- increased national savings and investment, higher economic growth, and improved competitiveness. We welcome debate, comments, suggestions, and constructive criticism on this legislation.

Mr. Chairman, as you and others on this Committee have suggested, our tax system needs more than a Band-Aid. It needs a transplant. If we are serious about our Nation's future, we have to scrap the current tax system and put in its place a system that will work for our people and for our country.

Senator Domenici and I believe we have such a system. We call our proposal the USA tax system. USA stands for Unlimited Savings Allowance, which is the key, fundamental part of this proposal. We believe it represents fundamental change in the way America taxes itself, the way America saves, and the way America invests.

What do we mean by a tax system that works? We mean a system that encourages savings and investment. We mean a system that is perceived to be fair and is fair. We mean a system that is understandable. We mean a system that reduces the complexity of paying taxes for ordinary Americans by taking less time, fewer forms, and fewer dollars to comply with. We mean a system that is attuned to the international competitive realities and gives U.S. companies and their employees a chance to compete fairly in the global marketplace, which we do not have today.

We mean a tax system that is fiscally responsible. There is no point in creating a system that increases the private sector component of the national savings with one hand, while further reducing the public sector component of national savings, by increasing the deficit, with the other hand. Our proposal is designed to be revenue neutral. We do not have an official revenue estimate from the Joint Committee on Taxation yet, but we have designed this legislation with the intention of being revenue neutral. We are not proposing a tax cut or a tax increase. In our view, that debate is best kept separate from

the issue of the what the proper structure of our tax system should be, which is the issue we are addressing in this bill.

Members of this Committee are well aware of the daunting task that lies ahead in order to fulfill the reconciliation instructions in the Budget Resolution. To find over a trillion dollars in savings over seven years will involve many painful decisions, some of which may not be sustainable over time. I believe it is counterproductive to increase that burden by simultaneously cutting taxes. To me that is like an alcoholic announcing that he was going on the wagon while chug-a-lugging a couple more bottles of whiskey.

When Senator Domenici and I began advocating our concept of a complete overhaul of the Tax Code three years ago, the prospect of fundamental reform appeared to be several years off at best. Today, however, the clock has moved up. It is clear that, while we are just beginning the process of debating how to change the Tax Code, there is already a broad consensus in this country and in this Congress that fundamental reform is necessary.

Mr. Chairman, I believe the central goal of any reform of our tax system should be to raise the level of national savings. Senator Domenici and I are proposing the unlimited savings allowance tax system because we believe it is better for taxpayers and for our economy, because it removes the current bias in our Tax Code against the saving and investment that are the key to higher living standards. Higher savings lead to more investment. More investment means that we have more productivity from American workers. The more productivity we have from our workers, the more competitive we are in the international arena. The more competitive we are in the international arena, the better jobs we have. The better jobs we have, the higher income we have as Americans.

That is a very important chain. That is the bottom line. The bottom line is what happens to the real income of the American people in the future. There is a direct connection between how much we save and the real income of Americans. That is the direct connection that we have to make sure people understand. If we cannot make that connection in the American mind, there is no point in talking about a fundamental reform of the tax system. If most Americans agree that this proposition is true, then I think there is a tremendous opportunity here to make the fundamental changes we are proposing.

The national savings rate in the United States is lower than that of any of our major competitors. In the 1980s, our savings rate dropped to an average of 3.6 percent, half the level of the 1960s and 1970s, and far below the comparable figures of 10 percent in Germany and 18 percent in Japan. In the first five years of this decade, 1990 to 1994, the U.S. savings rate has

fallen almost 50 percent from the already low levels of the 1980s, to just 2.1 percent.

Without increased savings and investment, we cannot raise our long-term standard of living, meet our financial obligations, and build a better society for today and for the generations that follow. The United States cannot continue to be the major competitive force in the world if other countries continue outsaving us and outinvesting us. It simply cannot happen over a long period of time. That is fundamental.

As Josef Joffe pointed out in a recent editorial in the New York Times,

> "... the U.S. has a big problem. America has lived like a person who writes checks at will. For almost a generation, it has bought more abroad than it sold -- hence, the zillions of dollars in global circulation. What happens when there is too much money? It buys less. Hence, no more four marks to the dollar.
>
> "Again, the external value of one's currency does not really matter as long as the fundamentals are sound. But the unstoppable fall of the dollar says that the fundamentals at home are askew. It virtually screams that America is consuming too much while saving and investing too little. The Government is living on borrowed money; so is the consumer."

It is often said that the best way to increase national saving is to reduce the federal budget deficit. I agree with that proposition. We not only need to reduce the share of our national savings being soaked up by the federal budget deficit -- we also need more savings. And we believe our proposal can turn the tax code from a major roadblock to higher savings into an important tool to promote higher savings.

As the members of this Committee know better than anyone, the tax code has been and will continue to be used to encourage or discourage certain behavior through such provisions as the deductibility of home mortgage interest or taxes on cigarettes. Yet the current tax code not only fails to encourage private saving, which is vital to our future, it actually discourages it. Yet there is no doubt that future generations will not have the same level of entitlement benefits from the government that we have today. Our present entitlement programs are not sustainable at their current growth rates. That means that Americans are going to have to save more, to take more personal responsibility for their own futures.

So we need to get the tax code working for us, not against us, to get people to once again adopt the mentality of savers who

think about tomorrow as well as today. We need to start an education process in this country to make saving a national issue -- not just a tax issue. People need to understand the fundamental importance of saving, both for their own future and for America's future. We literally and figuratively must "save America".

The USA Tax System is a Single Tax in Two Parts

The USA proposal consists of a single, integrated tax in two parts: a progressive tax on individual incomes, and a low, flat rate tax on all businesses. These two parts are meant to work together. It is important that people not try to consider the two parts separately, because if they do they will not grasp the significance of the whole concept. It is a single tax levied in two places: at the business level where wealth is created and at the individual level where wealth is received.

This proposal allows an unlimited deduction at the business level for capital investment and, more important, it permits all citizens an unlimited deduction for the amount of their annual income they save and invest. The USA Tax System directly and systematically addresses our saving and investment problems.

To the individual, our system says, "If you choose to defer some of your consumption in favor of saving income for your future and the future of your children, the Tax Code will not penalize you for doing so."

And to the business enterprise, whether very small or very large, manufacturing, service, or agricultural, the USA tax system says, "If you choose to invest your profits in a new machine or a new process that will help you grow and put more people to work, the Tax Code will help you." The USA Tax System, by its very nature, would align the way we tax with our common desire to provide our children with a better tomorrow.

Mr. Chairman, the details of this proposal are contained in the text of the bill we have introduced, and I hope the members and staff of this Committee will take the time to study it. Certainly Senator Domenici and I would value your views and suggestions. There are several major elements of this proposal that I think need some emphasis this afternoon.

The Individual Tax

Let me describe the key features of the individual part of our proposal first. The individual tax would function in a manner similar to that of the current income tax. Gross income would include wages, salaries, interest, dividends, earnings withdrawn from unincorporated businesses, proceeds from asset sales -- basically the same concept of income we have today.

From your gross income, you would make subtractions before you figure your tax, just as you do now. You would subtract personal exemptions, a new Family Living Allowance, a new savings allowance, and a limited number of itemized deductions.

First, the USA proposal contains a family living allowance that is similar to the current standard deduction except that it is in addition to any itemized deductions, not an alternative to itemized deductions. This family living allowance exempts the first dollars spent on consumption from taxation, because we know that people in low income brackets spend a higher proportion of their incomes on necessities than people in high income brackets.

In addition to the Family Living Allowance, you would have personal exemptions just as you do under current law. A family of four filing a joint return would have its first $17,600 of income exempt from taxation by adding this Family Living Allowance to its four personal exemptions.

The Unlimited Savings Allowance

In addition to these deductions, there would be a new deduction for the amount of income that is saved called the Unlimited Savings Allowance. We define savings in this proposal as net new savings. That is key. If you add to the national savings pool, you would deduct that money before you pay taxes. In other words, to make it simple, if someone makes $40,000 a year and saves $5,000, they would pay taxes on $35,000, instead of today paying taxes before the savings on the entire $40,000. That is fundamental. We encourage people to save.

The Unlimited Savings Allowance is similar to the IRA concept, but it is unlimited. It is not limited to $2000 or any other dollar amount. It is not limited to saving for retirement. But it is for net new savings. We do not give a deduction for merely shifting savings around. That has always been one of the problems with the IRA.

The USA Tax System is fundamentally different from the current tax code, which penalizes savings. Under the present tax code, savings are taxed twice, once when you earn the income that you save, and again when you receive a return on those savings; consumption is taxed only once.

The USA Tax System also reflects a fundamentally different philosophy in that we do not focus on where your income came from. We do not have different rates for wage income or dividends or capital gains. Under the USA Tax System, the point is not where the income comes from, it's what you do with it. The portion of your income you save, whether you're rich or poor, you defer paying tax on it. The portion you spend, above the level for basic necessities, is subject to tax at progressive

rates.

The deduction for individual saving also permits a new perspective toward designing a business tax. Because our proposal defers taxes on individual saving until they are spent, we can eliminate enormous complexities in today's tax code. There is no reason to be concerned about people sheltering their saving in corporations, which creates a huge portion of the complexity in today's the tax code. We do not need elaborate rules to force businesses to distribute "sheltered" saving.

Other Deductions for Individuals

In addition to the Family Living Allowance, the personal exemptions and the savings allowance, we propose a limited number of additional itemized deductions. The higher the number of deductions, as we all know, the higher the marginal tax rates would have to be. So, there is a trade-off. We are proposing to retain a deduction for home mortgage interest and charitable deductions. We could have more deductions, of course, and certainly we welcome debate on which deductions people think should be added to, or subtracted from, our proposal -- with one word of caution. The higher the number of deductions, the higher the rates will have to be to avoid increasing the deficit. There is a direct tradeoff between the number of deductions and the tax rate.

Our proposal does have one such additional deduction which I feel very strongly about, and that is a deduction for tuition expenses for post-secondary education, whether it is college, trade or vocational school, or remedial education. We feel it is important that the tax system provide a deduction for investment in human capital that parallels the deductions on the business side for investments in physical capital, since both investments raise the productivity and real incomes of workers.

The USA Tax System is Fair

The USA Tax System is a progressive tax. Our system will have three graduated rates. We are proposing a progressive system, not a flat tax. We do not believe it is necessary to abandon the principles of fairness and progressive taxation in order to get a simpler, more efficient, growth-oriented tax code. It is important to keep in mind that the graduated rates in the USA Tax System will not create the same disincentives for saving and growth as today's tax system, since taxes will be deferred on income that is saved and invested.

There are four main elements that make the USA tax on individuals fair. First, we have three progressive rates. Second, we have a Family Living Allowance that does not tax the first several thousand dollars of consumption for basic

necessities. Third, we retain some progressive elements of the current code, such as the Earned Income Tax Credit -- which we increase -- and the tax exempt status of food stamps and other safety-net benefits. Finally, we have a new payroll tax credit which I will discuss in a moment.

We would apply progressive tax rates to the amount of income that is consumed, after subtracting the Family Living Allowance, personal exemptions, and deductions for mortgage interest, charitable contributions, and education expenses.

The tax rates in the USA system are not directly comparable to the rates in the current income tax code, however. I know people are going to find that a little hard to understand at first, but the reason why they are not comparable is very important, and that is our payroll tax credit.

The Payroll Tax Credit

Under the USA system, after you determine the amount of tax resulting from applying graduated rates to your taxable income, as I have just described, you would subtract from that income tax the amount withheld from your salary for the employee share of your Social Security payroll, or FICA, tax. We think that is a very important feature of the USA system that would reduce the regressive nature of the present payroll tax. The payroll tax, which is absolutely essential to fund Social Security and Medicare, has also become the most regressive part of our Tax Code. The Social Security portion of the payroll tax does not apply above the first $60,000 of earnings. Higher-income people above that level pay only a limited portion for Medicare. But low-income people, medium-income people, are paying a very large percentage of their overall taxes on FICA tax. In fact, there are literally millions of Americans today that pay more FICA tax than they do income tax.

Our payroll tax credit would be refundable so that if you had more withheld in payroll taxes than you owed in taxes, as is the case for many people, the difference would be refunded to you. Therefore, people with earned income can, in effect, subtract 7.65 percent, the amount of pay withheld for the employee's share of the Social Security and Medicare payroll taxes, from our tax rates.

It is very important for people to understand this. To compare a tax rate under the USA proposal to current rates, you have to subtract the 7.65 percent credit. A 20 percent rate under the USA system would be, in effect, equal to a marginal rate of 12.35 percent under today's system after you take the payroll tax credit.

The payroll tax is a perfect example of why fundamental tax

reform is needed. While it was designed with the best of intentions, the payroll tax is a very regressive tax. It discourages hiring additional workers, especially lower-wage workers.

Our proposal does not abolish the payroll tax or affect the operation of the Social Security System in any way. But what it does try to do is offset the negative side effects of the payroll tax by crediting the payroll tax against an individual's or business's tax liability under the USA tax. The employer would also get the 7.65 percent credit against their taxes -- not a deduction, but a tax credit. Employees get a credit for the FICA taxes against the individual income tax, and employers get a credit for the employer share against the business tax.

So the same amount of revenue will continue to be deposited in the Social Security trust fund, but the payroll tax will be integrated into the income tax in a way that offsets its regressive nature. This is important for fairness purposes. It is also important so that we eliminate one of the major impediments to people with low skills being hired. Now people with low skills, minimum-wage-type jobs, the employer has to look very, very carefully before they hire because they are not only paying for the minimum wage, or whatever the wage is, they are also paying another, in effect, 15.3 percent because of these very high payroll taxes.

The Business Tax

Mr. Chairman, I will take just a few moments to describe the business side of our proposal.

The second component of our new tax code is the business tax. The business tax would work like this: Under the USA Tax System the business would add up its sales receipts during the year, then add up the cost of the goods and services it purchased for use in its business. The cost of these business purchases would be subtracted from the sales receipts. The difference would be subject to a business tax at a flat rate of 11 percent.

I am sure many people will wonder why the business rate seems so much lower than current law. The answer is that the two rates are really not comparable, because our tax would not be applied to corporate income as currently defined, but rather to a company's gross profits. It is a fundamentally different concept from what we have today, and it applies to all businesses, not just those that are incorporated.

I think everyone who studies this business tax needs to understand we have a fundamentally broader base for the business tax so we are dramatically lowering the rate but we are producing the same amount of revenue. We are not lowering the overall

proportion that businesses are paying. They are paying the same proportion. But we are able to lower the rate because we are greatly broadening the base, and that needs to be understood.

It is also important to understand that under the USA Tax System, the cost of investment in plant and equipment and inventory would be fully deductible when spent. There would be no need for complicated depreciation schedules. Investment would be deducted up front. Investment creates jobs. New plant and equipment increases productivity and that increases the income of our people. So that is the behavior we should be encouraging rather than discouraging.

Investment in plant and equipment is what we need in this country, and yet the amortization of these investments over a long period of time under current law discourages businesses from investing as much as they would otherwise.

The USA Tax Promotes U.S. Competitiveness

Another very important feature is that our USA Tax System puts U.S. companies on the same footing with our competitors. The USA business tax is territorial -- meaning it applies to all sales on U.S. soil no matter where the business is headquartered -- and it is border adjustable.

We want to encourage exports, and we do so in this proposal. We exclude the proceeds from export sales from taxation by rebating the tax on goods exported for sale abroad. And when a company, foreign or U.S. owned, manufactures abroad and sells to the United States market, the company is, through the operations of a new import tax, taxed essentially the same as if the factory were located in the U.S. That is border adjustability -- the tax is rebated on exports and added to imports, which is exactly the situation American exporters to Europe and Japan face today. We believe our business tax will place American companies and workers on an equal and level international playing field.

This is no small matter. The share of our economic output that is exported, and the share of our national income that we spend on imports, have both doubled over the past twenty five years. Yet the current U.S. tax code has not kept pace with the rapidly changing face of international competition. While our economy has shifted dramatically over the past 30 or 40 years, we have not made a comparable shift in our tax code. We have simply tinkered with it year in and year out.

Our current tax system is a holdover from another era, when international trade was a small component of our economy, when having a tax rule that applied to all American corporations equally was enough. But today American companies do not just compete with each other, they compete globally. And the current

U.S. tax code puts our companies at a disadvantage.

Under the rules of the General Agreement on Tariffs and Trade, or GATT, certain types of taxes can be levied on imports and rebated on exports -- border adjustability -- while other types of taxes cannot. Our competitors in Europe and Japan have business taxes that can be rebated under GATT, while we do not. We believe the USA business tax is legal under the GATT, since it would work essentially the same way as European and Japanese value-added taxes, which are GATT-legal, although without the complexity that adding a VAT to our current income tax would have.

Let me give a simple example of how our business tax applies to exports and imports. If a company has $2.5 million in sales, of which $500 thousand are export sales, for purposes of the business tax its receipts would be only the $2 million it had in domestic sales, not $2.5 million. But it will not have to go through a lot of complicated calculations to allocate its production costs between its domestic and foreign sales. All domestic input costs will be deductible regardless of whether the sales are domestic or export sales. Under our proposal there will no longer be a tax incentive to move production overseas.

Conversely, if the facilities used for the production of the $2 million in domestic sales are moved overseas and the $2 million of goods are imported into the U.S., an 11% import tax of $220,000 will be collected on those goods; the same as the domestic company I mentioned earlier.

In order to comply with the requirements of the GATT, businesses would not deduct wages. This is a key point, and I know there will be concern about this. But there are two important things to remember. First, our rates are much lower -- 11 percent -- than the rates currently imposed on corporate profits.

The second thing that we need to remember is that under our proposal, the deduction for wages would be replaced by the credit for the employer's share of the Social Security payroll tax -- which is 7.65% of its payroll -- which is the other half of the credit that employees get under the individual tax that I have already described. Businesses would get a credit back on that tax up to the maximum Social Security wage.

The USA Tax Is Designed to Be Deficit-Neutral

Under our proposal, the individual and the corporate shares of our total revenue would remain the same. We are not trying to shift the tax burden from businesses to individuals, or vice versa. We are not trying to shift the burden from the rich to the poor, or from the poor to the rich. We are not looking for

the fellow behind the tree to tax that my friend from Louisiana Russell Long often mentioned. We are designing this system to produce the same amount of revenue as the current tax code. It is not a proposal to cut taxes or raise taxes.

Because of the comprehensive nature of our proposal, and the enormous workload the Joint Committee on Taxation has had this year, they have not been yet been able to perform an official revenue analysis or a distributional analysis of this proposal. It is our intention that this system retain the progressivity of the current system, and that it be revenue neutral compared to the current system. Should the official estimates indicate that the bill we have introduced fails to completely meet either of those goals, we intend to work with the Joint Committee to refine this proposal so that we meet both, because we think they are very important.

The USA Tax Is Simpler and More Efficient

Although it is certainly possible to design a "simpler" tax system than the one we are proposing, I think the USA tax system also makes great strides in making our current tax code simpler and more economically efficient. The USA tax eliminates the need to calculate depreciation year after year, because investments are expensed immediately. We also eliminate the complicated, and in many cases counterproductive, Alternative Minimum Tax, or AMT.

The USA business tax puts debt and equity financing on an equal footing. We treat all forms of businesses the same - corporations, partnerships, and proprietorships.

One of the greatest contributions the USA system will make to simplification is that no longer will people have any reason to seek out unproductive, economically wasteful tax shelters in order to cut their taxes. If you want to lower your taxes, put your money in savings where it can work for all of us -- buy a CD, invest in a mutual fund. It might take a few minutes to do your net savings calculation once a year, but the net savings calculation should result more efficient use of our national income, as well as higher economic growth as saving and investment increase.

In an economy with a gross domestic product of over $6 trillion, taxation will never be a completely simple affair, and I do not think it is the only standard by which tax reform should be judged. But because the USA Tax System eliminates the need for rules against sheltering income in corporations, and because it is based on cash rather than accrual accounting, it promises major advances in simplicity and clarity.

Under the USA system, we believe whole volumes of tax code complications would fall away into welcome oblivion. The tax

shelter industry would shrink and compliance costs would plummet. All income would be treated alike. The key is what people do with their income. If it is reinvested, then the tax on it would be deferred. It is not reinvested, if it is consumed, then ordinary tax rates would apply. Those rules would be the same for everyone, for the factory worker, for the capitalist, for the miser, and for the wealthy conspicuous consumer.

There would be no more need for fights over capital gains, investment tax credits, Individual Retirement Accounts, and other targeted incentives for saving. The USA Tax System eliminates these issues because it offers a blanket deduction for personal saving and business investment.

And under the USA system, taxpayers will not have to keep track of the basis of their newly purchased savings assets such as stocks and mutual funds, the way they do now, and most taxpayers will not have to worry about the basis of savings assets they already hold. Finally, the USA tax system will not take a whole new bureaucracy to administer.

The USA Tax System is a Revolutionary Concept

In a way, the USA tax system could be described as simply taking the current tax system and adding a deduction for savings. That may be the major change most people would notice. But the USA Tax System represents a much more profound change in its effects than in its form.

For any given level of income, those who save and invest more will pay lower taxes. The taxpayers in the top bracket would pay roughly the same total amount of taxes they do now. But within that bracket, there will be those who pay less and those who pay more. The same will hold true whether you are in a higher or a lower tax bracket. That is the essence of our proposal. Those who help our economy, help create jobs, and boost productivity by saving and investing, will pay less than their neighbors with similar incomes who do not.

We are basically going to tax people on what they take out of the economy -- above a tax free level for necessities -- rather than what they put into the economy by working and saving. Our proposal represents a revolution in the philosophy of the income tax system. But we don't have to make major changes to the system already in place to administer the tax system to make our proposal work.

By contrast, a consumption or expenditure tax, such as a value-added tax, would impose enormous administrative expenses on American businesses, without the progressivity, and without creating the same explicit incentive to save and invest, that the USA tax system has.

Conclusion

Mr. Chairman, the USA tax proposal is a revolutionary concept with important advantages for our country.

The first advantage: This proposal will increase national savings by eliminating the bias in the current tax code against savings, without increasing the budget deficit. Increasing the pool of private savings will in turn allow increased investment at lower cost, which will increase the productivity of our workers.

Second, it will level the international playing field for U.S. companies, and promote U.S. exports of domestically produced goods, by rebating the business tax on goods sold for export. It will equalize the tax treatment of American-made and imported goods by having foreign companies pay their fair share of taxes on goods sold in America, just as American exports are taxed when they are sold in foreign markets.

Third, it will make our tax code more understandable and more efficient which will save both billions of dollars and millions of hours preparing individual and business tax returns. It will do so without sacrificing the principle of fairness in allocating the tax burden.

Fourth, the USA tax credit for the employer share of payroll taxes will help create jobs for workers who might not otherwise be hired by reducing the current disincentive to hire low skill workers that results from the regressive payroll tax which applies to the entire wage of lower-paid workers but to only part of the wage of higher-paid workers.

Finally, we believe it will foster greater personal responsibility by clearly showing the costs and benefits of saving versus consuming.

The current tax system is broken and, in my opinion, it cannot be fixed. In a very real way, it has aided and abetted our irresponsible tendency to live beyond our means. Our current tax code must be abolished and replaced.

We must being anew. The USA tax system provides a way to eliminate the complexities, the special subsidies, and the crippling biases present in the current code. By enacting real reform of the tax system, this Congress can take a giant step toward securing our nation's future.

Mr. CHRISTENSEN [presiding]. Thank you, Senator Nunn.

We would be pleased to hear your testimony, Senator Domenici.

STATEMENT OF HON. PETE V. DOMENICI, A U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator DOMENICI. Thank you very much, Mr. Chairman. I have a detailed statement and I have asked that it be made a part of the record.

Mr. Chairman and Members of the Committee, it seems to me that what we are trying to determine is what it is we ought to tax. And so the central focus of this set of hearings, as I understand it, is to determine what is the best tax base; or said another way, is it better to tax income that is earned or income that is spent?

We believe the better system is the latter, to tax income that is spent, not income that is earned. Our Tax Code is more neutral than the income tax in its treatment of present versus future consumption; it is neutral regarding the choice of savings or spending. It would be easier to administer than the income tax. Our tax base can be measured more accurately and simply than an income tax base.

Now, you will be looking at a number of proposals, and Senator Nunn and I submit that we don't just have an idea or a thought or a theme or a philosophy; we have actually put together an entire new Tax Code. It took a long time. So as you proceed through your deliberations, people will ask very specific questions about the U.S.A. tax, the Domenici-Nunn bill, because we have done away with the entire individual and corporate Internal Revenue Code, and substituted a brandnew Tax Code for it. In the process, we set some specific things that we wanted to make sure would happen in this Code, and frankly, we have spent a great deal of time, effort, and resources in modeling it so we know precisely where the tax burden lies. We know how it comes out vis-a-vis today's taxes, and as a consequence, clearly we can, in due course, have all of these details at your staff's disposal. We don't intend to do that today, obviously. But I would just talk about several quick things and then go through two tax returns, an individual return and a corporate return.

We create a system in which wages, if saved, and interest earned from those savings would be deferred from taxation until spent. Now, let me just make that very simple.

If in the United States anyone who is a taxpayer has income—and that is all kinds of income—if they have disposable income, they can, under this bill, make a conscious decision to lower their taxes by either saving the money or investing the money, in which event they pay no tax on it until they take it out of the savings pool or out of the investment pool of America, bring it back to their own and spend it.

Now, that concept is fundamental to changing American's culture and the way they treat their income and other financial resources. Because many will now be able to say, "why don't I start regular savings and investment, because I don't pay any tax on that until I cash it in and spend it."

Dividends received and saved would be deferred from taxation until the proceeds are spent. Tax on capital gains could be indefi-

nitely deferred as long as the proceeds are rolled over into other qualified investments, so the debate about capital gains is gone under the U.S.A. tax. And then, I would say, there is no bias—and this was one of our criteria—no bias in favor of either debt or equity financing.

The export competitiveness of the United States would be enhanced by providing border adjustability in terms of meeting the requirements of GATT. And we think we have done that.

The expensing of costs would replace other cost recovery systems; and seventh, dividends would be taxed only at the corporate level if the recipient invests or otherwise saves the dividends.

Now, obviously there will still be two kinds of tax returns filed. One will be for businesses and one will be for individuals. Let me quickly go through the individual and the business and then we will be ready to answer questions or to proceed however you would like.

First, individuals in the future, once this is adopted, would figure their total income by adding up wages, salaries, interest, dividends, royalties, whatever, wherever they would get money. They would add that all up, and then there would be a family living allowance, which recognizes that every family budget includes necessities, as Senator Nunn has indicated, and then there is the unlimited savings allowance.

So you take those earnings that I have just described, and determine how much of it was invested or saved. The total amount that you saved or invested is deducted from that total income that we just told you about. No difference as to sources. This deduction for personal savings parallels the business tax expense deduction for capital investment, and we will talk about that in 1 minute. This encourages people to save for whatever purpose they deem worthwhile, not to save pursuant through some government-concocted list—save it for whatever purpose you want, invest it in whatever you would like to invest it in.

It puts no time constraints on savings or investments, so that individuals can move from investment to investment without tax consequences so long as they don't take the proceeds, put them in their income and spend them. Not only is it an expanded universal IRA, it is a new and improved capital gains mechanism which allows taxpayers a series of investments and rollovers without incurring tax liability, so long as they leave it in the investment pool of our country or the savings pool of our country. We believe that investing in a home is a worthwhile investment. Therefore, we would keep the home mortgage deduction as in current law, and we would keep the charitable deduction as in current law.

Senator Nunn has indicated we have a new postsecondary education deduction, and that was to create some symmetry since we have investments in stocks and bonds and other things, which is, to provide capital for our country to grow and prosper, we thought we ought to encourage secondary education and have an incentive for investment in human capital. It is not large, $2,000 per year per student.

The employee payroll tax, or FICA payroll tax are often a larger tax burden on American families, than the current Federal income tax. It is a flat rate tax and it is regressive. Our system would ad-

dress both of these problems by providing a tax credit for FICA taxes paid both to the employer and the employee. The employee credit is refundable.

The FICA tax credit changes the way Americans should think about rates. We should think about rates as a combination of the U.S.A. tax and the FICA tax rate. We will have a combination rate structure for you to look at. We think that is very innovative, we think it is very progressive. Or put it another way, it rids the system of one of the most regressive taxes we have, the FICA tax on working men and women in the country.

The rate structure contained in our bill as we now have them figured out were modeled with one idea in mind, no new taxes. Our objective is to raise the same amount of tax we are collecting today. Our tax system is a replacement tax.

The business tax rate will be a flat rate. We think it will be about 11.5 percent on all businesses. Note that the business tax does not just tax corporations. You know that subchapter S corporations and partnerships continually have problems about how do they accumulate resources in their business so it can grow and prosper? We treat all businesses alike from a farm to a major corporation to a family partnership. There is a flat tax on those businesses of 11.5 percent. The base is very broad, and therefore, the tax rate is quite low. The business tax includes an unlimited deduction for capital investment, in the form of unrestricted expensing. The expensing deduction allows businesses to recover capital before they pay tax.

One of the worst challenges facing American businesses is the complexity of filing a Federal corporate tax return. I don't know if you have talked to any American companies' tax counsel, but there are some who have the IRS agents permanently officed in living quarters in their company headquarters. These live in IRA agents would get an eviction notice under the U.S.A. tax. Business taxpayers would be on a cash basis. They would expense what they buy as they pay for it, and if they don't, if they don't have enough resources that year, they carry the deduction over. The U.S.A. tax system puts American business on a cash basis instead of an accrual basis. Utterly simple.

Small firms favor expensing for several reasons. It is simple, it helps cash flow, it permits them to accumulate without paying income taxes on what they leave in there, again until they take it out and spend it.

Now, let me describe the nuts and bolts of the U.S.A. business tax. Businesses would add up all of their receipts from sales of goods and services excluding sales of American-made products to foreign markets. Let me repeat. We would put our American corporations on the same footing that foreign competitors are. Whatever exports American firms sell overseas would be deducted from their gross income. This makes the system border adjustable. A firm deducts foreign sales. Even with this export-enhancing feature, the 11.5 percent modeled into this system will still yield you the same amount of corporate tax because the U.S.A. tax base is much broader. The business deducts the cost of purchases from other businesses, the cost of plant and equipment, parts, components—and no depreciation, it is on a cash basis with unlimited

expensing. After subtracting purchases from U.S. sales, the remainder is gross profit or the tax base to which this flat business tax is applied.

Out of these gross profits, the business may pay a business tax, wages and salaries to workers, and dividends and interest to shareholders. The businesses would also continue to pay their share of Social Security taxes into the trust fund just as they are now.

There is a FICA credit which would then be available to the businesses and individuals. We replace the wage and salary deduction with a payroll tax credit—not deduction, but credit—to make our exports more competitive by achieving border adjustability. We did this so that we comply with GATT, which permits us to have border adjustability with reference to American sales overseas. Foreign companies or American companies producing goods outside America but selling inside America, would pay an import tax equal to the flat business tax paid by U.S. firms.

Now, there are a lot of other technical aspects on banks; there is a major transition section, and I call the transition section to your attention only because you are going to have a transition problem in all of the different tax systems that have been suggested.

Example: A sales tax, 20 percent. Many, many millions of seniors have already paid a tax on their savings. Now we are going to say, when you spend your savings, you pay 20 percent sales tax. That is obviously going to be very hard to sell.

The U.S.A. tax provides a mechanism whereby savings acquired with aftertax dollars under current law would not be taxed again under the U.S.A. tax system. While there will have to be some accounting during that transition period, we think we treat the "old savings" fairly. We are not going to tax them again, since they paid taxes as they saved.

So let me close by saying, we believe that it is time to do two things in America; and I am very proud to be part of both of them, and I hope you are. We need to balance the Federal budget, stop spending more than we take in, because the biggest user of our savings is the Federal deficit and its accumulated debt; and second, we should abolish our current Income Tax Code—a Tax Code which is antigrowth, anti-investment, antisavings—we should turn it into the opposite, and let it be an instrument and tool for business growth and job creation that is fair. The current tax system does not help individuals who might not be able to save and invest even though it is in their best interests to save and invest. The U.S.A. tax system would help individuals save and invest because it allows people to get a tax deferral for whatever they save or invest. They can save with pretax dollars.

Thank you very much. It is a pleasure to be with you.

[The prepared statement and attachments follow:]

TESTIMONY OF SENATOR PETE V. DOMENICI

S. 722–THE USA TAX

BEFORE THE COMMITTEE ON WAYS AND MEANS

June 7, 1995

The tax code determines our standard of living. The rise and fall of the American families' standard of living is tied to the amount of capital their employers are able to invest in them. To have access to investment capital, we, as a nation, need to increase the national savings rate.

We will be addressing two-thirds of the decline in the national savings rate (which has taken place since the 1950's) when we enact a balanced budget plan. With the enactment of this year's budget plan we will, for the first time in three decades, stop deficit spending and stop adding to the national debt. That debt is increasing at $335,000 a minute; $20 million an hour; $482 million a day. Government. Deficit spending and adding to the national debt is a form of dissavings that lowers our national savings rate. Out of shape individual savings habits are responsible for the other one third of the decline in our national savings rate.

We have to balance the budget and enact a new tax code in order to increase our savings rate so we can increase the national savings pool. A higher savings rate permits more investment in plant and equipment, R&D, improvements in technology education and training. A higher savings rate means more, better-paying, jobs, a higher standard of living and brighter future for our families.

The USA Tax, or the Unlimited Savings Allowance Tax System, S. 722 introduced by Senator Nunn and me would achieve those objectives. We could call it the "Family Standard of Living Improvement Act of 1995" because that is what it would accomplish. It would accomplish much more.

Before explaining our proposal, I want to commend the Chairman of the Ways and Means Committee for holding these hearings. It has been too long since the Congress engaged in a serious examination of how our current tax system is working. We have never, in a systematic way, examined alternative tax systems.

With a new century only five years away it is an opportune time to stop and determine what our tax system should do and how to best accomplish it.

There are some startling facts that emphasize how badly our current income tax system is serving us and the urgency of reform.

The U.S. ranks dead last among industrial nations in the fraction of GDP devoted to investment. More ominously, since 1986, our investment rate has fallen. U.S. tax policy explains much of this. And the investments our companies have been making are at a higher price. According to Professor John Shovan of Stanford, the tax code adds one-third to the cost of capital.

Economists proclaim that the nation's savings rate is the lowest among industrialized nations, and as a result, America is risking a bright economic future to pay for the present. These trends are unlikely to reverse themselves without a major tax policy change.

But, how do we encourage more savings among individuals? When Americans save they are really investing in America and our tax code should reflect that national priority. Our major trading partners encourage saving in their tax codes, and so should we.

The philosophy of the USA tax is to tax income that is not saved or invested rather than to tax all income that is earned. It should vastly expand the pool of savings, and achieve significant simplicity in the bargain.

The USA Tax base is total Gross Domestic Product (GDP). The Business Tax and the Individual Tax are two parts of a single tax on a single tax base. The Business Tax is intended to be the first in a two-step tax collection process. The Business Tax base would begin with Gross Domestic Product (GDP)--the sum of all goods and services produced and sold by all businesses together-- **minus,** in order to avoid double taxation, those goods and services they have bought from one another. The first taxable event would take place when businesses create income by producing and selling goods and services. The second taxable event takes place when individuals receive that income, net of the Business Tax, in the form of wages, salaries, interest, dividends and similar distributions to the owners of a business.

The Unlimited Savings Allowance Tax System described in the Act would replace the current progressive-rate income tax system with a simplified, progressive-rate tax on gross income which provides that income saved or invested by individuals, and the income generated by those investments would not be taxed, until the financial resources are spent on non-qualified purposes.

The bill replaces the current corporate income tax code with a simplified cash flow tax on business gross income (sales minus cost of goods sold) which would allow a deduction for savings reinvested in plant and equipment used for business purposes.

Our system recognizes that saving and investing is good for the economy and that people shouldn't be called upon to pay taxes on income that they are dedicating to the savings pool.

This deduction for personal saving parallels the business expensing deduction for capital investment. The former allows individuals to defer tax on that portion of income that is saved, and ultimately, converted into capital. The latter allows a business to recover capital costs before paying taxes.

The "Unlimited Savings Allowance" is the central feature of the individual tax. The objective is to raise the level of national savings because there is a direct relationship between how much we save and the real income of working Americans. If we increase savings and investment we can raise our long- term standard of living, meet our financial obligations and build a better society for today and for generations who will follow.

The aging of America adds a new sense of urgency for saving. The next century will see many Americans spending as much time in retirement as they did working. Adding to the savings pool is in the national interest but saving is also in the taxpayers' best interest because it will insure a better retirement life as well.

With that general introduction, let me go through the description of the individual USA tax:

Individuals calculate their total income by adding wages, salaries, interest, dividends, earnings withdrawn from unincorporated businesses, proceed from asset

sales, rents, royalties, annuities, withdrawals from savings accounts, taxable transfer payments and other similar cash inflows. The bill assumes that there will be a transition period, during which some withdrawals from savings acquired prior to enactment of the USA tax would be excluded from income.

The taxpayer would then subtract:

THE FAMILY LIVING ALLOWANCE

A standard deduction, personal exemptions similar to current law, and together are known as the "family living allowance." The family living allowance recognizes that every family's budget includes necessities and that the federal government should not tax that portion of a family's monthly bills. For a family of four, the annual "family living allowance" would be about $17,600. There would be bigger family living allowances for bigger families. This ensures equitable treatment of larger families because who typically spend more and save less than smaller families with the same incomes.

THE UNLIMITED SAVINGS ALLOWANCE

The "Unlimited Savings Allowance" is an important feature of the individual tax. For those who want to expand IRAs, this is the ultimate expansion. It will give all Americans, including those of modest means, more control over how much of their income is taxed each year. As a consequence, it empowers taxpayers to have some say in how large their tax bill will be.

The Unlimited Savings Allowance combines the best tax policy of the Individual Retirement Accounts (IRAs) and the Capital Gains differential. It maximizes taxpayer choice and flexibility. It encourages people to save for whatever purpose they deem worthwhile--not some government concocted list. It puts no time constraints on the savings or investment so that individuals can move from investment to investment without tax consequences as long as they continue to save and invest the proceeds from the preceding investment. In this respect the "Unlimited Savings Allowance" is not only an expanded, universal IRA, it is a new, and improved capital gains mechanism which allows taxpayers a series of investments and roll-overs without incurring tax liability.

The Unlimited Savings Allowance works like a zero rate on capital gains as long as the proceeds are reinvested. However, mere portfolio shuffling without a net addition to saving does not result in a deduction.

From adjusted income, the taxpayer then subtracts what he or she saved, including net increases in bank accounts, purchases of financial assets, other investment purchases, and life and casualty insurance payments.

HOME MORTGAGE DEDUCTION

Families think of their home as an important investment in their financial portfolios . Our tax proposal thinks like most American families think. Our new system would retain the current law home mortgage deduction. A taxpayer would, therefore, deduct his/her mortgage interest.

POST SECONDARY EDUCATION DEDUCTION

The USA tax system recognizes the importance of investment in human capital as well as the investment in productivity-enhancing plant and equipment. Investment in the education and training of taxpayers and their children will produce a significant, long lasting return on investment which will benefit the entire nation. Greater future earnings generated by those attending college and post secondary technical schools would eventually be taxed.

Therefore, the taxpayer would also be allowed to subtract an education allowance or deduction of $2,000 per year, per student, with an $8,000 per tax return limit.

PHILANTHROPIC TRANSFER DEDUCTION

This is the same as the charitable deduction under current law.

ASSETS ACQUIRED WITH AFTER-TAX DOLLARS UNDER THE CURRENT CODE--TRANSITION BASIS DEDUCTION

The USA tax recognizes that many taxpayers have accumulated savings assets with after tax dollars under the current tax system. It would not be fair to tax

those assets again when we switch to the USA Tax system. The USA Tax provides that if the basis does not exceed $50,000, one-third of it is added to the savings deduction in each of the first three years after enactment . If the basis exceeds $50,000 and the taxpayer has spent more than he saved or as the economists would say, if the taxpayer's savings are negative, the basis is used to offset the negative savings so that it does not become taxable. This continues each year until the original basis is used up.

If the basis exceeds $50,000 and the taxpayer added to the savings pool during the taxable year, there are additional transition rules.

RATE STRUCTURE--Joint Returns.

The taxable income under the USA Tax is very different from the current concept of taxable income. The rate structure looks similar--three brackets 15, 20 and 40 percent-- but they are applied to a very different tax base and need to be viewed in conjunction with the payroll tax credit. In addition, people have to change their thinking about rates because they have a great deal more control over the size of their tax bill as a result of the Unlimited Savings Allowance. It is progressive, a goal achieved through a combination of graduated rates, exemptions, personal deductions, a family living allowance and for lower income individuals, the earned income tax credit.

EMPLOYEE PAYROLL TAX CREDIT

The USA Tax recognizes that for lower and middle-income Americans who work for salaries and wages, the existing FICA payroll tax withheld from their paychecks is a often a larger tax burden on American families than is the current income tax code. Since the FICA tax is a flat tax, it is also inherently regressive. The USA Tax System would address both of these problems by providing a refundable tax credit.

The lowest bracket is 15 percent (or a 7.35 percent combined USA tax and FICA tax after the payroll tax credit is taken) for taxable income up to $5,400. After a transition period and beginning in 2000 that rate can be lowered to 10 percent (2.35 percent combined USA tax and FICA tax, after the payroll tax credit is taken). After the transition period the second bracket rate of 20 percent (12.35

percent combined USA tax and FICA tax, after the payroll tax credit is taken) for taxable income up to $24,000 in 1996 dollars.

EARNED INCOME TAX CREDIT

The current law Earned Income Tax Credit is reformed. The current law rate is retained, but the maximum amount is essentially doubled.

LOW INCOME FAMILIES FREED FROM USA AND FICA TAX

The family living allowance combined with a refundable payroll tax credit would free the lowest income families from both USA tax and employee payroll taxes.

Those not exempt would pay USA tax on the remainder--his or her "taxable income." The marginal rate of taxation is progressive and increases with taxable income.

These are but a few of the features of our new individual tax system.

THE USA BUSINESS TAX

The USA business tax is a flat tax on all businesses including corporations, partnerships, sole proprietorships and other forms of business organization. The base is very broad so that the rate can be quite low.

THE EXPENSING DEDUCTION

The business tax includes an unlimited deduction for capital investment--unrestricted expensing. The expensing deduction allows a business to recover capital before being taxed. Small firms favor expensing for several reasons: it is simple, it helps cash flow and it encourages capital formation. Expensing allows businesses to escape the complexity associated with calculating and tracking the depreciation schedules for every piece of equipment. Expensing is good for all businesses, but it is particularly attractive to small businesses because it helps them with the day-to-day cash flow problems that they face. It allows them to deduct more up front --putting resources back in the hands of the entrepreneur faster

instead of keeping it in the hands of the federal government.

Expensing facilitates firms who need working capital, as well as the entrepreneur who wants to expand his business through the purchase of an important piece of productivity-enhancing equipment. Finally, expensing is good for the economy. If businesses are allowed to write-off their investments in the year they are purchased, businesses are much more likely to make such investments, thereby, increasing jobs and economic growth.

Now let me briefly describe how the USA Business Tax would work:

First, the business would add up its receipts from sales of goods and services made during the year, excluding sales of American-made products to foreign markets. The business would deduct the costs of purchases from other businesses: the cost of plant and equipment (equivalent to expensing), parts, components, and contracted services.

After subtracting purchases from U.S. sales, the remainder is "gross profit," or the tax base to which the business tax rate is applied. Out of "gross profit" the business must pay the business tax, wages and salaries to workers, and dividends and interest to shareholders and debtholders.

FICA CREDIT REPLACES WAGE DEDUCTION TO ACHIEVE BORDER ADJUSTABILITY

The business would also continue to pay its share of Social Security payroll taxes on its wage and salary distributions, and those taxes would be deposited in the Social Security trust funds just as they are now. The business would, however, receive a credit against the business tax for the amount it pays in employer payroll taxes. Our system replaces the wage and salary deduction with the payroll tax credit in order to make our exports more competitive by achieving border adjustability which may of our trading partners already enjoy. The Employer Payroll credit would neutralize the payroll tax' adverse impact on job creation. The integrity of the social security trust fund is protected.

BORDER ADJUSTABILITY ACHIEVED/IMPORT TAX ACHIEVES PARITY FOR ALL GOODS COMPETING IN U.S. MARKET

To complete the "border adjustment" for import/export parity and fairness, an import tax equal to the business tax would be imposed on the production of goods and services outside the U.S. that are sold in the U.S. Through the import tax, any company (regardless of whether it is U.S.- or foreign-owned) located on foreign soil that manufactures goods to be sold in the U.S. market would be taxed essentially the same as if the factory were located in the U.S.

DIFFERENT RULES FOR FINANCIAL INTERMEDIARIES

There are different rules for banks, for insurance companies, for financial pass-thru entities and other businesses engaged in financial intermediation, for international transportation services and international communications.

BUSINESS TAX RATE

The Business USA Tax rate is modeled to be a flat 11.5 percent. And remember, total business taxes collected would be the same as today, but collected in a greatly simplified and more efficient way.

GENERAL DESIGN ASSUMPTIONS

As we started to design the Unlimited Savings Allowance Tax Act (USA) we made certain general assumptions:

* Raise as much revenue as the current code; corporations and businesses would continue to shoulder the same share of the total revenue burden as under current law.

* Retain current code progressivity so that people as a group would pay no more, no less in taxes. The top 20 percent of taxpayers would still pay the same percentage of taxes as they currently pay. The bottom 20 percent would still pay the same percent of the individual USA taxes.

* Replace the anti-savings and investment incentives in the current income tax code with a system that defers savings from taxation.

* Create a system under which:

1. wages, if saved and interest earned from those savings would be deferred from taxation until spent.
2. dividends received and saved would be deferred from taxation until the proceeds are spent;
3. tax on capital gains could be indefinitely deferred as long as the proceeds are rolled over in to other qualified savings and investment assets.
4. there would be no bias in favor of either debt or equity financing.
5. the export competitiveness of the United States would be enhanced by providing border adjustability on terms meeting the requirements of the General Agreement on Tariffs and Trade.
6. expensing of capital costs would replace other cost recovery systems.
7. dividends would be taxed only at the corporate level if the recipient reinvests or otherwise saves the dividend proceeds.

With a new tax code, America's rate of corporate investment in new plant, equipment and technology can be improved and increased--reversing a dangerous trend in the opposite direction.

We hope we will achieve simplicity by eliminating at least three-quarters of the tax code.

Our current code is primarily a wealth redistribution system. Recent tax policy debates quickly degenerate into class warfare shouting matches. Our proposed system is a wealth creation system for all Americans.

A central focus of your hearings is what is the best tax base, or said another way: whether it is better to tax income that is earned or income that is spent. We believe the better system is the latter. Our tax is more neutral than the income tax

in its treatment of present versus future consumption. It is neutral regarding the choice of saving or spending. It would be easier to administer than the income tax. Our tax base can be measured more accurately and simply than an income tax base.

Our tax system would avoid the basic inequity that arises depending upon how savings are accumulated and managed. It would eliminate the need to determine when "realization" and taxation occur. There would be no need for the nonrecognition rules. Our system eliminates the lock-in effect, the potential bunching of gains, and the need for a distinction between capital gains and ordinary income. Under our system amounts invested in productive assets are immediately deductible, making capital recovery deductions unnecessary. As a result, there would be no need to guesstimate decreases in value due to wear, tear, and obsolescence of assets and there would be no need to continue current law recording keeping. Because inflation is often dealt with on an ad hoc basis in the current code and has been used as a justification for accelerated capital recovery deductions, preferential capital gains rates and other special provisions in the income tax system those provisions and their accompanying complications would not be necessary under our system. The mismeasurement of real net worth changes that takes place under the current code because of inflation would not be factor under our system .

There would be no:

Alternative minimum tax.
Foreign tax credit calculations requiring supercomputers.
Heavy-weight tax returns weighing pounds.

REASONS FOR ABOLISHING THE CURRENT CODE

We want to abolish the current income tax system and replace it with the USA tax system because the federal income tax code is unamerican in spirit and wrong in principle. 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. It favors debt over equity financing. It encourages corporate management to neglect long-term investment in favor of focusing on short term profits.

Our current code is far too complex. Companies complain about IRS agents being permanently housed in their corporate headquarters and that the IRS is years behind in their auditing. Others perversely brag about needing supercomputers to calculate certain foreign tax credit computations.

Our current code penalizes savings by taxing income first when it is earned and again if that income is saved and earns interest or dividends. When an activity is penalized in the tax code, it influences behavior. Taxpayers do less of those disfavored activities. And the current code is doing a good job of discouraging saving. Americans are only saving about 2.8 percent of GDP.

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.

S. 722 IS THE STARTING POINT

We took the approach that the tax base in our bill should be as broad as possible. Since we introduced the legislation, we have been contacted by various groups who where included in the base broadening initiative of our bill. It will not surprise you that each group is eager to retain the favorable treatment they receive under the current code. We urge the tax writing committees to carefully evaluate each of these base broadening provisions. You are the experts, and are in the best position to determine which provisions would make sense in this new tax universe should you choose to create it.

Thank you , Mr. Chairman.

Updated May 11, 1995

OVERVIEW OF THE DOMENICI/NUNN TAX PROPOSAL
THE UNLIMITED SAVINGS ALLOWANCE (USA) TAX
S. 722

This complete reform of the income tax system removes the bias of the current tax system against savings and investment. The USA tax maintains the current progressive nature of the individual tax code, makes U.S. products more competitive in world markets, and maintains the same split in total tax burdens between businesses and individuals.

The Individual Tax	The Business Tax
A progressive, 3-bracket individual tax that allows a full deduction for income that is saved rather than consumed.	**A flat-rate tax applying to both corporate and noncorporate business that allows an immediate deduction for capital investment and new inventory.**

Features of the Business Tax

The business adds up its receipts from sales of goods and services made during the year, excluding sales of American-made products to foreign markets.

The business deducts the costs of purchases from other businesses: the cost of plant and equipment (equivalent to expensing), parts, components, and contracted services such as accounting, engineering, legal and transportation services.

After subtracting purchases from U.S. sales, the remainder is "gross profit," or the tax base to which the business tax rate is applied. The business tax rate would be imposed at a flat rate of 11.5 percent.

To complete the "border adjustment" for fairness, an import tax equal to the business tax would be imposed on the production of goods and services outside the U.S. that are sold in the U.S.. Through the import tax, any company (regardless of whether it is U.S.- or foreign-owned) located on foreign soil that manufactures goods to be sold in the U.S. market would be taxed essentially the same as if the factory were located in the U.S..

Out of "gross profit" the business must pay the business tax, wages and salaries to workers, and dividends and interest to shareholders and debtholders. The business would also continue to pay its share of payroll taxes on wage and salary distributions. The Domenici/Nunn business tax proposal therefore allows the business to take a credit against the business tax for the amount it paid in employer payroll taxes.

Features of the Individual (USA) Tax
To figure his or her tax, the individual subtracts total new savings from total income, and pays tax on the remainder. A standard deduction, personal exemptions and an EITC are allowed as under current law, and together are known as the "family living allowance." For a family of four, the "family living allowance" would be close to $17,600.
Individuals' total income includes wages, salaries, interest, dividends, earnings withdrawn from unincorporated businesses, proceeds from asset sales, rents, royalties, annuities, withdrawals from savings accounts and other similar cash inflows. During a transition period, some consumption from savings acquired prior to enactment of Domenici/Nunn would be excluded.
Individuals total up their income, then deduct any amount of income that is saved. Amounts deducted as savings include net increases in bank accounts, purchases of financial assets, other investment purchases, including homes, and life and casualty insurance payments.
The USA Tax allows charitable contributions, mortgage interest, large out-of-pocket medical expenses and to be deducted from income.
Retains current law treatment of mortgage interest.
Low and middle income workers are allowed a credit against the individual USA Tax for employee payroll taxes paid during the year. This way, the family living allowance combined with a refundable payroll tax credit would free the lowest income families from both income and employee payroll taxes.
The marginal rate of taxation, as under current law, is progressive and increases with consumed income. The brackets are designed so that the richest 20% of families continue to pay their current share of federal taxes, and the poorest 20% continue to pay their share of federal taxes. After allowing for the "family living allowance," the approximate consumed income brackets are: 8 percent, 19 percent, 40 percent.

USA INDIVIDUAL TAX

1. GROSS INCOME	Wages, salaries, interest and dividends and income from sale of stocks and other assets. If it is included in gross income under current law it is included in gross income under USA Tax.
2. VALUE OF FRINGE BENEFITS	Counted as part of Gross Income.
MINUS	
3. PERSONAL EXEMPTIONS	$2,550 for taxpayer, spouse and each dependent.
4. FAMILY LIVING ALLOWANCE	$4,400 single $7,400 joint return $5,400 head of household
4a. AMOUNT OF GROSS INCOME EXEMPT FROM TAXATION FOR FAMILY OF 4	$17,600 Total comprised of: $7,400 family living allowance and 4 $2,550 exemptions

4b. AMOUNT OF INCOME EXEMPT FOR SINGLE INDIVIDUAL	$ 6,950 Total comprised of $4,400 family living allowance and one $2,550 exemption
4c. AMOUNT EXEMPT FOR HEAD OF HOUSEHOLD WITH 3 CHILDREN	$13,050 Total comprised of $ 5,400 family living allowance and 3 $2,550 exemptions
5. UNLIMITED SAVINGS ALLOWANCE	Taxpayers can deduct any amount of new savings or investment. One investment can be sold and another purchased without incurring USA Tax liability--unrestricted rollover. Tax is deferred on income saved or invested until income is spent.
6. MORTGAGE DEDUCTION	Same as current law.
7. PHILANTHROPIC DEDUCTION	Same as current law.

8. POSTSECONDARY EDUCATION DEDUCTION	$2,000 per person for the taxpayer, a spouse and up to two dependents capped at $8,000 per year.
9. ALIMONY PAID DEDUCTION	Same as current law.
10. PREVIOUSLY ACQUIRED ASSET ADJUSTMENT	A retiree living on previously taxed savings accumulated prior to the USA Tax can spend that savings without paying USA Tax. (This is fair because it has already been taxed under the old federal income tax system). This rule applies to anyone with assets acquired with after-tax dollars prior to enactment of USA Tax.
11. TREATMENT OF BORROWING	Borrowing is not included in gross income. Repayments are not counted as qualified savings. This makes the tax a consumed income tax (income minus savings) and not an expenditure tax.

12. CAPITAL GAINS	Determining factor is use of proceeds. If proceeds are reinvested the tax on the gain is zero.
13. TREATMENT OF RENTAL PROPERTIES	Treated as a business Purchase expensed instead of depreciated. Income taxed at 11 percent business rate.
14. TREATMENT OF TAX EXEMPT BOND INCOME	Same as current law.
15. TREATMENT OF SOCIAL SECURITY INCOME	Same as current law except that amounts saved are eligible for unlimited savings allowance deduction.
16. TREATMENT OF GIFTS	Not a taxable event for USA tax purposes. Beneficiary takes same basis in the gift as the person making the gift. If recipient spends the gift it would be included in his/her taxable income.

ADJUSTED GROSS INCOME	
Minus	
17. EMPLOYEE PAID PAYROLL AND HEALTH INSURANCE TAX CREDIT	Both Social Security and Medicare portion of the payroll tax are eligible for the tax credit.
18. EARNED INCOME TAX CREDIT	Credit is doubled but eliminated for wage earners without children.
Equals	
TAXABLE INCOME	
Multiplied by	
USA TAX RATES after transition (beginning in year 2000)	8 percent 19 percent 40 percent
COMBINED USA TAX AND PAYROLL TAX RATES (beginning in year 2000).	.35 percent 11.35 percent 32.35 percent

CHANGE IN COMBINED USA and PAYROLL TAX BURDEN BY VARIOUS INCOME GROUPS after transition (beginning in year 2000).	People with taxable income of : 0 to $10,000: Combined USA and payroll tax burden decreased by 75% $10,000-$20,000 decreased by 9% $20,000-$30,000 decreased by 14% $30,000-$50,000 decreased by 5% $50,000-$75,000 decreased by 0 $75,000-100,000 decreased by 0 $100,000-$200,000 increased by 3% Over $200,000 increased by 4%

Mr. CHRISTENSEN [presiding]. Thank you, Senator Domenici. I have a couple of questions, and then I will let my colleagues address you.

First of all, I want to thank you for your leadership on this issue. It has been fun being on this Committee and listening to the various proposals that have been outlined. One of the things that we are trying to do is look at a system that will provide efficiency and equity, simplicity, and administration that gets away from the 14,000-plus pages of our current Code.

You stated that you currently have no bias in favor of debt or equity in the Nunn-Domenici plan. So that would apply in the municipal bond market. How would that affect that area?

Senator NUNN. The municipal bond market? The reason why we don't have any basic distinction between equity and debt is because neither is deductible in the business tax we have. They are placed on the same level playingfield.

Today, of course, interest is deductible and dividends are not. They are both on the same playingfield. So it neutralizes it in that way.

As far as the municipal bond market, that is a very good question. We wrestled with that one long and hard, and we basically came to the conclusion that municipal bonds had to continue to be given a preference. The way they are given a preference on our proposal is, since you can save and put money into a savings account and get the same kind of exclusion or deferral as you do today when you buy a municipal bond, in terms of interest, that would be level. But when you bring in that municipal income from a municipal bond or a State bond, you basically can consume that without being taxed on it.

So the preference is there as it is today. It is less of a preference, in all fairness, than it is today, because you can put money in the savings account or you can put money in a stock and defer income on it because it is investment—or defer income tax on it. So the preference remains, but it is not quite as significant a preference over other forms of saving as we have today.

Mr. CHRISTENSEN. OK.

Congressman Herger.

Mr. HERGER. Thank you, Mr. Chairman. I thank both of our Senators for being here. Your contribution—if there is one thing we hear as we go around to our townhall meetings in our districts is that people are universally unhappy with the system that we have now. It seems like every time we talk about simplifying it, at least in the years past, has made—that has merely meant that we made it more complex.

Senator Domenici, if you can tell me, compared to our current tax system, how much easier would it be to comply with your new U.S.A. tax proposal?

Senator DOMENICI. I can only give you what we have collectively assessed.

On the business side, it is about as big a simplification as you are going to get. I mean, the business side is truly simple. We actually believe it will be a revolution in terms of how corporations and businesses keep their books, how many records they have to keep;

and at the same time, there will be a bias toward investing rather than a bias against investing by the businesses.

On the individual side, we estimate that it is about 75 percent simpler than what we have now. How do I estimate that? I merely look at how many pages we get rid of and we get rid of about 75 percent of the Code pages, or more.

If there is some tax bill that this Committee, in the best interests of America, could pass that is as simple as the notion of a flat tax then we will admit to you the U.S.A. tax is not that simple. But we aren't here to criticize other plans, merely to say that a flat tax can't be flat; there will have to be some other things added and some appendages put on, and everybody knows that.

We opted for progressivity, because as my cohort, Senator Nunn said, we want—we think there is a certain fairness to progressivity, and so we built it in. In fact, wherever we could make things more progressive, we did, even on the FICA tax as you have heard us explain. We tried to get rid of its lack of progressivity by building a tax credit into the total tax base here.

Mr. HERGER. Also, in the area of the small businesses, I guess businesses in general, how would your payroll tax credit work? For employees that you have, as you pay them, how would that work?

Senator NUNN. The basic tax we anticipate at the business level for small business, every level of business, would be about 11 percent. And remember also the goods coming in would be taxed at 11 percent. So we broadened the tax base rather significantly.

We bring in an import tax—not in a discriminatory way; we think it is GATT-compliant—and therefore we have a much lower business tax rate than today. If you paid 11 percent on your business tax and then whatever your payroll is, you would take the payroll and you would take the full $60,000 where the cutoff is on FICA and Medicare and Social Security, you would then apply the 7.65 percent to that and that would be a complete tax credit against the 11 percent. So it is not a deduction, it is a credit back.

If your tax were $100,000 and you are multiplying 7 point—whatever the percent is, 5 or 7, I forget the exact number—times your payroll up to $60,000, then you would—if it was $50,000, you would credit that $50,000 against the $100,000 in tax otherwise owed.

Senator DOMENICI. So, Representative Herger, what we are doing now is, we have the experts that put this together, modeling different scenarios, because we have heard from businesses that are highly professional and they all are highly paid professionals and they want to know whether this approach, as compared with deducting all of the salary, turns out to be reasonably fair to them or not. We can't tell you that in every case it is. But you understand, we don't deduct total payroll; we give a tax credit for the FICA tax against business income, as defined. That is our approach. And we think we have to do that for border adjustability reasons, to comply with GATT. And we think there are a lot of benefits from it, and this will be looked at carefully, I am sure, by various committees.

Senator NUNN. Some of our friends in Europe and Japan may raise the issue of whether it is GATT-compliant, and I think the answer to that is rather simple. Isn't that what you do in your

value-added tax? You basically do not charge value-added tax on your businesses' products going abroad. You do tax us coming in. We are trying to level the playingfield. It is not discriminatory; we are trying to level the playingfield.

But the reason we could not have a wage deduction in that and also accomplish that competitiveness purpose, which we think is a very big purpose, is because we do not believe if you deducted wages it would be GATT-compliant.

Mr. HERGER. Thank you.

Senator NUNN. I think everyone needs to recognize when we say "not deducting wages," that is—at first sight is frightening, but you have to compare the percent. We are down to about an 11 percent rate. So the percent is much, much lower and you have the FICA credit back. So it is a different picture when you start looking at it in that light.

Mr. CHRISTENSEN. Mr. Levin.

Mr. LEVIN. Thank you very much, Mr. Chairman, and welcome to our two, to put it mildly, very distinguished colleagues. You know, we have talked about at least three standards here—simplicity, efficiency, including the savings rate, and fairness—and I think your proposal is—embodies an effort to touch, if not cover, all three. And I am not sure that some of the others make as serious an effort. But let me ask you a few questions within that spirit, and I mean it that way, and then a general question.

For example, health insurance payments by employers. How does that figure? Reading your testimony in the Joint Tax Committee analysis I can't quite tell whether health insurance payments today, which are now deductible, would continue to be.

Senator NUNN. They would not be deductible. The main exemptions today that we retain would be home interest, the mortgage deduction which we preserve, current law, and charitable, and then some of your low-income safety net proposals. But on health insurance, it would not be deductible and it would be includable.

We think that at first glance some people will not like that, but we think it is essential in order to have the rates get down, and we also think it would be part of health care reform in a way. We are not trying to do that, but it would, because it would make people think about the kind of plan they were going to have.

And third, it would add an element of progressivity because normally the people with the highest health benefits are those in the highest income brackets.

Mr. LEVIN. I think, if I might say so, that is an example of an issue that needs to be seriously considered. I think many people, though not all, would admit that if we had had that kind of a system 30 years ago without that kind of deductibility, that probably a large number of middle-income families, truly middle-income families that today have health coverage would not.

Senator NUNN. If you had had the savings account deduction over the years along with that, it would make an enormous difference, because people are going to be able to save. They also are going to be able, in our proposal, to deduct $2,000 for the cost of education. So you have to look at the offset. You have to be—you have to look at the opportunity people have.

Any of these deductions, though, that are currently available that we would eliminate could be added back. It would simply require higher rates. That is the tradeoff. The same thing under the flat tax.

I am not sure how Dick Armey's proposal handled the health insurance. I would imagine, though, to get his rates down, he is going to have to abolish virtually every deduction. It is a real tradeoff here. Any can be added back as a matter of policy; you just have to adjust the rates accordingly.

Senator DOMENICI. Representative Levin, I think that one has to look at the tax brackets and how much we have lowered the brackets for low/middle income and low income; and obviously, if we start putting more things off the table, so to speak, those rates go up.

Mr. LEVIN. Sure.

Senator DOMENICI. And frankly, we are trying to make it simple, and we have three progressive rates—we started with two, but we thought three was more fair—and that is part of the overall scheme.

Mr. LEVIN. All right. But take the typical family. I was going to talk about real estate taxes, but let me forget that for a moment.

Take the typical family, two or three kids, middle income, and you have a several tiered system, but the emphasis is on savings. Now, they have kids; the $2,000 a year education credit, or whatever it would be, doesn't go very far toward meeting those needs.

So this family that isn't able to save much over the years—it isn't easy—it is possible their rates would go up under your proposal. I mean, somebody's rates have to go up if other rates go down, right, if you receive the same amount in the Treasury; and I think yours is revenue neutral.

Senator NUNN. That is right.

Mr. LEVIN. So what assurance for middle-income families is there for those with several children, two or three kids, that this isn't going to hit them hard? Remember, what, 50 percent of the families kind of live, if not week to week, month to month. To——

Senator NUNN. I would say, Congressman Levin, I think that that is a very important question.

First of all, I would say that we think that the FICA credit back will really be a tax break for literally millions of people.

The second point I would make, our low-income brackets and low/middle-income brackets actually—by all tax measurements we have been able to have, their taxes go down.

The third point, we would retain the home mortgage and charitable deduction.

The fourth point, it is almost impossible for the kind of family you talked about to save money today because they have to pay taxes before, and it is the aftertax income that they save. In our proposal, it is before-tax income that they save, an enormous difference in their ability to save.

And finally, I would say we designed our system so that in each bracket, you are right, when taxes go down for somebody, they have to go up for others to be revenue neutral, or the economic pie has to grow. The more the economic pie grows—we think ours will

have enormous growth in the economic pie, but we don't claim that in terms of our scoring.

We tried to design our system so that within the present brackets, generally speaking—I am not saying it is absolutely precise—that within each bracket there would be about the same amount of income as coming in today. Obviously, those who save more will pay less taxes; those who save less will pay more taxes. But I would say to those who save less, they usually are—like me, they are borrowing money. The interest rates are going to be lower in this country than they would otherwise be, because our savings pool is going to go up. So even for borrowers who save less money and pay, thereby, more tax under our proposal, they are going to pay less interest, and I would think that over a period of time the economic pie is going to grow and our jobs are going to be better and they are going to make more income. So I would say, even for people under our proposal who actually pay some slightly more tax, I believe they are going to be net beneficiaries because the economic pie is going to grow and they are going to pay less for their borrowing, whether it is on an automobile or a house or a washing machine or whatever they would otherwise do, because our savings pool is bound to go up under this proposal.

Mr. LEVIN. Thank you.

Thank you, Mr. Chairman.

Senator DOMENICI. Could I also comment?

We went to great lengths in the modeling of this tax proposal to use the quintiles which are commonly used on the distributional tables prepared by the Joint Tax Committee. Each 20 percent current structure will pay essentially about the same amount that they paid before. So that the adjustments within each quintile will be for those who save or don't save. But essentially, each 20 percent of the current tax total will still yield about the same amount. So the top end will still yield its, the bottom end will yield its—it is a small amount, but it will yield the same; and some might want to change that as you move through this process. We just used that—and that is a partial answer to your question.

Mr. LEVIN. My time is up, and I appreciate the indulgence of the Chair.

You have some material, because I think it is an interesting proposal, but we really need to—and I know you agree, to think of it in terms of the impact on the people who pay the taxes. And any material that you have that would show the impact on middle-income families on the third and fourth quintiles, for example, by the number of dependents or the ability to save, the likely expenses for education.

I don't think either of you want a proposal that helps—in order to help savings, squeezes families, especially with several children, for whom savings isn't so easy, though it would be helpful if they would save more. So any material you have on that I would love to see.

[The information was not received at the time of printing.]

Senator NUNN. We have a number of examples, and we really thought as we were developing this right along the same line you are thinking now. We do not claim perfection. We do not claim that

this proposal can't be improved. We welcome constructive improvements in it. But that is exactly the kind of questions we asked.

We spent about 2 years doing this, and a lot of the second year was addressing this question that you have just posed and addressing the very difficult question that Senator Domenici has already alluded to; and that is, when you go to more of a consumption tax, what do you do about old savings? That is a tough question.

We believe we have a transition here that takes care of that problem as well as it can be taken care of for 90 percent of the people. The other people will have a little bit more complexity, the other 10 percent, but for the people who have net savings of $50,000 or less in financial, we think we have handled that.

Now, what you will face if you go to a sales tax or a value-added tax, let's take a couple that have $100,000 that they have saved. That is their life savings. They are now 70 years old or 75 and they want to spend that. They have to spend that. When you take a 17 to 20 percent sales tax, you have just grabbed $17,000 to $20,000 of that $100,000 right out of their pocket. And you are basically taxing old savings twice.

Now, that comes into play bigtime with a value-added or a sales tax, as it would in ours, but we think we have handled that. We let people who have $50,000 or less write off that $50,000 by claiming new savings over a 3-year period. That takes care of 90 percent of the savings in the country.

Mr. CHRISTENSEN. The gentleman's time has expired.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman. Distinguished Senators, I want to thank you for your leadership on fiscal issues generally, and certainly no two Members of either body have done more to point out the savings crisis—and I use that term advisedly, as I am sure you would concur—that we have in this country. I think it is alarming that when you think of the G–7 nations, we have such an abysmally low savings rate, rating a distant seventh with our trading partners.

Professor Feldstein did a study not long ago, I am sure you are familiar, saying if we converted all of—everything in terms of plant and equipment into savings, we couldn't—or savings, rather, into plant and equipment, into capital formation—we couldn't sustain any long-term economic growth. So I applaud your leadership certainly in that area.

Let me ask you a question specifically on your testimony, your proposal here today. I think we all know that the current tax system penalizes savings, as you have pointed out, through double and triple taxation and certainly discourages work and entrepreneurship. Any time you have marginal rates in excess of 50 percent, you can get no other result.

Tomorrow we are going to hear from proponents of the flat tax proposal. Doesn't the flat tax proposal in a more simple and direct way really also eliminate the double taxation of income derived from savings that you are trying to accomplish, thereby providing the same incentives to increase savings?

Senator NUNN. I would say that the flat tax has many similarities with our proposal. I think that—a lot of things in common, I believe that those who are proposing the flat tax are striv-

ing for more savings and for more investment and more simplicity. I believe that is the advantage that our proposal has over the flat tax, although I am saying I identify with almost every proposal as an alternative to what we have now, so I don't want to say that I am negative on other proposals vis-a-vis the current Tax Code. But comparing it to ours, we are revenue neutral, first of all, and I think any tax in this fiscal environment is going to have to be revenue neutral. I think the flat tax hasn't yet met that challenge.

The second thing is, I believe our proposal does much more on the competitiveness feature, putting businesses on the same level, because of what I have already explained in terms of goods sold in this country, and goods sold from other countries in this country would have the same tax.

The third thing, I think we have—the FICA credit is a big change in the current position. I think it is a much bigger improvement. Perhaps a flat tax could incorporate that change. It doesn't necessarily preclude that.

And finally, I think ours is much fairer than a flat tax. Just as Congressman Levin mentioned a few minutes ago, if somebody's rate goes down from 50 to 25 percent and you are going to be revenue neutral, somewhere, somebody else's rate has got to go up. Now, where is that going to be? As I understand the flat tax, it basically takes care of people at low-income levels by having a much bigger exclusion, but still, somebody has got to make up that revenue.

Now, where that will come from I think is probably—I haven't analyzed it and others would have to—it is probably going to have to come from people in middle income who now have a deduction on mortgage interest and also a charitable deduction. I think they are going to have to end up paying more, but that would be subject to someone else's scrutiny.

So those would be the big differences in terms of where I see our proposal having an advantage, but the flat tax would have—under the current reference, it would have some advantage on simplicity. It is more simple than ours because it has not dealt with some of these challenges that I think eventually it will have to deal with.

Mr. RAMSTAD. I am glad to hear you say, Senator Nunn, that either is preferable to the current structure and the current system. And certainly conceptually I like what you are saying and I support what you are saying. I also like the flat tax. But both look certainly superior to the situation we currently have.

My last question in the remaining seconds I have, when you look at value-added tax on businesses, aren't we really talking about a sales tax, because won't this in effect be passed on to consumers?

Senator NUNN. On the business tax?

Mr. RAMSTAD. Right.

Senator NUNN. That is a very good question, and our tax panel coming up next can talk about that incidence of taxation. I don't pretend to know how you basically allocate business tax. Some people say it falls on wage earners, some people say it falls on consumers, some people say it falls on profit, and it depends on the model that the Joint Economic Committee uses. That is a raging and technical debate.

But certainly any tax at a business level has to—businesses are not people, generally, but somebody has to pay it. It is either the stockholders pay it through less dividends or the consumer pays it through higher prices, or the wage earner pays it through lower wages. Somebody has to pay a business tax.

Senator DOMENICI. I would say obviously you could solve the problem and answer your question unequivocally if you had no business tax. There is plenty of thinking based on sound economics and tax policy that you don't necessarily—shouldn't necessarily have to have a business tax. We understood that and we went all the way through that in our thinking, but we thought in passing a new Tax Code you would probably have to have a business tax.

We went with a flat one, made it much broader because we taxed what people—what companies outside America bring in. That is, they are as if they were located in Savannah, Ga., or Albuquerque, N. Mex., as to what they import. And in addition, it seems that we could not find an easy way, such as not paying any tax on dividends, which some would have; and maybe the flat tax has that.

We don't think ultimately the people are going to support a system that taxes people on what they earn for working, but doesn't tax dividends they get. So we have something in between that we think works pretty well.

Senator NUNN. I think one of the big features in ours that is very important and Senator Domenici just referred to is, really, we get very close to treating all of the income alike, municipal bonds being one exception.

But we have had this raging debate ever since I have been here. We walk up the hill on capital gains and we walk back down. It goes back and forth and back and forth, and it is always a rich versus average income argument. But I would like for the first time to say to someone who had a $100 capital gain, fine, if you reinvest it; it keeps the money working for all of our citizens. Then it is tax deferred. But if you go out and get yourselves—if you have a party or you basically buy consumer items, you will pay the same tax that the wage earner pays.

We say the same thing to the wage earner. If you are making $45,000 a year and you save $5,000, you deduct the $5,000. So it puts both capital income and wage income on the same level. I think that would be an enormously important breakthrough in terms of both fairness and understanding and encouraging reinvestment.

The one other thing I would say is that there will be a complaint from some that wealthy income people can save more than others. There is no doubt about that. But as long as wealthy income people in America keep their capital working for the good of all of us, then fine. It is when they put it in the consumption stream and use it for themselves—nothing wrong with that, but at that stage, they ought to pay taxes on it. So that is the theory.

We are not trying to tax people that make a big income as long as their money is working for the whole good of the country. And when they are putting it in plants and equipment and savings accounts that we can all borrow, it is. So that is the philosophy behind it.

Mr. RAMSTAD. Thank you both for your bipartisan, pragmatic work in this area.

Thank you, Mr. Chairman.

Mr. CHRISTENSEN. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman. And I too have enjoyed your discussion of this tax program that you have proposed. We have been hearing a lot about it at home and here and there for the last—actually since about 2 years ago. So I have been eager to hear your explanation of it and will look forward to reading it in detail.

During the conversations we have had with folks in the last day and a half, we have heard about different types of replacement taxes, including the consumption-based tax and where your proposal has touched in a favorable way on all of the items that are of concern to me that I have heard back from the folks in my district, what I don't see mentioned here—and it may be, Senator Nunn, because I missed your explanation since we had a vote—I am wondering what your thoughts are on the underground economy.

Is this a problem that simply cannot be solved, or do you find that your proposal is more effective in getting your arms around this problem?

Senator NUNN. That is a very good question. I was hoping I wouldn't have to make any concessions to alternatives today, but on this one I have to make a concession, and that is, we do not get to the underground economy in our proposal. I kept thinking, how can we do it, and I can't think of where you can do it at the income tax level. I think that is the advantage that value-added tax or sales tax would have over our proposal.

There are a whole lot of disadvantages that they would have, including greatly increasing the cost of living, including the fairness challenge; the more you try to make it fair, the higher the rates are going to go. All of those things come into play.

But on the underground economy, I think you have to go to something like a sales tax or a consumption tax to really get at that.

Senator DOMENICI. Representative Dunn, I concur wholeheartedly, but I would have a caveat obviously. In going after the underground economy, I think we all have to be careful as to what kind of tax law we write for everybody else.

Senator NUNN. The other thing I would add is, I don't—although we don't get at the underground economy, that is, the taxes that are avoided altogether, I do think we dramatically reduce the search for loopholes, because there is a loophole that is available to everybody. Just put your money in a savings account. It is up front, you don't have to go paying a lawyer or an accountant or anyone else to tell you how you basically defer taxes. You don't avoid them, but you defer them. You put it in a savings account or a stock or a bond.

Ms. DUNN. I think that when we talk about incentives, there is an incentive in the current Tax Code to create an underground economy, so I think that is really going to have to be the effect we look for.

You have been sensitive in how you address senior citizens, and I appreciate that, because this is a big problem for them when they have gone through their income-earning years and have paid the penalty and now have—many of them have been self-reliant and responsible and set aside funding, but they are on fixed incomes and would be hit terribly hard by any kind of a national sales tax.

I also appreciate your keeping in the tax policy the incentive for home ownership, because I believe that is terribly important, and I think we really—we really have to pay attention to what our Tax Code is doing in terms of encouraging certain types of behavior here.

So—and the border adjustment, I like that very much too. I think that is just great, and I think you have been very good on that.

So I look forward to this, and thanks very much——

Senator NUNN. It sounds like to me you have already done your homework on this proposal. I am amazed.

Ms. DUNN. Thank you.

Senator DOMENICI. The last time I worked with you, Representative Dunn, was on the reform package, and I just want to say, if you spend as much of your good effort on this, you will come up with some good things, because I was very pleased to have an opportunity to work with you on that.

Ms. DUNN. Thank you.

Mr. CHRISTENSEN. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. And welcome and thanks very much, Senator Nunn and Senator Domenici. I too want to commend you for the leadership role that you are playing in terms of fiscal responsibility, in terms of economic development and competitiveness, and I too appreciate your testimony and appreciate what you have done.

Earlier today Les Samuels was here from the Treasury Department and he was commenting on various proposals. He had a lot of good things to say about your proposal, but he went on to say he had some concerns about complexity and specifically mentioned that your proposal would require some new calculations. In effect, you would have to calculate a personal balance sheet. Because of the fact that as long as your money was in either a savings pool or an investment pool it wouldn't be taxed, but if it should come out, then it would be; there would have to be some way to know when it was coming in and out.

Also, you spoke about the fact that there would be an attempt over 3 years to look at old savings, and so there would have to be some way to identify what old savings were and how then each year you would show what might have been used out of old savings versus other sources. How would you respond to that? I don't know what these calculations are, but do you think they are onerous? Do you think this is something that would make it more difficult for the taxpayer?

Senator DOMENICI. Well, I will take the old savings and Senator Nunn will take the other part. Actually I believe almost any proposal that you are going to be considering has a real problem for senior citizens with a pool of old savings, savings acquired with aftertax dollars under an old system. Because we all know, they

have already paid tax on that and now we are trying to figure out a way to tax income completely different, and so you have their savings that they are going to start spending, and you have got to work on trying to alleviate that double taxation.

We think if you admit that to be a problem and acknowledge it, we think our experts have come up with as good a way as you can come up with. There will be some recordkeeping, but obviously if you are trying to make that transition in a 5-year period, I would assume what we propose would be welcome compared to what might happen under some proposal where they would have to pay 20 percent of every dollar they take out of there and spend or 23 or 18 percent.

Sam, do you want to take the other part?

Senator NUNN. Yes, I think by the time people get through examining a sales tax or consumption tax that is more probably from one point of view more simple, they will be screaming for some complexity, that is, what do we do with old savings. They will be demanding one complex alleviation of that burden on old savings.

On the question of balance sheet, we don't think it would take a balance sheet approach for 90 percent of the American taxpayers. You basically—let's assume, for instance, and this is pretty close in concept of what we do—let's assume you had an IRA account, and you basically said you could take any amount of money and put it in an IRA every year and you would basically keep up with how much you deposited and you would keep up with how much you were withdrawing.

For 90 percent of the American people, it is going to be that simple, and whoever is handling your IRA would give you a sheet at the end of the year, you would have net deposits, net withdrawals, and the calculation would be what you actually net in terms of increased savings or what your decreased savings, which would be consumption, so it would be that simple for most people.

Obviously, people having more financial transactions would have a more complex account of calculations because they have to keep up with it but they already have to keep up with it. They have to keep up with it now for capital gains purposes, they have to keep up with it for any kind of basis on any kind of investment, so we don't think it adds complexity, we think that basically it is rather simple to do for most people.

But we do, and this is important, we do have a different approach than what we had on the IRAs. We are talking about net savings. We are not talking about simply shifting from one bank account to another, we are talking about net savings. So, basically, if you have a net withdrawal from savings, that is deemed consumption.

Mr. PAYNE. Let me shift gears just a minute. Another thing Les Samuels said was that Treasury didn't think, given the research that had been done by various economists, that there were any of these tax proposals that could be guaranteed to increase savings, no matter what they were, and he mentioned the OECD economist and what had happened in other countries and so forth.

How do you feel about that?

Senator NUNN. I think that, analytically, in terms of us being able to show you analytically that this is going to increase savings,

that he is right. We don't have an analytical study doing that. You would have to have a system in order to be able to do that, but in terms of common sense, if you get to deduct your savings, I think just good old common horse sense tells you we are going to increase savings in this country.

Senator DOMENICI. I agree. There is no empirical way we can present to this Committee that the U.S.A. tax system will increase savings 10 percent. However, if you think of it, think about families, you know, who are making family budget decisions, wouldn't they—aren't they apt to say, well, this year I think we should save $5,000 instead of spending it, especially since we deduct it from our income. If we spend it we pay taxes, if we save it we don't. And by saving we will have a better future.

I think it is going to change American attitudes in due course and that will result in higher savings rates and more investment in stock. It doesn't have to be a savings account. I think all of that turns out on the plus side for America's future.

Mr. PAYNE. I agree, and I commend you both very much for coming up with such an innovative plan.

Senator NUNN. Thank you, Mr. Payne. We appreciate it.

Mr. PAYNE. Thank you.

Mr. CHRISTENSEN. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

I noticed in your schedule of the different taxes in the back, Mr. Domenici, I do not see anything on estate tax, so I am assuming that estate tax will be eliminated or abolished?

Senator DOMENICI. We left current estate tax laws on the books. We didn't raise it, change it, we just left it as it is.

Senator NUNN. We didn't address that. We figured that is somebody else's, we are going to leave that up to the wisdom of the Ways and Means and Finance Committees.

Mr. COLLINS. But the estate tax, though, those are assets that have already been tax paid; is that not true?

Senator NUNN. It taxes previously taxed items, that is right. Now, it is important in our proposal to understand that, let's say, an individual bought a stock and that stock had gone from a value of $100 to $1,000, and it was passed on in the estate, we don't change the estate tax, depending on the bracket, they would still pay the estate tax. If the heirs kept the investment in that stock, though, there would still be no tax on income tax.

Mr. COLLINS. How about a farm that exceeds the $600,000 or the $750,000 limit that we set in place, how would you treat that? Say the estate was worth $1.5 million based on the value of the farm but no cash in the estate.

Senator NUNN. If we keep the same system we have today, I favor increasing that exemption on estate tax. I think the House bill that has passed does that, and if Senator Domenici can assure us he has found the revenue to pay for that, or the spending cuts to pay for it, then I think there will be a lot of support for adding it to the $1.2 trillion that he is already hunting for or found.

Mr. COLLINS. We figure he will be able to find some somewhere, he is good at that. How about the earned income tax credit? That is a refundable credit today that has created a lot of problems for the IRS, especially in the area of fraud and abuse. I notice you are

doubling the credit. What do you anticipate being the results based on the current situation with the IRS and the fraud?

Senator DOMENICI. Well, frankly, this was another part of our struggle to see if we could create fairness in lower income groups of working people, people that were earning some money. We are fully aware that the current EITC is subject to fraud. In theory and in numbers, we think something like this would work very well for lower income groups to assure more fairness.

We started this out this way, Representative Collins. We knew that by proposing a tax system that taxes income spent rather than income earned, people would say: "how about those who don't have enough money left over at the end of the month, who cannot save, and therefore this plan doesn't help them." We wanted to prove to the American people and the taxwriters that we have a program that is not going to make it more difficult for those who don't have enough to save, and the EITC expansion was one effort to build into our new tax base an assurance that that would occur. That is the best way I can explain it to you.

Senator NUNN. I think whether this proposal goes into law or not, that fraud in the earned income tax credit has got to be addressed. We did not pretend to solve that problem, but we do believe that the fairness element here is absolutely essential for low-income working people.

Mr. COLLINS. The FICA refundable credit, it is refundable according to the statement. Will this again add another situation similar to the EITC or possibly add another area of fraud?

Senator DOMENICI. I wouldn't think so. As you probably know, the earned income tax credit is not based on any records as authentic as payroll tax and the FICA tax. Those will come right off, everybody prepares them, everybody has them, they are turned in regularly, and it will come right off those. Now, ingenious tax cheaters can use any system and they may be using FICA today to cheat, but essentially we think that is pretty authentic and authenticatable.

Mr. COLLINS. I was thinking more in the area of the independent contractor whose bottom line may be very small, and the 11 percent, very small, sure enough, and you have a large credit based on FICA, that could exceed what his bottom line was before taxation, you are opening yourself up again for possible fraud.

Senator DOMENICI. It is possible.

Senator NUNN. Remember one thing on this one, it would be money already paid in under our present deduction system, so it would be money paid in and they would be asking for money back.

Mr. COLLINS. But they could get back beyond what they paid in?

Senator NUNN. I think it is possible under any system to cheat, and that would certainly not be exempt in ours. That possibility is there.

Mr. COLLINS. Well, I too commend both of you for your work. I think you put together a package that has a lot of merit to it, makes a lot of sense. We thank each of you.

Senator NUNN. Thank you very much.

Senator DOMENICI. Thank you.

Mr. CHRISTENSEN. Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

I talked earlier to the administration, and got to the issue of fairness because I think that that is an issue within our Tax Code that we need to address as a fundamental issue. Where does our definition for fairness come because that word is bantered about quite a bit, progressive taxes seem to be more fair than flat taxes and you have attempted to make this a fair tax system.

So, first of all, what is your definition of fairness and where do you come up with it?

Senator NUNN. I guess the ultimate definition is the perception of the American people. And I think this proposal will depend on whether the American people believe that it is fair to everyone for savings to be deferred, for savings not to be taxed, and that depends on whether we can convince people that when even wealthy people save and defer tax, that it helps everybody, it helps us all, the economic pie grows, the less interest paid by people who have to borrow, I think it will depend in terms of this proposal on whether people who are borrowers and don't believe they are going to be able to save even when they get savings deductions before they pay taxes believe that it is in their benefit for the economic pie to grow, the savings pool increase, all of us pay less interest rates. So, on these features, I think those are the big elements of fairness that I think this proposal has to be weighed against.

What we didn't want to do was do something in this proposal that made the system on its face an unfair system, and we did everything we could to avoid that by the earned income tax credit, by the FICA credit, by the progressive rates and so forth. So it is a matter of perception in the eyes of the taxpayers, but if you are going to have a fundamental reform, I think people have to be convinced that the system is not tilted in favor of the rich and against the working and middle-income people.

Mr. ENSIGN. Well, you know, I think that when we are addressing the question of fairness, the reason that I think it is such an important issue is because if 90 percent of the people benefit by something and 10 percent are hurt by it, those 90 percent can perceive that as fair. When we start getting to definitions based on perception, the administration's definition today was based on ability to pay.

And, you know, in that case, somebody who makes seven figures a year could afford to pay a 90 percent tax rate much better than somebody could pay a 10 percent tax rate making $20,000 a year, so I think we have to be very careful.

While I like your proposal, I like a lot of the aspects of your proposal, I just have a lot of problems with progressive taxes, progressive tax rates in that we still get to the fact that we penalize people that work harder than other people, not all the time, sometimes people get lucky or whatever. But the bottom line is that most people that make more money than other people work a lot harder than everybody else, that has been my experience in the workplace.

And it gets back to the old analogy, if you have two farmers and one works twice as hard and produces more crop than the other one, should the farmer that works twice as hard be taxed at a higher rate or should they both be taxed at the same percentage? That is where I think we get into penalizing instead of rewarding effort.

Senator DOMENICI. Well, let me say, while I tend to agree with my partner, Senator Nunn, on perception, I would not agree that the basic premise of fairness is based on perception because I would have thought of the same concern that you raised, but you must be assured that these two Senators are staunch believers in a capitalistic system of government.

We didn't go to this trouble because we were for taxing people more than they ought to pay or for taxing people at a marginal rate which would knock out drive and enthusiasm and effort, quite to the contrary. But we also understand that the American people would be very leery of a Tax Code that permitted people who were making a lot of money each year, part earned and part unearned, to get by without paying any taxes or paying the same percentage as somebody making $22,000.

Mr. ENSIGN. That is because we have allowed that. That is because we have allowed that in the public debates. When the 16th amendment was adopted, nobody thought that. This is something that we have allowed to develop, and we are perpetuating it.

Senator DOMENICI. I would agree that we have allowed it, but I think so long as you don't go with your marginal rates to the point where you are truly having an adverse effect on the things that you obviously are concerned about, the farmer that works harder than somebody else, so long as you are not having an adverse effect on that, and I think that might be measurable, marginal rates, when they get to a certain level, are probably negative in a quantitative and quantifiable way, and we don't think we are at that level. We are not up in that 70 and 80 percent which we had at one point which just pushed Americans into loopholes seeking tax shelters in order to convince people we were being fair.

We think this is, in concept, fair, and unless one believes that every dollar earned and unearned that goes to a citizen should be taxed at the same percent regardless of how much they earn each year, which maybe you believe, and you are entitled to it, it might be as fair as ours, we are not quite there, but, otherwise, we think we are pretty much for a system where capitalism will flourish, people will save to make the system work better, and have a little more control over how much tax they pay.

Mr. ENSIGN. Thank you very much for my time, Mr. Chairman.

Just one last quick comment, and that is, politically, you guys are probably more realistic. Just ideologically, I would just oppose the progressivity of what you have done but, politically, it is a lot better and, even from an ideological standpoint, it is a lot better than the current system. Thanks.

Senator NUNN. I would say there is a pretty good test of fairness, whether it is perception or some other definition, in whether you can get a proposal that is sweeping tax reform through the U.S. Congress, that is a test, it is a democratic test of both perceptions or whatever one might say it takes a lot of convincing.

But I would ask you to remember one thing, Mr. Ensign, that marginal rates in our proposal are fundamentally different than marginal rates today, not just amount of money, whether it is 40 percent or 30 or 35 or 25, you have marginal rates that are applied after you have deducted your savings and investment. That is a major difference in the current Tax Code.

Mr. CHRISTENSEN. Mr. Neal.

Mr. NEAL. Thank you. Thank you, Mr. Chairman, and thank our two panelists for a thoughtful analysis.

I guess one of the jobs that we have in the governmental system is to draw the distinction between what is fair and what is favorable, and that indeed is not an easy responsibility because those who find themselves outside of the argument will typically say we have been treated unfairly when oftentimes they mean we have been treated unfavorably.

I also might say that I want to thank you for your comments about the earned income tax credit today because I think that there has been an effort in some quarters to kind of demagog that issue when there seems to be considerable empirical data that supports what the earned income tax credit set out to do. This morning, Congressman Cox offered kind of a thoughtful analysis, again, of tax policy in the country. Also, Chairman Archer spoke of a fairly compelling statistic, and I thought you two fellows might want to comment on it.

Mr. Cox talked about, increasingly, the IRS is seen as the opponent of the American people, and then Chairman Archer suggested that there are up to 40 million people in any given year who will have a problem with the IRS. That is a fairly chilling statistic if you consider there are about 260 million people in the country. He did not suggest that all those problems were adversarial, but there appears to me to be the growing perception, if we want to use that word, that the IRS indeed is overreaching, and I think, in some measure, that is what is driving this tax debate.

Perhaps you two gentlemen would want to comment on that.

Senator DOMENICI. Well, I was kind of surprised. I conducted in my State a series of meetings with small business people. I used it to form an advocacy group and I went to 7 cities and talked to about 800, maybe 1,000 small business people in a conference mode where they actually sat down and talked about their problems. And before we were finished, they told us which agencies of the Federal Government were most adversarial and most considered to be their enemy instead of one to work with them, and I would not have thought that the number one was the IRS, but it was. Number two was OSHA, number three was EPA, the latter two in some order, second or third. There is no question.

Oh, let me give you another one. I talked to a major American corporation that said that the IRS year after year was in their office for 9 months out of the 12, and they went to Japan and talked to their counterparts, somebody about equally as big with a similar amount of workers and the factories and that in Japan they audited them in 3 weeks with a similar sized team. So obviously something is very wrong.

On the business side the current Code is utter complexity of the amount of records you have got to keep and subjective determinations. Taxpayers are constantly being put to the test by the auditors. That has to be fixed, and I think our bill meets that test. When you look at the corporate side, I think we have done that.

On the individual side, you have got to have less and less interpretations. We are very hopeful that we got rid of a lot of the Tax Code that is subject to interpretation. We can't claim that it is the

most simple ever and will eliminate IRS. You can't just say we don't need them anymore, but we think a lot of CPAs and lawyers will be out of work if this Code is adopted.

Senator NUNN. We hope.

Mr. NEAL. Thank you.

Mr. CHRISTENSEN. Thank you.

Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

I would like to welcome you all and thank you for bringing this issue up because I have heard a lot of good comments about how thoughtful the process has been, and I agree with you on the IRS.

As a matter of fact, they not only send whole teams in, but they make companies provide office space for long periods of time, which is an expense that shouldn't be, and it is too much government, and I think you both agree with that.

Senator NUNN. I certainly do, though I wouldn't defend them for 1 minute, but I would say we need to keep in mind two things: We have given the IRS the Code they are enforcing, as the Congress has done that.

Mr. JOHNSON. That is true. The fault lies everywhere.

Senator NUNN. That is right. And we have given them the $200 billion deficit, and somebody over there in Treasury keeps telling them they need more money, and that basic premise is probably correct.

Mr. JOHNSON. The U.S.A. tax, as I understand it, would disallow current deductions for wages and benefits and, therefore, increase the cost of doing business for companies that have a relatively large number of employees and a relatively small investment in plant and equipment. And, you know, the problem is masked by the fact that these proposals lower the corporate tax rate and provide some relief from current payroll taxes.

The lower rate, the payroll tax relief that we see doesn't necessarily offset the effect of the loss of deductibility of wages and benefits, and that is due, I think, in part to an effort to increase the value of deductions from investments in plant and equipment, while keeping your proposals revenue neutral.

In a revenue neutral proposal, which is confined to tax issues, the only way to reduce taxes for one sector of the economy is to increase taxes on another sector. In this case, the proposals result in double taxation of wages, sort of. I am wondering what the effect of this proposal would be on deductions for wages and benefits and would there be any net increase in the cost of labor.

Senator DOMENICI. Let me try my hand on it. Certainly it is a fundamental question that we must answer every time we appear. First of all, I don't think you were here, Representative Johnson, when we discussed the fact that we have a proposal which is border adjustable. Therefore, it meets GATT. We believe that if we have a business tax system where wages would be deductible we would not have a GATT-legal cleared Code to help exports by allowing the tax on exports to be reported.

So we went with two or three concepts that we think make up for the problem, but it is being modeled now, most of the companies we modeled, it came out all right, even if they were service industries. What we are now hearing from a few who are highly profes-

sional with very few investments and high paid and we are running those through, but when you get a tax credit for FICA, that is a credit that is against a very low corporate tax. The tax is somewhere around 11 percent and you get to deduct all of the—not deduct it, you get a full credit for it.

When you add all of those things together, we thought the benefits, overall, were on the side of the country and were not going to discriminate against businesses.

Now, when you put something like this together, even though there are a lot of resources and wonderful people putting it together, we cannot sit here and tell you as you proceed with hearings you won't find some companies that are going to be able to show you their balance sheets and say it won't quite work, but we start with the proposition that for most American businesses and for many, many small businesses it is going to work very, very well.

Mr. JOHNSON. Thank you, sir.

Senator NUNN. If I could just add to that, Mr. Johnson, I think that as you think about this proposal, you are probably going to hear from companies that have a very large number of people that make over $60,000, the excess over $60,000 would not get the credit back because that is where it would cut off on FICA.

Those companies would tend to be service companies that don't have much in the way of investment in terms of depreciation because they wouldn't be investing much. I think that they will probably be able to show that their business tax will go up, but on the same hand, this has got to be viewed as a whole proposal. And those people are high-income people by definition, those people who work there. So if you look at their individual opportunity for savings and investment, it is going to be substantially more than people who make $60,000 or less.

Mr. JOHNSON. It will be an individual benefit.

Senator NUNN. So the individuals in those companies are going to tend to benefit. When companies come in and focus on nothing but the business tax and don't think about the opportunities, their people will have——

Mr. JOHNSON. I agree with you. Thank you for your answer. I appreciate it. I appreciate you all being here.

Mr. CHRISTENSEN. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

I want to congratulate both of you on your proposal. Senator Breaux and I introduced a very similar bill 2 or 3 years ago, at least on the individual tax side. Although we did not have it scored by Joint Tax, the initial reaction of the staff from Joint Tax was that by offering this unlimited savings exemption you would have a big hole, a big revenue hole in the short term at least.

Can you explain to me what you have been told by Joint Tax or anybody else as to what the effect of this is going to be in the short term and how you are getting it scored?

Senator NUNN. This is a very interesting question. And there is a real paradox there because, if you claim increased savings coming out of this, you will be probably accused by Joint Tax of dynamic scoring, because if savings really go up and we lose revenue in the short run, the first 3 or 4 years, the economic pie is going to grow

by most economic definitions and we are going to gain huge amounts of revenue over a 10-year period.

That would be the tempting way to show this proposal, would basically be a revenue gainer over 10 years, loser in the first 4 or 5 years because more savings, economic pie grows because more investment, therefore, it grows, then you can lower your rates, so as tempting as it is to do that, because I think that probably is what may happen, it would be said to be dynamic scoring which we know has its own criticisms, so we did not do that.

We used basically the model as best we could, we had experts model our proposal in terms of revenue loss, guessing what they think the Joint Tax Committee may do, and the next panel, I think Rudy Penner can address that in some detail, but we don't know yet how the Joint Tax Committee is going to score this, but if they show revenue losses in the first 3 or 4 years under this, by almost a consensus economic definition, that means revenue gains over a longer period of time.

Senator DOMENICI. Joint Tax Committee is not going to do that. That is way too much dynamics for them. They won't do that, and essentially we think it is going to work much better than IRAs in the past.

We also want to share this with you because, if you recall, there are still two schools of thought about IRAs and did it really increase the net savings pool or not. But part of that argument centers around the fact that you didn't have to have a net increase in savings. Remember when we started, that you could have a bank account and you could just determine that part of that was your IRA and the net effect on the savings pool of the country was zero, net increase. That is not the case here.

At a point in time when this becomes law, you will be talking about net, net savings, and we think that will have a big positive effect. But Senator Nunn is right, if it is as positive as we think, then it is positive on the other side, too.

Mr. MCCRERY. Well, thank you. I can't speak for Senator Breaux, but I can certainly say I appreciate what you have done with our proposal, and we look forward to working with you on it.

Senator NUNN. Thank you for your leadership. You and Senator Breaux helped pave the way on this. We appreciate it.

Mr. CHRISTENSEN. Mr. Hancock.

Mr. HANCOCK. Just a quick question.

Frankly, I haven't heard any of the panels address the question of abolishing the current income tax system, in fact, changing the income tax system or just getting rid of an income tax system completely. As you are well aware, there are an awful lot of States that basically have piggybacked their income tax onto the Federal tax.

What would be, or, in your judgment, have you had an opportunity to look at what the impact would be to those States that are in that position?

Senator NUNN. I would have to say that I don't know about Senator Domenici; I have not. That is a challenge for us that lies in front of us. We have not done that, and it is an important question.

Senator DOMENICI. I think we can ask our technical people, but my own conclusion would be that since we have not changed the percentile, the bottom 20 contributes about the same as they do

now. And right up the percentile, probably there is not going to be a very significant change if the States continue to piggyback on it, but our experts have looked at it because I recall them saying it sometime, but I don't remember it precisely.

Mr. HANCOCK. One of the things I would like to possibly suggest, and that is, I am very much in favor of, quite frankly, the repeal of the 16th amendment, the total abolishment of the income tax. If in fact we would advise people that probably would result in the abolishment of their State income tax, it might generate some support to get it done up here.

Thank you very much.

Senator NUNN. Thank you.

Mr. CHRISTENSEN. I thank the panel, and I would like to call up the fourth panel.

Senator NUNN. Thank you, Mr. Chairman. Also, if you would thank Chairman Archer and Mr. Gibbons for both of us for holding these hearings.

Mr. CHRISTENSEN. Thank you for your leadership. Around here we call it the Archer rule of common sense on the fact that this would allow more savings in this country, and appreciate your leadership on this issue.

Senator DOMENICI. Thank you very much.

Mr. CHRISTENSEN. Ernest Christian, Hon. Murray Weidenbaum, Rudolph Penner, and Barry Rogstad, our fourth and final panel of the day.

The oral testimony will be limited to 5 minutes. A red light will come on when the 5-minute timer is up. Your full written statement will be entered into the record.

Dr. Penner, would you please start.

Mr. CHRISTIAN. I think we have agreed among ourselves that I would start first.

Mr. CHRISTENSEN. Whoever would like to start first.

STATEMENT OF ERNEST S. CHRISTIAN, APPEARING ON HIS OWN BEHALF, FORMER TAX LEGISLATIVE COUNSEL AND DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. CHRISTIAN. Mr. Chairman, Members of the Committee, I have appeared before this Committee, as some of you may know, on many occasions for the last 25 years, but never with as much enthusiasm and conviction as I have today.

The U.S.A. tax proposal by Senator Domenici and Senator Nunn is a true landmark in the development of tax policy in the United States. It shows that you can accomplish revolutionary change in the American tax system. It also points the way to do it. A full deduction for personal savings, allow wage earners a full credit for the payroll tax, full expensing of business capital equipment, exclude exports from tax while taxing imports, simplify the tax law, make it less wasteful, less intrusive, easier to understand, and easier to apply. That is all achieved.

You can do this without either raising taxes or increasing the deficit. You have choices. You are not forced to diminish progressivity. You can retain deductions for charitable contributions and home mortgage interest. You can add for investment in human cap-

ital. You have the choice to accomplish all of this within the framework of a tax on people's income, in this case, consumed income.

The U.S.A. tax does not stop at a theoretical stage. S. 722 contains a fully articulated new American tax system that would actually work. It is a successful exercise in the art of using the fewest and simplest elements to achieve the greatest effect. Its hallmark is neutrality, not regulation. It concentrates on fairness by removing barriers to individual choice, barriers to economic growth, barriers to greater personal independence and responsibility.

We will all still file tax returns. Tax returns remind us each year of how much tax we pay for what government spends. U.S.A. tax returns will also remind us that we, too, have a choice to spend or to save. Simply put, the U.S.A. tax levels the playingfield. Families will have a choice to save without tax penalty. Families will have a choice to invest in their children's future. All income is taxed alike and taxed at the same progressive rate.

All businesses are taxed alike at the same flat rate. All businesses can invest in new plant and equipment without a tax penalty. All American workers, all American companies can compete in global markets. Given a fair chance, they will win.

Foreign companies that compete in our markets will pay their fair share of the tax burden in this country the same as we do.

The U.S.A. tax is built from the ground up around a set of principles that are derived solely from the way that income is actually created, received, and used. Every dollar of income is created at the business level by people who do the work and people who provide the capital out of their savings. When a dollar of income is created by the production of goods and services, the first part of the total U.S.A. tax is collected from the business, unless the business reinvests the income to produce additional goods and services, additional dollars of income for us all.

When the reinvestment ends and additional dollars of income net of the tax paid at the business level flow out to individuals as compensation for work or for the use of their capital, the second part of the U.S.A. tax is collected from them unless they, too, choose to put the income back into the national savings pool where it will again be reinvested to produce additional goods and services, dollars of income for us all.

The U.S.A. tax taxes income when withdrawn from the national savings pool and spent but only if that income has not been taxed when earned. For example, a retiree who withdraws and spends aftertax savings accumulated under present law would not be taxed. Further, the U.S.A. tax only taxes income. For example, a student who borrowed money and spent it to live on would not be taxed. Borrowings are not income.

In conclusion, Mr. Chairman, the U.S.A. tax is not the only route to revolutionary change and improvement. There are other worthy alternatives. None of them are perfect. The U.S.A. tax is not perfect, either. You can improve it, as Senator Nunn said, as Senator Domenici said. The U.S.A. tax is, however, a great place to start.

That concludes my statement, Mr. Chairman, and thank you.

[The prepared statement follows:]

STATEMENT OF ERNEST S. CHRISTIAN

Appearing on Own Behalf and as Former Tax Legislative Counsel and Deputy Assistant Secretary (Tax Policy) of the Treasury Department

BEFORE THE COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

JUNE 7, 1995

RE: S. 722, THE USA TAX ACT OF 1995

Introduction to USA Tax

Over the last 25 years I have on many occasions appeared before this Committee but never with as much enthusiasm and conviction as today. The USA Tax proposal by Senators Domenici and Nunn is a landmark achievement in the on-going development of tax policy and design. It shows how you can accomplish revolutionary change in the American tax system. You can allow a full deduction for personal savings. You can allow wage earners a full tax credit for the FICA payroll tax on their wages. You can allow full expensing of business capital investment. You can exclude exports from tax while taxing imports. You can simplify the tax law, thereby making it less wasteful and less intrusive. You can do all this and more within the framework of a tax on income -- in this case, *consumed* income. You can do it without either raising taxes or increasing the deficit and without diminishing progressivity unless you choose to do so.

The USA Tax does not stop at the theoretical stage. S. 722 confronts the hard questions of reality and contains a fully articulated, fully functional new American tax system that would actually work in our complex economy and society. Yet, it is a true and successful exercise in minimalism.

> *The art of using the fewest and simplest elements to achieve the greatest effect.*

Its hallmark is neutrality, not regulation. The USA Tax is expressly designed not to interfere in the economic lives of Americans to any material extent beyond the amount of tax they pay. It concentrates on removing barriers to individual choice and barriers to economic growth. These are the keys to greater personal independence and responsibility. These are the keys to a higher standard of living which is the true measure of fairness.

The USA Tax is a completely new replacement tax. It is built from the ground up around a set of principles derived solely from the way income is actually created, received and used. Every dollar of income is created *at* the business level *by* the people who do the work and the people who provide the capital out of their savings.

When a dollar of income is created through the production of goods and services, the first part of the total USA Tax is collected from the business -- unless that income is reinvested to produce additional goods, services and income for us all. In that case, the business tax is deferred and is collected later when reinvestment ends. At that point, assuming a successful reinvestment, additional dollars of income will have been created and a greater amount of tax will be collected.

When the same dollars of income, net of the tax paid at the business level, flow out to and are received by individuals as compensation for work or as compensation for the use of capital, the second part of the USA Tax is collected from them -- unless they choose to put the income back into the national savings pool where it will again be reinvested to produce additional goods, services and income for us all. In that case, the individual tax is deferred and is collected later when income is withdrawn from savings and spent. Only at that point have people actually

"received" income for their own use and enjoyment and only at that point is the individual part of the USA Tax collected.

Although the USA Tax collects tax at points, it also splits the tax rate into two parts. The total tax is the same as if (i) individuals were allowed a tax credit for the business tax or (ii) there were no business tax and all tax was paid by individuals. This is illustrated below where in all three cases the desire is to collect $28 of tax on $100 of income created.

> USA Tax Split Rate: $100 of income × 11% business tax rate = $11 tax; $89 income received by individual × 19% individual tax rate = $17 tax. Total tax of $28 collected.
>
> Credit For Business Tax: $100 income × 11% business tax rate = $11 tax; $100 "grossed up" income received by individual × 28% individual tax rate = $28 gross tax less $11 credit = $17 tax. Total tax of $28 collected.
>
> Individual-Only Tax: $100 income received by individual × 28% individual tax rate = $28 total tax collected.

The USA Tax Removes the Tax Bias against Saving and Allows All Americans a Fair Choice. For individuals, the USA Tax is a simple tax on income minus the amount saved -- like a fully deductible IRA but without special governmental restrictions or accounts. For example, the Jones Family earns a combined salary of $48,000 and saves $5,000 which they use to start their own small business. They deduct $5,000 and pay tax only on the amount by which $43,000 exceeds their other deductions and exemptions. Having deferred tax on $5,000 of salary, if the Joneses later withdraw $5,000 from the business (and from the national savings pool), they will pay tax on the $5,000 of deferred salary at that time -- unless they roll it over into a stock, bond, a CD or any one of the many other choices people can make both when they initially save and when they move savings from one investment to another. So long as earnings are deferred and remain in the national savings pool, the tax continues to be deferred. Not only is the USA Tax neutral in an economic sense -- in the choice to save -- it also gives people full control over their savings. The USA Tax also does not tell people how much or how little they can save or for what purpose. Saving is not limited in amount or restricted to retirement uses.

The USA Tax is also even-handed in its definition of income. Interest, dividends and gains are treated the same as wages and salaries. All are included in income -- less the amount saved -- and are taxed under the same rate schedule.

The USA Tax Simplifies the Tax Law, Thereby Reducing the Presently High Cost of Compliance and Administration. The proposed new income tax code in S. 722 is much smaller in size than the present monstrosity and will be much easier to apply. It consists primarily of straightforward, understandable rules of universal application with few exceptions. For a tax statute, and given the complexities of the economy in which it must operate, the USA Tax is written in plain English.

The USA Tax retains deductions for charitable contributions and home mortgage interest, and allows a new deduction for education costs but these are not the source of any significant amount of complexity. For example, the home mortgage interest deduction involves no more than transferring onto a tax return a single number furnished annually to the homeowner by the mortgage lender. The USA Tax uses progressive tax rates in a three-bracket system, but the use of one, two or three rates has no material effect on complexity one way or the other.

Under the USA Tax, people will still have to file tax returns. In that respect, paying taxes will still involve some paperwork and computation, although much less than today. We might all wish to be totally relieved of that burden, just as we all might wish to be excused from paying taxes altogether. On balance, however, the annual process of Americans filing simple tax returns is a net positive. It reinforces in our minds an acute awareness of how much tax we pay for what government spends.

The USA Tax Allows Wage Earners a Full Tax Credit for the Employee-Paid 7.65% FICA Payroll Tax, Thereby Assuring That the Real Marginal Rate on Wage Income Is No Longer Higher Than on Dividends, Interest and Other Financial Income. Because of this credit, the nominal rates under the USA Tax are *inclusive* of the payroll tax and are, therefore, the real marginal rates on both wage income and financial income. In contrast, the rates under present law are in *addition* to the payroll tax. For example, a middle bracket rate of 31% under present law is 31% on dividends, but the real marginal rate in the same bracket is 38.65% on wage income up to the OASDI wage base.

Another Way of Looking at the Payroll Tax Credit Is to Say That the Stated Rates under the USA Tax Are Lower Than They Appear To Be. In the first year, on a joint return, the USA Tax rates in S. 722 are 19%, 27% and 40%, and after a transition period are 8%, 19% and 40%. From the perspective of most wage income, another way of looking at the rates under the USA Tax is to reduce each bracket rate by 7.65 percentage points. Viewed that way, the rates under the USA Tax on wage income up to the OASDI wage base are as follows.

First Year (Joint Return)	Fifth Year (Joint Return)
11.35%	1%
19.35%	11.35%
32.35%	32.35%

The USA Tax Removes the Bias against Business Capital Investment and Levels the International Playing Field. In the business area, the USA Tax also concentrates on eliminating arbitrary distinctions and removing barriers to productivity and growth. All businesses are taxed alike without regard to size, corporate or noncorporate form of organization, or whether financed by debt or equity capital. The business tax rate is a uniform 11%. Because the USA Tax allows all businesses a full credit for the employer-paid 7.65% FICA payroll tax, the uniform 11% rate is *inclusive* of the payroll tax. This 11% inclusive rate compares to a 35% present law corporate tax rate in addition to a 7.65% employer-paid payroll tax rate.

All businesses are allowed to expense the cost of plant and equipment, inventory and supplies. Having recovered these costs out of sales, the remaining "gross profit" is taxed at 11% before paying employees their share and before paying shareholders and debtholders their share. The result is a uniform 11% tax at the business level on returns to labor and returns to capital. Both are treated the same, just as they are under the individual tax.

The USA Tax achieves parity in the international arena, thereby giving American workers and companies a fair chance to compete and win in global markets. The USA Tax excludes export sales from the 11% business gross profit tax. It taxes imports at 11%. Thus, the more a U.S. company increases its exports to foreign markets, the less tax it will pay in proportion to total revenues and total gross profit. Conversely, the more foreign-based companies manufacture abroad and compete in the U.S. market, the more import tax they will pay. All businesses that compete in our markets will pay their proportionate share of the cost of government in this country.

The USA Tax Neither Increases Nor Decreases Total Revenues and Does Not Materially Alter the Distribution of the Total Tax Burden Either Between Businesses and Individuals or Among High, Middle and Low Income Groups. The USA Tax concentrates on restructuring the fundamental components of the tax system. Separating the *way* we tax ourselves from the *amount* we tax ourselves serves several purposes. First, it permits full and objective concentration on arriving at the best fundamental tax structure for the long-term best interests of America, unimpeded by other considerations that will vary over time as revenue needs change and as attitudes about progressive versus proportional taxation change. Second, it serves to demonstrate that such a tax structure can be created and that the fundamental goals of tax restructuring can be achieved even within the constraints of revenue and distributional neutrality.

For example, within these constraints, the USA Tax still allows a full deduction for personal savings, expenses business capital investment, excludes exports from tax, and greatly simplifies the tax law.

If the constraints of revenue and distributional neutrality were to be relaxed, the rates of tax could be lowered and compressed -- even into a single rate, if the Congress desired. Similarly, the Congress could decide not to allow personal deductions for charitable contributions or home mortgage interest. The structure of the USA Tax would, however, remain the same and all the goals related to savings, business investment, exports and simplification would still be achieved. Rates of tax, the total revenues raised, etc. are important policy decisions, but they are extraneous to the highly salutary basic structure of the USA Tax which is designed to produce fundamentally correct and consistent results in all events.

It should be kept in mind that by historical standards, the USA Tax rates are already fairly "flat." There are only three bracket rates, the brackets are not very wide, and the top rate is only twice the bottom rate. The credit for employee-paid FICA tax, allowed by the USA Tax but not allowed by present law, plays a major role in maintaining distributional neutrality relative to present law.

USA Tax for Individuals -- Rates, Exemptions, Deductions and Basic Computations

The USA Tax has three brackets and three rates that increase as income increases. For illustration, the rate schedule for married persons filing jointly is set forth below.

Taxable Income Above	1996	1997	1998	1999	2000
$ 0	19.00%	15.00%	13.00%	10.00%	8.00%
5,400	27.00%	26.00%	25.00%	20.00%	19.00%
24,000	40.00%	40.00%	40.00%	40.00%	40.00%

Taxable Income equals Gross Income minus Exemptions and Deductions.

Gross Income = Wages and salaries plus financial income such as interest, dividends and amounts received from the sale of assets.

Exemptions = A Family Allowance:

..... $4,400 Single

..... $7,400 Married/Joint

..... $3,700 Married/Separate

..... $5,400 Head-of-Household

Personal and Dependents: $2,550 each for taxpayer, spouse and all dependents.

Deductions = The Unlimited Savings Allowance -- Everyone is allowed a full deduction for the amount of income they save. E.g., deposits in a savings account, purchase of a stock or bond, start-up capital contributed to one's own small business.

Higher Education Deduction -- The USA Tax allows a deduction for tuition paid for higher education. The deduction is limited to $2,000 per person for the taxpayer, a spouse and up to two dependents. The total deduction in a year is limited to $8,000. Higher education generally includes college and similar vocational education. The deduction is also allowed for remedial education of students under 18 years of age.

Home Mortgage Interest Deduction -- generally same as under present law.

Charitable Contribution Deduction -- generally same as under present law.

Alimony Paid Deduction -- same as under present law.

Tax Due equals (Taxable Income × Tax Rate) minus Credits.

Credits = A refundable credit for the employee-paid portion of the FICA payroll tax.

A refundable credit for the amount of withholding tax paid in advance.

A refundable credit for the amount of estimated tax paid in advance.

S. 722 also allows a refundable Earned Income Tax Credit, although the status of the EITC in general may be uncertain under House and Senate budget resolutions.

Because the deduction for income that is saved defers tax only for so long as that income is left in the national savings pool, taxable income for a year may include withdrawals from savings of income that had been deducted and deferred in a prior year. Further, in the year that prior-year savings is withdrawn, the same person may also have deposited some current-year income in savings. Thus, depending on whether the amount withdrawn exceeds the amount deposited or vice versa, the person may have "net withdrawal income" or a net savings deduction. For example, in 1996 (prior year), the Smith Family deferred tax on $1,000 of salary income by putting it in Savings Account A. In 1998 (current-year), the Smith Family deposits $500 of 1998 salary in Savings Account B, but withdraws $1,000 from Savings Account A. In 1998, the Smith Family has net withdrawal income of $500 ($1,000 withdrawn from Savings Account A less $500 deposited in Savings Account B). On the other hand, had the Smiths in 1998 deposited $1,000 in Savings Account B and withdrawn only $500 from Savings Account A, they would in

1998 have a net savings deduction of $500 ($1,000 deposited in Savings Account B minus $500 withdrawn from Savings Account A).

Because the USA Tax only taxes income (current-year plus prior-year income on which tax has been deferred), retirees and others will not have additional taxable income when they withdraw "old savings" that has already been taxed under present law. For example, before they retired in 1996 (first year of USA Tax), Mr. and Mrs. Brown had saved $100,000 out of after-tax income. Because they had been allowed no deduction (and had prepaid tax instead of being allowed to defer tax), they can during retirement withdraw the $100,000 without having to again pay tax on it. The USA Tax only taxes income *once,* not twice.

Also, because the USA Tax taxes income (not expenditures), borrowing does not result in tax even though the amount borrowed is "consumed." For example, James Jones borrows $7,000 to live on while in his last year of college. James will not pay tax because he has no 'income." However, when he graduates, gets a job and earns a salary, he will repay the loan out of income and get no deduction for the repayment. Thus, when James does have income, he will pay tax on the income that he had "consumed in advance" while in school.

It is under the USA Tax conceptually and in every other way correct not to include in income either borrowing or withdrawals of "old saving" that has already been taxed. It is, however, necessary to take these events into account in another way in a some circumstances. For example, in 1998 Mr. Executive earns $200,000, consumes $200,000, borrows $200,000, and buys Stock A for $200,000. The USA Tax would not allow him to claim a $200,000 savings deduction and pay zero tax on his $200,000 of earnings. *Reason*: Net of borrowing, Mr. Executive did not save anything. He did not add to the national savings pool. He only borrowed someone else's existing savings and shifted it into Stock A. Similarly, Mr. Executive could not withdraw $200,000 of his own "old savings" *and* at the same time, claim a deduction for $200,000 Stock A purportedly bought with his $200,000 current-year earnings. Again, he did not add anything to the national savings pool. He only shifted his savings to another investment.

This special netting rule for borrowing and old savings involves some amount of computation and complexity. Borrowing must be accounted for and old saving must be distinguished from new saving that has been deducted. In order to relieve nearly all taxpayers from the special netting rule, the USA Tax contains two simplifying rules. First, all home mortgage debt plus ordinary consumer debt up to $35,000 is excluded. Second, people with less than $50,000 of previously-taxed "old savings" can elect to deduct it over three years. Thus, nearly all taxpayers will be excluded from the special netting rule and will never be involved with it.

The three-year amortization deduction for $50,000 of old savings also provides an additional and substantial monetary benefit to retirees and others. The amortization deduction, in effect, gives back to them the present law tax that they prepaid on savings up to $50,000.

The USA Business Tax -- Rates, Deductions and Basic Calculation

Every business that is producing and selling goods and services, and, therefore, creating income, must file an annual business tax return and pay the 11% tax on its annual "gross profit" which is a defined term under the USA business tax. In calculating its gross profit tax base to which the 11% tax is applied, the business adds the amount it received from sales of goods and services and subtracts the amount it paid to other businesses for the goods and services it had to buy from them (plant, equipment, inventory, supplies, rent, utilities, telephones, fuel, legal and accounting fees, etc.). Excluded from the gross profit calculation are financial receipts and payments. For example, the business neither includes interest and dividends received nor deducts interest and dividends paid. Compensation payments to employees are not deductible. Amounts received from export sales of goods or services to a purchaser outside the United States are excluded from the calculation of gross profit. Correspondingly, an 11% import tax is imposed on the sale of goods and services into the United States from abroad. E.g., a foreign business that manufactures outside the United States but sells its products in the U.S. market will pay the import tax. A tax credit is allowed for the 7.65% employer FICA payroll tax that

businesses must pay on wages paid to employees. The USA business tax is territorial. Businesses will not include in gross profit the proceeds from sales made or services provided outside the United States and they will not subtract amounts paid for the purchase of goods or the provision of services outside the United States. Businesses will not be taxed on dividends paid by foreign subsidiaries. Foreign businesses will include in gross profit amounts received for goods sold or services provided in the United States and will subtract amounts paid for goods acquired and services provided in the United States.

Resisting Analogies -- The USA Tax Is *Sui Generis*

The USA Tax combines some elements that may also be found, variously, to some extent, and in different forms, in taxes said to be based on net cash flow, net income, consumed income or true business valued added, but because the USA Tax is a hybrid, none of those analogies is altogether accurate or especially illuminating.

Interesting and fairly accurate analogies could also be made to an amended, much improved and simplified version of present law. For example, the USA Tax on businesses has been analogized to a combination of the existing employer payroll tax and a low-rate version of the existing corporate income tax amended to provide for expensing of capital investment and amended to treat debt and equity the same. The USA Tax on individuals has also been analogized to a simple version of the existing individual income tax amended to allow an unlimited, unrestricted IRA deduction for income that is saved and that is taxed only when withdrawn from the IRA. But, here again, the attempt to translate the USA Tax into something else tends to obscure its own merits.

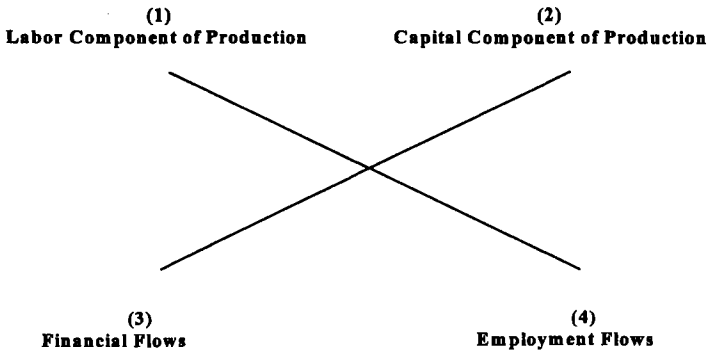
The USA Tax is best understood in terms of its own actual substance and its own consistently applied concepts -- not in terms of the tax system of the past that is being repealed and not in terms of some tax system that exists somewhere else or that is only generally described in academic literature.

Fundamental Concepts -- Understanding the USA Tax as an Integrated Whole

The USA Tax is an integrated, internally consistent whole that collects a single amount of tax in two parts and at two points in the economy. The first part is collected at the business level where income first arises from the production of goods and services and the second part is collected when the income (net of the tax collected at the business level) is received by individuals either as wages and salaries or as interest, dividends, gains, etc.

Because the rate of tax is also split into two parts, with one part applying to income when created and another part applying to income when received, the total amount of tax and the total rate of tax on a dollar of income is the same as if the total amount of tax had been collected solely at the business level or, in the alternative, solely at the individual level.

The USA Tax derives from the way the economy actually works -- from the way real goods and services are actually produced, from the fact that this productive process is the source of all income, and from the way that individuals actually receive that income either as employment flows (wages and salaries as compensation for work) or as financial flows (interest and dividends, etc. as compensation for the use of their capital and, ultimately, a return of that capital). When a tax is injected into the economic process by which income is created, it must be collected either at the point of production (businesses) or the point of receipt (individuals). If the tax is collected at the point of production, it must be based either on the labor component of production or the capital component of production, or both. If the tax is collected at the point of receipt, it must be based either on the employment flows to individuals, or the financial flows to individuals, or both. Therefore, this basic structure and operation of the economy dictates the structure of almost any tax -- whether it is called the USA Tax or, generically, "X."



A potential component of a tax base appears at each of the four endpoints marking the extremities of the two intersecting lines in the form of an "X," but there is, in a sense, some duplication. The Employments Flows (4) are a reappearance at the individual level of the Labor Component (1) at the business level, and (4) is equal in amount to (1) less any tax already collected out of (1) at the business level. Similarly, the Financial Flows (3) are a reappearance at the individual level of the Capital Component (2) at the business level, and (3) is equal in amount to (2) less any tax already collected out of (2) at the business level.

Within this rigid construct, there is flexibility in the design of a tax in choosing to impose tax at all or only on some of the four possible points, in choosing to impose tax at uniform or varied rates on one, more or all of the potential components of the tax base, and in choosing to specially define one, more or all of the potential components of the tax base. Even these choices are, however, not open-ended. Great care must be exercised in order to avoid inconsistent treatments of "likes" and similar anomalies that cause undesirable economic or political consequences. The administrative consequences of choices and combinations of choices must also be taken into account.

Setting aside matters such as the tax rates, and concentrating on fundamentals, there are four basic constructs that are highly pertinent to the origins and development of both the USA Tax as well as various alternatives.

Basic Construct X-1. Collect all tax at the business level based on the Labor Component (1) of production and the Capital Component (2) of production.

Basic Construct X-2. Collect all tax, in the same total amount, at the individual level based on the Financial Flows (3) and the Employment Flows (4).

Basic Construct X-3. Collect the same total amount of tax, but collect it in part at the business level and in part at the individual level as follows. Tax the Capital Component (2) at the business level and tax the Employment Flows (4) at the individual level.

Basic Construct X-4. The same as X-3 except that a partial tax at the business level is collected from both the Labor Component (1) and the Capital Component (2), and, at the individual level, the remainder of the tax is collected from both the Employment Flows (4) and the Financial Flows (3).

Basic Construct X-4 represents the USA Tax. The essential ingredients of a modified business cash flow tax or true tax on business value added (as distinguished from the VAT form of retail sales tax) can be found in Basic Construct X-1. Basic Construct X-2 contains the basic building blocks of a household-only cash flow tax. Basic Construct X-3 represents the Flat Tax.

Although less clearly and completely, a sales tax can also to some extent be fitted into and understood within this framework. Like X-2, a sales tax is also a household-only tax. Unlike X-2, however, the sales tax is not based on any direct measurement of total Employment Flows (4) and Financial Flows (3), but is instead based solely on item-by-item purchases. Therefore, it involves no tax return by a household and because it does not, the sales tax cannot vary the rate of tax by household income and cannot distinguish between purchases made with income, purchases made with previously taxed savings, or purchases made with borrowed funds.

* * *

Mr. CHRISTENSEN. Thank you, Mr. Christian.

Mr. Weidenbaum, Dr. Weidenbaum.

STATEMENT OF HON. MURRAY WEIDENBAUM, PH.D., CHAIRMAN, CENTER FOR THE STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY, ST. LOUIS, MO., FORMER ASSISTANT SECRETARY, U.S. DEPARTMENT OF THE TREASURY; AND FORMER CHAIRMAN, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Mr. WEIDENBAUM. Thank you, Mr. Chairman, Members of the Committee. To summarize my statement briefly, the U.S.A. tax is the only one of the proposals that has been discussed before this Committee that simultaneously promotes growth and simplification without losing fairness. It also leaves for the citizen a lot of decisions that are now made by the government—how much to save, how much to invest, and in what form. The taxpayer would make that decision.

Basically the U.S.A. tax puts the fiscal burden on what people take from society, the goods and services they consume. That is part of the fundamentals of this plan because, as someone who has worked with and observed this Committee for several decades, it is clear you have the taxwriting responsibility ahead of you.

Hopefully, some of the best of these various plans can help you in that important job, and the idea of exempting savings and writing off investment both simplifies the Internal Revenue Code and provides the economic growth that, over a period of time, is the most painless way of reducing the budget deficit. It is that growth that brings in more revenues and reduces the spending on entitlements.

We have worked, as you know, for several years on the details of this proposal. We are submitting it for the record and I emphasize that even though, very frankly, we are here to push our particular program, all of the four alternatives—the flat tax, the sales tax, the VAT, as well as the U.S.A. tax—are variations on the same theme. They all promote investment, they promote economic growth. They are all so much simpler than the status quo.

Some of them do have some differences. This is the plan that does more to promote, keep fairness than any of the others. There is a tradeoff. Some of them look like they are a lot simpler. However, I urge you to read the fine print. For example, I have heard claims that some of these will eliminate the IRS, but then they say, well, of course, we will have to provide refunds to low-income people.

Well, how do you provide the refunds? People will have to fill out a form and submit it to some bureau in the Treasury Department. You can call it something else, but it will still be the Internal Revenue Service reviewing and auditing the returns of millions of Americans. So as an old Treasury hand, maybe I am pleased to say the IRS won't be out of business under any of these plans, but under all of them. And that is the heartening thing, we move to a lot of simplification but, again, I don't overemphasize this.

Take the VAT. France originated the VAT. They had a real debate, was Head and Shoulders antidandruff shampoo a tax-exempt medicine or was this a cosmetic subject to the VAT? That is the

kind of debate that the VAT generates. There are all sorts of loopholes, by the way. The idea that you exempt medicines, you exempt food, things like that, that sounds good. But, very frankly, above average income people like my wife and I, we will do a lot better than low-income people if you exempt—we will get a much bigger tax saving if you exempt our food than the people with very modest incomes, so that there is a tradeoff as you write any of these tax bills.

But let me emphasize that, warts and all, the U.S.A. tax is the most attractive approach to fundamental tax reform. It provides the most favorable combination of simplification, economic incentive, and fairness, and, as pointed out earlier in this hearing, it simultaneously reduces the role of government in citizen decision-making and enhances our international competitiveness.

Thank you very much.

[The prepared statement follows:]

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ANALYZING THE NUNN-DOMENICI USA TAX

by Murray Weidenbaum

Testimony Before the
House Ways and Means Committee
Washington, DC, June 7, 1995

The Nunn-Domenici USA Tax is unique among the many attractive proposals for reforming the federal tax structure. It alone promotes economic growth and simplification without sacrificing fairness. Let us analyze the major alternatives in the light of these three goals: growth, simplification, and fairness.

Encouraging Saving, Investment, and Economic Growth

The Nunn-Domenici USA Tax reduces the tax burden on saving and investment. The intent is to encourage a higher rate of capital formation and a more rapidly growing economy.

Under the Nunn-Domenici approach, the basic way for taxpayers to reduce their tax liability — legally — is for individuals and families to save more and for companies to invest more. This tax treatment provides a powerful and direct incentive to engage in activities that will promote economic growth. Yet the decision on how much to save or invest — and in what form — is not made by the government, but by the taxpayer.

A consumption-based tax like the USA Tax Plan puts the fiscal burden on what people take from society — the goods and services they consume. Traditional income taxes penalize taxpayers for what they contribute to society by working and saving. Under this proposal and over a period of time, Americans are likely to achieve higher levels of *both* saving and consumption. This is so because the added investment, by generating a faster growing economy, will lead to higher levels of income — enabling taxpayers both to save more and to consume more, if that is what they want to do.

Fundamental tax reform is necessary because the United States devotes a smaller fraction of its national output to saving and investment than the other major industrial nations. This hurts economic growth because there is a very close relationship between the investment share of GDP and the growth rate of the economy. This close relationship between investment and growth has held true for the major industrialized nations over the past three decades.

A faster rate of economic growth also automatically generates two favorable budgetary consequences: more revenue into the Treasury and fewer payments for unemployment benefits, welfare, and other entitlements. That is the most painless way of bringing down the deficit.

In addition, by adopting a territorial approach, the USA Tax Plan eliminates the business tax on exports from the United States and imposes it on imports into the United States. Any effect on our foreign trade position will be to reduce our trade deficit.

Promoting Simplification

The Nunn-Domenici plan also simplifies the tax system. It eliminates about 75 percent of the income tax provisions in the Internal Revenue Code. The code is reduced from several thousand pages to about three hundred.

By making all saving deductible from gross income, there is no need for the paperwork and overhead expenses now required for IRAs, Keoghs, SEPs, and other "tax favored" accounts. Uncle Sam will no longer tell the taxpayer how much to save or in what form.

Similarly, by expensing investment, the business taxpayer no longer has to estimate the useful life of assets nor choose from an array of complicated depreciation systems. Also, there is little incentive to fuss with the conversion of ordinary income into capital gains because only the income actually consumed winds up in the tax base. Tax is deferred on capital gains, dividends, interest, and other forms of income that remain in the pool of savings.

Murray Weidenbaum is Chairman of the Center for the Study of American Business and Mallinckrodt Distinguished University Professor at Washington University in St. Louis. He has served as an Assistant Secretary of the Treasury and Chairman of the President's Council of Economic Advisers. The views expressed are strictly personal.

Because all businesses — whether incorporated or not — are subject to one and the same tax system, there is no incentive to go through the expense and bother of changing the legal form of the enterprise merely to take advantage of shifting differentials between individual and corporate tax rates.

Likewise, because interest and dividends are subject to the same tax treatment, there is no longer any tax incentive to leverage a company's financial structure or to convert dividend payments into interest payments. This will not end the merger boom, but businesses will take such actions on the basis of economic advantages — not tax considerations.

Maintaining Fairness

Economists view the fairness of a tax system in terms of horizontal equity and vertical equity. Horizontal equity is simply "equal treatment of equals." The idea is that taxpayers with similar incomes should generally pay the same amount in taxes.

The Nunn-Domenici USA Tax Plan increases horizontal equity in many ways. For individual taxpayers, virtually all types of income are treated the same, as is all forms of saving. In the case of businesses, all enterprises — corporations, partnerships, and individual proprietorships — are subject to a single tax system. Likewise, all capital investment is treated equally, as is the return on financial investment (e.g., interest versus dividends).

As for vertical equity, a progressive rate structure is usually chosen as the appropriate way of achieving this aspect of fairness. The Nunn-Domenici rate structure is clearly progressive. It contains three rates.

Nunn-Domenici and the Flat Tax

How does the USA Tax Plan compare with the other tax proposals? The most popular alternative is Representative Dick Armey's flat tax. Other current proposals include a national sales tax and a VAT.

It is fashionable to focus on the differences between Nunn-Domenici and the Flat Tax — and they exist. I, however, am struck by their similarities.

Both tax reforms promote economic growth by putting more of the tax burden on consumption, and lightening it on saving. Both expense investment. Both simplify the tax system and reduce the role of government in private decision making. Neither requires an additional record-keeping apparatus or enforcement system because neither creates a new tax. Both are "direct" taxes, paid by the taxpayer to the Treasury. By avoiding the form of a sales tax or VAT, neither is regressive or inflationary. Thus, either would be a substantial improvement over the status quo.

We can compare the progressivity of different tax structures by computing the ratio of the top rate to the bottom rate. By this standard, most of the move from a highly progressive rate structure to a flat tax already has occurred. In 1980, the top rate of 70 percent was five times as high as the bottom rate of 14 percent. By 1987, the ratio of the top rate to the bottom rate was down from 5.0 to 3.5. By 1994, it fell to 2.6. Under Nunn-Domenici, this measure of progressivity drops further to 2.1 (the ratio for the Flat Tax is 1.0).

Sales Taxes and the VAT

Sales taxes and value-added taxes represent a very different approach to raising revenue. They are levied on individual purchases. Hence, both are "indirect" taxes, whose amount is hidden from the taxpayer. As a result, both require a new record-keeping apparatus for business and a new collection system for government. The version that provides refunds for low-income people also requires continuing some variation of the present record-keeping arrangements as well as auditing by the IRS.

Because both the retail sales tax and the VAT are levied on individual transactions, they are included in the price of goods and services. Their introduction triggers an upward movement in the CPI and other measures of inflation. So does any future increase in the rates of either tax.

Because people with higher incomes tend to consume a smaller portion of their income than people with lower incomes, both proportional rate sales taxes and VATs are regressive. Efforts to reduce this regressivity require complicated adjustments and provide unintended loopholes.

Collecting the VAT is not simple. Exemptions are no minor matter. In France, an extensive debate occurred over whether Head and Shoulders anti-dandruff shampoo was a tax-exempt medicine or a cosmetic subject to the full VAT.

Conclusion

In their fundamentals, Nunn-Domenici and the Flat Tax are closely related. Both promote capital formation and economic growth, and move toward greater simplification of the tax system. Both reduce the current progressive nature of the federal income tax. The

Flat Tax provides somewhat more simplification at the expense of a loss of fairness (as measured by progressivity or vertical equity). In contrast, value-added or sales taxes generate a new array of problems, ranging from increasing inflation to new paperwork requirements to a regressive tax structure.

Therefore, I conclude that — among the different approaches to fundamental tax reform currently under consideration — the Nunn-Domenici USA Tax is the most attractive. Its structure provides the most favorable combination of simplification, economic incentive, and fairness. Moreover, the USA Tax simultaneously reduces the role of the federal government in personal and business decisionmaking and enhances the international competitiveness of the American economy.

Mr. CHRISTENSEN. Thank you, Dr. Weidenbaum.
Dr. Penner.

STATEMENT OF RUDOLPH G. PENNER, PH.D., MANAGING DIRECTOR, BARENTS GROUP, LLC, KPMG PEAT MARWICK

Mr. PENNER. Thank you, Mr. Chairman. I appreciate the opportunity to testify on some of the economic impacts of the U.S.A. tax. I will confine my remarks to our effort to design the tax to impose the same personal payroll and business tax burdens on different income classes as are imposed by the current tax system and to assess the effects of the tax on private saving and the macroeconomy.

It should first be noted that there is nothing sacred about the distribution of the tax burden applied by current law. Whether it is judged to be too progressive, too regressive, or just right is largely a matter of political values. To avoid arguing about progressivity, initially, the U.S.A. tax attempts to start where we are now and to design a system that approximates the current distribution of the tax burden.

Now, any effort to design a new tax to emulate the distributional impact of the current tax system is fraught with a number of conceptual and empirical difficulties. The Committee should clearly understand that the distributional tables that play such an important role in the political debates over any tax reform are largely based on black magic.

Saying that our proposed system has the same distributional effects as the current system presumes that we understand the distributional impact of the current system, and that is a statement more of faith than reality. The most difficult challenge is understanding the impact of the current corporate tax.

We know that there is not an abstract being called business that can bear a tax burden. Tax burdens must be borne by living, breathing people. But which people bear the current corporate tax? Is it shareholders, owners of all capital, employees, all wage earners, or buyers of corporate products?

One of the many issues related to this question is how mobile capital is internationally. If capital were perfectly mobile, it would flee any increase in a U.S. tax, thus reducing U.S. worker productivity. The end result would be that the corporate tax would turn into a tax on wages.

In our analysis, we assume that capital is highly mobile internationally but that international capital markets are not quite perfect. Because of this belief, we distribute the corporate tax burden on wages and capital incomes in proportion to their importance in the economy. We think that this is a reasonable judgment but wouldn't be surprised to find that others make other judgments. We do not, however, think it reasonable to assume that the current corporate tax rests entirely on capital income.

In designing the rate structure of the new tax, we are also hampered by our ignorance regarding the saving behavior of different income groups. This is obviously crucially important in deciding the distributional implications of a tax reform that allows the full deduction of saving from the tax base. The distribution of savings by income groups shown in survey data collected by the Bureau of Labor Statistics is quite different than that shown in surveys done

by the Federal Reserve System. In our analysis, we chose to rely more heavily on the Federal Reserve System's data simply because it looked more reasonable.

Now, because distributional analyses and the tables that they produce are so unreliable, it may be better to ignore them and start afresh when designing a new tax system. Admitting the distributional uncertainty, one might simply ask whether the new tax structure seems, on the surface, to have found the proper tradeoff between equity, efficiency, and administrative feasibility. In other words, does our top rate of 40 percent pass this test, and do our exemptions and family allowances seem reasonable? We think that they do, even though the distributional consequences cannot be estimated with precision.

Tax reforms that ease the burden on saving are often criticized for two opposite reasons. Many economists are skeptical that there will be a significant improvement in saving, and they, therefore, conclude that tax reform is not worth it. On the other hand, noneconomists often argue that the increase in saving and the implied reduction in consumption will be so large that the economy will be shocked into recession.

The skepticism of economists rests in part on the disappointing results of various marginal rate cuts and savings incentives tried in the eighties. However, there is little similarity between these policies and the reform implied by the U.S.A. tax.

There are good, theoretical reasons for the apparent failure of the initiatives of the early eighties on which I elaborate in my complete testimony. A major difference between the early eighties marginal rate cuts and the U.S.A. tax is that you did not have to save more in the eighties to get a tax cut. For the typical taxpayer under a U.S.A. tax, they will only get a tax cut if they save more.

Another important point is that since the same tax is extracted from each income group, there will be some redistribution of aftertax income within income groups. Those with a higher than average propensity to save within an income group will gain relatively, and they can be expected to save a disproportionate share of this gain. In contrast, those with a higher than average propensity to spend will face a relatively higher tax burden, and it is probable that they will pay this higher tax by reducing their consumption disproportionately.

This redistribution within income groups should, itself, raise aggregate savings significantly. Could it go up too much? I very much doubt it, Mr. Chairman. Saving is so low in this country right now that a huge, proportionate increase in the savings rate implies a very, very small fall in consumption that can easily be handled by the Federal Reserve System.

Thank you.

[The prepared statement follows:]

TESTIMONY OF RUDOLPH G. PENNER
BARENTS GROUP, LLC OF KPMG PEAT MARWICK

Mr. Chairman, members of the committee, thank you for the opportunity to testify on some of the economic impacts of the USA tax. I shall confine my remarks to our efforts to design the tax to impose the same personal income, payroll, and business tax burdens on different income classes as are imposed by the current tax system and to assess the effects of the tax on private saving and the macro economy.

Distributional Questions

It should first be noted that there is nothing sacred about the distribution of the tax burden implied by current law. Whether it is judged to be too progressive, too regressive or just right is largely a matter of political values. There does, however, seem to be a very broad consensus that our tax system should contain a considerable degree of progression. Even the so-called flat tax is highly progressive, because its generous exemptions and tax-free amounts cause the average tax burden to rise rapidly over a wide range of the income distribution.

On the other side, it is widely recognized that a tax system that is too progressive can sap economic incentives and be difficult to administer as taxpayers try mightily to avoid and evade very high marginal rates of taxation.

There is, however, wide disagreement as to the relative importance that should be attached to the goals of equity, economic efficiency, and administrative feasibility. Consequently, there are intense conflicts over the appropriate degree of progressivity of the tax system.

In the hope of muting that argument initially, the USA tax attempts to start where we are now and to design a system that approximates the current distribution of the tax burden. It must be emphasized, however, that the most important conceptual reform contained in the USA tax is the redefinition of the tax base that allows the deduction of saving from income. Technically, there is no problem with combining the new definition of the tax base with a great variety of tax rate structures including a flat tax.

Any effort to design a new tax to emulate the distributional impact of the current tax system is fraught with a number of severe conceptual and empirical difficulties. The Committee should clearly understand that the distributional tables that play such an important role in the political debates over any tax reform are largely based on black magic. Saying that our proposed system has the same distributional effects as the current system presumes that we understand the distributional impact of the current system and that is a statement more of faith than reality.

The most difficult challenge is understanding the impact of the current corporate tax. We know that there is not an abstract being called business that can bear a tax burden. Tax burdens must be borne by living, breathing people. But which people bear the current corporate tax? Is it shareholders, owners of all capital, employees, all wage earners, or buyers of corporate products?

The current corporate tax is difficult to analyze, because it is difficult to characterize. Economists generally regard it to be a tax on capital invested in businesses adopting the corporate form of organization. However, the corporate tax is so monstrously complicated with its many credits, excess deductions, limitations on credits and deductions, and the alternative minimum tax that it could contain elements of a consumption tax within its structure. Even if it were a pure tax on corporate capital, its effects would not be crystal clear. The most important issue is how mobile capital is internationally. If capital were perfectly mobile, it would flee any U.S. tax, thus reducing U.S. worker productivity. It would ultimately turn into a tax on wages.

In our analysis, we assume that capital is highly mobile internationally, but that international capital markets are not quite perfect. However, it must be noted that they are becoming more perfect every day from a U.S. perspective as the institutions involved

in moving capital around the globe improve their efficiency and the United States sinks in relative importance as a supplier and demander of capital.

Because of our belief that capital is highly mobile internationally and that the current corporate tax contains some elements of a consumption tax, we distribute its burden to wages and capital incomes in proportion to their importance in the economy. We think this a reasonable judgment, but would not be surprised to find that others make other judgments. We do not, however, think it reasonable to assume that the current corporate tax rests entirely on capital income.

It should be noted that because of the conceptual problems involved in trying to distribute the corporate tax, the Joint Tax Committee has given up trying and just ignores it. We do not believe that we can do that since we are substituting one important business tax for another.

In designing the rate structure for the new tax, we were also hampered by our ignorance regarding the saving behavior of different income groups. This is obviously crucially important in deciding the distributional implications of a tax reform that allows the full deduction of saving from the tax base.

The distributions of saving by income group shown by the Bureau of Labor Statistics Consumer Expenditure Survey (CES) and that implied by balance sheet data in that survey and in the Federal Reserve s Survey of Consumer Finances (SCF) are very different. All these surveys contain highly implausible results for particular individual records. The CES indicates that consumption exceeds income by huge amounts at the bottom of the income distribution. Some dissaving is quite plausible when income declines temporarily, but the amounts of dissaving shown in the CES defy the imagination. In contrast, data from the SCF imply that some individuals save more than 100 percent of their income and we know that is logically impossible.

In determining the distribution of saving by income class that we would use, we relied heavily on balance sheet data to distribute saving across income classes while using the CES information to distribute saving within income classes. The latter distribution was important in making revenue estimates.

I have noted but two of a very large number of problems involving the estimation of the distributions of the tax burden implied by current law and the USA tax. Other analysts may claim that the results of the tax structure based on our assumptions and analysis may be more or less progressive than that implied by the current system. That is understandable, but beware of anyone claiming to have found truth in these matters.

Because distribution analyses and the tables that they produce are so unreliable, it may be better to ignore them and start afresh when designing a new tax system. Admitting the distributional uncertainty, one might simply ask whether the new tax structure seems, on the surface, to have found the proper tradeoff between equity, efficiency and administrative feasibility. In other words, does our top rate of 40 percent pass this test and do our exemptions and family allowances seem reasonable? We think that they do, even though their distributional consequences cannot be estimated with precision.

The Impact on Saving

Tax reforms, such as that implied by the USA tax, are often criticized for two opposite reasons. Many economists are skeptical that there will be a significant improvement in saving and they, therefore, conclude that the tax reform is not worth it. On the other hand, non-economists often argue that the increase in saving and the implied reduction in consumption will be so large that the economy will be shocked into recession.

The skepticism of economists rests, in part, on the disappointing results of various marginal rate cuts and saving incentives tried in the 1980s. However, there is little similarity between those policies and the reform implied by the USA tax.

There are good theoretical reasons for the apparent failure of the initiatives of the early 1980s. Initiatives such as IRAs were limited in scope applying only to the first $2,000 of saving and that had to be for retirement. Most saving comes from people who save more than $2,000 and for them, the IRA provided no extra incentive to save.

Moreover, because the incentive only applied to one type of saving, it was easy to enjoy by moving funds from one account to another. I do not mean to imply that the incentive was totally ineffective. Academics still argue over that issue. However, it is not surprising that the success of IRAs was not overwhelming. In contrast, the IRAs provided by the USA tax are unlimited and provide incentives for all savers regardless of the amount that they save or the purpose of their saving.

The marginal rate cuts of the early 1980s were straight tax cuts. As such, they had two effects that would be expected to have opposite impacts on saving. They increased the reward to saving, which would be expected to increase it. They also increased people's after-tax income and that might make them wish to consume more, both in the present and the future. To the extent that they wanted to use their increased income to consume more immediately that would tend to reduce saving. Put another way, individuals did not have to save more to get a tax cut.

The USA tax proposal does not provide an overall tax cut. It substitutes a new tax for the present system and the new tax raises the same amount of revenue. The average taxpayer is no better off than before, and therefore, he or she cannot consume more in both present and future. The only change in incentives that an average taxpayer faces is a higher reward for saving and the only way to get a tax cut is to save more.

Since the same tax is extracted from each income group, there will be some redistribution of after-tax income within income groups. Those with a higher than average propensity to save within an income group will gain relatively and they can be expected to save a disproportionate share of this gain. In contrast, those with a higher than average propensity to spend will face a relatively higher tax burden and it is probable that they will pay this higher tax by reducing their consumption disproportionately. This redistribution within income groups should itself raise aggregate saving significantly.

What about the fear that the tax will be too successful and raise aggregate saving so much that the implied fall in the production of consumption goods causes a recession and rising unemployment? It is important to remember that the USA tax not only provides an increased incentive for saving. The business tax reforms provide an increased incentive for investment as well by allowing expensing. Consequently, the increased production of investment goods will make up for the decreased production of consumption goods. The planned increase in investment and reduction in consumption need not match exactly, but any residual net impact on the economy should be relatively small and well within the capability of the Federal Reserve to smooth out.

The net shock is likely to be small because saving is today such a small portion of disposable income. It has risen recently and let us optimistically assume that saving is running at 5 percent of disposable income when the new tax is implemented. A 20 percent increase in saving would then translate into less than a 1.1 percent fall in consumption, a tiny shock even if investment did not increase at all.

It seems clear that fears that saving will not go up or will go up too much are both misplaced. It does not seem unreasonable to forecast a Goldilocks effect. That is to say, the increase in saving will be just right .

Mr. CHRISTENSEN. Thank you, Dr. Penner.
Dr. Rogstad.

STATEMENT OF BARRY K. ROGSTAD, PH.D., PRESIDENT, AMERICAN BUSINESS CONFERENCE

Mr. ROGSTAD. Thank you, Mr. Chairman. On behalf of the members of the American Business Conference, may I congratulate the Committee for holding these hearings and for the opportunity to appear before you today.

In expressing my support and the support of my members for S. 722, I do not suggest that we see S. 722 as somehow in competition with other proposals for fundamental tax reform. This is not a horserace or a beauty contest; this is a serious discussion about our economy and its tax system.

As an economist, I find much to admire about all the major proposals that this Committee is in the process of examining. We are at the beginning of a national discussion, not at the end. We should not foreclose any possible avenue for intelligent tax reform.

I have been involved in the S. 722 proposal for over 5 years, and I have never been more convinced of the merits of a properly conceived tax reform proposal than I am at the present time. If I could, I would just like to limit my comments to three aspects of the proposal.

First, with respect to the all-important issue of saving. Everyone else that has appeared before you on this panel, and Senators Nunn and Domenici, have noted that part of our saving problem is tax driven. The current income tax is biased against saving in favor of consumption. S. 722 removes that bias by seeking to tax every dollar once and only once.

S. 722 does not, and I think this is the key point, offer a subsidy to saving. It merely removes the double taxation on saving that now occurs. Please note that in offering an unlimited, unrestricted tax deferral on saving, S. 722 would give wage earners a control over their tax liability now enjoyed only by the rich. Simply by saving more, all people can control the size of their tax obligation each year, and because the deferral is frontloaded, that is, the tax advantages of saving are enjoyed when the saving occurs, S. 722 addresses the cash flow restrictions of middle-income citizens who now believe they do not have enough money to save.

I think that if we are to improve the level of personal savings, the act of saving itself must be more than an afterthought, it must become a higher priority.

I also believe that there is a critical link between the U.S.A. individual tax proposal and entitlement reform. As Congress considers reducing the rate of growth in nonmeans tested entitlement programs, it is fair to ask whether citizens are adequately empowered to do more to provide for themselves. The unlimited, unrestricted deferral of saving offered by S. 722 would provide a powerful tool with which responsible citizens could more ably provide for future requirements such as health care, education expenses, or retirement.

I do not say that Congress should replace nonmeans tested entitlement programs with S. 722. I do say that S. 722, with its sav-

ings deferral, might make slowing the growth of such programs as politically feasible as it is economically desirable.

If I could make a comment with respect to capital gains. I represent growth companies that are very dependent on equity financing. This is so because they tend to be knowledge intensive, which means they have little collateral upon which to borrow. That raises the cost of capital for growth companies because the current Tax Code favors borrowing over equity investment.

This is not news to this Committee. You have long recognized that equity investment is handicapped. You have urged enactment of a substantial capital gains differential to correct this problem. You have quite properly recognized that a differential would lower the cost of equity capital, facilitate the "unlocking" of current investment, thereby encouraging a more efficient allocation of saving, and promote a long-term perspective on the part of savers and investors by encouraging rollover of assets.

We support a capital gains differential. Nonetheless, we believe that S. 722 would provide a more comprehensive framework to deal with the capital gains issue.

Finally, if I might, I would like to just comment on its feasibility. In introducing S. 722, Senators Domenici and Nunn have proven that their concept for fundamental tax reform is technically possible. The very gratifying reaction to their legislation may already suggest that it is politically feasible as well. Beyond business groups such as my own, other organizations that in the past have defined their tax ideas largely in opposition to the business community have found much to praise in S. 722.

I am hardly the person to make political prognostications, but it does seem to me that S. 722 is promising specifically because it scrambles the usual battle lines on tax reform. It is instead a proposal to create an efficient and intelligent tax system, and it takes advantage of a very rare confluence in public policy of individual and national interest. It is imperative in my judgment that we not lose sight of the opportunity for large and constructive change that faces us at this moment.

I would be happy to answer any questions you may have. Thank you.

[The prepared statement follows:]

TESTIMONY OF BARRY K. ROGSTAD
AMERICAN BUSINESS CONFERENCE

Mr. Chairman and Members of the Committee:

I am Barry Rogstad an economist and president of the American Business Conference (ABC). ABC is a nonpartisan coalition of chief executives of fast-growing midsize companies. As you may recall, three of our members, Dr. George Hatsopoulos, James Hoak, and James Mann appeared before this Committee earlier this year.

I applaud your decision to hold three days of hearings on fundamental tax reform. May this sort of open and honest forum, dedicated to public education, be replicated in other committee rooms of Congress and in towns and cities across the country.

I am here today to discuss a comprehensive tax reform proposal to stimulate economic growth: S. 722, the USA Tax Act of 1995 which was introduced by Senators Pete Domenici and Sam Nunn last April 25.

In expressing my support and the support of my members for S. 722, I do not suggest that we see S. 722 as somehow in competition with other proposals for fundamental tax reform. This is not a horse race or a beauty contest; this is a serious discussion about our economy and its tax system. As an economist, I find much to admire in all the major proposals that this Committee is in the process of examining. We are at the beginning of a national discussion, not at the end. We should not foreclose any possible avenue for intelligent tax reform.

In that regard, I believe Senators Domenici and Nunn have performed a service by offering their proposal in a form that is fully articulated and therefore susceptible to sustained and detailed inspection.

S. 722 specifies a rate structure and the assumptions behind it, tackles the thorny problem of transition, and addresses the inevitable complexities inherent in our enormous and dynamic economy. To their credit, the Senators wrote their bill in plain English. The bill's first title provides an explanation to the American people of why the Senators think fundamental tax reform is necessary. It is an excellent introduction to the macroeconomic problems the nation faces and deserves a large readership.

S. 722 sets a standard of openness and comprehensiveness that proponents of other proposals must match if this Committee is going to be able to decide the appropriate direction for tax policy. Otherwise, comparisons across proposals are not of much use. In S. 722, Senators Domenici and Nunn have provided detailed blueprints for change. It is not a criticism of the ultimate worth of other proposals to note that they, in contrast, remain pinned to their architects' drawing boards.

I.

Any proposal, such as S. 722, to replace the current income tax code with a better alternative immediately raises the old question from World War II: "Is this trip necessary?"

All Americans understand the frustrations inherent in fundamentally changing the way we tax: the difficulty of communicating new ideas, the resistance, including from within the business community, to change, and the ever-present anticipation that good proposals will be sidetracked or stopped entirely. Advocating comprehensive change is to risk death by a thousand cuts.

In my opinion, the rewards of a properly conceived and fundamental tax reform merit the effort. Without offering a comprehensive exposition of the USA Tax System, I would like to touch on aspects of the proposal that demonstrate its great promise for the country.

Saving In its essence, the Domenici/Nunn proposal is an integrated tax that defers all new saving by individuals and permits immediate expensing for all new business investment.

Saving and investment, are the indispensable seed corn with which we create future growth and, therefore, a higher level of future consumption. We need a tax system that does not penalize saving and investment and that insures the best possible allocation of our saving for productive investment.

As you know, the United States has an abysmally low level of national saving. That low level is in part the result of our chronic federal budget deficits, which we all hope the current budget process will address.

But part of our saving problem is tax-driven. The current income tax is biased against saving in favor of consumption. S. 722 removes that bias by seeking to tax every dollar once and only once. S. 722 does not -- and this is a key point -- offer a subsidy to saving; it merely removes the double taxation on saving that now occurs.

Please note that in offering an unlimited, unrestricted tax deferral on saving, S. 722 would give wage earners a control over their tax liability now enjoyed only by the rich. Simply by saving more, people can control the size of their tax obligation each year.

Because the deferral is front-loaded -- that is, the tax advantages of saving are enjoyed when the saving occurs -- S. 722 addresses the cash-flow restrictions of middle income citizens who now believe they do not have enough money to save. If we are to improve the level of personal saving, the act of saving itself must be more than an afterthought. It must become a higher priority. In terms of changing saving behavior, the up-front deferral of taxes on saving seems to me a far more promising approach than patronizing lectures to John and Jane Doe regarding how they should use their money. It is also more consonant with our national idea of individual economic freedom.

I believe that there is a critical link between the USA Individual Tax proposal and entitlement reform. As Congress considers reducing the rate of growth in non-means tested entitlement programs, it is fair to ask whether citizens are adequately empowered to do more to provide for themselves.

The unlimited, unrestricted deferral of saving offered by S. 722 would provide a powerful tool with which responsible citizens could more ably provide for future exigencies such as health care, education expenses, or retirement. I do not say that Congress should replace non-means tested entitlement programs with S. 722. I do say that S. 722, with its saving deferral, might make slowing the growth of such programs as politically feasible as it is economically desirable.

Capital Gains I represent growth companies that are very dependent on equity financing. This is so because they tend to be knowledge-intensive which means they have little collateral upon which to borrow. That raises the cost of capital for growth companies because the current tax code favors borrowing over equity investment.

This is not news to this Committee. You have long recognized that equity investment is handicapped. You have urged enactment of a substantial capital gains tax differential to correct the problem. You have quite properly recognized that a differential would lower the cost of equity capital, facilitate the "unlocking" of current investment, thereby encouraging a more efficient allocation of saving, and promote a long-term perspective on the part of savers and investors by encouraging rollover of assets.

ABC supports a capital gains tax differential. We nonetheless believe that S. 722 would provide a more comprehensive framework to deal with capital gains. Under the Domenici/Nunn proposal, capital gains would not be taxed until they were realized and used for consumption. All returns on investment would remain untaxed for as long as those returns remained in saving. Selling a share of stock of one company and using the proceeds to buy stock in another would thus not be a taxable event.

S. 722, because it does not distinguish between equity and debt financing ends the bias in the current code. Its saving deduction does not tax the "unlocking" of existing assets for the purpose of new investment. It allows unlimited rollover. And, most important, it does not limit the tax advantages of saving to capital income. It allows wage earners with a savings account to enjoy the same deferral as those with extensive stock portfolios.

Investment Investment is the mirror-image of saving. Absent inflows of foreign capital, the amount of investment that can occur is dependent upon the amount of available saving.

Like other proposals before this Committee, S. 722 does not tax business investment. To that end, it would allow the immediate expensing of all real business investment. Such investment is necessary to raise employee productivity. Productivity gains are the only way over time to raise our standard of living.

To insure balance in the treatment of capital and labor, Senators Domenici and Nunn recognized that they had to provide some allowance for investment in people. That is why they included on the individual side of S. 722 a deduction for tuition paid for higher education. That deduction acknowledges that people are more productive with higher levels of education and training much as they are more productive when working with new and better equipment.

International Implications The USA Business Tax is territorial. An American-based business would not include in its gross tax base the proceeds from sales made by subsidiaries outside the United States. It would also not deduct the purchase of goods or services outside the United States. For their part, foreign businesses with a commercial presence in this country would include in their tax base amounts received for goods sold or services provided in the United States and would subtract amounts paid for goods acquired and services provided in the United States.

For an American company, territoriality would free entrepreneurs to base their international strategies on business opportunities rather than on tax considerations. From a public policy standpoint, it would rid the code of such vexing issues as the tax implications of transfer pricing and PFICs, vastly simplifying the tax structure and, not incidentally, your agenda.

The USA Business Tax is also border adjustable. Goods made here and shipped abroad would receive a tax rebate. Goods made abroad and imported and sold in the United States would be subject to tax. This provision would align the tax system of the United States with that of most of our major trading partners while insuring that all products sold in this country carried their appropriate share of the tax burden.

Complexity Questions about the complexity of the USA Tax System invariably beg the question, "Compared to what?" When contrasted to the current individual and corporate income taxes, the USA Tax System clearly and unequivocally offers large gains in simplicity.

By taxing all businesses -- corporations, partnerships, limited liability companies, and unincorporated proprietorships -- the same, the USA Business Tax eliminates the false and unwieldy distinctions the current code makes among business enterprises. By moving from accrual accounting toward cash flow accounting, the USA Business Tax eliminates the maze of complexities and the high compliance costs which businesses now face. And because the USA Individual Tax permits an unlimited and unrestricted deferral for saving, the USA Business Tax would not have to deal with nonproductive or superfluous business arrangements designed to avoid the personal income tax.

For its part, the USA Individual Tax requires no new tax bureaucracy. Taxes would continue to be due on April 15 and there would be withholding. The individual tax form, while vastly simplified, would still be familiar to taxpayers. There would be no new record-keeping burden since information about net changes in saving behavior is already collected to permit the interest calculations in Form 1099.

Now, it is true that the Individual Tax's progressive structure is inherently less simple than a flat rate structure. And, beyond the saving deduction, the USA Individual Tax does include several other deductions such as one for home mortgage interest. I happen to believe that a progressive structure is desirable but would add that, in any event, S. 722 could easily accommodate a flat rate structure if Congress thought it wise. As for the deductions, they are few in number and again, if Congress so chose, could be eliminated.

As for comparisons of the USA Tax System with the avowed simplicity of other major tax reform proposals, I am not sure such contrasts are at this point possible. Only until those alternative proposals are fully fleshed out, complete with transition measures, will we be able to draw meaningful distinctions.

Feasibility In introducing S. 722, Senators Domenici and Nunn have proven that their concept for fundamental tax reform is technically possible. The very gratifying reaction to their legislation may already suggest that it is politically feasible as well. Beyond business groups such as my own, other organizations that in the past have defined their tax ideas largely in opposition to the business community, have found much to praise in S. 722.

I am hardly the person to make political prognostications. But it does seem to me that S. 722 is promising specifically because it scrambles the usual battle lines on tax reform. This is not a conservative or a liberal proposal. It is instead a proposal to create an efficient, intelligent tax system. It takes advantage of a very rare confluence in public policy of individual and national interest. I think this latter point was made best by Senator Robert Kerrey when he and Senator Robert Bennett announced their decision to be co-sponsors of S. 722:

> Mr. President, to be clear, there are not very many situations where the interest of the individual and the interest of the Nation intersect, where they are the same....With savings, there is an intersection. It is in the interest of American families to acquire and accumulate wealth. It is in the interest of the Nation to do the same. Unless both the individual has an incentive to save and the Nation has the discipline to save, then the standard of living of the United States of America simply will not rise. (Congressional Record, April 25, 1995, p. S. 5671)

This, it seems to me, is the essential matter. It explains why fundamental tax reform is both necessary and possible. As this Committee and the Congress address the merits of the various tax reform proposals, it is imperative that you not lose sight of this opportunity for large and constructive change.

I would be happy to answer any questions you may have.

Mr. CHRISTENSEN. Thank you, Dr. Rogstad.

My question would be for Dr. Weidenbaum.

We heard Senator Domenici and Senator Nunn say that their U.S.A. tax did not address the underground economy issue. How important do you believe it is that we find a solution to raising revenue from that sector, or is it something that we should not worry about because a couple of the proposals don't address that area?

Obviously, the consumption tax proposal goes after that 20 to 25 percent or do you have a solution on how we could fold that into a Nunn-Domenici U.S.A. tax proposal?

Mr. WEIDENBAUM. No, I don't. And, very frankly, I am skeptical of expecting much change in the underground economy from any of the tax plans that have been or will be presented later this week to this Committee. I think that the fundamental incentives to go or stay underground are still very much there, and if you raise the tax on legal purchases, if anything, you are going to increase the incentive for shady characters to go underground more than they do today.

Mr. CHRISTENSEN. Any other comments? Mr. Christian, a comment on that?

Mr. CHRISTIAN. I would agree with Dr. Weidenbaum. I don't think the U.S.A. tax or any tax on income addresses the underground economy any more than the present tax system addresses it. As Mr. Gibbons and I and others have talked about for many years, it may be that some portion of the present corporate income tax is embedded in the price of goods.

No one knows what it is. If it is there, the people who are buying things, whether they are legal or illegal, are paying it. Other taxes have various portions of them that are embedded in the price of goods. Other portions go back to labor factors that produce things, and other portions go back to capital factors. Again, no one knows what those proportions are.

I would share in what Dr. Weidenbaum says. I am not at all sure, either administratively or as a matter of fundamental economics, in the end that there is any way to deal with the concern about the underground economy.

Mr. CHRISTENSEN. So you would disagree with the premise, then, that the consumption tax or the national sales tax would pick up a significant portion of that underground economy or would you have any other thoughts on that? Because, I mean, there has been testimony already that the national sales tax would pick up a significant portion of that economy.

Dr. Penner, Dr. Rogstad.

Mr. ROGSTAD. I would just observe that I think over time that that premise may not stand up.

I have another concern here that I would like to surface. I think our entire system of government and our payment of taxes is based on voluntary compliance by our citizens, and whatever we do in terms of fundamental tax restructuring, we should not lose sight of that underlying philosophy that is so key to our system of government. This is a very important perspective to keep in play here.

Mr. PENNER. I would just point out, Mr. Chairman, that there is, in fact, a lot of evasion of State sales tax. There is enormous evasion of the VAT in Europe, particularly in Italy where they don't

seem to want to pay any taxes at all. So that certainly is not a sure-fire solution to the problem.

Mr. CHRISTENSEN. One of the aspects of the consumption tax that has been touted is that it would pick up that part of the economy. That is one of the things that has been touted highly over the flat tax.

I like the flat tax idea because of the simplicity. I think the U.S.A. tax doesn't match the flat tax when it comes to simplicity. It may when it comes to fairness and efficiency. What would you, in your opinions, believe that the main drawback of the flat tax would be? We will be having testimony tomorrow on that issue. What are some things in your opinion that cause the flat tax to be second or third in your ranking?

Mr. WEIDENBAUM. A couple of things. First of all, it doesn't give a direct incentive to saving the way the U.S.A. tax does where a dollar saving is a dollar less of taxable income. It is only the interest and dividends on your saving that gets the benefit of being exempt from the flat tax. And also, as I understand it, not one tax return, but 12 monthly tax returns are due under the flat tax, together with 12 checks from each taxpayer a year. That I think presents a difficult enforcement challenge to the IRS.

Mr. CHRISTIAN. Mr. Christensen, I think that the flat tax would be vastly better than present law, but in answer to your question, I would list the following: Under the flat tax regime, if that became the tax law of the United States, there would be no line on the individual tax return, for all of the vast number of American people, for interest, dividends or capital gains. The only line on that tax return would be for wages. I question whether that would be viewed favorably by everyone.

I would reiterate what Dr. Weidenbaum said about the "yield exemption approach," as we call it. Excluding the return on capital is one way of dealing with the bias against savings.

You talked earlier about transition. If you enacted the flat tax today, as it stands, the returns to capital—all existing capital in the United States, all interest, dividends and gains in the future would be outside the tax system insofar as the individual tax under the flat tax is concerned. That is unrelated to new savings occurring in the United States.

Mr. PENNER. I think I would add, Mr. Chairman, that because, as Mr. Christian said, the only thing that appears on the individual's tax return is wages, there would be enormous pressure to try and convey compensation using other means. I think that would immediately make the flat tax very much more complicated than it appears as it is now structured. You would have to worry about what to do with stock options; you would have to worry a lot more about payments in kind of various types. So I think technically it is much harder than it appears on the surface.

Moreover, I just don't think the politics are good. I know that I would get one heck of a big tax cut if this tax were put in effect, and I would enjoy that. But I suspect for everyone that gets a very large tax cut, like me, there will be a very large number of people who get a small tax increase, and I think that is just very bad politics.

Mr. CHRISTIAN. To follow up on what Dr. Penner said. Mr. Gibbons and many others will also perhaps remember this. I remember at the Treasury Department a long time ago when we had distinctions between earned income and unearned income. Now, this flat tax will again reinstitute, in effect, that same distinction. I remember having struggled at the Treasury Department to determine what is the difference between earned income and unearned income.

The famous example, which was in the funny papers for a few years as Mr. Gibbons perhaps remembers, was about a radiologist. The radiologist was in business for himself. Now tell me, what is he earning? Is it capital income or is it his own earnings?

I also share your view about marginal rates. One of the appeals of the flat tax is the low marginal rate. I would point out that the marginal rate under the flat tax, let's say it is 20 percent as now proposed, is not 20 percent on earnings, on work effort as was talked about earlier. The marginal rate under the flat tax is 27.65 percent on earnings, because you must count, in determining the marginal rate of tax on work effort, the employee payroll tax.

Mr. CHRISTENSEN. OK. Mr. Gibbons.

Mr. GIBBONS. Well, I want to start off by saying, first of all, I appreciate the enormous effort that each of you at the table has contributed to the whole discussion and thought of what we do about a future revenue system for the United States. You know, you may go down as unsung heroes in this battle, but I know you have all contributed to it.

Mr. Christensen asked an important question, what is the fatal flaw in the flat tax? And the fatal flaw in it is that it is classified as an income tax and therefore, you cannot adjust it at the international border, and as long as you continue to tax exports and not tax imports, you are going to be exporting jobs from the American economy. Mr. Armey recognizes that. It is a fatal flaw in the flat tax.

You know, you can love the flat tax all you want to, but if you are going to adopt it with a fatal flaw, you just cannot—under the rules that we established starting back in 1947 for world trade, you cannot adjust a flat income tax at the international border. And you are just going to export all of your job opportunities as we are already doing under the income tax.

Now, Dr. Penner and all the rest of you, I need some help. I need to find out how regressive and what is the real tax burden under the current system? Because in step 3 of the revenue system that I propose—you know, in step 1 I repeal all of the income taxes, personal and corporate, and I also repeal all of the FICA payroll tax. That is a lot of—I have repealed a lot of taxes there, almost 1.2 trillion dollars' worth of taxes I have repealed right there; and I have to replace it with a tax. In step 2, I replace it with a value-added tax, raising most of the money. But in step 3, I have got to do something about adjusting the tax burden among income classes.

Now, where is my best information about what the current burden is, and how would you adjust the burden outside of the value-added tax? I wouldn't want to adjust the burden within the value-added tax, because you would get a horribly complicated,

unadministrable value-added tax. You best do it outside of the tax, completely divorced from it.

I think that is really the mistake we made back in the beginning on the income tax; we tried to do social engineering and economic engineering through the income tax, and it became so screwed up, nobody can understand it today. There are a couple of people around here, but that is about all, that can understand it.

How—where do I get my information about what the current burden is? I am using in my calculations the Congressional Budget Office figures. You are familiar with the Congressional Budget Office—I assume you are familiar with the burden figures. What is wrong with them, if anything?

Mr. PENNER. Well, I think the major problem is knowing the distribution of the corporate tax. It has become such an extraordinary monster, so complicated that it defies human understanding. It defies human understanding in knowing what its efficiency effects are, and I think the same with the distributional effects.

The Congressional Budget Office has reacted to that problem by often distributing the corporate tax two different ways—one, putting it entirely on capital; the other, spreading it 50-50 between wages and capital. But those are just guesses. They just give you a range.

The Joint Committee on Taxation recently has decided not to distribute it at all. So that is an extremely difficult problem.

We do distribute it. The burden is distributed according to the importance of different kinds of factor income in the economy. Doing it various other ways doesn't result in a huge change in the kind of marginal tax rates you need under our individual tax to emulate the distribution of the current burden, but it does result in some considerable change.

In answer to your second question, how do you achieve the kind of distribution you want, limited by our ignorance of the distribution of the current tax system, you do have to remember that you can do it on both sides of the ledger. That is to say, if you are not satisfied with the distribution of the tax burden, you can adjust the expenditure side to achieve certain distributional results.

Mr. GIBBONS. You mean through the appropriations process?

Mr. PENNER. Well, it could be through the appropriations process, it could be through entitlements, it could even be through refundable tax credits. For example, Bradburne, one variant of the kind of tax reform that he suggests would simply have essentially all of the tax levied at the business level, but then some portion of that would be taken and distributed to individuals using basically a refundable credit.

Mr. GIBBONS. That is essentially what I do in my proposal. But I am not satisfied with it.

I have to determine what the burden is now, and I realize the corporate tax has always been debatable about who pays the burden of it. In my own thinking, I allocate the whole burden of the corporate tax to the consumer, because I never saw a corporation that stayed in business very long that did pass on all of its expenses on its product. And so I look upon the corporation primarily as a tax accumulator that gets it out of the cost of its product. If it didn't, I reason that it will end up in bankruptcy sooner or later.

Now I see Dr. Weidenbaum shaking his head on that. But the corporate taxes, first of all, are not a large part of all of the taxes we are discussing here, and I don't think we ought to wrangle over the distribution of the corporate tax in the burden figuring. But Dr. Weidenbaum, do you want to comment?

Mr. WEIDENBAUM. Well, Mr. Gibbons, I think you have raised the dilemma in choosing among any of these alternatives for comprehensive tax reform. They have all got some warts, and I think when you get down to the wire, you are going to have to choose the one with the least number of warts, and really go for—for the VAT, for example, or national retail sales tax. I think you just have to accept the fact that it is somewhat regressive, because whether you go the route of some countries' exempt categories—and you have indicated that is an excessive complication—or you go with some kind of refundable credit, you are back—as I point out in my testimony, you are back with IRS auditing tax returns for millions of taxpayers. So that none of these, none of these is going to be perfect.

If you go for a transaction-based tax, whether it is retail sales tax or VAT because of simplification, because of the focus on consumption, I am saying, by definition, then I think you are just going to have to accept the fact that it doesn't help you on income distribution or fairness or equity. But you have no perfect tax alternative.

Mr. GIBBONS. Well, essentially I reason that selling the American public and the Congress any massive tax reform, you are going to have to limit the number of fights you start in all of this. One fight I don't want to get into is massively changing the tax burden between the income categories. So right now I am trying to find out what is the tax burden? Where do I—CBO has issued a burden table, Treasury has a burden table, and the Joint Committee has got a burden table. Who is right?

Mr. WEIDENBAUM. They are all right and they are all wrong, because each of them has a set of reasonable assumptions—not facts, but assumptions—on which the numbers are based; and you could take six honest, competent analysts, put them in six different rooms, and they will come up with six different sets of assumptions, and therefore, come up with six different sets of burden tables, even though each of them is doing as honest a job as they can.

The bottom line here, every analysis that I have ever seen, whether it is done by private organizations or by government agency, convinces me that, on balance, the Federal revenue system is mildly progressive.

Mr. GIBBONS. Yes.

Mr. WEIDENBAUM. So that is the starting point.

Mr. GIBBONS. It is not nearly as regressive as some of the radicals think it is, and it is not nearly as progressive as some of the very conservatives think it is.

Mr. WEIDENBAUM. Yes, sir.

Mr. GIBBONS. It is just mildly progressive.

Well, thank you. Maybe the best solution is to take all of those tables, add them all up, and divide them by three.

Mr. PENNER. Or to ignore them altogether.

Mr. GIBBONS. Or ignore them altogether.

You can't ignore them altogether, because if you do, you are going to have a political battle around here over shifting burden. You have to have some authoritative decision as to what is the current burden.

You know, as I say, I used CBO's burden table. But—yes?

Mr. ROGSTAD. To just add on to your point, Congressman Gibbons, that these tables are sufficiently tenuous that they should not drive the choice of which tax reform proposal you are looking at.

Mr. GIBBONS. I agree with you on that, and I agree with you, how we distribute the corporate tax shouldn't drive the whole thing because it is not that great a part when you compare it to the FICA tax and the personal income tax. Those are huge taxes.

Mr. PENNER. And for what it is worth, Congressman, on those two taxes, economists feel reasonably confident that the personal tax is borne by the people who actually pay it, and both sides of the FICA—employer and employee—are borne by labor.

Mr. GIBBONS. Yes. I think there is general consensus that in the FICA tax—am I correct when I state this—that it all comes out of the cash payment of wages to the employee? Is that right?

Mr. PENNER. That is the general consensus, yes.

Mr. GIBBONS. That is the general consensus amongst economists. OK, fine. Thank you very much.

Mr. CHRISTENSEN. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

Gentlemen, I have just one question, and it is late in the day, but I really need to ask you this question.

I really like this S. 722 proposal. What I need to know for my constituents is, do you believe that the proposal is going to be enough simpler than the current system so that when folks look forward to April 15, or whenever it is, they don't do it with horror; and that they can fill out their own returns, and they can do it without lawyers and CPAs. I am not talking so much about corporations, but individuals. Are we doing the folks a favor processwise as opposed to substantively?

Mr. CHRISTIAN. Yes. I have spent 35 years struggling with the Internal Revenue Code. This, for example, as I hold it up, is the entire income tax of the United States under the S. 722 approach, triple spaced, narrow margins, great big type. I couldn't even lift the present income tax printed in this same way. It would be stacked high up to here.

More directly, the U.S.A. tax has very few moving parts; it has few exceptions and no exceptions to exceptions. I think that the U.S.A. Tax Code is about 30 percent the size of what it is today, in the Internal Revenue Code. A charitable contribution is not complicated. A home mortgage interest deduction is not complicated at all. You take one number off a statement provided to you annually by the mortgage lender and you transfer that one number to a line on a tax return.

I have been for many years one of the most vociferous critics of the Internal Revenue Code of the United States. I have described it in very colorful terms at times, "absurd" being one term that is on the public record quite often. I am confident that the reality of the U.S.A. tax—as it operates with people, as opposed to a percep-

tion—will be quite simple. Filing tax returns is never going to be pleasant, but it is not going to be the annual agony that it is today.

I would make two points, if I may, about dealing with the Internal Revenue Service. Again, I have been very critical, but there are two different kinds of things that happen. One is contact with the Internal Revenue Service, simply filing a return; that is one thing. Some people seem to think that is bad. My concern about the tax law is not just contact; it is what the present tax law does to society and what it does to people's lives. That is, the reason I emphasize so strongly meant I fundamentally believe and know to be the fact—that the U.S.A. tax system will essentially have zero substantive impact one way or another on shaping what people do or don't do. It will let them alone to make free, efficient economic and personal choices.

Ms. DUNN. I thank you for that answer.

Would anybody else like to comment on that, agree or disagree?

Mr. ROGSTAD. I would answer, Congresswoman, yes, again in the strong affirmative. In addition to what Mr. Christian said, I think that taxpayers will not only understand the basis on which they are paying taxes, I think that this is a system that will allow them to understand the basis on which their fellow citizens are paying as well. And I think the notion of raising the level of saving through an unlimited deferral, which is the core of this proposal, will reinforce for people that saving is at the core of our future economic growth. And I think once that becomes the frame of reference, this will be viewed not only as appropriate to ourselves from a compliance standpoint, but one that will facilitate all of us feeling a little more comfortable about the basis on which the whole economy and all of our citizens are being taxed.

Ms. DUNN. It sounds to me—I worry a lot about the disconnect that people feel with government, and I think our current tax system adds to that and doesn't detract from that; and it seems to me that this would be a great big step in the right direction.

I just returned from a trip to some South American countries, including Chile, and on your comment on savings, I mean it is just stunning. It is very good to get out of the country and become a little less nationalistic, and that 25 percent savings rate that they have created for themselves in a brief number of years through the revision and privatization of the pension system is stunning and a great example for us. But it brings home loud and clear how it can make a nation such as Chile self-reliant and not need to go outside for the majority of its capital; and I think we could be doing the same thing if we make the proper choices in the next year or so as we consider this new tax system. Thank you.

Mr. CHRISTENSEN. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Gentlemen, earlier today I asked Secretary Samuels his opinion of the border adjustability of the business side of the U.S.A. tax, and he answered that Treasury hadn't drawn any conclusions on that. Are you confident that the U.S.A. tax is going to be border adjustable?

Mr. Rogstad.

Mr. ROGSTAD. Yes, I am. There are a number of technical issues involved. A basic that we undertook in the fundamental design of

the system with respect to wage deductibility at the business level was directed to ensure border adjustability would stand up in the WTO.

Mr. ENGLISH. Mr. Penner, do you agree with that?

Mr. PENNER. I am certainly not the lawyer here, Mr. English, and I wouldn't want to venture an opinion.

Mr. ENGLISH. Mr. Christian.

Mr. CHRISTIAN. I am absolutely certain of it. If you would like me to explain, I will.

Mr. ENGLISH. Certainly.

Mr. CHRISTIAN. As Senator Domenici said and Senator Nunn said, the U.S.A. tax has been worked on by them for a number of years. That work includes the same issue about border adjustability of this type of a tax which includes at the business level both the labor component of production and the capital component of production. You notice that Les Samuels at the Treasury didn't tell you this morning that he concluded that the U.S.A. tax couldn't be adjusted at the border.

Mr. ENGLISH. Well, he didn't tell me very much, so I——

Mr. CHRISTIAN. In any event, not to prolong the day, but the GATT is a flexible, international instrument of comity as well as a piece of black letter law. I don't have any real doubt. I don't even think there will be a challenge when the U.S.A. tax is enacted, and I am very confident that it would prevail.

Even back in the seventies, to give you an illustration, when the European VAT first came in, there was a real question about whether on a black letter of the law basis the VAT qualified. I would be happy to discuss that with you at some time if you would be interested.

Mr. ENGLISH. I would be delighted.

Mr. CHRISTIAN. The GATT is a flexible instrument, and I think, as a practical matter among adults, that there is no question about it.

Mr. ENGLISH. One of the interesting features of the U.S.A. tax to me was the FICA credit. How important do each of you feel that is to the design?

Mr. PENNER. I think it is extremely important, Mr. English, because, as Mr. Christensen pointed out earlier, if you don't have some kind of credit for the payroll tax, it is a marginal rate on top of whatever else you have. And in our system, you in essence subtract it from the statutory rate. So you get some very low marginal rates at the bottom, which is very important.

Mr. WEIDENBAUM. May I add to that?

Mr. ENGLISH. Certainly.

Mr. WEIDENBAUM. For an awful lot of modest-income, working people, the main Federal tax they pay is not the income tax, but the FICA tax. I think you will do more to ease the financial burden on working people of modest means by enacting this FICA credit than any of the other changes in any of the plans.

Mr. ENGLISH. Well, that is powerful. One of the other issues that I was impressed with in this bill was the effort it makes to make a transition from the existing tax system to the new tax system. Are all of you satisfied that this bill addresses all of those transitional issues, and which ones do you feel are the most important?

Mr. CHRISTIAN. The U.S.A. tax does address them all. It addresses them all adequately. Before Senator Domenici and Senator Nunn began their work on this, there were many people who had thought about the issue of old savings and who thought that it would not be possible to avoid taxing yet again income that had already been taxed. There were many publications in the academic literature to the effect that they didn't think this could be done.

Senators Nunn and Domenici did do it, and I will tell you that their system is very good and it is not a complex system.

On the business side, there are issues with respect to old investment, that is to say, existing investment, that have to be handled. They have a very good way of handling that which is not complex. There is no phase-in here. This tax goes in effect immediately with respect to a taxable year. The only issue is a set of straightforward, highly workable and efficient rules for dealing with the transition you are talking about. The U.S.A. transition rules work like a watch.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. CHRISTENSEN. I thank the panel for staying late into the day. The Committee will stand in recess until 10 o'clock tomorrow morning.

[Whereupon, at 5:45 p.m., the hearing was adjourned, to reconvene at 10 a.m., Thursday, June 8, 1995.]

REPLACING THE FEDERAL INCOME TAX

THURSDAY, JUNE 8, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The Committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

Chairman ARCHER. The Committee will come to order, and I would ask that our guests and staff take their seats and give us an opportunity to be heard.

Today we begin the third and final day of hearings on concepts to replace the current Income Tax Code, and during the balance of the 104th Congress I do intend to hold additional hearings on various aspects of this fundamental exercise.

Yesterday we heard from advocates of two of the alternatives to our tax system, the value-added tax and the U.S.A. tax, and today we are going to hear from those who believe a flat tax is the answer, led by Majority Leader Dick Armey, and those who believe that we should have a national sales tax.

We will also hear from our former colleague Jack Kemp who is chairing the Economic Growth and Tax Reform Commission, but before we do that, we are going to lead off and hear from our colleague, the Ranking Democrat on the Committee, the gentleman from Florida, who has spent a number of years developing an alternative to the current income tax, and has his own plan, and, Sam, I don't know what label you would put on it.

I will let you make that decision. But we are really happy to have you here to make your presentation to the Members of your Committee, so I don't have to welcome you, you are always welcome here.

Mr. GIBBONS. Thank you.

May I yield to the Senator?

Chairman ARCHER. Oh, all right.

Mr. GIBBONS. Would you like to go first, Arlen, because I realize your time is very short.

Chairman ARCHER. Well, we are happy, and of course honored, to have Senator Specter here with us because you have taken the lead in wanting to replace the income tax in your candidacy for the Presidency, and you have an approach that is your own, and we welcome you to the Committee because you are very, very important in developing this debate across the country, and we are pleased to hear your comments and you may proceed.

Senator SPECTER. Well, Mr. Chairman, thank you very much. I am indebted to my colleague for yielding, but I decline. I want to listen to Chairman Gibbons and learn a little before I offer my testimony.

STATEMENT OF HON. SAM GIBBONS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. GIBBONS. Well, I am flattered.

Mr. Chairman, thank you for opening this subject matter. It is something that this Committee should have examined years ago, and I want to apologize to all my colleagues on the Committee for having harassed them for a number of years.

Most recently, I spent a long time harassing the Members at the Austin, Tex. retreat 2 years ago when I finally got some time to explain what I thought ought to replace the current revenue system.

Let me make it clear that I speak only for Sam Gibbons. I do not speak as a spokesman for the Democratic Party or the Democrats on this Committee or the Democrats anywhere. It is not that they have told me they are opposed to this, it is just that I have not tried to seek any specific endorsements from them or from anyone else.

I think we need a discussion, a national discussion, about the situation we are in, and I think we need a solution, and it can only come about if we develop a national consensus. In developing that national consensus, I think we ought to keep our attention focused on some principles.

The first principle I would like to mention is that we ought to seek revenue neutrality in all of this. We should not allow this to become a debate over how big government should be or how much government should spend, and so we ought to hit the test for neutrality. There is a time for that debate, but this is not the time. We are talking about process here.

Second, amongst the fundamental principles of neutrality of revenue is neutrality of burden. In my testimony you will find there on page 4, and I wish you would turn to that page and look at the current tax distribution burden table there. Only with great deference should we attempt to change that burden table. I say that because for about the last 30 years the tax burden amongst Americans as far as income categories is concerned has been approximately that shown on page 4. You will find on page 5 what the burden has been over the last 20 years in those same categories.

You will see there has been very little fluctuation in the burden. Now, I am not saying that the burden that is there exhibited in those Congressional Budget Office tables is magic, but it is the best measure we have of tax burden that I know of. Essentially there are three different versions of this table: One put out by Treasury, one put out by Joint Committee, and one put out by Congressional Budget Office. They are slightly different, but only slightly different, and that is the best I have been able to determine what the current burden is. So we should be neutral on that burden.

Third, we ought to try to make our tax system much more simple, and I think the system I am about to describe to you is the ultimate in simplicity.

Fourth, we ought to be competitive in the international marketplace.

Our current system—and anybody that advocates an income tax-based system is walking right into this trap—is penalizing America heavily. Let me give you a simple illustration.

Take this pair of eyeglasses that I am wearing. If you manufacture them in the United States and you try to export them, here is the burden you run into: These glasses, when they leave the United States, will carry the full cost of government, and that is a substantial part of the cost of these glasses.

When they get to a foreign country, almost any foreign country with the exception of Australia, they will stop them at the border and they will add their cost of government to these glasses. As a result, these glasses now have the U.S. cost and the foreign government cost. When they are sold to the consumer in the foreign country, they carry those two costs of government. If you manufacture these glasses in any other country other than Australia, any industrialized country, when it gets to their border, they strike out practically all of their cost of government in these glasses, and when these glasses arrive at the U.S. border, we have nothing that will intercept these glasses and place the cost of government on them.

So these glasses when sold in a foreign country manufactured in the United States have two costs of government in them. When you manufacture them in a foreign country and put them back in the United States for sale to the consumer, they have got no cost of government in them.

Where are you going to manufacture these glasses? You are not going to manufacture them in the United States.

And the same applies to every product and every service that we create in the United States. That is because since 1947, the world trade agreement, the General Agreement on Tariffs and Trade has said you cannot adjust an income tax at the international border. Lord, we have tried.

Mr. Archer and a lot of the rest of us here have tried to adjust that international burden at the border, the U.S. burden at the border, and we have been struck down every time by it. You can't do it. It is impossible.

So anybody that comes to you and says we can reform the tax system and make it a lot simpler is overlooking one key factor, and that is you are going to lose jobs in the United States if you stick to an income tax-based system, and you are going to gain competitive opportunity if you go to a consumption tax.

Everybody on Earth understands that except the United States. Let me drive that home again.

Everybody on the Earth understands that except the United States, and the travesty is we put it in the General Agreement on Tariffs and Trade in 1947. We are stuck with it. We might as well adjust to it.

Now, let me describe the system I have proposed. Let me just show you in my testimony in front of you, the most important page of the whole statement is the VAT form. That is all you need to collect the necessary amount of revenue.

Now, there are essentially three steps that I would like to see us carry out.

First, I want to repeal the income tax, the personal income tax and the corporate income tax, and then I want to go further.

Second, I want to repeal the FICA tax, and that is a whale of a lot of repealing. That is most of the revenue in the United States. I don't want to start a debate about excise taxes, estate taxes and things like that. We can—that is not a lot of money, we can attack that at another period of time in the history of this Committee.

But we ought to repeal the income tax, the personal and corporate, and we ought to repeal the FICA tax, and we ought to replace it with a consumption-type tax, and we can do that without changing the tax burden and without increasing or decreasing the revenue that we collect. We ought to do it cold turkey.

There is going to be a little blood on the table when we do it cold turkey, but there will be a lot more blood on the table if we have to try to phase all this in. On January 1, 199*x* or 200*x*, we ought to bite the bullet and get it done. We can. It is just going to take understanding; it is going to take cooperation; and it is going to take debate.

Now, the third step in all of this is that we would have adjusted it, as far as American taxpayers are concerned, we would have slid the burden of taxation down if we go to a straight consumption tax. We are going to have to have some kind of burden adjuster in the system.

There are many ways we can do it, but we should not do it within the value-added tax that I advocate because it will make the value-added tax very, very complicated and impossible to administer.

We are essentially going to have to give back to some very low income—go to page 4 and look at the problem we face there. I would imagine that we would for all practical purposes probably have a value-added tax rate, if we repeal all the taxes I have talked about, of around 20 percent.

Now, we could have a lower rate than that if we don't repeal as many taxes, but if we repeal all the taxes I have talked about, the value-added tax rate would be around 20 percent. Just look on that table and see where the tax burden falls above and below 20 percent.

Look down at the bottom and you'll see the current effective tax rate is 23.9 percent, so we are going to have to do some adjusting. We can do that very simply by using perhaps, but this is not an exclusive method, the earned income credit, we could have a lower earned income. We could have an increased income credit for the low-income individuals and we could have a higher income credit or negative income credit for the upper income people. We could do it all in one short piece of paper, and just do it that way, very simply. There are lots of other ways we could do it, but we should not do it within the structure of the value-added tax.

Now, how do you collect the value-added tax?

First of all, only businesses would be involved in collecting the tax. The consumer would pay the tax, the consumer pays the tax today.

Anybody who tells you the consumer doesn't pay the tax today doesn't understand how the system works, but the consumer would pay the tax and the business would collect it.

What would the business do?

The business at the end of the tax paying period would simply add up all of its sales, everything it sold that had been used in its business, whether it sold a piece of its—what we now call capital equipment, or whether it sold its consumer goods, but just add them all up, and from that they would subtract all of the value of the goods that they exported.

Bang, there goes your cost of government on these glasses right there. We become much more competitive by that simple step.

If you export goods, you subtract it from the total amount of goods that you report as income. And then you subtract from all of that the total purchases that your business made during the same tax paying period, and you then multiply that times the tax rate.

If you had more sales than you did purchases, you pay a tax. If you had less sales than you do purchases, you get a check back from the government.

I know that is going to shock some of you, but that is the way all other value-added taxes in the world work. If the purchases exceed the sales, the taxpayer gets back a check. That is all there is to it. Individuals, nonbusinesses, individuals would not be involved in this at all.

We now harass through the IRS about 130 million Americans every year. If you go to the value-added tax you would be harassing something less than 12 million businesses, and you would only harass them with this very short and very simple form. Anybody could fill this out.

My 8-year-old grandson could fill out this form. He could read it and he could do the mathematics on it, and he could fill it out, and that is all of the intervention that we would have to do to raise the amount of money of the taxes that I think we ought to repeal.

We ought to repeal the personal income tax, the corporate income tax, and all of the FICA tax. That would make America competitive internationally, we would begin to save jobs in America and rebuild our worker employment here.

We would have a little unemployment based in the tax industry—and those are fine people, and I want to say they are fine people and well educated people who are spending most of their life now making substantial livings. We had a tax expert here with us yesterday that did that, manipulating the income tax. That is one of the finest paying jobs. One of the best trained work forces in America tries to figure out how do you manipulate, get out of paying this cotton pickin' income tax we have got now. Those people are smart enough, they would find other employment.

But Americans by and large would profit by this. We would save.

You know, we are now spending at least $300 billion a year to collect the $1.4 trillion we spend. We are probably spending as much as $6 billion—$600 billion a year. I would imagine that on the foreign tax provisions alone, we now spend more money trying to collect the tax than we collect in revenue.

On the income tax we are probably spending 50 percent of what we collect, just to collect the tax. On the personal income tax, it is less than that, and on the FICA tax it is a steal. It is the greatest ripoff that we have ever done as far as collecting.

It is real simple. Everything except the nanny tax, that is the most complicated thing that we ever imposed on the world. At least it was up until I think we corrected it last year, but—so that is what I advocate. In principle, I don't want to change the amount of revenue we collect. I don't want to change the tax burden that we collect from, and we ought to get on with it and we ought to do it cold turkey.

[The prepared statement and attachments follow:]

TESTIMONY OF
THE HONORABLE SAM M. GIBBONS
RANKING DEMOCRAT
COMMITTEE ON WAYS AND MEANS
BEFORE
THE COMMITTEE ON WAYS AND MEANS
ON
REPLACING THE FEDERAL INCOME TAX
JUNE 7, 1995

Mr. Chairman and my colleagues,

In my 26 years on this esteemed Committee and during my tenure as Acting Chairman and now as Ranking Democratic Member of the Committee, I have thought a great deal about the best way for our government to raise the revenue it needs and about the impact of the various alternatives on taxpayers, on our national economy, on our competitive position worldwide, and on our future. I am very pleased that Chairman Archer is committed to taking a serious look at alternatives to our revenue system.

More than a decade ago, I came to the conclusion that the current system should be replaced and that one particular alternative is preferable to others. As most of you know, I have developed and refined over the years my version of a single-rate subtraction-method value-added tax as a replacement for our current personal and corporate income taxes as well as most of our payroll taxes.

I have attached to my testimony and submit for the record a description of my value-added tax proposal. I have designed a sample tax form, which, as you can see, is the cover sheet of this testimony. I will take you through this form line by line. I am gratified that national attention is now focused on the tax system that I have worked so hard on for so many years.

Major Change in Our Federal Revenue System

First, I want to take this opportunity to talk with you about why I think fundamental tax reform is important.The current income tax should be repealed. It has become a maze of complexity. It is widely perceived as unfair. It has not kept pace with the economic realities of the modern global marketplace. It creates economic distortions, thus interfering with economic efficiency and growth. It does not reach the huge underground economy. It has become burdensome to many taxpayers, particularly small businesses who must struggle through a pile of Federal tax forms every quarter.

My proposal represents a major change in our revenue system. There are three basic steps:

Step 1. Repeal of the individual and corporate income taxes and most payroll taxes. Wage-earners would no longer be subject to FICA (social security) taxes on their first dollar of earnings. They would not see their gross paychecks shrink, as they do today because income and FICA taxes are withheld today. Their net paychecks would equal their gross earnings. Businesses would no longer pay the corporate income tax.

Step 2. Imposition of a single-rate, subtraction-method value-added tax on businesses. This would be collected at the business level only. Every incorporated and unincorporated business would be subject to this system.

The rate would be set to raise only sufficient revenue to replace the current income and payroll taxes. Businesses only would collect and remit the tax, as I illustrate in the attached "Description of Value-Added

Tax Form" beginning on page 8. Most of these calculations required would be made anyway in the ordinary course of their businesses.

It is important to point out that this system is not a national retail sales tax. A sales tax is applied as a set percentage of the *retail* price of goods and services. On the other hand, a value-added tax is levied at each stage of production only on a firm's *net* value-added.

Step 3. Adjustments to the resulting tax burden would be necessary to maintain the current distribution of the Federal tax system. Any new tax system should result in the same tax burden on each income group as the current tax system imposes. The distribution of the current tax burden is presented in Table 1, and the historical stability of the tax burden over the last two decades is presented in bar-graph form (see pages 4 and 5).

Fundamental Principles

This week's hearings focus on several different consumption tax alternatives. These differ in design, in administration, and in impact. I believe that they and any other alternative must satisfy four fundamental criteria. I am unwilling to entertain proposals that violate these principles.

Revenue Neutrality. The debate about the best method by which the government raises revenue should not be confused with the issue of how much revenue the government should raise. As we did in 1986, we should maintain a standard of revenue neutrality. This is not the debate about how large our government should be, about what the proper role of government in society is, or about what the priorities of government spending should be. All those issues can be and should be discussed, but not in the context of tax restructuring.

Fairness. Equitable distribution of the tax burden is of paramount importance. I believe in a progressive tax system. I believe in some relief for the least well-off among us. I believe in a society that worries about all of its citizens, not just the successful ones. I will not advocate any alternative revenue system that fails to address the question of fairness by including measures to maintain the current distribution of the tax burden.

Simplicity. Both individuals and businesses resent and complain about the level of complexity of the current tax system. Taxpayers worry that they are being unfairly taxed and that others have found ways to avoid the tax. Extensive and lucrative industries of lawyers, accountants, and tax preparers spend countless hours and unbounded energy helping taxpayers through the maze of complexity to minimize their tax liabilities. A simpler tax system would free up these resources to engage in more productive economic enterprises. A simpler system would be better understood by the average citizen and, thus, would avoid the ill will and skepticism generated by the current system. A simpler system would improve compliance and streamline administration.

Many alternative tax systems purport to be simple, but a close examination of the details belies that claim. One of the reasons I believe my proposal is preferable to others is that it has almost no special exemptions or deductions and it has only one rate. This is very important to achieving the simplicity for which we all hope.

Economic Efficiency. A good revenue system should minimize interference in economic markets. It should result in the least amount of distortion and bias, should encourage economic growth, and should promote the vigor and competitiveness of American companies. Complying with a good revenue system should be straightforward and not too costly. A simpler, less burdensome, more neutral tax system would provide opportunities for more efficient use of our Nation's resources. That would be to the benefit of all Americans and would improve the future standards of living of our children and grandchildren. In our examination of alternative tax systems, we must keep this goal in the forefront and make sure that every decision we make along the way furthers this goal.

International Competitiveness. The current income tax is an impediment to maximum competitiveness of American companies in international markets. The income tax simply has not kept up with the many changes that have occurred in the global marketplace. The current system penalizes exports because under the rules of the World Trade Organization (WTO), formerly the General Agreement on Tariffs and Trade (GATT), only indirect taxes, such as a VAT, can be adjusted at the border. Income taxes cannot be removed from the price of goods when they cross the border to be exported. I believe that a border-adjustable tax system would promote the competitiveness of American companies and invigorate American exports.

Conclusion

I believe that we must be open-minded when we consider alternative revenue systems. There are many competing ideas. No proposal has the inside track.

Any final decision about restructuring our tax system is a long way off. I agree with Chairman Archer that none of these alternatives is going to become law in this Congress. The effort to reform the tax system will take time. It should be the subject of much careful thought and planning. It cannot happen without exhaustive study by this Committee and its Senate counterpart.

The implications of replacing large elements of our current system must be understood and dealt with. We need to educate ourselves and the public about the advantages and disadvantages of our current system and of the many alternatives. We need to hear expert opinions and openly and objectively debate the issues. The public must understand the choices and knowingly signal its readiness to embrace a new system. As with all successful legislation, a new revenue system must evolve from an deliberate, ongoing exercise in education and serious thought. It cannot be a flash-in-the-pan solution -- if it is, it won't work.

I encourage thorough review of the issues. I am sure that my colleagues, who care about the American people just as I do, will see the wisdom of the four principles I have outlined here. I believe that each alternative proposal must be assessed against these criteria.

After years of study and review, I have come to the conclusion that my single-rate subtraction-method value-added tax is the best way to satisfy these criteria. I welcome the discussion in the coming months about fundamental tax reform. I hope that the research and thought I have devoted to this issue over many years will help to further the discussion and will be of use to my colleagues. A description of my proposal begins on page 6.

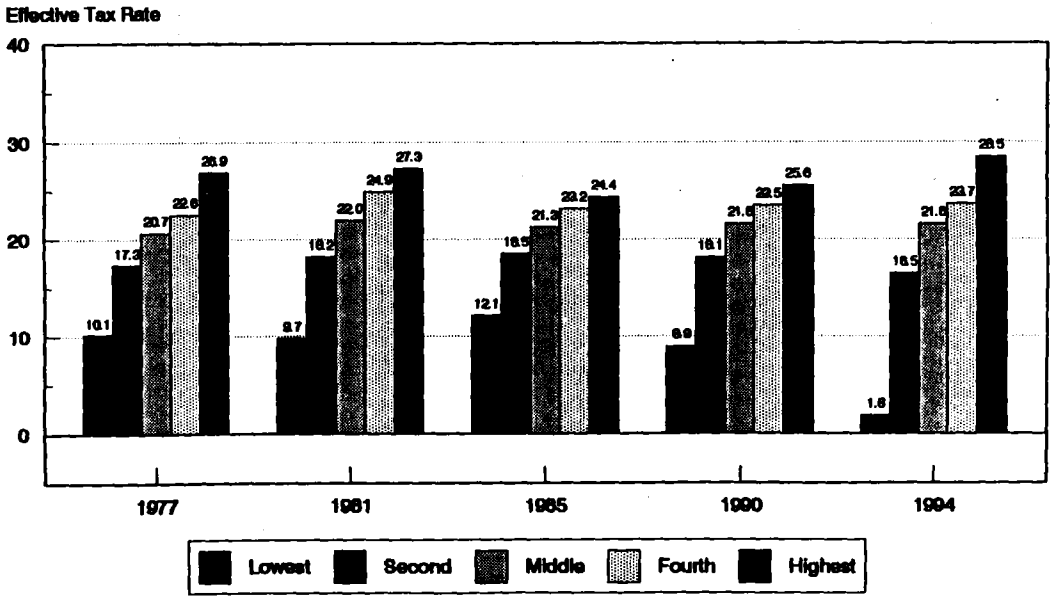
TABLE 1

DISTRIBUTION OF THE CURRENT FEDERAL TAX BURDEN
(1996 INCOME LEVELS)

INCOME RANGE	NUMBER OF FAMILIES (in millions)	AVERAGE INCOME (in dollars)	EFFECTIVE TAX RATE (in percent)
Less than $10,000	14.6	$6,009	6.7
$10,000 - 20,000	18.5	$14,794	10.4
$20,000 - 30,000	16.6	$24,941	16.5
$30,000 - 40,000	13.5	$34,841	19.4
$40,000 - 50,000	10.8	$44,808	21.7
$50,000 - 75,000	17.7	$61,278	23.6
$75,000 - 100,000	8.6	$85,637	25.4
$100,000 - 200,000	7.0	$129,788	26.7
$200,00 or more	1.9	$486,031	32.0
ALL	110.8	$48,165	23.9

SOURCE: Congressional Budget Office, January 1995.

Effective Total Federal Tax Rates, by Income Quintile, Selected Years 1977-1994 (in percent) Families With Children



NOTE: Families ranked by adjusted family income (AFI), equal number of people per percentile. Projected rates for 1994 reflect the fully phased-in effects of OBRA93.

SOURCE: Congressional Budget Office

DISCUSSION DRAFT OF A NEW REVENUE SYSTEM: A VALUE-ADDED TAX

The centerpiece of a comprehensive program to reform the Federal Government's revenue system should be a broadly based and uniformly applied value-added tax (VAT). The following is an outline of the principal features of a potential tax system:

- BUSINESSES ARE TAXPAYERS

  Businesses (i.e., corporations, partnerships, and sole proprietorships) would be required to collect the tax. The business itself would be responsible for filing periodic returns and remitting the tax. For sole proprietorships, the individual owner would be responsible. Other individuals would not be subject to collecting or remitting the VAT.

- ONE TAX RATE

  There would be a single tax rate applied to all businesses (including government businesses). The rate would be a function of the desired revenue level to replace the repealed taxes.

- BROAD TAXABLE BASE

  The taxable amount for each business would be its economic "value-added," which equals the excess (if any) of its receipts from sales of goods and services over its payments for purchases of goods and services from other businesses. Sales of all goods and services by businesses would be included in the system (except exports, as discussed below), including all professional services, financial services, food and beverages, medical services and products, new houses, and rental housing. No businesses would be "exempted" from the system.

- SUBTRACTION METHOD OF COMPUTING TAX LIABILITY

  The tax would be computed using the subtraction method. Gross receipts from sales of goods and services would be the tentative taxable amount. Gross costs for purchases of goods and services would be deducted from that amount. The balance would be the business' value-added base, which would be multiplied by the tax rate to determine the tax liability. If the balance is negative because purchases exceeded sales for that period, the business would receive a refund equal to the balance multiplied by the tax rate.

- BORDER ADJUSTMENTS

  Imports. The tax would apply to sales of imported goods and services. This should be done in a manner which imposes the least administrative costs while assuring the highest rate of compliance. For goods, the options include:

  (1) payment by the seller or purchaser when goods enter the country at customs locations, with a subsequent deduction by the purchaser for the cost of the goods, or

  (2) denial of a deduction by the purchaser for the cost of the goods.

For imported services (with the possible exception of transportation services for imported goods), the only workable option probably is (2) above.

Exports. The tax would not apply to sales of goods or services for export. A business which sells goods for delivery outside the U.S. (or, in general, services for use outside the U.S.) would exclude such sales when computing its taxable base while still deducting all purchases.

- TREATMENT OF PARTICULAR BUSINESSES

Housing Sectors. Sales of houses by businesses such as builders, developers, renovators, etc., would be included in the system, just like sales of all other goods by businesses. Renovation and remodelling services would also be included. Rentals by landlords would be included. Resales of houses by homeowners would not be subject to the tax.

Financial Intermediaries. The financial intermediation services of businesses such as banks and insurance companies would be included in the system, just like all other services. In general, their gross sales of services would be limited to the "spread" between the sum of interest, premiums, and investment income received (from borrowers, insureds, and investments) and the sum of interest and claims paid (to depositors and insureds), plus identifiable fees for specific services and other sales receipts.

Governments. Sales of goods and services to governments would be included in the system. Governments should not be exempt from the tax for their sales of goods and services.

Non-Profit Entities. Sales to non-profit entities would be included in the system. These entities should not be exempt from the tax for their sales of goods and services.

Agricultural Enterprises. Agricultural enterprises would be included in the system.

Leasing Companies. Receipts of businesses which lease and rent goods would be included in the system.

- TREATMENT OF PARTICULAR GOODS AND SERVICES

Used Property. The receipts from sales of used machinery, equipment, and other property that has been previously deducted by a business would be included in that business' gross sales receipts.

Leased Property. Payments for leased property would be deductible by the lessee business.

Intangible Assets. The receipts from sales of intangible assets such as patents, copyrights, trademarks, etc., would be included in gross sales receipts. Purchases of such intangibles would be deductible by the purchasing business.

DESCRIPTION OF VALUE-ADDED TAX FORM

The value-added tax that I am outlining today would be an extraordinarily simple tax form for businesses to fill out. The VAT would be collected and remitted only by businesses and would require fewer than a half dozen simple computations, many of which would be made whether or not there was a value-added tax.

First, on line 1, the business would be required to compute its gross business sales. It is impossible to conceive of a business that wouldn't make this computation, whether or not it was subject to a value-added tax. In determining this amount, the business would only have to take into account the following amounts:

- Sales of goods and services produced or sold in the course of its business;
- Amounts (such as rents or royalties) received for granting the right to use property (whether tangible or intangible); and
- Amounts received from sale of assets which were used in the business.

From the amount of the gross business sales, a business would subtract the following amounts:

- The amount of <u>returns</u> and allowances made during the taxable period and the amount previously included in gross sales that becomes uncollectible during the taxable period; and
- On line 2, the portion of the gross business sales received for export of property or services.

The subtraction for exports is the simple way of making the value-added tax adjustable at the border for American exports.

After computing its net business sales, a business would have to compute its total business purchases on line 4. Again, the computation would be quite simple, and it is a mirror image of its computation of gross business sales. It would consist of the gross amount spent for the following amounts:

- Goods and services to be used or sold in the business;
- Rents and royalties for the right to use property, whether tangible or intangible, in the business; and
- Acquisitions of property to be used in the business.

The only adjustment to the gross amount of business purchases would be made on line 5: a reduction for the amount of purchases of property or services imported by the business. This is a very simple adjustment to carry out the policy of having the value-added tax adjustable at the border.

Finally, the tax on line 8 would equal a specified percentage of the excess of the net business sales over business purchases. If the business purchases exceed the net business sales, the business would be entitled to a refund equal to such percentage of that difference. This again carries out the policy of having the tax adjustable at the border. In all cases, businesses would be entitled to a refund of the value-added tax imbedded in their business purchases used in producing exported property .

It is far easier for me to set forth what a business must do to comply with my proposed value-added tax than to enumerate the many things required under existing law that businesses would no longer be required to do.

Many companies file consolidated income tax returns for purposes of the existing corporate tax. This involves elaborate record keeping for inter-company transactions. Complex rules govern the extent to which the losses of a subsidiary can be used to offset income of the other members of the group. Under my value-added tax, the only computations on a consolidated basis would be computations of gross sales and business purchases. This could simply be accomplished by not taking into account sales and purchases between members of the group.

Under existing law, many companies are required to maintain inventories. They must keep records of amounts in inventory and allocate expenses between amounts that have to be capitalized as part of inventory and those that can be expensed as overhead. In addition, companies using the LIFO method must maintain elaborate records as to the various layers of its inventory. None of this is required under my proposed value-added tax.

Under existing law, businesses are required to capitalize and then depreciate acquisitions of plant and equipment. They are required to distinguish between items such as repairs, which can be immediately expensed, and other items which are betterments or improvements and must therefore be capitalized and depreciated. They must maintain records as to the depreciable basis of each asset. None of this would be required under the value-added tax. All amounts for acquisitions or improvements of property would be immediately expensed.

All of the enormous complexity involving the foreign tax credit would be eliminated.

A Revenue System for America's Future

Form VAT	U.S. Value - Added Tax Return (For Businesses Only For taxable period beginning ____)	1995
Check if a consolidated return (attach schedule) ☐	Business Name: Every Business in USA Address: 1234 Main Street City, State, Zip: Anytown, USA 12345	Business ID # _____

1. Gross Receipts from Sales Net of Returns	1. $
2. Less Receipts from exports	2. ($)
3. Total taxable receipts . . . . *subtract line 2 from line 1*	3. $
4. Gross purchases	4. $
5. Less import purchases	5. ($)
6. Total business purchases . . *subtract line 5 from line 4*	6. $
7. Total value-added . . . . . *subtract line 6 from line 3*	7. $
8. Total tax . . . . . (??% x line 7)	8. $
9. Tax due if line 7 positive - Refund due if line 7 negative	9. $

Please Sign Here	*I declare that the information given above is true and complete.* X_____ *Signature of Officer* *Date* *Title*

Mr. GIBBONS. Senator?

I am ready for questions about it. What do you say, Mr. Chairman, do you want to go through the question session now?

Chairman ARCHER. Sam, if it is OK with you, I would like for you to stay where you are and if Senator Specter would grace us with his statement, maybe we could release him and send him back to other things. I know you must have a few other things to do. We would be pleased to hear from you, and then we will inquire of Congressman Gibbons.

Senator Specter.

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SPECTER. Thank you very much, Mr. Chairman. I very much appreciate the opportunity to testify before this very distinguished Committee in this very beautiful room. This is the first time I have ever had a chance to testify here, and we don't have one to match it on the Senate side, so I am delighted to be here.

I very much appreciated an opportunity to listen to Congressman Gibbons' testimony, and there is one unifying feature which I believe is emerging from all corners. That is that we need a reform of the current tax system, and I saw you, Mr. Chairman, on television on Tuesday evening to the same effect, and the question is where we go from here to achieve such reform.

When Congressman Gibbons testifies about the intrusiveness of the current tax system on 130 million Americans, I think he perhaps even understates a bit to the extent that the statistics show that we spend 5.4 trillion hours on tax returns, and so many of us have received these computer printouts saying we owe $111.17.

It takes a tremendous amount of time to figure out that the government is wrong, and that the computer is inaccurate, and so we desperately need a change.

My own view is that the best system is the flat tax, and I say that because of its tremendous progrowth capabilities and its simplicity and its fairness. The legislation which I have introduced in the Senate, S. 488, is modeled after a program designed by two distinguished professors at Stanford—Hall and Rabushka. They have worked on it for a long time.

Their first publication was put out in 1981, and they have revised it since, and it is a hard matter to get a comprehensive handle to see to it that it turns out to be tax neutral, revenue neutral, and also turns out to be fair.

When we talk about a balanced budget, we are talking about a long overdue objective of government, but that is one side of the economic coin. The other side is stimulus in order to have progrowth. And the Hall-Rabushka projections show an increase in the gross national product of $2 trillion within 7 years and a lowering of the interest rate by 2 percent, which is very, very substantial.

The tax rate which Hall and Rabushka propose is a 19 percent flat tax which is tax neutral. The Majority Leader, Congressman Dick Armey, has modeled his legislation after Hall-Rabushka.

He has it slightly different than I do. He projects 20 percent to start and down to 17 percent, but there may be an issue about rev-

enue neutrality with Congressman Armey's plan. I have added one point to the 19 percent flat tax of Hall-Rabushka, and I do so because I believe there needs to be just a little bit of deductibility to have a practical alternative to get the legislation passed.

I leave very limited deductions for interest on home mortgages, up to $100,000 in borrowing, and deductibility on charitable contributions limited to $2500. Congressman Souder, who is listed as a witness later today, has advised me that he intends to introduce a companion bill to mine with one modification. He does not want to limit charitable contributions.

I think that it is difficult to have a tax which is entirely flat, but I think that these two concessions still leave it reasonably flat, and I see the intermediate light is on, so I would come to a close here by showing the tax return under my tax proposal. I hope you won't mind if I defer to C–SPAN to show the return.

It is a postcard tax, can be filled out in 15 or 20 minutes, would save tremendous amounts of time, and I agree totally with what Congressman Gibbons has said and what you have said, Mr. Chairman, and others have said about the need for a national consensus, and I will confess to having done quite a bit of traveling recently, and wherever I go I am never without my American Express or my flat tax postcard, and I show it on all the television interviews and perhaps one of the best tests is that invariably the cameraman wants a copy.

There is a lot of interest in the flat tax, a tremendous amount of interest, and I compliment you, Chairman Archer, for these hearings. I have had the pleasure to appear with Congressman Armey on three other hearings; on the Senate side, the House side, and the Joint Economic Committee, and I believe when there is sufficient public understanding that there will be a demand, an avalanche on the Congress to change the system. And I am prepared to listen to Congressman Gibbons or to variations of Congressman Armey or other proposals, but I think debate is very healthy and after a lot of analysis I have come down in favor of the flat tax.

I thank you very much, Mr. Chairman, and Members of the Committee.

[The prepared statement and attachments follow:]

Testimony of Senator Arlen Specter
House Ways & Means Committee
Flat Tax Hearing
June 8, 1995

Mr. Chairman, I appreciate this opportunity to appear before the House Ways & Means Committee to testify regarding flat tax legislation and my bill, the Flat Tax Act of 1995, S.488. I am also pleased to recognize the efforts of Congressmen Mark Souder and Gerold Solomon who are introducing companion legislation to S.488 in the House of Representatives today.

Over the past several weeks, Congressman Armey and I have testified before the Senate Finance Committee, the House Small Business Subcommittee on Tax and Finance and the Joint Economic Committee regarding the incredible complexity of the tax code and the fact that very few people understand our tax laws, much less the implications of a dramatic reform of these laws. I firmly, believe, however, that the more Americans learn about the flat tax, the more they like it. A recent poll by Newsweek magazine demonstrates the breadth of this support already, with 61% of the respondents indicating they favor a flat tax and a majority of these supporters expressing their preference for my flat tax plan, S.488.

This groundswell of support has extended to the halls of Congress, as more and more Members of the Senate and the House of Representatives are expressing their interest in the flat tax. This support has increased after our recent Easter and Memorial Day recesses, when many Members of Congress travelled to their home states and districts and heard first-hand the demands of their constituents for simplification and reform.

The tax system that we use in America today is a national disgrace, with a dedicated deduction for every interest group and a loophole for every lobbyist. Our current system is bizarre, burdensome, and biased against growth. The flat tax will give the American people a system which is simple, fair and pro-growth.

My flat tax bill would scrap the vast majority of IRS rules and regulations, with the myriad rates, deductions and instructions, and replace them with a 20% flat tax under which Americans could file their tax returns on a simple 10-line postcard. Thus, instead of spending billions of dollars every year on high-priced tax attorneys or accountants who are a virtual necessity for anyone seeking to fill out tax returns, and billions of hours, Americans could devote their energies to more productive pursuits.

The basic model for my legislation comes from a plan created by Professors Robert Hall and Alvin Rabushka of the Hoover Institute and a flat tax bill introduced in the House of Representatives by Majority Leader Richard Armey. These other plans, however, would eliminate all deductions.

I have included limited deductions for home mortgage interest on up to $100,000 in borrowing and charitable contributions up to $2,500. While these modifications limit the purity of the flat tax principle, I believe that those two deductions are so deeply ingrained in the financial planning of American families that they should be retained as a matter of fairness -- and also political practicality. With those two deductions maintained, passage of a modified flat tax will be difficult; but without them, probably impossible.

For example, I have had several meetings with representatives of the real estate industry, including the National Association of Realtors, and they have expressed their strong opposition to an outright repeal of a deduction which many low and middle income Americans desperately need in order to afford the homes they live in or to maintain the hope of eventual home ownership. According to the Congressional Research Service, however, my flat tax will accommodate over 80% of taxpayers who have home mortgages under $100,000 and the remaining taxpayers will reap the benefits of lower borrowing costs by a drop in interest rates of up to two points.

In this Congress, we have been concerned with the work of reducing the size and cost of government, and this is work which is vitally important. But the work of downsizing

government is only one side of the coin. What we must do at the same time, and with as much energy and care, is to promote economic growth. As we reform the welfare programs and government bureaucracies of past administrations, we must replace those programs with a prosperity that extends to all segments of American society through private investment and job creation -- which can have the additional benefit of producing even lower taxes for Americans as economic expansion adds to federal revenues. Just as Americans need a tax code that is fair and simple, they also are entitled to tax laws designed to foster rather than retard economic growth.

Under my tax plan, individuals would be taxed at a flat rate of 20% on all income they earn from wages, pensions and salaries. Individuals would not be taxed on any capital gains, interest on savings, or dividends. The flat tax will also eliminate all but two of the deductions and exemptions currently contained within the tax code. Instead, taxpayers will be entitled to "personal allowances" for themselves and their children: $9,500 for a single taxpayer, $14,000 for a single head of household and $16,500 for a married couple filing jointly; and $4,500 per child or dependent. These personal allowances would be adjusted annually for inflation. Thus, a family of four would be entitled to $25,500 in tax-free income before any taxes were assessed on their wages.

Businesses would also be taxed at a flat rate of 20%. My legislation would eliminate the intricate scheme of depreciation schedules, deductions, credits, and other complexities. Instead, businesses would only deduct wages, direct expenses and purchases. Businesses would be allowed to expense 100% of the cost of capital formation, including purchases of capital equipment, structures and land, and to do so in the year in which the investments are made.

The key advantages of this flat tax plan are three-fold: First, it will dramatically simplify the payment of taxes. Second, it will remove much of the IRS regulatory morass now imposed on individual and corporate taxpayers, and allow those taxpayers to devote more of their energies to productive pursuits. Third, since it is a plan which rewards savings and investment, the flat tax will spur economic growth in all sectors of the economy as more money flows into investments and savings accounts, and as interest rates drop. By contrast, there will be a

contraction of the IRS if this proposal is enacted.

Simplicity

The first major advantage to this flat tax is simplicity. According to reliable studies, Americans spend approximately 5.4 billion hours each year filling out tax forms. Much of this time is spent burrowing through IRS laws and regulations, which, according to the Tax Foundation, have grown from 744,000 words in 1955 to 5.6 million words in 1994. Even those IRS forms which are intended to be simple are not. The IRS notes proudly that it should take taxpayers "only" 2 hours and 54 minutes to complete and file the 1040EZ form, which is supposedly the most simple tax form available.

Whenever the government gets involved in any aspect of our lives, it can convert the most simple goal or task into a tangled array of complexity, frustration and inefficiency. By way of example, most Americans have become familiar with the absurdities of the government's military procurement programs. If these programs have taught us anything, it is how a simple purchase order for a hammer or a toilet seat can mushroom into thousands of words of regulations and restrictions when the government gets involved. The Internal Revenue Service is certainly no exception. Indeed, it has become a distressingly common experience for taxpayers to receive computerized print-outs claiming that additional taxes are due, which require repeated exchanges of correspondence or personal visits before it is determined, as it so often is, that the taxpayer was right in the first place.

My plan would eliminate these kinds of frustrations for millions of taxpayers. This flat tax would enable us to scrap the great majority of the IRS rules, regulations and instructions and delete literally millions of words from the Internal Revenue Code. Instead of billions of hours of non-productive time spent in compliance with (or avoidance of) the tax code, taxpayers would spend only the small amount of time necessary to fill out a postcard-sized form. Both business and individual taxpayers would thus find valuable hours freed up to engage in productive business activity, or for more time with their families, instead of poring over tax tables, schedules and regulations.

The flat tax I have proposed can be calculated just by filling out a small postcard which requires a taxpayer only to answer a few easy questions. The postcard would look like this:

Form 1	**Individual Wage Tax**	**1995**
Your first name and initial (if joint return, also give spouse's name and initial)		Your social security number – –
Home address (number and street including apartment number or rural route)		Spouse's social security number – –
City, town, or post office, state, and ZIP code		
1.	Wages, salary, pension and retirement benefits	1_____
2.	Personal allowance (enter only one) -- $16,500 for married filing jointly -- $9,500 for single -- $14,000 for single head of household	2_____
3.	Number of dependents, not including spouse, multiplied by $4500	3_____
4.	Mortgage interest on debt up to $100,000 for owner-occupied home	4_____
5.	Cash or equivalent charitable contributions (up to $2,500)	5_____
6.	Total allowances and deductions (lines 2, 3, 4 and 5)	6_____
7.	Taxable compensation (line 1 less line 6, if positive; otherwise zero)	7_____
8.	Tax (20% of line 7)	8_____
9.	Tax withheld by employer	9_____
10.	Tax or refund due (difference between lines 8 and 9)	10_____

Filing a tax return would become a manageable chore, not a seemingly endless nightmare, for most taxpayers.

Slash the IRS

Along with the advantage of simplicity, enactment of this flat tax bill will help to remove the burden of costly and unnecessary government regulation, bureaucracy and red tape from our everyday lives. The heavy hand of government bureaucracy is particularly onerous in the case of the Internal Revenue Service, which has been able to extend its influence into so many aspects of our lives.

In 1994, the IRS employed over 110,000 people, spread out over 650 offices across the United States. Its budget was in excess of $13 billion, with some $7.1 billion spent annually just to administer the tax laws, and another $4 billion for enforcement. By simplifying the tax code and eliminating most of the IRS' vast array of rules and regulations, the flat tax would enable us to cut a significant portion of the IRS budget, including the bulk of the funding now needed for enforcement and administration.

In addition, a flat tax would allow taxpayers to redirect their time, energies and money away from the yearly morass of tax compliance. According to the Tax Foundation, in 1994, businesses spent approximately $127 billion in compliance with the federal tax laws, and individuals spent an additional $65 billion, for a total of $192 billion. Monies spent by businesses and investors in creating tax shelters and finding loopholes could be instead directed to productive and job-creating economic activity. With the adoption of a flat tax, the opportunities for fraud and cheating would also be vastly reduced, allowing the government to collect, according to some estimates, over $120 billion annually.

Economic Growth

Another major advantage to a flat tax is that it will be a tremendous spur to economic growth. Recently, Congressman Armey and I testified before the Joint Economic Committee, along with two of the fathers of the flat tax, Jack Kemp and professor Alvin Rabushka, on how the flat tax will unleash up to $2 trillion in new economic growth and a drop in interest rates by as much as two points.

The economic principles are fairly straightforward. Our current tax system is inefficient; it is biased toward too little savings and too much consumption. The flat tax creates substantial incentives for savings and investment by eliminating taxation on interest, dividends and capital gains -- and tax policies which promote capital formation and investment are the best vehicle for creation of new and high paying jobs, and for a greater prosperity for all Americans.

It is well recognized that to promote future economic growth, we need not only to eliminate the federal government's reliance on deficits and borrowed money, but to restore and expand the base of private savings and investment that has been the real engine driving American prosperity throughout our history. These concepts are interrelated, for the federal budget deficit soaks up much of what we have saved, leaving less for businesses to borrow for investments.

It is the sum total of savings by all aspects of the U.S. economy that represents the pool of all capital available for investment -- in training, education, research, machinery, physical plant, etc. -- and that constitutes the real seed of future prosperity. The statistics here are daunting. In the 1960s, the net U.S. national savings rate was 8.2 percent, but it has fallen to a dismal 1.5 percent. In recent international comparisons, the U.S. has the lowest savings rate of any of the G-7 countries. We save at only one-tenth the rate of the Japanese, and only one-fifth the rate of the Germans, which is clearly reflected in the comparative growth rates of our economies over the last three decades.

An analysis of the components of U.S. savings patterns shows that although the federal budget deficit is the largest cause of "dissavings," both personal and business savings rates have declined significantly over the past three decades. Thus, to recreate the pool of capital stock that is critical to future U.S. growth and prosperity, we have to do more than just get rid of the deficit. We have to very materially raise our levels of private savings and investment. And we have to do so in a way that will not cause additional deficits.

The less money people save, the less money is available for business investment and growth. The current tax system discourages savings and investment, because it taxes the interest we earn from our savings accounts, the dividends we receive from investing in the stock market, and the capital gains we earn from successful investments in our homes and the financial markets. Indeed, under the current law these rewards for saving and investment are not only taxed, they are overtaxed -- since gains due solely to inflation, which represent no real increase in value, are taxed as if they were really profit.

With the limited exceptions of retirement plans and tax free municipal bonds, our current tax code does virtually nothing to encourage personal savings and investment, or to reward it over consumption. As William Schreyer wrote recently in the Harvard Business Review, "the budget deficit is only one part of a larger national problem: the U.S. saving deficit."

S.488 will change this system, and address this problem. The proposed legislation reverses the current skewed incentives by promoting savings and investment by individuals and by businesses. Individuals would be able to invest and save their money tax-free and reap the benefits of the accumulated value of those investments without paying a capital gains tax upon the sale of these investments. Businesses would also invest more as the flat tax allowed them to expense fully all sums invested in new equipment and technology in the year the expense was incurred, rather than dragging out the tax benefits for these investments through complicated depreciation schedules. With greater investment and a larger pool of savings available, interest rates and the costs of investment would also drop, spurring even further economic growth.

Critics of the flat tax have argued that we cannot afford the revenue losses associated with the tremendous savings and investment incentives the bill affords to businesses and individuals. Those critics are wrong . Not only is this bill intended to be revenue neutral, but historically we have seen that when taxes are cut, revenues actually increase, as more taxpayers work harder for a larger share of their take-home pay, and investors are more willing to take risks in pursuit of rewards that will not get eaten up in taxes. As one example, under President Kennedy individual tax rates were lowered, investment incentives including the investment tax credit were created and then expanded, depreciation rates were accelerated, and yet between 1962 and 1967 gross annual federal tax receipts went from $99.7 billion to $148 billion -- an increase of nearly 50%. More recently under President Reagan, after his tax cuts in the early 1980's, government tax revenues rose from just under $600 billion in 1981 to nearly $1 trillion in 1989. In fact, the Reagan tax cut program helped to bring about the longest peacetime expansion of the U.S. economy in history. There is every reason to believe that the flat tax proposed here can do far more -- and by maintaining revenue neutrality in this flat tax proposal, as we have, we can avoid any increases in annual deficits and the national debt.

As Professors Hall and Rabushka state it, the growth case for a flat tax is compelling. It is even more compelling in the case of a tax revision that is simple and demonstrably fair.

Fairness

In addition to increasing federal revenues by fostering economic growth, the flat tax can also add to federal revenues without increasing taxes by closing tax loopholes. Personal income in the United States totals about $5 trillion. Of this amount, however, only $2.4 trillion is reported as taxable income. Thus, over 50% of personal income is sheltered by legal loopholes, deductions, credits, exemptions or outright fraud. Under a flat tax system, all tax shelters will disappear and all income will be subject to taxation. With a broader tax base, we can then lower tax rates and ensure that all Americans pay their fair share of taxes.

The flat tax also promotes fairness by lessening the tax burden on working families. By eliminating loopholes and thus broadening the tax base, my legislation will force many higher income taxpayers to pay their fair share of taxes -- and it will allow us to lower the taxes paid by lower and middle income families. IRS statistics indicate that in 1994, over 50% of all tax returns were filed by taxpayers earning less than $30,000. The vast majority of these taxpayers would pay little or no taxes under my flat tax, because of the $25,500 income exclusion for a family of four and the continuation of limited deductions for home mortgage interest and charitable contributions.

Mr. Chairman, no one likes to pay taxes, and no one likes the billions of dollars in additional hidden taxes and costs they incur every year simply seeking to comprehend and comply with the tax code. My 20% Flat Tax Act will dramatically restructure the IRS by eliminating most of its rules and regulations and firing most of its employees, and, as a result, it will change the way Americans feel about the tax code. I believe that all Americans would be willing to pay their share of taxes under a system that they believe is fair, a system that they can understand, and a system that they recognize promotes rather than prevents growth and prosperity. My 20% flat tax bill affords Americans such a tax system.

The flat tax is an idea whose time has come. I am committed to working with Majority Leader Richard Armey, Congressmen Mark Souder and Gerold Solomon, and others to ensure continued progress in the flat tax debate, both in Congress and throughout this country. In this regard, I am also encouraged by the formation of the Dole-Gingrich Flat Tax Commission, to be headed by Jack Kemp, which will work toward promoting passage of flat tax reform.

Therefore, I urge this Committee to bring the flat tax to the floor of the House of Representatives at the earliest possible moment so that all congressmen may be allowed to express their support for this fundamental reform. I look forward to working with you in this endeavor.

Thank you Mr. Chairman and members of the Committee.

ADVANTAGES TO FLAT TAX PLAN

* SIMPLICITY	A 10-line postcard filing would replace the myriad forms and attachments currently required, thus saving Americans up to 5.4 billion hours they currently spend every year in tax compliance.
* CUTS GOVERNMENT	The flat tax would eliminate the lion's share of IRS rules, regulations and requirements, which take up 12,000 pages, and have grown from 744,000 words in 1955 to 5.6 million words in 1994. It would also allow us to slash the mammoth IRS bureaucracy of 110,000 employees spread out over 650 offices nationwide.
* PROMOTES ECONOMIC GROWTH	Economists estimate a growth of over $2 trillion in national wealth over seven years, representing an increase of $1900 in personal income for every man, woman and child in America.
* INCREASES EFFICIENCY	Investment decisions would be made on the basis of productivity rather than simply for tax avoidance, thus leading to even greater economic expansion.
* REDUCES INTEREST RATES	Economic forecasts indicate that interest rates would fall substantially, by as much as two points, as the flat tax removes many of the current disincentives to savings.
* LOWERS COMPLIANCE COSTS	Americans would be able to save up to $192 billion they currently spend every year in tax compliance.
* DECREASES FRAUD	As tax loopholes are eliminated and the tax code is simplified, there will be far less opportunity for tax avoidance and fraud, which now amounts to over $120 billion in uncollected revenue annually.
* REDUCES IRS COSTS	Simplification of the tax code will allow us to save significantly on the $13 billion annual budget currently allocated to the Internal Revenue Service.

	1995 Income Tax		Specter Flat Tax	
Income	Taxes Owed	Effective Rate	Taxes Owed	Effective Rate
<$25,500	$1,105	4.5%	None	0%
$30,000	$2,018	6.7%	None	0%
$40,000	$3,300	8.3%	$1,300	3.3%
$50,000	$4,500	9.0%	$2,900	5.8%
$60,000	$5,700	9.5%	$4,860	8.1%
$70,000	$7,810	11.1%	$6,820	9.7%
$80,000	$10,050	12.6%	$8,780	11%
$90,000	$12,290	13.7%	$10,740	11.9%
$100,000	$14,530	14.5%	$12,700	12.7%
$125,000	$20,217	16.2%	$17,600	14.1%
$150,000	$26,531	17.7%	$22,600	15.1%
$200,000	$40,708	20.4%	$32,600	16.3%
$250,000	$57,088	22.8%	$42,600	17.0%
$500,000	$138,666	27.7%	$92,600	18.5%
$1,000,000	$303,006	30.3%	$192,600	19.3%

Chairman ARCHER. Senator Specter, thank you for your presentation. I certainly agree with you that we have got to generate a consensus throughout this country, and all of this debate is healthy, even though there may be some smaller disagreements or differences between us.

Your colleague from Pennsylvania, Mr. English, would like to inquire.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Senator Specter, welcome, and we very much appreciate your advocacy on this issue.

I want to say I particularly appreciate the fact that as an advocate for the flat tax you have also been an advocate for retaining the mortgage interest deduction. As you know, home ownership has been a key cultural value in America, and has certainly been one of the central tenets of the Republican Party going back to the sixties in the Homestead Act. I would like your sense of how high a priority it is to retain the mortgage interest deduction in an alternate tax system.

Senator SPECTER. Thank you very much for the question, Congressman English. And it is a great pleasure to sit across this panel and see you in the House of Representatives, having worked with you, for you, and with your parents for many years. You have done an outstanding job representing the area in northwestern Pennsylvania.

To the point, I think it is important to retain the home mortgage interest deduction to a modest extent. I think we are going to have a hard time passing tax reform and if we have the homeowners of America against us, it is a block that we cannot win without.

There is controversy as to what the amount ought to be. When I was in Los Angeles a week ago Monday, everybody told me it was too little. In Beverly Hills you have to put an extra zero behind the $100,000 before you can buy anything, but I have pegged it at $100,000 because I think that addresses middle America, and I think it is a high priority.

Mr. ENGLISH. Thank you, Senator.

One last question. I know your time is limited here.

Your system provides for radically simplifying the income tax system in America. And I was wondering what do you anticipate will be the savings and compliance cost for these changes? And do you anticipate that given that 60 percent of filers currently need help when they prepare their tax return, we are going to be able to dramatically lower that under your tax system?

Senator SPECTER. The estimate of some leading economists is $200 billion. The estimate in the current issue of Fortune magazine is $595 billion.

I think it is very hard to really gauge what the compliance savings will be. I think in psychic savings, it is limitless not to have to fill out the tax return.

I do fill out mine so that I have an understanding as to what we are imposing on the American people, and it is an ungodly mess every year. Every year I take out last year's return, I go over all the forms. They are invariably changed.

I don't care what the circumstance is, that nothing has been done from the Congress, the form has been changed, there are different formulas, and you really need to hire a second Philadelphia lawyer to begin to start with the compliance.

Mr. ENGLISH. Well, thank you, Senator. You are a powerful advocate for change, and we appreciate your being here today.

Thank you, Mr. Chairman.

Chairman ARCHER. Are there any additional questions for Senator Specter?

Senator, I know you have other things to do, and again thank you for coming and appearing before our Committee.

Senator SPECTER. Thank you very much, Mr. Chairman. It is a great pleasure being here.

I thank you for your courtesy in expediting my appearance. Thank you.

Chairman ARCHER. OK, Bill Thomas, do you have questions for Congressman Gibbons?

Mr. THOMAS. Mr. Chairman, I don't know that I have a question other than just to indicate to Sam that I think as we listen to these other models and attempts to explain away the international trade competitive aspect, that somehow the circular flow of economic activity doesn't go through goods and services purchased and that there aren't adjustments, I believe his arguments are the most compelling, and that regardless of the change in system, his belief that we have to go cold turkey in a new tax system is absolutely, I believe, correct.

It is interesting that advocates of flat tax are already beginning to talk about carve-outs for mortgage deductions as the Senator just did and others. The term I dearly love is a modified flat tax because it depends on which end of the telescope you are looking through. Our current tax system could be argued to be a modified flat tax, and so given the years that the gentleman from Florida has spent looking at alternative models and attempts to make change, I come down finding myself virtually totally in agreement with him. The only possible downside—and perhaps you might want to talk to this a little bit because I think it is more in theory that every system slips—is the argument that the value-added tax is somewhat insidious as a tax because it is invisible and it is easy to increase and so people won't appreciate the ability of government in the shadows and at night out of view to increase the revenue that it extracts from the American people.

My brief response would be that if you are going to repeal the income tax, both personal and corporate, and you are going to repeal the FICA tax, I will take the other side as a possible negative.

But, Sam, how would you respond to it?

Mr. GIBBONS. I have thought a lot about what you put forward there, and about how it would be handled in this Committee.

Essentially, if the Congress wanted to increase or decrease the amount of revenue with the system that I have advocated, there would be one very straightforward debate. You have got to either increase the rate or decrease the rate. You know when we change the amount of money we collect from Americans on this Committee, you get the most convoluted debate about all of those ramifications

of the change of the Code, and when you get all through we have done a hoodwink job on America.

We have either increased their taxes by gobbledygook that we talk about around here or we have decreased their taxes with the same kind of gobbledygook talk, but the talk on the Committee when we want to increase the amount of revenue under a value-added tax that I have advocated here is going to be very direct. We are going to have to either vote to increase the rate or decrease the rate because we should not try to tinker with the tax.

It is going to be very obvious. It is going to be almost impossible to tinker with the base of the tax under the system that I advocate. We would be debating rates, and that is what we ought to be debating here in the Ways and Means Committee.

Very clearly, the American public ought to know whether we stand for raising more money or returning more money to them, and believe me, under the current system we have got around here now, you get a very mixed message, and I think that we ought to avoid that.

Mr. THOMAS. Just let me say also that the Chairman's argument that if we are going to deal with the income tax, we have to pull it out by its roots, clearly you are doing that with your proposal. To me, the idea of going to a flat tax or a modified flat tax is analogous to going to a block grant in terms of a Federal program because inevitably what has happened to virtually every one of us is that they erode back to categorical programs over time.

We inevitably give into the pressure of making adjustments in a Tax Code that can be adjusted, and a flat tax is kind of regrouping and going back to a more fundamental Income Tax Code, which in my opinion starts the process all over again.

Is that one of the reasons that you decided to talk about going cold turkey?

Mr. GIBBONS. Absolutely. You know, the transition rules, if you tried to work out transition rules, you could spend the rest of your life trying to work out transition rules from the current system to the future system. There is going to be a little blood on the table when we get through with going cold turkey, but there will be a lot more blood on the table if we try to go through transition rules.

All of you who served on this Committee know the terrible time we have with transition rules. So, you know, we just have to do rough justice as best we can by the taxpayer and by the government, but going cold turkey, frankly, is the only way to go in this.

Don't let anybody hoodwink you. There will be a lot of lobbyists out there who will make a fortune out of transition rules. They will come to your office and plead with you that we have got to have these kind of transition rules or not, but I would advocate, based on my experience, going cold turkey on the first day of January of some year in the future.

Mr. THOMAS. I want to thank you very much for your contribution.

I believe, as I said, you have got the structure that is the correct one with the approach that is the correct one. I happen to think the American people, when you lay out the options and you are honest with them, will agree with us and I appreciate very much the contribution that you have made, and I can only say that I will

contrast your presentation with the administration's, and I hope that we do not get into a partisan discussion, that we should talk about the key four principles that you talked about because it is a Tax Code for the American people, not Republicans or Democrats, and I want to thank you for your contribution.

Mr. GIBBONS. Thank you.

Chairman ARCHER. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Gibbons, I want to congratulate you for your testimony, for your efforts for many, many years in trying to simplify our Tax Code.

I want you to know that I agree with you that I think we should be replacing the income tax with a VAT tax, and I particularly appreciate the two standards that you mentioned and underscored: That we are talking about revenue neutrality so that we can talk about the most efficient and fair way to raise the revenues that we need for government and not to get into an argument as to how much revenue should be raised.

We should equate with the current revenues the substitute plan, and second—and here I think you have stood alone in the proposals that have been brought forward, and that is that we don't adversely affect middle- and low-income Americans in the distributional effect of any tax proposal and the impact that a tax change may have.

One of my deep concerns about the flat tax proposals that have been made is that I find it very difficult to understand how they can be implemented without imposing additional tax burdens on middle- and low-income taxpayers. No proposals have been brought forward that compensate for the distributional impact.

I must tell you, I don't agree with everything you have said. The transitional problems are very, very severe. If we don't have transition rules, we need to take a look at the impact we are going to have on various sectors.

Let me just mention one—State and local governments in the financing of their infrastructure. The cold turkey approach would have a dramatic impact on the ability of local governments to finance their projects, and it is something that we need to understand before we act, and we are going to need to take some compensatory action in order not to adversely affect the ability of our local governments to move forward with their infrastructure needs.

Let me just focus on one point. In order to achieve the distributional effects that you want under your value-added tax and which I want out of the value-added tax, it seems to me that you are going to have to have some relationship to income. You have mentioned it as perhaps an earned income tax credit or a negative earned income tax credit.

So we are going to still need to impose some form of income adjustment to the consumption tax in order to be able to achieve these levels. If I understand your testimony, your plea is don't make the value-added tax complex by trying to adjust which products are subject to the tax, let's work on it based upon the taxpayers' ability to pay and make adjustments for low- and middle-income taxpayers as well as for the wealthier taxpayers.

Is that what I understand you to be saying?

Mr. GIBBONS. Absolutely. You know, you can't escape the pure fact that for 30 years we have imposed upon classes of taxpayers different burdens of taxation in the United States, and page 5 shows you clearly and unequivocally for 20 years what the burden has been. These are CBO figures, not Sam Gibbons' figures.

That is what the burden has been. You can see what little change we made in it in 20 or 30 years, and that has taken on some kind of aura of respectability.

I am not saying it is perfect, I am not saying that if we actually voted on a burden sharing table we would come up with this table, but that is what we have done for 30 years. Now, I give you a snapshot on page 4 of what the burdens actually are.

That includes the burdens of all Federal taxes, all Federal taxes. You can't think of one Federal tax that is not included in that, and that is the CBO figures again about that, and there is nothing sacred about those figures, but we have got to look at them realistically and say politically can we change that burden table without—can we walk away from that, and when you go to flat tax, flat income tax you are going to shift that burden down.

If you go to the value-added tax without making some kind of adjustments outside of the tax for that, you are going to shift the burden down. I don't want to do that. I don't think this Committee will want to do it. That is the debate we ought to be having here in the Committee and in the Congress and in the Nation really.

Mr. CARDIN. Mr. Gibbons, very quickly, also on the issue such as State financing, I saw you shaking your head affirmatively. I take it you would also be amenable to considering changes to help State governments as long as we don't make the Tax Code more complex?

Mr. GIBBONS. That is correct. We ought to do it outside of the value-added tax. It can be done.

Mr. CARDIN. I thank you for your testimony.

Thank you, Mr. Chairman.

Mr. THOMAS [presiding]. The gentleman from Florida, Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to voice my praise to you, Mr. Gibbons, along with Mr. Thomas and the others.

You have been, I know for the last 14 years, sort of a voice in the wilderness with regard to this because I don't think this Committee has really seriously considered alternative tax systems since Mr. Ullman left these halls.

Obviously, it is something we have to approach quite carefully. It is revolutionary—the income tax has certainly been built up throughout the years. Senator Specter was talking about how difficult and complicated the existing income tax level is.

I have to confess, unlike the Chairman of this Committee, I do not prepare my own tax return. I have a master's degree in accounting, I am a CPA, I am a lawyer, and I am on the Taxwriting Committee, and I hire a CPA to file my tax return.

That has got to tell you there is something drastically wrong with either me or the Code or perhaps both, but I think that when we look at these tables that you have produced for us, when we look through the massive tables that we require the citizens of this country to fill out, we lose so much of our income, so much of it is not reported, so much of it is in an underground economy where

there is cheating going on, and those of us who are conscientious about paying our full share quite frankly resent what is going on for those that do not pay their share.

The simplicity of the process of the VAT tax, once we get to know what it is, I think, would be far, far preferable and I think, as you very eloquently put forth, would certainly make us much more competitive abroad. How this is finally going to break down, how many people are going to come out to this Committee, how many industries are going to be affected by it, are things that we are going to have to wade through, and quite obviously the whole mindset of the way we do business, the way we give to charities, the way we pay taxes, the way we take out mortgages, all of those things are going to be affected by such a revolutionary change, and quite frankly before this Committee makes a decision and before I as a Member make a decision to support a value-added tax, it is necessary for us to have exhaustive and extensive hearings, and the Chairman has begun that process.

As to the flat tax, Congressman Thomas made reference to the fact that we did in fact put in a modified flat tax some years ago, and the question is if you are going to have a pure flat tax, that is one thing. However, as we get through the hearings and as we heard from Senator Specter, that process is going to begin to collapse.

In addition to praising you for your work on this, I ask for this time to have one simple question, and that is what would you do with the Constitution if we were to do away with the income tax? Would you leave the constitutional amendment in place that originally authorized the Federal Government to go forward with an income tax or would you repeal it?

Mr. GIBBONS. When I was talking to Chairman Archer a few days ago, one of my many conversations I have had with him, he asked me the same question, and I asked him to let me think about it a while.

I would like to get rid of all indicia of the income tax because I think it is a 17th or 18th century idea that we put the death knell to it in 1947 when we agreed to the General Agreement on Tariffs and Trade—we actually put in the GATT that you couldn't adjust the income tax at the border, but you could adjust a consumption or indirect tax at the border.

That signed the death knell for the income tax. I would like to get rid of it. If we had a good value-added tax system in place and working and if we had been able to maintain something closely approaching the burden table that we have got here in place, then I would be willing to sign on and abolish the 16th amendment, too, but I think I want to put some caveats in there. We have got a lot of steps to take along this road, and I want to get rid of it.

I believe history has already signed its death knell on the income tax.

Mr. SHAW. I believe that if we fail to do that, the American people would be suspicious of the value-added tax as simply an addition to the other tax.

Mr. GIBBONS. I agree with you. I agree with you.

Mr. SHAW. Thank you.

Thank you, Mr. Chairman.

Mr. THOMAS. The gentleman from Kentucky, Mr. Bunning.

Mr. BUNNING. Thank you. Sam, I appreciate your testimony and couldn't agree with you more that if we don't do something we are going to lose the respect and the confidence that the American people have in the Congress of the United States to do something about a problem when it presents itself.

I think the quicker we can get it done, the better off we will all be. I think I worry more about compliance, and if they lose confidence in the system, the compliance numbers seems to me that they will be dropping quicker and quicker, and I wonder if you feel that same way?

Mr. GIBBONS. Yes, sir. Mr. Bunning, that is a good point. I am glad you brought it up.

I think one of the things that has poisoned the well of American opinion about their government is the fact that they don't believe we have got enough sense to collect the revenue right. You know, this very intrusive tax system that we have, horribly complicated, everybody looks at their neighbor and says they are getting some break that I am not getting, it is not fair, it is too complicated, I don't understand it, I think that has poisoned the well.

This is a huge operation. Twenty-three percent of everything Americans do goes to taxes, goes to Federal taxes, just on an average, and the fact that the system is so unfair and so misunderstood and so unable to be understood has poisoned the well about our ability to govern.

Mr. BUNNING. I thank you for your contribution and look forward to working with you to get something done fast.

Mr. THOMAS. The gentlewoman from Connecticut, Mrs. Kennelly.

Mrs. KENNELLY. No questions, Mr. Chairman.

I have had the good fortune to discuss this with the Ranking Member, Mr. Gibbons, and I salute him on his testimony.

Mr. THOMAS. I thank the gentlelady.

The gentleman from New Jersey, Mr. Zimmer.

Mr. ZIMMER. Thank you, Mr. Chairman. I would like to focus on exactly how you would keep the distribution of the incidence of taxation the same under your proposed tax. Would individuals have to file a return to establish their eligibility for an earned income tax credit or their liability for an assessment on excess income?

Mr. GIBBONS. That is a good question, and let me say I would welcome any input you can have in this. I just point out that on page 4 that is the current version, and I point out on page 5 that is about what we have been doing for the last 20 or 30 years, so we have got to face that issue as to how to do it.

The Canadians in their tax have an adjuster for burden sharing, and we could follow their system. I just hit upon the idea that, you know, in adjusting the burden we could go to the earned income credit system and say for low-income people you get the same earned income credit you get today to bring you into this place and for the upper-income people you would get a negative earned income credit for that, so there would be the necessity of filing something every year to show what your income is.

We are going to have to do that anyway unless we make radical changes in the Social Security system. We are going to have to know what people earned in income so that we will know what

benefits to pay them in the Social Security system. I preserve the Social Security system just by making a permanent appropriation in the legislation to the Social Security Trust Fund.

That is the same way we pay the interest on the national debt today. It has to be appropriated. It is a permanent appropriation, and we would just appropriate through the Social Security Trust Fund that amount of money.

So you would have to have some system in which people annually reported their total income or we couldn't operate the Social Security system because we wouldn't know how much to pay the beneficiaries, so we are going to have to have that anyway.

Mr. ZIMMER. Mr. Gibbons, I can understand why you would want to do that, but it sort of undercuts much of the appeal of the value-added tax in the first instance. An accountant in my district gave me this button which says, "Simplify," which I intend to keep. By adding an income component you are essentially requiring taxpayers, individual citizens, to file a tax return every year.

I don't know how the Canadians do it, but it sounds to me like you are going to get into all the complexities of what defines "income," what deductions there are from income and the like, and I think it would make it impossible to repeal the 16th amendment because based at least on what Congressman Cox, a former law professor, told us yesterday, if you try to have a modified consumption tax based on income, that would not work without the 16th amendment or a new amendment to the Constitution that would make it possible.

Mr. GIBBONS. Mr. Zimmer, nobody ever said this was going to be easy, and I am sure you recognize that. But you have to face the fact that since the beginning of the income tax, there has been a tax burden imposed upon the American people—probably since the beginning of the country. I am just trying to show you here historically what the burden has been over the last 20 or 30 years.

Politically, and we are all in the political arena, we are going to have to either change the burden or we are going to have to adopt some mechanism for keeping the burden approximately the same. I don't say that this burden table is perfect, but it is the best I can find in exploring around. And we want to—as I say, we want to have revenue neutrality, we want to dismiss that argument right now, and I think we had better dismiss the burden neutrality thing unless we want to take on full scale political warfare about how you do it.

My admonition is, don't try to adjust the burden within the mechanism that is collecting 95 percent of the money in this system. If you do, you are going to end up with the same complex system that we now have for the income tax.

Mr. ZIMMER. On that point, I think we agree.

Mr. GIBBONS. We could do it. There is a way to adjust the burden, and I don't claim to be the final answer on that.

I think I am the final answer on the basic kind of tax we ought to have though.

Mr. ZIMMER. Thank you.

Mr. THOMAS. The gentleman from Texas, Mr. Johnson.

The gentleman from Massachusetts, Mr. Neal.

Mr. NEAL. Thank you. I have no specific questions, but let me ask you this. No matter what we do, aren't there going to be winners and losers in this debate?

Mr. GIBBONS. As far as individuals are concerned, no, because we are going to come right back to the same burden that we have now.

Mr. NEAL. Isn't the point that Mr. Thomas made essential when he said to Senator Specter on his proposal that we exclude mortgage deductions? Isn't that the point of this?

I remember the cheer across the country in 1986 that we were going to change the system once and for all. People got their bills the following year, and they were off the wall about it.

Mr. GIBBONS. Within the burden adjuster, we would take that into consideration. The last column on page 4, you can manipulate that any way you want to. I would point out on the home mortgage adjustment—and I don't want to make the homebuilders mad and the realtors—Mr. English, you ought to step across the border into Canada, right across Lake Erie—that is a big step——

Mr. ENGLISH. I do occasionally.

Mr. GIBBONS. They have pretty good housing and most look better than houses in the United States.

You know, the Canadians think we are nuts. They have never had a home mortgage interest deduction in the history of Canada, and they have got the same incidence of home ownership that we have in the United States. I am no economist, but I think the home mortgage deduction has had one ultimate impact. I have a home mortgage interest deduction even today, so I am in love with it. It has driven up the price of raw land.

I will give you a personal illustration. I bought the lot on which I have lived for 45 years in Tampa for $1,500. That same lot is now worth over $200,000. What has driven it up? All the stimulus that we have put into real estate on this Committee for the 30 years that I have been around here. We have stimulated real estate values, and it has run up the price of raw land and has made it impossible for a young family to buy a lot. For $1,500, I bought the same lot and it is worth $200,000; it is worth more than the house that is on it. That is what has happened with all these crazy stimuli.

I am in love with the home mortgage deduction. If you want to preserve that, I will go along.

It comes down to the right hand column on page 4, that is the burdens, and every time you mess around with it, you have to come back to it. It all comes back to that.

Mr. NEAL. How many votes do you think there would be in the House tomorrow to eliminate the home mortgage deduction?

Mr. GIBBONS. I don't know. I don't know. I think once Americans stop and think about it, they will realize—we could do it in the income adjuster. Only 30 percent of the people who file income tax returns even file a long form, so there are not a lot of people that take home mortgage interest deductions. Most of our crowd, you and I are in that last column, the bottom figure, the $100,000 to $200,000. We are in that category, and our friends have home mortgage interest deductions so we hear a lot from them. But 70 percent of the taxpayers don't even claim a home mortgage interest deduction because they don't file a form on which you can claim it.

So it is a big political issue around our set, but you can look right next door—as I pointed out to Mr. English, you can go to Canada, not far from Massachusetts, and look at their housing stock, look at the way they have done it; and they think we are nuts for having home mortgage deductions. They have never had one in Canada.

I am not here advocating elimination of the home mortgage deduction. That is a different debate. It will come out of the column on the right-hand side. I apologize to the homebuilders and the realtors and all the people that are out there peddling home mortgage interest deductions, but——

Mr. THOMAS. The gentleman from Pennsylvania, Mr. English.

Mr. ENGLISH. Thank you. Really, it is an enormous asset to have someone of your long expertise on this issue on this panel at a time when it is considering this issue.

I have a couple of questions and maybe a couple of concerns with the value-added tax. I think you can probably address them directly. Mr. Thomas skirted one and that is the issue of visibility. I have noticed that, as the VAT advocates have been before this panel, they haven't listed visibility as one of the virtues to be sought in a tax system. I am also aware many of the European countries that have adopted a VAT have experienced a growth in the size of government after adopting it, because it is a relatively easy tax to increase, it is so pervasive, it is an incredibly efficient revenue machine, and that gives me cause for concern. I would like your comments on those points and to the question, would you be supportive of a VAT if it included a provision that consumers see the price tag of the VAT at the point of sale?

Mr. GIBBONS. Sure. We could do that; that is simple. All we would require is that every sales receipt for everything you bought and all that business bought said, "This price contains a 20 percent value-added tax." That makes it visible. Every gasoline receipt you had, every meal receipt you had, every hospital bill you had, every bill that comes through your hands would have, This bill contains a 20 percent value-added tax. I use 20 percent because that is a good round figure. We could make it visible.

Two, is it easier to increase taxes in the convoluted way we have been going about it here in this Committee—I have been 27 years on this thing—or is it easier to vote on a simple, I am going to increase the rate from 20 to 21 percent? I would say you would get a lot more heat on going up 1 or 2 or 5 percent than you do in this conversation that we carry on about all the ramifications of the income tax that obviously confuses everybody but the lobbyists out here. They know what we are talking about, but the public doesn't know what we are talking about when we go into tax reform formation.

I think it would be much more difficult to increase the rate than it is to increase it the way we currently do now, by limiting the deductions and limiting the credits and limiting all the other things that—depreciations and changing the depreciation schedule—we raise a lot of money by just a little tinkering with LIFO and FIFO and things like that that only the audience in this room understands. The public on the other end of the camera doesn't understand all that tax language we throw out there.

Mr. ENGLISH. Do you feel that if we move to a VAT-like consumption tax it would increase our savings pool and have a positive effect on the economy? The reason I ask is, Secretary Samuels said something yesterday that sounded like the savings pool does not increase or doesn't change based on tax changes. Do you concur with that or do you think this could be a benefit to savings?

Mr. GIBBONS. I heard Secretary Samuels say that. I am not sure that I agree with him. I have looked at the savings rate of citizens. The first caveat is that we don't do a very good job measuring savings rates. I would encourage you not to put too much faith in the statistical data you get on savings rates.

Second, I don't think we really understand too well why people save or why they don't save. And I do think—this value-added tax system that I have does not tax savings. Savings do not get taxed in the value-added system, so if you don't spend it, you don't get taxed. I believe that would increase the savings rate, but that is just an intuitive thought that I have.

You certainly get rid of the double taxation on savings that you have now, or the triple taxation; you take away a lot of disincentives. But I am not sure I understand why Americans save. I imagine they do fail to save because of the disincentives now to save.

Mr. ENGLISH. I have great faith in your intuition, and I appreciate the opportunity to ask those questions.

Chairman ARCHER [presiding]. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Mr. Gibbons, assuming revenue neutrality, what do you think would be the most important if we were to rank in order of one through four the areas of simplicity, efficiency, equity and administration? In your own personal opinion, what do you think is the most important of those four goals that we are trying to achieve with a new tax system for the American people? Whether it is a VAT or a flat or a standard consumption tax system, what do you think is the most important, one through four?

Mr. GIBBONS. I think we would all intangibly gain something from it, and that is that there would be a greater trust in government, in its ability to conduct its business so that people understand what is going on. Frankly, they don't understand what we are doing now, as far as taxes are concerned, and I think that poisons the well for any positive feelings that Americans have about government.

As I go around the world, I find Americans distrust their government much more than, say, the Canadians distrust their government or the English distrust their government or the French distrust their government. There is nowhere in the world the level of hate that I have been able to measure toward government that is in this country. It goes back to the fundamental fact we have a convoluted, impossible to understand revenue-raising system that is very intrusive and very burdensome to the average American.

Mr. CHRISTENSEN. I agree.

Is simplicity number one, then?

Mr. GIBBONS. Simplicity and understanding of it. I think if Americans understand it, they can make the kinds of changes they need to make, but they do not understand this present system.

Mr. CHRISTENSEN. So simplicity would be number one. I agree, I think simplicity is probably the number one thing that we have to fashion a new tax system around.

Where would efficiency and equity fall?

Mr. GIBBONS. They are very important. I don't think that the U.S. economy can continue to pay as much out in overhead to collect its revenue as we are now paying out. I used $300 billion; it is probably much higher, around $600 billion out of the $1.4 trillion we are now collecting. It is an extremely expensive as well as convoluted, not understandable system.

Mr. CHRISTENSEN. In light of that, if simplicity would be number one of the four that we are after in ranking, I would think that the flat tax has an edge up on the VAT tax or maybe even the standard consumption tax because it is such a simple tax to understand, and the American people seem to be understanding the flat tax more than the consumption tax.

Mr. GIBBONS. The problem with any tax that classifies as an income tax is that you cannot adjust it at the international border. Remember these glasses that I wear. You can't get around that. Unless we decide to get around that, we are going to denude the United States of good jobs.

You know, I wish you to could get the AFL–CIO to understand that. Their love affair with the income tax is what is destroying their jobs.

Mr. CHRISTENSEN. When I am talking about a flat tax, I mean a pure flat tax. For example, when we talk about administration and elimination of the IRS, a consumption national sales tax, I think, has a leg up on a flat tax.

Mr. GIBBONS. No. A national sales tax is a national retail sales tax, and I am very experienced in that. My father drew up the first sales tax in Florida and I served on the legislative committee for 10 years that legislated on the thing. A retail sales tax is extremely complicated to administer because it depends upon identifying the last sale to the consumer, and when you get into that, that is a very complex thing.

That is the reason why a value-added tax is much simpler to administer. Every transaction carries with it the tax, but gives a credit for the tax that has already been paid. So it is spread through the whole system and you don't have to identify each particular sale. It is self-enforcing.

Mr. CHRISTENSEN. Thank you. I appreciate your testimony. I look forward to working with you on this truly historic issue. We are not trying to fix the old, but pull out the roots and start with a new program.

I couldn't agree more with the fact that we need to go cold turkey, and this transitional phase, I think you are right on the mark when we talk about going cold turkey and starting over from the start.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman.

Thank you, Mr. Gibbons, for being here. You have a long and rich history as a leader in support of reform of our present tax system.

I am concerned about whatever system that we are able to devise, that it is fair and it is revenue neutral. I would like for you to put on your thinking cap for a moment and be a person of vision like you are.

Do you think that we have the ability, the capacity or the will as a body to devise a system that would be fair and at the same time revenue neutral and would be embraced by the American people?

Mr. GIBBONS. We haven't had that ability yet, but Mr. Lewis, I think we are developing that ability. The very fact that we are having these hearings and that we are earnestly discussing a change, I think the message ought to go out that we are sincere in examining the mistakes of the past and going forward with the future with something not just because it is new, but because it is—we can make it just, we can make it understandable, and we can make it—and we can make it so people know what they are doing.

They are suspicious of us and of their friends and neighbors and everybody else because of the current system, and we need to dispel that.

You know, fairness, I can't tell you whether this burden table that I have on page 4 is what the burden table ought to be. I can only tell you that is what the burden table has been for 20 or 30 years, and we should come back to that as the first point of discussion. We should not get the American public all upset that we are going to change the burden table on them, that we are going to slide the tax burden down to the low-income people or slide it up to the upper-income people.

Let's use as a point of departure, what we have been doing for 30 years and say, that is kind of, de facto, accepted as to what is the appropriate burden, but we are not going to surreptitiously slide down to low-income people a heavier burden or slide up to high-income people a heavier burden. Start where we are and say, we can adjust it and have a debate about it. I think we could do it and far simpler than the current system.

Mr. LEWIS. We continue to discuss the need for reform of the tax system. I am concerned that we do not play into the hands of this mindset that we should downsize the National Government, the Federal Government, that something is bad and evil with the Federal Government and with the American society and that it must be overhauled from bottom up or from the top down.

Mr. GIBBONS. Yes. In taking on this really awesome burden that we are taking on here to change the revenue system, we ought to try to eliminate as many arguments from the overall argument as possible.

You remember in the 1984–85–86 Tax Reform Act we adopted the principle of revenue neutrality, that we would not include in the debate we carried on then the debate about whether government was too big or too little. That debate ought to be carried on, but not in this framework.

Page 2, the first thing I say, revenue neutrality. Let's agree that neither side in this debate or all the sides in this debate, that we are not bringing in a lot of extraneous material. We are really trying to correct the revenue-gathering system right now. We can argue about the other things at other times.

Mr. LEWIS. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. McCrery. Mr. McCrery is not here.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Gibbons, you mentioned several taxes that would be eliminated—FICA, the personal income, corporate income. What about estate tax?

Mr. GIBBONS. I didn't tackle that. One, it is not a lot of money. I know it is important.

Let me say that this Committee has not had a lot of experience on the estate tax. I have been on the Committee 27 years, and I think only one time in 27 years have we spent time on estate tax. I didn't want to open up that argument at the time I opened up these other arguments.

I realize this Committee ought to get to that subject and pay a lot of attention to it. It is only about $6 billion out of $1.4 trillion, and I didn't want to throw that argument into this debate. That is the only reason I avoided that.

Mr. COLLINS. Let's go to the earned income tax credit. You spoke of that as adjust the burden?

Mr. GIBBONS. Well, if you have roughly a 20 percent value-added tax rate, bear in mind that most people, particularly people at the lower end of this chart I show you on page 4, every year they spend almost 100 percent of their income and so they would have roughly an effective tax rate of 20 percent. And if you look at that burden table that I showed you there, you will notice that the lowest income people really have an effective tax rate now of 6.7 percent.

So that is—there is some makeup to be done there. We can't increase their tax rate by 12, 13 percent without creating a whale of a political and social impact. Now I don't know how far up this revenue-sharing thing you have to come, the revenue table, before people start saving, but most of those people at the lower end are spending all of their income, and all of their income would be taxed. So we have to do something about them. That is a political necessity that you and I face.

I don't say that my system of burden sharing adjustment is correct, but somewhere along the line we have to in this Committee adopt something to make sure we are not just shooting the burden of taxation, the burden of government, down to those low-income people.

Those are shocking figures when you see that from the less than 10,000 people—there are 14 million families who have an average income of $6,000 a year. I am not sure I am psychologically prepared for that; and they have a current tax burden of 6.7 percent of their income. That includes FICA tax.

Mr. COLLINS. The earned income tax——

Mr. GIBBONS. The earned income tax credit is reflected in that 6.7 percent. That figure—if you look on the next page, you will see that that figure has dropped remarkably. You know, that figure in 1977 was 10 percent and look what it is in 1994. That is the same 10 million families. That is the impact of the earned income tax credit.

Mr. COLLINS. The earned income tax credit was originally designed to offset the FICA tax.

Mr. GIBBONS. It really has down there, yes, sir; you can see it.

Mr. COLLINS. One other question. You mentioned appropriations for Social Security. Some of this we do with a standing appropriation for interest. Would that not make the Social Security program a true social program rather than an intended pension program, as it was first designed?

Mr. GIBBONS. There are going to be people that will make that argument, and one of the ways that we could lower the VAT tax rate is not repeal the FICA tax. But the FICA tax is going to be embedded in these glasses if we don't. I want to get the FICA tax out of these glasses.

That FICA tax is big. I have the figures—it is almost as big as the personal income tax. It is a huge tax. And it is probably the most regressive tax that anybody on Earth ever invented.

Mr. COLLINS. I understand.

One of the things you mentioned——

Chairman ARCHER. The gentleman's time is about to expire.

Mr. COLLINS. There are two wells, one wet and one dry; the dry well is the one we keep pouring money into.

Mr. GIBBONS. I didn't hear you.

Chairman ARCHER. Sam, you have done an outstanding job in your presentation today, and I don't want to curtail the continued questioning.

We committed to the Majority Leader that we would receive him at 11:15, and unless there is anybody else on the Committee that has not inquired, that feels absolutely constrained that they must inquire, I would hope that at least we should try to shorten this as much as possible so that we don't keep the Majority Leader, who has arrived and is waiting.

Mr. GIBBONS. I don't want to do that. He is a good friend of mine and there are many things on which we agree on this. The only effect of his proposal is he can't adjust it at the border and you will have trouble with burden.

He has one fatal defect in his proposal; you can't adjust it at the border, or you are going get slapped down as we have been slapped down before by the General Agreement on Tariffs and Trade.

Chairman ARCHER. Mr. Rangel, do you have a very short inquiry?

Mr. RANGEL. Yes, Mr. Chairman, and I am aware of the direction in which you would like the Members to go.

My problem is that I don't think that we are seeking to change the system this year or next year, but we are prepared to define the issues for the Presidential election. But notwithstanding that, I am going to try to be as nonpartisan and openminded as I can on this question.

It seems to me if we are talking about flat taxes and consumption taxes and protecting savings, that basically what we are saying is that if you don't spend it, it is not going to be taxed. If you save it, or if you have income interest coming in, that is not going to be taxed; it is only when you spend.

I guess it is pretty well accepted that poor people and low-income people spend more of a percentage of their disposable income for

food, shelter, health care. But you are saying that even though you are not giving deductions and special treatments at one rate, that when it is all over between consumption tax and VAT tax, that you are now going to make adjustments so that we don't have a disparity based on the facts of the different ways we are going to do it, and so your tax will be flat in the middle, but when it comes to the poor folks that are out there that really don't come out ahead in this concept, that you make the necessary adjustment somehow so that they are not paying more of a percentage of what they are earning than the others who don't have to spend as much.

Then you make this up by eliminating FICA taxes and other types of payroll taxes by taking a look at the upper end of the high-income people, which would indeed include those who have the interest income, and somehow you would do what to them to make up for the difference?

Mr. GIBBONS. I propose three steps. Step 1: Repeal the income tax, corporate and personal; repeal the FICA tax. That is step 1.

Step 2: You impose a value-added tax, which is that form there, and only business would remit the tax.

Mr. RANGEL. I am with you.

Mr. GIBBONS. The third step, and that is the one you are talking about is table 1 on page 4 of my testimony. I want us to come out in the same way in the last column as we are today. I think that is what I want us to do. We can have a burden adjuster, that is—or any other thing, but it is essentially a burden adjuster. We have to do that, in my opinion.

Mr. RANGEL. Since all my colleagues over here have been complimenting you for your bipartisanship and the direction that you are going, I would like to join this group and ask my Chairman, do you agree in concept that the flat tax would be flat in the middle, that we make adjustments for the low-income people that, we all agree, don't have that much to save; and where you find the high-income people, that we have something there to eliminate the disparity between the higher incomes and the low incomes? If you think that is—in principle, and we can work out the details later—that is where you want us to go, then you would want you to compliment me as you do Sam Gibbons.

Chairman ARCHER. Charlie, I will be very happy to discuss this with you. Mr. Gibbons, as the witness, might like to respond.

But in the constraints of time, I would say, Sam, thank you for your presentation.

Mr. GIBBONS. Thank you.

I want to thank my fellow Committee Members for allowing me to do this. I have tried to do this individually with you for a long, long time; and I hogged the scene here today, so I apologize to you.

I want to apologize to the Majority Leader, who I have kept waiting here.

Chairman ARCHER. Sam, you have been paid the ultimate compliment by this Committee and that is that people have genuinely been interested in your presentation and have inquired in great depth, because you know when we go before other committees there are very few questions ever asked of us. We are sort of dismissed when we appear as witnesses. So I thank you very much.

Mr. GIBBONS. Thank you.

Chairman ARCHER. I see the Majority Leader is here. If the Majority Leader would honor us by stepping up to the witness table and taking a chair at the witness table: Mr. Leader, welcome to our Committee. For some period of time, we know that you have done considerable work on trying to replace the currently nonproductive income tax system by which we collect revenue; and we are here to listen to all approaches that can be alternatives to the current system—not reforms. We have been through too many reforms, and I think you and I both agree that the current income tax system is broken, it cannot be fixed, and we must replace it with something else.

We will be pleased to hear your testimony and you may proceed.

STATEMENT OF HON. RICHARD K. ARMEY, MAJORITY LEADER AND A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. ARMEY. Thank you, Mr. Chairman. I want to thank the Committee. Not only am I very pleased to see you holding these hearings, which I believe to be very timely, but it is a particular pleasure for me to follow Sam Gibbons. Of course, we all have enormous respect and admiration for Sam, so it is a privilege.

You did not keep me waiting; you kept me entertained and informed, so it was a pleasure to listen to you.

Mr. Chairman, I think it is clear there is no escaping an understanding that for some time now the American people have been telegraphing us a message that they will no longer tolerate the Tax Code as we know it today. Their resolve, I think, has solidified in this Nation; and I have to say to our credit across this Congress, we have many good proposals by people who have read the resolve of the American people and have said, let me offer my alternative.

Mr. Gibbons has just done a presentation on his value-added tax. We certainly can admire and respect the work that has been done by our colleagues in the Senate, Senators Nunn and Domenici. The Chairman, of course, has his proposal on a national consumption tax. Mr. Specter, who I understand was here earlier, offers a variation of a flat tax, and I offer mine.

Now, I must say that over a year ago when I began to read the will of the American people, I began to ask the question, What might I offer as a comprehensive tax reform that replaces the Tax Code as we know it? And I recall, my initial tenure, when there was during my campaign in 1984 and during the first couple of years of my tenure an enormous public debate about flat tax. So I took the time to go back and review that, as I reviewed others.

One, I asked, what was it the country found attractive about the flat tax? Two, why did it not happen earlier, when I remember the debate seemed to have some vitality attached to it? Having researched past efforts, I came to some conclusions and wrote my own bill.

In that process, of course, I rediscovered the works of Professors Hall and Rabushka and found that to be quite an inspiration to me. I managed to establish a contact with the professors, discovered them to be in the process of a reiteration of their work—it is, of course, now available to us—and in discussions with them and others created my variation on the flat tax.

I revealed my iteration of the flat tax on June 11, June 16 of last year, kicking it off with the editorial in the Wall Street Journal; other editorials followed. I had an interesting curiosity with respect to, how would the Nation respond to this offering? It was my view that if it is a good idea, it will be recognized and embraced by the American people and that will give it standing in the legislative process. I must say that I tried to encourage their understanding and acceptance of it by virtue of being on talk radio shows, approximately 15 a week for every week following June 16 up until mid-October last year when I became preoccupied with other matters.

I dare say that we have had a bigger, broader, more enthusiastic acceptance of a flat tax by the American people at large than what anyone would have dared to hope for on June 11. And I have gotten thousands of letters, phone calls, and had additional thousands of personal conversations with people as I have traveled across this country; and there is enormous enthusiasm.

I thought what I would try to do today is distill for you my understanding of what the American people have told me they have seen in the flat tax proposal that endears it to them. I should point out that there is a businesswriter in the Dallas Morning News named Scott Burns, for example, who wrote a single article on the flat tax. It was a syndicated article, and within 2 weeks Scott Burns received over 5,000 letters. He was quite impressed by that.

On a personal note, earlier this year I happened to be on a television show with Sam Donaldson. Sam Donaldson expressed his reservations about the flat tax, and I saw him 1 week later and he said he had never received so many letters from people who wanted to straighten him out. I found that a gratifying experience and enjoyed sharing it with Sam.

So I believe I have a great deal of testimony.

Why do the American people, if I dare say, "love" the flat tax? One, they see it as fair. In that respect, they recognize that the flat tax collects every dime that is earned in the U.S. economy, brings it in the tax base and taxes it only one time with a simple flat rate applied to every dollar of earning in the economy. That they believe to be fair.

The current Tax Code, as you know, exempts hundreds of billions of dollars from the tax base and compensates, of course, for the revenue shortage that arises from that exemption by double-taxing hundreds of billions of dollars' worth of income. That is patently unfair, especially if one takes it back to production theory and recognizes that for production to take place, efficiency with increasing productivity, there must be vitality and change in the provision, in necessary coordinates of both capital and labor to the production process.

It turns out that most of the income that is exempted from the tax base is income that derives from provision of labor; most that is double-taxed is income that derives from provision of capital, and that gives you an imbalance.

I like to point with some pride to Congress that it was Senator Douglas that gave us the Cobb-Douglas production function, which always reminds us of the necessary combination of capital and labor and their cojoint need in production, so we end that kind of bias against capital provision.

One of my favorite stories on the question of fairness comes to me from a fellow who parks cars at one of the hotels in Dallas where I was going to give a speech one day. A person in charge of parking cars is not a person of extraordinary income. He is an ordinary American wage earner with a family. As I parked my car 1 day, he said, Congressman, I love your flat tax. He said, the reason I love your flat tax is because it treats everybody the same. There is one rate for everybody and I don't have to listen to this class warfare baloney that I keep hearing.

I found that a gratifying observation. And I believe he spoke for a great deal of America. This is very important to me.

I believe that America today and in the 1996 Presidential campaign will give expression to the uniquely American definition of fairness; that is, fairness is when everybody is treated exactly the same as everybody else. I think the embrace of the flat tax reflects that definition of fairness which I happen to think is admirable in the American people.

The other thing that is often recognized and cited is, a flat tax will generate growth in the American economy. A flat tax, of course, does give a reduction in the marginal tax rate to most Americans and, of course, we know already that reducing the marginal tax rate provides an incentive to work more.

Jack Kemp illustrates that by saying, if in fact on Monday you paid a 20 percent tax rate, on Tuesday a 30, on Wednesday a 40, on Thursday a 50, and on Friday a 60, which day of the week would you not work? It is very clear the marginal day with the marginal rate is the day you take, and I frankly would take fridays off.

The other thing that helps us with growth is the treatment of investment, that in the flat tax, as I propose it, investment is immediately written off, that the time you put a machine online, you write that off as an immediate expensing.

We have a unique encouragement to savings in that interest earnings are not taxed to the individual, which will encourage more savings; and we end the estate tax, which on the incentive side, I think is another boon. The fact of the matter is that when you talk about the marginal years that I will work in my life, the marginal effort I will make to build my business stronger if I happen to own a corner drugstore, to build my estate larger if I happen to have a wage job, knowing that when I die, should I have something left, it will go to my children, gives me greater incentive to work longer and harder and build greater and larger than if I am afraid the government will run off with half of it. Given a choice of working to support my government and working to support my grandchildren, I will vote for my grandchildren, and I think the American people will; and they will make the extra effort for their grandchildren they will never make for the government.

Another thing often cited in letters I receive is neutrality. The flat tax, as I have written it, is completely neutral with respect to consumption, savings and investment. People understand they are a better judge of how to allocate their expenditure between these three activities; and within these activities, how I will consume, where I will invest and in which manner I will save is a decision

better made by me than one prompted by government tax treatment.

Simplification, of course, is adored by the American people and there is no doubt the poster child for tax simplification is the postcard size simple flat tax form with 10 lines, and that pretty well speaks for itself.

Also the flat tax promises honesty, visibility and directness. I take this as far as I can go with my proposal, which is to end withholding. First of all, I argue, and I will tell you as a matter of fact, all taxes are paid by people and all taxes are paid out of current income flows, so the most direct way you can show them what their tax bill is is the way to make them most aware of what the cost of big government is in their lives and will most prompt them to ask the question, am I getting my money's worth, so they will be more judicious in what it is they vote for.

In my proposal, I give them an opportunity which, in my vision, would afford them the opportunity at the first day of every month as they sit down at their kitchen table to write their bills for their rent, or their house payment, to the Penney store, wherever, that they will also write a bill and send a check to Washington. And each month I am sure they will realize that I have just sent a check to Washington which is more than I just wrote out for food, shelter and clothing combined, and I wonder if am I getting my money's worth, and there will be no doubt about it.

Furthermore, in addition to the insight that people get who pay their taxes, which incidentally I am prompted by my observation, the only thing that is worse than a nation that loves the IRS is a nation—I am sorry, the only thing that is worse than a nation that hates the IRS is a nation that loves the IRS—and in the current withholding system all too many people feel some misinformed sense of gratification when at the end of the whole process they get a check back without any realization of what they paid.

My final point is, if I could speak for every average man and woman, it is my money. I earned it. Why should the government preempt my right to take my own paycheck and make my own disbursements commensurate with my obligations? Some will say, if you give people that right, they won't honor that. But I would offer this. The enforcement power of J.C. Penney is considerably less than the enforcement power of the government. If people in their ordinary course of business and their ordinary life willfully pay their Penney's bill, I think we can dare risk that they will willfully pay their tax bill; and I have no doubt.

A flat tax, in summary, is a tax that bets on the goodness of the American people, not the guile of the Federal Government; and I think that is a bet that we ought to make.

I thank you. I ask that you put my formal statement in the record.

Chairman ARCHER. Without objection, your complete statement will be put into the record.

[The prepared statement follows:]

STATEMENT BY CONGRESSMAN DICK ARMEY
HOUSE WAYS AND MEANS COMMITTEE

June 8, 1995

Mr. Chairman and Members of the Committee,

Thank you for this opportunity to discuss the issue of tax reform. I would like to begin by complementing you, Mr. Chairman, for holding these hearings this week. I couldn't agree with you more that the current tax system needs to be replaced.

The hearings this week reveal more, however, than a recognition on your part of how counterproductive our current tax system is. These hearings also illustrate that you, Mr. Chairman, are a refreshing change, particularly for those who study Public Choice. Public Choice is a school of economics that seeks to explain the political process. A key premise in Public Choice theory is that politicians maximize votes by securing benefits to small segments of the electorate, the cost of which are largely lost on the population at large.

Public Choice theory tells us that a chairman of the Ways and Means Committee might use his position to disburse favors to narrow interests. We are here today, however, because this Chairman is committed to a neutral tax system which will advance the broader public interest. The tax reforms being discussed this week would give average Americans far more, and elected officials far less, control over resources in our economy. Make no mistake about it, the proposals before this Committee would expand freedom and opportunity for the American people. I want to take this opportunity to commend the Chairman for his eagerness to place the public interest over any other consideration.

Mr. Chairman, when you announced this week's hearings, you stated that any tax reform proposal should meet four goals. I agree with those goals, and my testimony today will focus on them. Before I explain why the flat tax meets those goals, let me begin by briefly outlining how my proposal would work.

How it Works

My plan, which is based on a 1981 proposal by Hoover Institution fellows Robert Hall and Alvin Rabushka, would scrap the existing tax code entirely. Instead, *all income would be taxed once and only once at the single low rate of 17 percent.* To minimize revenue loss, the rate would initially be set at 20 percent, then drop to 17 percent in year three. Income is defined as the total of wages, salary, and pensions. There would be no credits or deductions, although each taxpayer would receive a generous family allowance. Beginning in year three of the plan, this allowance, which is indexed for inflation, would be $13,100 for an individual, $26,200 for a married couple, and $5,300 for each child. A family of four would have to earn $36,800 before it

owed a penny of federal income tax.

Business income would be handled with equal simplicity. A corporation would simply subtract expenses from revenues and pay 17 percent on the remainder. Revenues are defined as corporate, partnership, professional, farm, and rental income. The base is gross revenue less purchases of goods and services, capital equipment, structures, land, and wage and pension contributions to employees.

Goal No. 1 -- Simplicity

Like you, Mr. Chairman, I believe the first goal of tax reform should make the tax code easy to comply with and reduce the role of the federal government in the American people's lives. Unfortunately, the current tax code is complex and intrusive. Each year Americans spend 5.4 billion man-hours preparing their taxes for the government. That's more time than it takes to build every car, truck, and van manufactured in the United States. The IRS now sends out eight billion pages of forms and instructions each year. Laid end to end, they would stretch 28 times the circumference of the earth. After seven decades of amendments, revisions, exemptions, loopholes and extensions, the code has become an incoherent mess.

Does the flat tax make this system more simple and less burdensome? It certainly does. By eliminating the various credits, deductions and loopholes, the flat tax makes the tax system so simple Americans could file their taxes on a form the size of a postcard. Not only would this dramatically reduce the time and resources devoted to complying with the tax code, it would also make the federal government far less intrusive. Americans would need to reveal far less information to the Internal Revenue Service, and under much less duress, than the current system.

Goal No. 2 -- Promote Saving

Tax reform should encourage greater saving and investment. Perhaps the worst feature of today's tax code is its discriminatory treatment of saving. Consider how the present tax code treats saving and investment. Today, we double tax business earnings, which places a strong bias against saving and investment. For example, we tax business earnings through the corporate income tax and then tax dividends -- which are, in fact, after-tax payments. This double taxation of the same stream of income creates a strong bias against saving and investing. Obviously, this makes saving and investing much less attractive relative to consumption. And the nation is poorer as a result.

Capital is the lifeblood of an economy. Without capital, workers cannot enhance their productivity and their wages stagnate. Today's double and even triple taxation of income discourages saving, reduces the pool of capital available to entrepreneurs and workers, slows productivity and wage growth, lowers living standards, and, as a side effect, reduces revenue to the Treasury.

Like the other alternatives the committee is considering this week, the tax base of the flat tax is consumption. By eliminating the double taxation of saving and providing for the full expensing of capital investment, the flat tax functions as a kind of consumption tax, much favored by economists. In this sense, the Domenici-Nunn proposal for a consumed income tax and my flat tax are trying to accomplish the same thing. They are blood brothers in spirit. This goal would be achieved, as well, by a national retail sales tax, or even a European-style value-added tax. All of these plans can lay claim to the title of "consumption tax."

Goal No. 3 -- Improve Competitiveness

Mr. Chairman, the third goal for tax reform you mentioned is to improve the international competitiveness of American workers and businesses. The flat tax would make the U.S. the most attractive nation in the world for investment, produce a higher economic growth rate and raise living standards. It would liberate America's businesses to be more efficient, replacing today's maze of politically targeted tax breaks with a system that is perfectly neutral as between types and sizes of business, between economic sectors, and between types of investment. America's entrepreneurs could make decisions based on what makes the best economic sense, rather than diverting talent and resources for tax avoidance strategies.

In other words, the flat tax would relieve the economy from what economists call "dead weight" or social welfare loss. According to James L. Payne, just the compliance costs of today's tax code add up to $232 billion. When other costs of the current system -- such as tax distortions which shift resources away from their most efficient use, thus lowering output -- are included, the cost to the economy is well into the hundreds of billions of dollars. These costs are pure waste and directly lower the standard of living of the American people. The flat tax would eliminate the vast majority of these costs and dramatically improve the performance of the economy.

The flat tax would also lower the burden currently placed on work, saving, and investment. It rewards *work* by lowering the top marginal income-tax rate from 40 percent to 17 percent. It rewards *saving* by ending the current double taxation of saving, sweeping away the estate tax, the capital gains tax, and the double tax on dividends. And it rewards *investment* by permitting businesses to immediately deduct all expenses, plant, and equipment. Thus, the flat tax would produce higher productivity and economic growth, leading to higher employment and wages.

When adding the effects of more work effort, a higher capital stock, and improved incentives for entrepreneurial effort, Professors Hall and Rabushka estimate that a flat tax would increase per capita income by $1,900 by the year 2002. In other words, a typical family of four in America would see its income increase $7,600 more than if we preserve the tax system we have today. Let me emphasize that while this is a truly astonishing number, it is based on the consensus of the economic literature and is a mainstream estimate. Many studies suggest the number would be even higher.

Border Adjustability

Some have suggested that our tax system should tax imports and not tax exports as a way of making U.S. businesses more competitive in the world market. Congress should make the tax code "border adjustable," as tax policy people put it. The sales tax, VAT, and the Domenici-Nunn USA Tax are all border adjustable, but the flat tax I have proposed is not.

Supporters of a border adjustable system say that it would increase U.S. competitiveness by taxing imports and not taxing exports. This way, American firms receive an advantage over foreign firms and that will favorably alter the balance of trade.

In my view, a border adjustable tax will not be effective in reducing the trade deficit. It's an immutable law of economics which says that trade surpluses and deficits are linked to the amount a nation lends or borrows. When saving is low, the trade deficit must be high. A tax on imports which is merely a substitute for another tax will not effect the amount Americans save. That means the trade deficit not only will stay the same, it must stay the same, as a basic principle of economics.

Economists might explain it this way: If there is more investing happening in our economy than can be financed by our saving, then foreign investors must be accounting for the difference. In effect, they are taking the money we give them for their cars and VCRs and using it to buy our stocks and bonds, thus supplying the investment capital that we don't supply ourselves. This difference is the "trade deficit."

The only way to change the deficit, then, is to change our savings rate. If we increase our saving relative to our domestic investment, we have less need for foreign cash. The trade deficit will then drop, as we spend relatively less money buying foreign goods and relatively more investing at home.

But anything we do to tax incoming foreign goods--including putting a sales tax on them--will have no effect on the amount of money Americans are putting into domestic stocks and bonds or even their own bank accounts. There is simply no relationship between them.

What will happen instead is this: Our exports will increase at first because of the new tax advantage. But since our saving will remain the same, the dollar will be artificially strengthened. This will make our exports more expensive and imports cheaper, and the original balance of trade will be gradually restored--along with the trade deficit. The policy will be self-defeating.

Even if a border adjustment were to work, I still believe it would be unwise. It would make goods Americans buy--whether produced here in America or abroad--more expensive, while foreigners could purchase American-made goods cheaper. It's hard to see how Americans benefit from paying higher prices than foreigners do to purchase American products.

Adam Smith makes a relevant point in *The Wealth of Nations*. Smith reminds us, "Consumption is the sole end and purpose of all production; and the interests of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer." In a border adjustable system, however, to borrow from Smith again, "the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce."

Goal No. 4 -- Diminish the Underground Economy

Your final goal, Mr. Chairman, is to increase revenue from the underground economy and others who currently do not comply with the tax laws. While by its very nature it is difficult to measure, the underground economy is estimated to be in the hundreds of billions of dollars. Of course, much of the underground economy is trade in illegal activities such as drugs and prostitution. This income will never be taxed under any tax system. However, most of the underground economy is trade in legal goods and services that goes unreported. Taxing this portion of the underground economy should be an important goal of any tax reform.

The issue of the underground economy is a very serious one because the computer revolution is fundamentally transforming our economy in a way that will make it much more difficult for the federal government to collect revenue. Personal computers, modems and fax machines have made it possible for greater numbers of people to work out of their homes instead of at large businesses. Many of these small businesses can avoid paying taxes far more easily than large companies because they can operate invisibly. The geometric growth of on-line services such as the Internet portends an era when more goods and services will be traded without a paper trail, making it more difficult for the IRS to audit. As these trends accelerate, our tax system is truly becoming more voluntary everyday. That's why it's especially important to develop a tax code for the 21st Century that Americans are willing to voluntarily comply with.

I am confident the flat tax would shrink the underground economy because it eliminates the three primary excuses for noncompliance. These are, first, the current system's maddening complexity; second, the low likelihood of getting caught; and third, the feeling that today's system is somehow rigged to favor special interests "at my expense" -- which, for the most part, it is. Stripped of these rationales for noncompliance, the great majority of taxpayers will find it much easier to pay their taxes and they will be more willing to do so because they will perceive the system as fair. Even for those who still wish to cheat, they will find it much harder to elude detection in a simple system. Therefore, the underground economy will actually shrink. After all, if you give the American people a tax system that is honest, direct, simple, low, and fair -- something they have not had in decades -- does it not stand to reason they would be more inclined to pay their fair share?

I should point out that many advocates of a sales tax have argued that it would more effectively tax the underground economy. The neighborhood drug dealer almost always serves as the illustration. Since the drug dealer declines to file a 1040 form, the argument runs, maybe we

would could at least recoup some of his income through a sales tax. The government may have no record that he exists, but when he buy a sports car, the government will collect tax from him.

That sounds compelling at first, but it doesn't hold together. The reason is this: Both systems will equally fail to tax the drug trade for the simple reason that the drug dealer will not play along in either one. If there is an income tax in place, he won't report his income. If there's a sales tax in place, he won't collect tax from his customers. Either way, the government loses exactly the same amount of money.

Consider the following example. Suppose there is a drug dealer and a drug consumer who each earns $50,000. Thus, the total income in the economy is--and the tax base should be--$100,000. Under an income tax system, we wish to tax the income of both people, while under a sales tax we wish to tax the purchases of both people. Under an income tax, we tax the income of the drug consumer (assuming he is law-abiding citizens besides his use of illegal drugs), but we don't tax the income of a drug dealer. Total tax base: $50,000. While under the sales tax we tax the purchases of the drug dealer, we don't tax the purchases of the drug consumer. Total tax base: $50,000. It has to be the case that neither system taxes the value of the drug trade because the amount people spend on drugs must equal the income of the drug dealer. And since the drug dealer will not report sales or income tax, neither system will capture the value of the drug trade.

The same would hold true for the underground economy in legal goods and services as well--which of course is much larger. The proverbial plumber who doesn't report his house call for income tax purposes today would not report it for sales tax purposes either. At best, it would be a wash. That assumes that the sales tax would not encourage more economic activity to move underground, which I believe it would. Historical experience demonstrates that a national sales tax of 20 percent would cause the underground economy to explode.

A Final Goal: Fairness

Let me briefly discuss another virtue of the flat tax that I believe is important. The flat tax is fair because everyone pays the same rate, with no special breaks going to politically favored groups. The plan I have proposed is true to the idea of fairness we all learned in grade school: Everyone should be treated the same.

At the same time, it is progressive, thanks to the generous family allowance. The plan is progressive because the family allowance is worth more the less you make. For example, a family of four making $36,000 would pay zero percent of its income in income tax, a family making $50,000 would pay 5 percent of its income, and a family making $200,000 would pay 14 percent of its income. I estimate the plan takes about ten million low-income taxpayers off the rolls entirely. This is the definition of progressive.

Conclusion

Mr. Chairman, as you have often pointed out, the current tax system is broken and must be replaced. I commend you for your leadership in holding these hearings and for outlining a set of criteria for the tax reform debate. I am proud to say that the flat tax meets each of your criteria. It would raise revenue efficiently with as little duress and paperwork as possible. It would end the discriminatory treatment of saving and investment and promote growth in the economy. It would make American businesses the most competitive in the world, creating jobs, boosting wages, and raising living standards. It holds the greatest promise for shrinking the underground economy by causing taxpayers to be more willing and able to comply with the tax system. And it is neutral--it would treat everybody the same.

For all these reasons, Mr. Chairman, I hope you will give the flat tax the close and thoughtful examination this increasingly popular idea deserves.

Thank you.

Chairman ARCHER. Thank you very much for your presentation. Mr. Gibbons will inquire.

Mr. GIBBONS. I thank you, too, Mr. Armey for your presentation.

I made some flat calculations as you were talking here. The 260 million people in America, they break down into 110 million families. As I calculate the impact of your flat tax, you would increase the taxes on 63 million families and lower the taxes on 46 million families—that is not quite 110, but that is as close as I can calculate on the back of an envelope here.

I don't know whether we can get away with that politically, and I am not sure that there is justice in that because you increase the tax on lower income families and you lower the tax on upper-income families. That is one of the problems.

The second problem, as we have discussed, I think we are in agreement that we both understand that you can't adjust your tax at the international border. So those are really the only two faults I have with your proposal. But I want to commend you for what you have done. You have started a good debate over what we ought to do for America's revenue system in the future. As I say, my only two faults with it are, one, you have shifted the burden downward to 63 million families while you have lowered it on 46 million other families, and two, we still have the problem of not being able to adjust it at the border.

Thank you.

Mr. ARMEY. First of all, knowing, of course, that the Gettysburg Address was written on the back of an envelope, I don't want to quickly discourage anything that was done on the back of an envelope.

Mr. GIBBONS. Well, thank you.

Mr. ARMEY. But to have a full understanding of the distributional impact will be a much more elaborate and difficult process, so I hope you will forgive me if I don't accept your back-of-the-envelope conclusions.

Mr. GIBBONS. I understand.

Mr. ARMEY. It is an important question. We are concerned with distributional impacts. The fairness issue is very much a paramount issue, and we are seeking additional distributional studies, and we are not insensitive to that point.

The question of border adjustability is, I think, a big question. There are many people who think it is necessary and desirable to have a new tax system that accommodates to a desired border adjustability. I am not one of those people.

There are two fundamental reasons why I don't share an enthusiasm for border adjustability. One, on the practical side, I don't think it will work; and my view that efforts at border adjustability to the Tax Code will not work are shared by a great many economists, not the least of whom are Dale Jorgensen, chairman of the Harvard department who testified before this Committee, and Michael Boskin at Stanford, who convened a discussion on this subject by a great many economists, in which they made that agreement. That, I think, is a question we will have to address in terms of its feasibility.

My other reason for not sharing the enthusiasm for border adjustability is, I don't think it is the right thing to do. I don't be-

lieve it is necessary, I don't believe it is right, and I don't believe it will work anyway.

Why do I think it is not the right thing to do? Because I don't think it is appropriate to make American-made products less expensive to foreigners than to American consumers. I am driven in my understanding of government policy; my concept of the public interest is given to me by Adam Smith in his great book "The Wealth of Nations," where he says consumption is the sole purpose of all economic activity, and to the extent that government attends to the affairs of the producer, it should only do so on behalf of the consumer. I believe that border adjustability doesn't comply with that definition of public interest.

And finally, I have to say in all candor, border adjustability smacks to me as dumping through the Tax Code, and I am not sure it is within the spirit of a free or even, for that matter, fair trade. So this is going to be a lively discussion. There are sincere, well-intentioned feelings on both sides, but I feel it is only right for me to be candid.

Mr. GIBBONS. Let me address border adjustability with you for 1 minute.

I realize it is controversial, but every industrial nation adjusts at the border except us and Australia. And for the life of me, I can't get through my skull the fact that if we remain out of step with everybody else that we are going to suffer from it by the loss of jobs and job opportunities and markets; and I made the same argument that you made, sitting almost in the same place you are sitting, 25 years ago about the fairness to American taxpayers of the goods that they are exporting should carry with them the full cost of government.

In that 25 years, I have examined over and over my argument for that. I still wish the world were organized that way, but unfortunately, as you and I know, the world is not organized that way. And unless we are prepared to pay the huge economic price in jobs and job opportunities and wages and all those things, we are going to have to get in step with the rest of the world.

Mr. ARMEY. I understand. This is a position that you have come to through a long time. Two observations: One, I would compare the growth rate of the U.S. economy and Australia with any of these nations across the globe that have, in practice, border adjustability, and I feel confident of what I would discover.

And two, insofar as we talk about we need do this because other nations do it, I would first say, yes, Germany for example wants to increase taxes on their citizens in order to give tax breaks to Americans; I would say as long as the German people let them get away with it, I want to encourage them to do so. Insofar as I should do it because they do—in an attempt to be humorous, I tried that line on my mama once, and she said—so we will debate this further, and I hope you will not think I am being just frivolous.

Mr. GIBBONS. I understand. Thank you.

Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Armey, you quoted some other economists that happen to agree with you about the flat tax. I probably could line up 10 economists here and get 20 different opinions.

Let me ask you the question that I worry about on a flat tax. How do we try to capture the cash economy with a flat tax?

It seems to me that we have an economy in the United States that caters to those who may not comply with the laws, and sometimes there is an awful lot of bartering and trading done and direct cash that never appears as income and therefore is not taxed.

Mr. ARMEY. There is no doubt about it.

Mr. BUNNING. How do we get to that?

Mr. ARMEY. There are basically two types of cash transactions that we would like to try to capture. One, of course, is the illegal transaction, a perfect example being the drug dealer, and, of course, people who are criminals simply don't pay taxes.

Now, it is argued that if in fact you have a national sales tax, the drug dealer will pay taxes because that money he earns is spent for Cadillacs or automobiles whatever, and they pay the tax then, but every dime a drug dealer earns is a resultant dime from the purchase of drugs by somebody else. So the sales tax does not apply in the sale of the drugs, only in the purchase.

So in either case, if you have two people at $50,000 under an income tax, the person who buys the drugs pays taxes on $50,000, the person that sells the drugs does not. If you have a national sales tax, the person that sells the drugs pays $50,000 on income, the person who buys the drugs or those people who buy the drugs do not, so you don't do a better job one way or the other.

Now, the question is, how can you diminish the underground economy that is not criminal, if I may, that are not engaged in illegal activities, the plumber?

Mr. BUNNING. Well, I would say to my friend from Texas, even those are criminal.

Mr. ARMEY. Let me say a normal, everyday, law-abiding person that goes out and does a job on Saturday and takes cash payment, you know, he is not——

Mr. BUNNING. Doesn't claim the cash payment?

Mr. ARMEY. That is——

Mr. BUNNING. That is criminal.

Mr. ARMEY. That is criminal, I understand, but this is a person who is not criminal in the ordinary course of his life.

Let's say the plumber that does a weekend job on Saturday collects $1,500 from taxes. The fact of the matter is, again, the person that paid him the $1,500 under sales tax is not paying taxes on that; he is not going to collect the $1,500 to report $1,500 in sales, and submit the taxes.

So now the question is, I believe that most Americans want to obey the tax laws, but given the Tax Code as we know it today, believe this is a Tax Code that has a break in it for everybody but me, so I will give myself a break, and they go do that extra weekend job. Furthermore, they believe that the Tax Code is so complex and the IRS must track so many billions of data points they couldn't catch me anyway.

Now, most of us if we think we can do something that we are justified in doing and won't get caught doing it are probably going

to do it. Now, in the flat tax they know with a dead certain understanding, Hey, I am being treated fair, there is no break for somebody else that I am not getting, we are all getting the same breaks, so I have no justification, plus the fact that the IRS has so few data points to track, they would probably catch me anyway. And I am willing to argue flat tax will do more to eliminate the underground economy than anything.

We know by real experience that in the 21 nations that have put in the sales tax that tax evasion has become a national pastime, and that enforcement has become such a frustrating experience that in 20 of the 21 cases the sales tax has evolved into a value-added tax.

Mr. BUNNING. Well, Mr. Majority Leader, I am not going to get into the philosophic compliance or noncompliance and all that, but the fact of the matter is that the flat tax does not reach the underground economy.

Mr. ARMEY. Nor does a national sales tax.

Mr. BUNNING. I didn't say it did. We were talking about your specific proposal, and it does not get to the underground economy any better than any of the others.

Mr. ARMEY. Other than the fact that it takes away any incentive for doing so.

Mr. BUNNING. Thank you for your testimony.

Mr. ARMEY. Thank you.

Chairman ARCHER. Mr. Hancock is not here. Mr. Camp, Mr. Zimmer, Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. Armey, would your flat tax be based on cash or accrual-type method of accounting?

Mr. ARMEY. Cash accounting. It is my judgment that the Federal Government is and should be on cash accounting. I think the summary statement, all taxes are paid by people and paid out of current income flows is a cash accounting.

Mr. JOHNSON. So that would cause some restructuring of current data collection systems?

Mr. ARMEY. Well, it simplifies that. For example, a business simply writes down its inventory at the time it purchases it, when it expenses capital at the time it purchases, and for business reporting basis, they could go more to a cash accounting basis and less to an accrual accounting basis.

Mr. JOHNSON. OK. I understand that.

What would be the estimated loss to American business from the absence of any transition relief relating to net operating loss carryover or carryover of previously unutilized foreign tax credits, AMT credits or other general business credits?

Mr. ARMEY. Can I preface my remarks by saying, Wow? The transition is, I think——

Mr. JOHNSON. I didn't want them to think I was going easy on a Texan.

Mr. ARMEY. No, I do understand. The transition as we know, especially from the 1986 experience where in fact the transition spawned a very wonderfully useful book called "Showdown at Gucci Gulch," transition irrespective of what change we make, and I am convinced a change will be made, is critically important. In recogni-

tion of that importance, I have put together a transition task force to study exactly these kinds of questions.

We must understand and we must premeditate the transition. It is not something that I think that can be left at the impulses of the moment in a workout session. It must be pretty well premeditated, worked out ahead of time, and I have a transition task force.

I cannot answer your question now, but I can tell you that is exactly the kind of questions we need to work out ahead of time.

Mr. JOHNSON. I am glad you don't know the answer, either. I don't, either.

Mr. ARMEY. You are obviously not a good lawyer, then.

Mr. JOHNSON. Do you intend to have other taxes along with your flat tax, that is, excise taxes?

Mr. ARMEY. No, I do not.

Mr. JOHNSON. So you would repeal everything?

Mr. ARMEY. At the Federal level there would be for general revenues a simple, flat, direct, honest, fair, lovable flat tax, and only that, and then of course we do not change payroll taxes, so they would remain in existence as they are.

Mr. JOHNSON. OK. Thank you very much. I appreciate your testimony.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. ARMEY. Speaking of lovable.

Mr. RANGEL. Thank you.

Under this fair, honest, lovable proposal that you have, if my friend Sam Gibbons is right with his statistics that the way it ends up, not because you intended to do that, is that the low-income people find themselves paying more because they have to consume more of their disposable income than the more blessed people that have more money to save, what adjustments are you prepared to make, if that is true, to make it more fair and honest and equitable?

Mr. ARMEY. Let me just say we have worked very hard on the whole question of distributional impact. It is a matter we have been concerned about. The first thing I will say again, I don't think Mr. Gibbons is right, but we must study this.

Now, as I have written the flat tax, as we think we understand the distributional impact, first of all, you can make an observation that approximately 10 million low-income people are taken off the tax rolls. With the generous family allowance we give, a family of four must make over $36,800 before they incur any income tax liability at all. If you take that same family of four, then they pay zero tax at $36,800, they would pay about 4 percent of their total income in taxes at $50,000 a year, they would pay about 14 percent of their total income in taxes at $150,000, and they would pay about 16 percent at $200,000, so that——

Mr. RANGEL. Is that how you make up for the taxes that are lost by dropping the $36,000 people?

Mr. ARMEY. Well, with respect to, as it were, the total tax take, we think by broadening the base as we do, where in fact after the flat tax a greater share of total taxes will be borne by the business sector as opposed to the individual sector, that we can get within about $40 billion of the current tax rate on the first year.

Now, this is again a number that is being contested. My own view is we get that close, we can make up the difference with spending reductions out of a $1.5 trillion and growing Federal budget.

The other area that we need to better understand is, where can we utilize savings from compliance costs and enforcement costs in helping with the revenue enhancement? And finally, if we are not at the right number that makes it revenue neutral, we have got two points of adjustment, either the rate or the family adjustment.

Mr. RANGEL. How would you treat the charitable organizations, the not-for-profits?

Mr. ARMEY. In the flat tax there are neither itemized nor standard deductions. That playingfield is simply removed from the Tax Code, and of course along that, charitable deductions go as well as any other itemized deduction.

Mr. RANGEL. Well, how is that justified if it is agreed that the Federal Government should not be involved in providing too much assistance in terms of health and welfare and that those closer to the problem should have better answers, like mayors and Governors, and then if we don't mandate that they do it because that would be unconstitutional, I think ultimately we say that the people who don't get the services, that is what charitable organizations are for. I think that is where it ends up in the Contract.

Now, if the charitable organizations already feel and have substantial evidence and support that they are carrying a heavy burden as it is now, and if Mr. Gingrich is right that people want to take care of those who are truly needy by making contributions to them as traditionally we have, why would you not make it easier for people to contribute money to the last safety net that would be out there under your Contract?

Mr. ARMEY. Let me say, first of all, we studied on this. This was a very important question. We were worried about it a great deal. We have discovered a couple of things.

One, less than 50 percent of charitable contributions made in America today are declared on tax returns. That surprised us.

Two, during the eighties when the tax value of a charitable contribution was substantially reduced and understanding what the tax regulations related to it was severely confounded to the point where I am now in a position for the first time in my life to make a significant charitable deduction through the royalties of a book I have just written, all of which are pledged to charity, but I can't yet understand under the tax law how I can make those charitable deductions without paying taxes on those charitable deductions. I am working on it, I can assure you. But during the eighties, in fact——

Mr. RANGEL. You are working on trying to get a tax deduction for making a charitable contribution now?

Mr. ARMEY. You know, with all due respect, I don't mind giving away the money that I will earn on the book. I don't think I want to pay taxes out of my meager earnings elsewhere on that money.

Mr. RANGEL. You think this is a good thing to do, to encourage?

Mr. ARMEY. Under current tax law, I could do that. Of course I think it is a good thing to do. But the wonderful thing about the

eighties is that during the eighties charitable giving more than doubled even while the tax value of a charitable gift was reduced.

Now, I said earlier——

Mr. RANGEL. But in the eighties because—and I know that light is on so I have got to get out of here—but in the eighties we were providing all of these New Deal socialistic-type of programs as they do in Europe, and now that type of thing will not be existing on the Federal level, as it relates to my city and State, less than that. So that safety net is going to be really needed.

Mr. ARMEY. Well, let me again say, first of all, you are absolutely right, during a period of time when the Nation might have perceived less need for charitable giving because of the massive expansion of social services of the government, the charity in the heart of the American people still expanded by more than double.

Now, I would say given the nature and character of the American people as I know them, during the decades of the first 10 years, the first decade of the next century after we enact this tax, in a growing economy you are going to see that expansion of charitable giving even more so, if in fact there is a need for it.

If you are concerned that there is going to be a reduction in social services through government expenditure in the next decade, then obviously we would be concerned to have that Tax Code which would most encourage increased charitable giving. I think the flat tax is that Tax Code.

Chairman ARCHER. The gentleman's time has expired.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

And thank you, Mr. Leader, for joining us today. You really have, I think, a well-thought-out plan—much better thought out than most critics would give you credit for.

The flat tax sounds simple, and it is in many respects, but the depth to which you have gone to explain how this is similar to a consumption tax and how it promotes economic growth are things that Members of this Committee are going to be vitally concerned with. So we appreciate very much your coming and explaining those things to us.

I would like to give you an opportunity to explain a little further, though, how this would impact on the economy, because, after all, if we are concerned about low-income people, if we are concerned about the poor, many of us believe the best way to address those concerns is to grow the economy and to create more and better-paying jobs in this country. Mr. Gibbons has talked about that today as one of his concerns. Would you explain to us how your flat tax would impact the economy?

Mr. ARMEY. Yes, and it is very important part of—Professors Hall and Rabushka, for example, estimate that under the flat tax the income of the typical American family would be $7,600 higher by the year 2002.

How would that happen? It seems to me one of the most important things we do, obviously we provide incentive for savings and investment, but one of the very critically important things we do is the expensing of capital purchases. Our most high-growth, dynamic areas of the American economy are in these rather mysterious worlds of electronics and computers where the rate of techno-

logical innovation is just mindboggling. To expense capital would make it more possible for more often a person to keep pace with the march of technology, knowing that they are putting on line machinery that in 2 years may be obsolete, but they expense it today, they can recover in time to keep that pace.

The fact of the matter is economic growth is born out of an expansion of capacity through capital accumulation, but more importantly, out of an expanding of the capacity of the capital through productivity increases, which is the growth of scientific and engineering knowledge as innovated in the capital which then brings the labor along. As the labor enjoys greater productivity, their wages go up, we get greater total output, national income goes up, and of course there accrues to the State greater tax revenues.

So this is very much savings-and-capital-accumulation friendly, and now, in addition to that, there are the incentive factors that we have in that. There is a greater encouragement on the part of the individual to save and to make investments and to continue to nurture investments because of the end of the estate tax, which I think is an incentive factor that I think should not be overlooked.

Many of us work all our life and just when we get to those areas where our productivity and our gains and our ability to push a $1 million concern to the $2 or $3 million level, we accept the tradeoff, we will quit now because if I do build this bigger, it will just go to the government. If, in fact, we are at that point, we say should we go on, and the answer is, Well, it will all go to our grandchildren, I think there will be an important incentive to cap off your work life with that growth thrust at the end.

Mr. McCrery. Will you very eloquently explain how your proposal would increase productivity? In the next century this is certainly going to be important as we compete with China and the European Community, and others.

Mr. Armey. My own view, incidentally, is that increased productivity and the ability to keep pace at a faster rate will do more to improve the balance of payments than border adjustability will.

Mr. McCrery. I think the support that you have among the economic community is substantial, more so than Mr. Bunning might have intimated.

One thing you left out in your analysis, though, is that we need more workers in the work force if we are going to compete in the next century. The only way to get more workers in the work force is to create more jobs. I think you have already stated that your proposal has the potential to create many more jobs in our economy.

One last question, would you, as briefly as you can, explain how your flat tax proposal is similar to the Nunn-Domenici proposal and similar to a consumption tax?

Mr. Armey. I believe that the one thing that I would congratulate all the proposals for is that they do a much more inclusive job of capturing the entire income flow of America in the tax base, and I think every proposal should be commended for that.

I think the Nunn-Domenici proposal is clearly pointed at encouraging savings. My own view is that we do that more directly, more effectively in the flat tax, but I think there is a similarity.

I think other than the similarity of the tax base that there is a fundamental difference between the income tax, flat tax, and the sales tax. I try to characterize that difference this way.

The flat tax is a tax that is levied on incomes generated from the production process. The sales tax is a tax that is levied on production outcomes, and I think they are remarkably different approaches to the Tax Code, so I dare say I see little similarity between the sales tax and the flat tax.

Mr. MCCRERY. But——

Chairman ARCHER. The gentleman's time——

Mr. MCCRERY. But Nunn-Domenici and yours——

Mr. ARMEY. In the sense that we are both very much interested in encouraging savings. Nunn-Domenici I don't think taps into the essential anger of the American people, which is "I don't like this Tax Code."

Chairman ARCHER. The Chair would like to be able to conclude the Majority Leader's presentation by the time that we leave for this vote because the Minority Leader is due to come very shortly. I don't want to cut anybody off, but we do have to move along.

Mrs. Kennelly, we will recognize you hopefully for a short inquiry and short answers, and then we will see where we are, whether we need to go to vote at that time and release the Majority Leader.

Mrs. KENNELLY. Thank you, and welcome, Mr. Majority Leader.

Mr. Leader, when I look at your proposal or as much as I have been able to see of your proposal, I see there are no deductions for State and local taxes. Now, I look at my own State of Connecticut which has high taxes, has a State income tax and has high property taxes, then I look at your State of Texas. It is well known that it is fortunate and doesn't have a State income tax, but you do get a great deal of revenue from oil and gas royalties.

In your flat tax, how would we avoid having a shift of resources to Texas from places like Connecticut or Massachusetts or New York? Is there a transition in your proposal that I haven't seen, or how do you address this that this won't happen?

Mr. ARMEY. Well, I don't really know what you can do to save any State from the construction of its own Tax Code, but I would say if I can, the State of Connecticut is a State that is going to be much better off as a State and as a people within the State if they are living in a growing, dynamic flat tax world than they will be if they live in the static, complex tax world we have today.

It strikes me that the manner in which the various States finance their State governments will always be a function of the resources available to that State to draw upon, and I am not sure how you can change that.

Now, if you are talking about the movement of people between States, there are many impulses that cause people to move from one State or another. For example, a right-to-work State is likely to attract business and industry from a State that doesn't do that. So I do think regional differences will have to be worked out by States as they pursue their most prosperous State configuration to meet their desires.

Mrs. KENNELLY. Thank you.

I think my point was there is no way we can figure out how we can get natural assets like oil and gas, and we worry about this as a flat tax comes.

One quick last one, Mr. Leader, since you are the Majority Leader and you have so much influence, when do you think we will be seeing this come up before us?

Mr. ARMEY. Again, the Committee will march at its own pace, there is no doubt. Certainly the same is true of the Finance Committee. Whatever is done in tax reform will be done through the normal workings of the committees of jurisdiction who have in fact not only the jurisdictional right and obligation but the expertise. So that my own personal prediction is that a major tax reform will probably be completed sometime in 1997 at the latest. That is just my guess.

Mr. RANGEL. Is that after the election?

Mr. ARMEY. Again, that is my best guess. I don't know. I mean, if the Committee decides to march to a faster drummer, certainly I will do my best to try to keep up.

Mrs. KENNELLY. Thank you.

Chairman ARCHER. We have time for one brief question from the gentleman from California, Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman.

Again, Mr. Leader, I want to thank you. I just have concluded a series of townhall meetings and again the enthusiasm at the thought of actually completely restructuring our tax system has a tremendous amount of support out in the heartland of America.

My question to you would be, would you consider—as I understand your plan, the flat tax, everyone is paying the same rate. There really isn't any incentive for someone to go out at a time when we are purposely moving away from the welfare state and attempting to encourage our people to donate more to charities, to go out and put his extra dollars into a luxury car or to, say, donate to his tithing or donate to some other charities.

Would you consider perhaps changing your plan to have a deduction for charitable contributions to encourage charitable deductions as opposed to buying a luxury car?

Mr. ARMEY. The short answer is I would not. The flat tax, you either—if you allow one exception, you have built the best excuse for the next exception.

Let me just say, finally, I profoundly believe that charity is found in the hearts and the sense of well-being of the American people, and if we give them a growing, prosperous economy, charity will flow at a much greater rate than it can ever be made to flow by tax incentives.

Chairman ARCHER. The Leader is excused. The Committee will stand in recess until after this vote. We will come back immediately and reconvene.

[Recess.]

Chairman ARCHER. The Committee will come to order.

Mr. Minority Leader, we apologize to you for not being able to take you earlier this morning as was originally expected. We have, obviously, a lot of Members who want to ask a lot of questions, and it has been difficult to move the process along, but we welcome you to the Committee. We are pleased that you could adjust your sched-

ule and come back and be with us, and we are delighted that you are going to present to us your ideas of what we ought to do to, what we like to call, replace this current income tax system. So you may proceed.

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. GEPHARDT. Thank you, Mr. Chairman. I fully understand the problems in a Committee like this. I served on the Committee, and I know that everyone wants to ask questions, and they should, and this is a very important issue, and I commend you and the Members of the Committee for taking on this big task, along with all the other big assignments that this Committee has right now.

I would like to offer my testimony. I may not say every word here, and if I don't, I would be happy if you would take my testimony as it is written.

Chairman ARCHER. Without objection, your entire testimony will be inserted in the record.

Mr. GEPHARDT. I thank the Chairman.

Mr. Chairman, Members of the Committee, I believe and have believed for a long time that we have a need to completely rebuild a very complex, a very confusing, and confounding tax system that is not serving the needs of average, hardworking Americans. We need to do it in a way that preserves the cornerstone not just of our tax system but of a decent, civil society, that those who have prospered the most have an obligation to shoulder more of society's burdens. It is a progressive principle that I believe is as old as the Bible itself.

As you all know, I am not a stranger to tax reform. Since my very first term in Congress, as a Member of this Committee, I have worked to make our Tax Code simpler and fairer, to end the sea of redtape that swamps our economy, overwhelms our taxpayers, and takes a veritable team of lawyers and accountants to navigate.

Without many of the people in this room, including the Chairman, the Ranking Member, and others, working in a broad, bipartisan fashion, we never would have succeeded in passing the 1986 Tax Reform Act, which at least tried—didn't succeed entirely—but it tried to make our system more accountable, more reasonable, and more understandable. But we have a long way to go and much yet to accomplish.

That is why I am grateful for this hearing and for the leadership of Chairman Archer, who is using Congress' oldest Committee to advance this Congress' most important new idea. We may disagree on certain principles and on certain details of the tax system that we want for this country, but we all agree that today's system is indefensible and unacceptable. By starting this debate, you are saying to the entire country that we can do a lot better, and I am confident that we will.

Let me be very clear about my purpose today. I believe we need a simpler and fairer tax system, and I believe we need to design that system to help average, hardworking families, not just the privileged and powerful corporations or special interests. The fact is, if you don't have a team of experts on your side, it is pretty hard to find your way through the maze that is known as our Tax Code.

Today, an astonishing 49 percent of Americans are forced to hire professionals to help prepare their returns. Nearly 1 million Americans using the 1-page EZ form feel they need professional help to fill out that supposedly simple form.

If you ask me, that is the most damning statistic about our tax system. For many people, even the EZ form is far from easy.

But if you look beyond the percentages, it is the perceptions of our tax system that are the most damaging. When I go door to door in my district in St. Louis, when I talk to the people who are working two or three jobs and extra part-time jobs to pay their bills, I find a deep anger and resentment at a system that favors the tax experts and insiders at the expense of average families. And I have to admit that I find that to be a legitimate anger.

Our tax system was intended to collect tax dollars fairly, simply, and broadly, to pay for crucial public purposes. Today it is a test of legal brain power, an accountant's decathlon, a treasure hunt for hidden deductions and arcane tax breaks.

We need a tax system that works for ordinary people. We need a tax system that doesn't require a CPA to fill out the forms, and we need a tax system that doesn't have so many inducements, incentives and restrictions that it tries to micromanage the economy to a point where I think it creates a drag on economic growth. And for all the problems with the current system, we need to make this a debate not about bashing government but about improving it.

Quite frankly, we are not going to achieve those goals by toying and tinkering at the margins, in my opinion, as we have done sometimes in the past. I think it is time for massive, radical change of our tax system.

Next month I will be offering a detailed proposal for a fundamental overhaul of our entire Tax Code so that we have fewer rates, fewer loopholes, less paperwork, and lower tax rates for all Americans. I look forward to comparing it with proposals such as yours, Mr. Chairman, and Mr. Armey's flat tax, and Mr. Gibbons' tax proposal.

We need an open and vigorous debate. As that dialog begins, let me simply focus, in closing, on a few broad principles that are shaping my plan because they differ in important ways from some of the principles behind the Republican plans that have been advanced.

The basic difference is this. My tax plan will be progressive, not regressive. My tax plan will maintain a longstanding tax tradition that those who have the most in our society, those who have prospered more than anyone else should pay a little more.

Given the choice between maintaining a balance where millionaires pay a little more in taxes or asking struggling families to pay more, I believe we should continue to ask the millionaires to shoulder their fair share of the burden.

Mind you, I am not talking about raising taxes on anyone, just maintaining the progressive principle that has always been at the heart of our tax system. That is my basic problem with the main Republican tax reform proposals. They do a lot to simplify the tax system, and that is good. But in the process, they offer a large tax break to the wealthiest Americans, making the overwhelming ma-

jority of Americans pay more taxes than they should, certainly more than they would under my and other plans.

With due respect, let me suggest that the flat tax proposed by Republican Leader Armey is actually an army of perks for the privileged. It doesn't tax what we call unearned income, which can amount to untold millions in dividends and capital gains. And by offering only one tax rate, 17 percent of earned income, it gives a huge break to the wealthiest Americans.

The only way to pay for this kind of tax break is to raise the taxes for working families and the middle class, or to significantly increase the deficit, both of which I think are unacceptable.

I feel that this approach is wrong. I think the tax breaks should go to people who need them: Working families and the middle-income people. And the notion that the benefits of this kind of tax giveaway will trickle down to the rest of the people has been so thoroughly discredited and disregarded by economic opinion that it is simply not a sound basis for public policy.

I have a similar problem with Chairman Archer's notion of a national sales tax, a tax on spending as opposed to earning. By definition, it taxes far less of the income of those who have the most and far more of the income of working families and the middle class because they spend a higher proportion of their total earnings to get through each week and each month. And Chairman Archer's plan, in my view, has none of the redeeming features of Congressman Gibbons' consumption tax, which shares the commitment to a progressive tax system and one which does not redistribute income among the various income classes.

We cannot go back and should not go back to a tax system that echoes the 19th century. I think we need a 21st century progressive tax. This is the central guiding principle of my plan. It will be staunchly and unapologetically progressive.

My plan will be dramatically simpler and easier than today's tax system. It will focus on collecting more of the taxes that are due because today's system, with its mind-numbing complexities, encourages tax evasion. It will not exempt unearned income because most Americans would agree there is no reason stock dividends should go untaxed while hourly wages are fully taxed.

It will be a plan that promotes economic growth and lets hard-working families keep more of what they earn without the kind of micromanagement and complex incentives that only take away more deductions from the marketplace and put them in the hands of the government.

It will be a plan that does not change the deficit, explode the deficit, increase the deficit, unlike some of the proposals that are on the table. This is an issue that we ought to discuss in every budget, but it should not be confused with a discussion of tax reform.

It will be a plan that does not redistribute income from the middle class to the wealthy or vice versa. My plan is not designed to raise taxes on any income group, period, but it will not give a large tax giveaway to the wealthy.

Finally, in my view, families will save more when they have more. If you are barely making ends meet and if you are saddled with debt such as loans, student loans, car loans, and a home mortgage, you can't save, no matter what the incentive. But by focusing

on letting these families keep more of what they earn, I believe we can do more to increase savings than any tax loophole or tax inducement.

In closing, I just want to leave one thought. We can and must work toward a bipartisan consensus on tax reform. We may begin in different places. We are certainly going to have some differences in our plans, but we must seek a common ground defined, in my view, by principles similar to those that we have outlined which can give us a Tax Code that is simpler and fairer. We don't have to choose between these goals. We have to pursue both.

To do that, we have got to educate the American people about the real consequences of each and every proposal that is on the table. When we do, I believe we will find an astonishing amount of support for a tax system that is flatter but not flattening for working families, a tax system that doesn't submerge its fundamental fairness for the sake of oversimplification instead of simplification, a tax system that takes what is needed to educate our children, pave our roads and care for our elderly and other essential public purposes that we can agree on, but leaves the rest right where it belongs, in the hands of the American people who earned the wealth.

I thank you for listening. I admire your Committee for again taking on this gigantic task. I remember how hard it was in 1986. It was a bear, but we did make the Code I think better, but we need to do more, and I am convinced this Committee and this Congress has the capability to do that.

[The prepared statement follows:]

NEWS FROM THE HOUSE DEMOCRATIC LEADER

For Immediate Release:
Thursday, June 8, 1995

Democratic Leader Richard A. Gephardt
H-204, U.S. Capitol

TESTIMONY BY HOUSE DEMOCRATIC LEADER RICHARD A. GEPHARDT
COMMITTEE ON WAYS AND MEANS
HEARING ON TAX REFORM, 1100 LONGWORTH H.O.B.

Chairman Archer and members of the Committee:

I thank you for the opportunity to testify this morning, to talk about one of the most crucial issues before this or any other Congress --

The need to rebuild a tax system that is simply too complex, too confusing, too confounding to serve the needs of average hard-working Americans --

And the need to do it in a way that preserves the very cornerstone not just of our tax system, but of a decent, civil society -- that those who have prospered the most have an almost sacred obligation to shoulder more of society's burdens. It's a progressive principle that is as old as the Bible itself.

As you all know, I'm no stranger to tax reform. Since my very first term in Congress -- as a member of this very committee -- I've worked to make our tax code simpler and fairer -- to end the sea of red tape that swamps our economy, overwhelms too many taxpayers, and often takes a veritable team of lawyers and accountants to navigate.

Without many of the people in this room -- working in a broad, bipartisan fashion -- we would never have succeeded in passing the 1986 Tax Reform Act, which at least tried to make our tax system more reasonable and more understandable. But it left us with a long way to go, and too much yet to accomplish.

That's why I am grateful for this hearing, and for the leadership of Chairman Archer, who is using Congress's oldest committee to advance this Congress's most important new idea. We may disagree on certain principles or details of the tax system we want for this country, but we all agree that today's system is unacceptable and indefensible. By starting this debate, you are saying to this entire country that we can do a lot better. And I'm confident that we will.

Let me be very clear about my purpose here today: I believe we need a simpler and fairer tax system. And I believe we need to design that system to help average, hard-working families -- not the privileged and powerful corporations or special interests.

The fact is, if you don't have a team of experts on your side, it's pretty hard to find your way through the maze of our tax code. Today, an astonishing 49 percent of Americans are forced to hire professionals to prepare their taxes. Nearly a million Americans using the one-page "EZ" form feel they need professional help.

If you ask me, that's a damning statistic. For many people, even the "EZ" form is far from easy.

But if you look beyond the percentages, it's the perceptions of our tax system that are the most damaging. When I go door to door in my town of St. Louis -- when I talk to the people who are working two or three jobs, and extra part-time jobs just to pay the rent and put food on the table -- I find a deep anger and resentment at a system that favors the tax experts and insiders at the expense of average families. And I have to admit that I find a lot of that anger legitimate.

Our tax system was intended to collect tax dollars fairly, simply, and broadly, to pay for crucial public purposes. Today it is a test of legal brainpower, an accountants' decathlon, a treasure hunt for hidden deductions and arcane tax breaks.

We need a tax system that works for working people. We need a tax system that doesn't require a C.P.A. just to fill out the forms and get a fair shake.

We need a tax system that doesn't have so many inducements, incentives, and restrictions that it tries to micromanage our economy, to the point that it creates a drag on economic growth.

And for all the problems with the current system, we need to make this a debate not about bashing government, but about improving it.

Quite frankly, we're not going to achieve these goals by toying and tinkering at the margins, as we have done so often in the past. It's time for massive, radical change. Next month, I will be offering my own proposal for a fundamental overhaul of our entire tax code -- so that we have fewer rates, fewer loopholes, less paperwork, and lower tax rates for all Americans.

I look forward to comparing it with proposals such as yours, Mr. Chairman, and Mr. Armey's Flat Tax." We need an open and vigorous debate. As that dialogue begins, let me focus today on the broad principles that are shaping my plan, because they differ in important ways from the principles behind every Republican plan that has been advanced.

The basic difference is this: my tax plan will be progressive, not regressive.

My tax plan will maintain a longstanding tax tradition in this country: that those who have the most in our society, those who have profited and prospered more than anyone else, should have to pay a little more.

Given the choice between maintaining a balance where millionaires pay a little more in taxes, or asking struggling families to pay more, I believe we should continue to ask the millionaires to shoulder more of the burden.

Mind you, I'm not talking about raising taxes on anyone -- just maintaining the progressive principle that has always been at the heart of our tax system.

This is my basic problem with the main Republican tax reform proposals. They do a lot to simplify the tax system -- and that's a good thing.

But in the process, they offer most of the breaks to the wealthiest Americans, making the overwhelming majority of Americans pay more taxes than they should -- certainly more than they would under my plan.

With all due respect, let me suggest that the Flat Tax proposed by Republican Leader Dick Armey is actually an army of perks for the privileged. It doesn't tax what we call "unearned income" -- which can amount to untold millions in stock dividends and capital gains.

And by offering only one tax rate -- seventeen percent of earned income -- it gives a huge tax break to the wealthiest Americans. The only way to pay for this kind of upper-income tax break is to raise taxes for working families and the middle class, or to significantly increase the deficit -- both of which are completely unacceptable.

I feel strongly that this approach is wrong. I think the tax breaks should go primarily to the people who really need them -- working families and the middle class. My guess is that most Americans don't even realize that the Armey Flat Tax is actually a major tax giveaway for the wealthy.

And the notion that the benefits of this kind of tax giveaway will somehow "trickle-down" to the rest of us has been so thoroughly discredited -- so completely disregarded by mainstream economic opinion -- that it is simply not a sound basis for any public policy.

I have the same problem with Chairman Archer's notion of a national sales tax -- a tax on spending, as opposed to earning. By definition, it taxes far less of the income of those who have the most, and far more of the income of working families and the middle class, because they have to spend a higher portion of their total earnings to get through each week.

And Chairman Archer's plan has none of the redeeming features of Congressman Gibbons's consumption tax, which shares the Democratic commitment to a progressive tax system, and one which does not redistribute income among the different income classes.

America cannot go back and should not go back to a regressive tax system that echoes the

19th Century. Instead, we need a new 21st Century progressive tax.

That is the essential guiding principle of my plan. It will be staunchly and unapologetically progressive.

My plan will be dramatically simpler and easier than today's tax system.

It will focus on collecting more of the taxes that are due, because today's system, with its mind-numbing complexities, almost encourages tax evasion.

It will not exempt unearned income, because most Americans would agree that there is no reason stock dividends should go untaxed, while hourly wages are fully taxed.

It will be a plan that promotes economic growth, and lets hard-working families keep more of what they earn -- without the kind of micromanagement and complex incentives that only take more decisions away from the marketplace, and put them in the hands of government.

It will be a plan that does not explode the deficit -- unlike some of the proposals that are currently on the table.

It will be a plan that does not redistribute income from the middle class to the wealthy, or vice versa. My plan is not designed to raise taxes on <u>any</u> income group, period. But it will not give a large and unaffordable tax giveaway to the wealthy, as several Republican plans would.

Finally, in my view, families will save more when they <u>have</u> more. If you're barely making ends meet -- and if you're saddled with debt, such as student loans, and car loans, and a home mortgage -- you often cannot save, no matter what the incentive. By focussing on letting these families keep more of what they earn, I believe we can do more to increase savings than any tax inducement or loophole.

In closing, I want to be very clear about one thing: we can and must work toward a bipartisan consensus on tax reform. We may begin in different places, but we must seek a common ground defined, in my view, by principles similar to those I have outlined -- which can give us a tax code that is both simpler and fairer. We don't have to choose between these goals; we have to pursue <u>both</u>.

But to do that, we have to educate the American people about the real consequences of each and every proposal that is on the table.

When we do, I believe we will find an astonishing level of support for a tax system that is flatter, but not flattening for working families --

A tax system that doesn't submerge its fundamental fairness for the sake of oversimplification, instead of simplification --

A tax system that takes what is needed to educate our children, and pave our roads, and care for our elderly, and other essential public purposes -- but leaves the rest right where it belongs: in the hands of the American people.

I thank you for listening -- and now I'm happy to take your questions.

# # #

Chairman ARCHER. Mr. Leader, thank you for your presentation. I want to compliment you on a number of counts. First, I want to compliment you for laying to rest any question whatsoever that might be in the minds of historians that this is the oldest Committee in the Congress of the United States. I am grateful.

Mr. GEPHARDT. The Members are not the oldest, the Committee is the oldest.

Chairman ARCHER. And second, I sincerely and genuinely want to compliment you for coming to us and saying that you will have a specific proposal that can be made a part of the mix, that you will be engaged in the process, because my sincere hope is that it can be bipartisan. I think it is too important to every American as to what we do with the method by which we raise the taxes to pay the government's bills.

There are many, many parts of your statement where you and I are in complete agreement, and I think we should build on the areas of agreement and see if we can't come out with something that will truly benefit America and give us a chance to see Americans have the opportunity to realize their hope and dream, which is greater real family income, and the opportunity for their children to do even better than they have done.

I think the way we tax can have a major impact on that, particularly in the next century, and as Sam Gibbons has so well articulated, in our ability to compete in a commercial global marketplace, because I am convinced that if we don't give ourselves the greatest opportunity to do that and to win that battle that we will see our standard of living decline in the next century for Americans. So we need to all roll up our sleeves and attempt to reach that halcyon position for this country.

Having said that, I would take just minor exception to your comment that I have endorsed a national sales tax. I have endorsed some form of tax on goods and services rather than a tax on income, and it may be that something similar to what Sam Gibbons has proposed could be the vehicle to accomplish that, but I want to look at all of the suggestions, and that is the purpose of these hearings.

Having said all that, I again am pleased that you, as Minority Leader, will be engaged. I was very disappointed that the administration does not wish to be engaged in this process by submitting a proposal, and I believe that it is very important, in our bifurcated form of government, that the President also be a participant with the Congress in something that is this important to the future of this country.

So I don't really have any questions to ask of you, and I would yield to the Ranking Minority Member, Mr. Gibbons, for any statement that he would like to make or question that he would like to ask.

Mr. GIBBONS. Well, I would like to make a little statement.

First of all, Mr. Chairman, Mr. Gephardt, I welcome you here. I remember your distinguished service on this Committee. You have joined a whole rank of distinguished alumni of this Committee, Presidents, Vice Presidents, Speakers, Chief Justices, and we are proud of you. Right now you are the oldest, most distinguished active alumnus that we have, and you are not very old, but of all

the people still in active political life, you are the most distinguished alumnus we have. We are proud of you.

Second, I want to express my personal appreciation for your having put our Democratic Party firmly in the position of wanting change in the system. I am sorry that that didn't come forward in the testimony of the Treasury yesterday, but we Democrats do stand for change. We are not defending the old status quo in this tax system. We are for change that is under the outlines that you presented.

I am glad that you are entering into the fray again, as you have always been in the fray in putting forward proposals. You have never been ashamed to put forward a proposal and you usually have well-thought-out proposals. So I look forward to that.

I think the thing that distinguishes your position from Mr. Armey's position is that I made some rapid calculations on Mr. Armey's position when he was here, and he disagrees with me, so I may be wrong. But I figured there are 110 million families in America, a little more, a little less. His proposal, and I am trying to be conservative now, raises the taxes on the lowest 63 million families, but lowers the taxes on the highest 46 million families. I don't know whether he intended to do that, but that is my rough calculation of what his does.

Now, yesterday, embedded in the Treasury's testimony, and they had gobbles of it, that is an analysis of it, their figures of Mr. Armey's proposal versus the status quo was even worse, but I don't remember those exactly. I think that unless we recognize that for the last 20 or 30 years we have sort of de facto established a burden sharing, that seems to be accepted as reasonable in the American system that any proposal that changes that is going to kick off one terrific debate about who we are requiring to pay for a greater share of government, and I think that we have to be careful about that.

I am not sure that the burden table that I have presented in mine is exactly right. I have presented the best that I could get my hands on. It may be wrong, but I think we have got to be careful as we enter that debate. We are dealing with a lot of people, a lot of families, and we are going to need the best guidance we can have.

As I see it right now, the principal defect of Mr. Armey's proposal is one that is not adjustable at the international border. There is no argument about that. And, two, it seems to shift the burden down markedly on low-income families.

Mr. GEPHARDT. Let me say that we all have, and you especially have two big, tough threshold questions that we have got to deal with as we talk about tax reform. The first one is, what activity or event to tax, and that is probably the first decision you have got to make. And obviously Mr. Archer and Mr. Gibbons you are thinking about, talking about, trying to intellectually deal with the idea of coming off of the income tax at least to some extent and moving to taxing other activity somewhere in the economy, and that is a very legitimate idea, one that we need to really think through.

The second tough question is, whichever way we go on that, is there a differing burden on people according to their means, and

that is a question that goes to the very existence of our tax system and has been debated and redebated through the years.

So you understand where I come from, I strongly believe that whichever way we go on the events that we tax, it ought to be according to means, at least to the extent we do it today. I am addressing the income tax in my proposal.

I am trying to get as close as I can to taking all the exceptions out, increasing the base to the greatest extent possible, and getting the rates as low as humanly possible for everybody, but having different rates for at least some people. And I am probably headed toward three rates as opposed to where we are today, and I would like to get those rates in every case as low as I can possibly get them.

Mr. GIBBONS. Well, may I add just one more caveat here, Mr. Chairman.

Chairman ARCHER. Certainly.

Mr. GIBBONS. The FICA tax, every economist that has ever testified before this Committee tells us that the FICA tax, although it appears to be paid half by the employer and half by the employee, all comes out of the employee's wages. So the FICA tax is borne entirely by the employee, and all of the tables we have about tax burden distribution distribute the FICA tax to the employee.

That means that when you deal only with the income tax in any of your calculations, you are overlooking a 15 percent tax on the first dollar earned by every person, 15 percent, and the earned income credit was designed to take away some of the burden of the FICA tax on the first dollar. So all calculations that you make in changing the tax system have in some way got to impact upon the FICA tax as well as the income tax because we are now collecting almost half, we are collecting almost as much in FICA tax as we are in personal income taxes.

That is just one of the characteristics of the very complex equation we have to solve here, and so I just throw that out as sort of an observation of the dilemma we face and the problem we face. We have got to take that into consideration as we try to distribute the burden equitably and fairly to the American public.

Mr. GEPHARDT. I agree.

Chairman ARCHER. Dick, can you give us some idea of the timeframe in which you will be able to submit your proposal so that we can begin to consider it in the mix here?

Mr. GEPHARDT. I am shooting to have it ready in the next 30, 35 days. That is what I would like to be able to do.

Chairman ARCHER. Excellent. Excellent.

Mr. Hancock.

Mr. HANCOCK. Thank you very much, Mr. Chairman.

That was the first question I had on my mind, is when we could anticipate some specifics. We have had specifics from Senator Nunn and Senator Domenici. Mr. Gibbons has given us a lot of specifics. Actually the value-added is in some foreign countries now so therefore we can kind of take a look and see what history has done on that.

Any plan that we do, I think you will agree, is going to have to have a lot of stroking and massaging, whether it is yours or whether it is a value-added or whatever we finally come up with. I am

even asking some of the people that are presenting to come up with a flow chart showing us where that money would be taxed, who would be paying it and that type of thing.

I do think, though, Dick, you and I have known each other real well, I think it would be beneficial to all of us to look at everybody's proposal since none of it is in concrete now, and not criticize the other person's proposal. I think for us to say that what somebody else is going to do before it has been stroked and massaged and worked around is unproductive. I don't think it benefits anything, anybody, but creates confusion on the part of a lot of people.

I don't know that I could support your plan, but I am not going to criticize your plan until I see it, and I just believe as a suggestion that we would all be better off if we got away from trying to talk about the rich and the poor and what have you and who is going to benefit under any plan and said, look, let's look at every possible option, yours included, Dick Armey's, Sam Gibbons', and get away from this class warfare type of approach.

I understand exactly where we are coming from. I also understand that the people that have worked hard and accumulated capital are also the employers, and we have got to make sure that individuals continue to have that opportunity to become wealthy and to keep enough of their wealth to where they can employ other people and give them the opportunity.

So with that suggestion, I hope you will concur that let's look at everybody's plan before we start being too critical.

Thank you.

Mr. GEPHARDT. I appreciate your thought, and I hope that it is possible for the Committee to come up with a common way of evaluating all of the plans so that we can get a good view of what is going on. At the end of the day, back, if I remember, in 1986, we wound up mixing and matching by the time we got down to really putting it together, so you are probably going to be taking features out of different plans before you are done. But I think it is important to have a good evaluation of each plan, I agree.

Mr. HANCOCK. I think you would agree that the easiest way to evaluate it would be through a flow chart approach, what is collected, who is going to pay, what have you. As of right now I have not seen any flow chart approaches to the tax. I just hope it doesn't come up with a flow chart like the health care plan had.

Mr. GEPHARDT. Right.

Chairman ARCHER. Well, I would also chime in very quickly and say this. My hope is that whatever we end up with, it will be not just reform. The term reform has been used over and over and over again in this Committee. And I also hope that we not simply end up clipping around the edges or pruning but that we end up with something that is a replacement for this system and that will really and truly get the IRS more out of people's lives.

Mr. Ensign.

Mr. ENSIGN. Thank you, Mr. Chairman.

Mr. Gephardt, you mentioned in your testimony about progressivity and the idea being as old as the Bible itself. I certainly hope you weren't referring to that concept being in the Bible as far as forced taxation and a progressive nature, because that certainly is not a concept that is in the Bible. But I want to address that be-

cause I think that is a fundamental issue that needs to be discussed in this whole tax system replacement that we are talking about here.

And I address this question, and perhaps you can, the administration wasn't very forthcoming in their answer yesterday. We talk about, obviously you are dealing with the issue of fairness, what is fair to pay, what tax rate depending on your income level. Where do you get your definition of fairness?

We had a definition by Mr. Armey today that said that fair is when you treat everybody the same. That is his definition of fairness. Where do you get your definition so that we can determine what rate is fair to pay?

Mr. GEPHARDT. Through the years we have had a progressive income tax system. We have made a decision as a country that if you are better off, you fairly should pay more of a burden to make the government——

Mr. ENSIGN. Under the same tax rates, don't you pay more of a burden? If everybody pays the same tax rate, don't they pay more of a burden because somebody makes $100,000 versus $20,000, they pay more of a burden?

Mr. GEPHARDT. It goes back to what Mr. Gibbons was saying, with the payroll tax today, everybody pays 6, 7 percent out of their income. Now, that is a different thing if you are earning $30,000 a year or $40,000 a year than if you are earning $4 million a year. It is much easier in your circumstance if you are making $4 million a year to afford to pay that amount of money, whether it is——

Mr. ENSIGN. Let's take that amount of money. Let's say someone is making $1 million a year—we will keep these figures nice and round—and that somebody else is making $10,000 a year.

Now, that person that is making $1 million a year could afford to pay a 90 percent tax rate much easier than the person that makes $10,000 a year could afford to pay a 90 percent tax rate. By your definition, is that true?

Mr. GEPHARDT. It is true, but it is a question of what is reasonable——

Mr. ENSIGN. That is why I am asking where you get your definition, so that we can find out.

Mr. GEPHARDT. From a consensus that I think we have had in our society for a long time.

Mr. ENSIGN. That consensus goes up and down. That is why we change marginal tax rates.

Mr. GEPHARDT. It is interesting—if you look back at history and look at how much of income we have taken with all taxes—State, local, Federal, payroll—and you put it in your income classes, you will see that there is a stunning sameness to the progressivity chart that we have had in existence; and I would call that a consensus. You can argue that it is not right, and I respect that argument, but I am arguing that that consensus has been in effect in this country for a long time.

Mr. ENSIGN. Let me take it from a different angle.

The basis of socialism is redistribution of wealth, bring everything into a common fund and redistribute it so that everybody is equal. If you have two farmers, farmer A is here, farmer B here, farmer A works 20 hours a week, produces enough to get by, farm-

er B works about 80 hours a week, produces a lot more crop, should farmer B be taxed at a higher rate than farmer A? Just because farmer B works harder, produces more, should that person be taxed at a higher rate? Or should they be basically taxed at the same rate?

Mr. GEPHARDT. Well, I don't accept socialism.

Mr. ENSIGN. Isn't that what progressivity is, it is just a form of——

Mr. GEPHARDT. There are a lot of factors that go into people being able to earn more. Some people work very hard and still don't make very much money. My dad was a milk truck driver. He worked very hard. I would say he worked as hard as anybody ever has in this country, but he didn't make a lot of money.

So the issue is, do we want to have a tax system that affects a lot of different people in different circumstances, most of whom are working very hard, but because of a lot of different things—lack of education, lack of having a wealthy family, they don't make much money——

Mr. ENSIGN. In socialistic countries, they basically start with that premise. Just because you are a farmer or a milk truck driver or whatever, you are just as valuable to a society as somebody that creates 1,000 jobs here; and therefore, they should make the same amount of money.

Mr. GEPHARDT. I am not arguing for socialism. I am arguing for fairness. There is a big difference.

Mr. ENSIGN. You haven't defined how you get your fairness other than a consensus of the population, but that is not a definition.

Mr. GEPHARDT. People who earn more—I think it is in the Bible, maybe not, but to those to whom much is given, much is asked.

Mr. ENSIGN. Voluntarily, not forced, not coerced.

Mr. GEPHARDT. We have a government that is requiring to have funds, to make it operate, to build roads, to do the things that we all agree need to be done. The question is, who pays what according to their means.

You can argue, and I respect the argument, that everybody ought to have the same right and that is a very respectable argument to make. I don't agree with it, and that is where our disagreement needs to be argued out, teased out, and the whole country needs to be involved, because if we are going to do basic tax reform, this is a major element that has to be discussed.

Mr. ENSIGN. I appreciate your testimony.

Thank you, Mr. Chairman. The reason that I brought up the issue is because I think it needs to be part of the discussion.

Chairman ARCHER. Mr. Leader, are you able to spend any more time? I was just informed that you needed to leave by 1:20. It is now 1:22.

Mr. GEPHARDT. I think they have the cane on me so I need to go to some meetings I am late for. I deeply appreciate the ability to be here and will be happy to come back at another time and engage in more questions and dialog.

Chairman ARCHER. We may accept that offer on your part. We thank you very much.

Mr. GEPHARDT. Maybe you will have another set of hearings, and by that time my specifics will be out there.

Chairman ARCHER. I anticipate that we will.

Mr. RANGEL. Mr. Chairman, as he leaves, may I ask one question and get an answer later?

Chairman ARCHER. I would hope that the gentleman would suspend in deference to his Leader, who has to leave.

Mr. RANGEL. You have taken plenty of time. I am trying to help you in being openminded about this and look at this in a very bipartisan way.

I was about to ask my Leader whether or not he knew of any proposals coming from the so-called "other side" that dealt with the question of—disparity, as you have indicated, must be in the bill that you would support. Because if you do know of it, whether it is in the Armey bill or any other, I would want to study it over the weekend.

Mr. GEPHARDT. I don't know, but that doesn't mean it is not there. I have seen some Republican Members on the floor this week in "1 minutes" saying they had tax reform proposals, and we ought to be looking at them all.

Chairman ARCHER. I expect we will be looking at a myriad of proposals. Thank you very much.

Congressman Souder is our next witness. Welcome to the Committee. We will be pleased to receive your presentation. We would appreciate it if you could limit your oral presentation to 5 minutes or less and your entire written statement can be inserted in the record, without objection.

Welcome and you may proceed.

STATEMENT OF HON. MARK E. SOUDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF INDIANA

Mr. SOUDER. Thank you, Mr. Chairman, for the opportunity to testify before you. It is exciting to have a Chairman committed to radical tax reform and to changing our Code.

Before I begin, I also wish to thank our Majority Leader, Mr. Armey, whose untiring efforts have made a lot of our flat tax efforts possible, as well as the pioneer in tax reform, Jack Kemp, who has been a personal inspiration in my life. Without Mr. Armey's tax proposal, I would not be sitting here today with mine, and while Mr. Armey and I may disagree on some of the fine points, we do agree that the fairest and simplest way to collect revenue is a flat tax system.

Most of us here today would agree that our current tax system has failed. Chairman Archer, I agree with your assessment that it would be too easy to simply judge a tax proposal against our current tax system without setting certain standards. After all, the current Code makes anything look good and, if I may borrow from Congressman Armey's statistics, any system that forces its citizens to devote 5.4 billion hours and $232 billion only to comply with its Code must be a miserable failure.

A pure flat tax with personal allowances, such as what Congressman Armey is proposing, is the kind of system that will simplify the lives of all Americans by creating a flat rate and taxing income only once; it will cut down on the tremendous tax bureaucracy and it will boost the American economy because of its favorable treatment toward savings and investments.

I have studied this plan and listened to Mr. Armey with respect and admiration. I agree wholeheartedly with his flat tax premise. However, there are issues concerning a pure flat tax that concern me. That is why I, along with Congressman Solomon of New York, the Chairman of the Rules Committee, and Congressmen Doolittle and Baker of California, Foley of Florida, and Barton of Texas introduced a proposal yesterday that is similar to the one made by Senator Specter of Pennsylvania.

Our legislation is for a modified flat tax, and we have given it the name "McFlat." In what sounds like an unusual name for a serious tax proposal, we have incorporated the meat of Congressman Armey's flat tax proposal along with deductions for mortgage interest and charitable contributions—hence McFlat, "M" for mortgage and "c" for charitable.

Before I go into further detail about our plan, let me explain briefly why I included those two things. I realize that whenever you put deductions in, you could have creeping exceptions. I know that even in tax rates, whether it is a VAT, a sales tax, income tax, we will face bracket creep to some degree. If there is a continuing insatiable demand for government services, we must control spending. Any of these kinds of systems can change, but I believe the mortgage interest and charitable deductions are critical.

To incriminate myself a bit, when I came here in January, our family decided that we wanted to stay based in Indiana where our friends are, where our home is, where our schools are, where our family is; and it made a lot of sense. I live in a highrise apartment in the area called "Crystal City." For a long time, I didn't know whether it was in Alexandria or Arlington. I don't know the schools there. I don't know who is on the city council. I don't know my neighbors. Like most but not all renters, since I don't own my apartment, I do not have the same level of concern about my surrounding community. That is because I do not have a direct stake in that community.

Owning a home is one of America's greatest and oldest traditions. It is something that most people aspire to all their lives. The mortgage interest deduction in our current Tax Code enables many of those people to achieve that dream.

For similar reasons, I feel we must retain the charitable contribution deduction. Charities and the poor and disabled obviously benefit a great deal from the deduction available in the current Tax Code. In fact, I have also introduced legislation to increase the charitable contribution Peter Drucker proposed a number of years ago in the Wall Street Journal. I believe if we don't do the type of changes that are radical, we need to increase the charitable deduction in the current Code. We need to have our tax changes blend with the other policies we are doing. We are trying to reform government, back government off, move some services to the private sector; and to do that, we need to make sure there are incentives for people to keep giving. As a social conservative, I believe it is important to have values such as home ownership and charitable deductions included in the Tax Code.

Most of the other components of McFlat are very similar to Mr. Armey's and Mr. Specter's proposals, such as the 20 percent flat rate. Ours is slightly higher than Mr. Armey's because of the home

mortgage and charitable deductions. Mr. Armey's goes down to 17 percent after 3 years. There is a question whether his could really go down to 17; that is why we are proposing a flat 20 percent rate. We are keeping the businessowners' taxes. Like Majority Leader Armey's, it still goes on one card. There is just one additional line for mortgage and one additional line for charitable deductions. We cap the mortgage at $100,000 which, in effect, enables people to get started. If we go higher than $100,000, we run into questions of how to keep the 20 percent flat rate.

So I believe that while there are differences between the many proposals you have heard so far today and will hear—my distinguished colleague and Senator from Indiana, Senator Lugar, has a sales tax which he will be talking about later today—we agree with your basic point that we need to root out the current system if we are really going to make these changes.

I hope that McFlat provides the "arches," so to speak, between the different plans.

I know you have many witnesses. I will be happy to take questions if you choose.

[The prepared statement follows:]

Testimony of Representative Mark E. Souder
Committee on Ways and Means
June 8, 1995

Mr. Chairman, thank you for this opportunity to appear before the Committee on Ways and Means to testify on behalf of replacing the federal income tax. Before, I begin I wish to extend my thanks to our Majority Leader, Congressman Dick Armey, for his untiring efforts to show Congress and the American people that there is a better way than our current tax system. Without Mr. Armey's flat tax proposal, I would not be sitting here today with Senator Specter and my proposal. And, while Congressman Armey and I may disagree on some of the fine points, we do agree that the fairest and simplest way to collect revenue is a flat tax system.

All of us here today would most likely agree that our current tax system has failed. It has failed the middle class, failed the poor, and allowed outrageous loopholes for some of the very rich. Through the years, as Americans have suffered one tax increase after another, public satisfaction with the federal government has plummeted to all-time lows. While the government's appetite for spending has become insatiable, the public has cried 'uncle.' There has got to be a better way.

Chairman Archer, I agree with your assessment that it would be too easy to simply judge a tax proposal against the current tax system without setting certain standards. After all, the current code makes *anything* look good. And--if I may borrow from Congressman Armey's statistics--any system that forces its citizens to devote 5.4 billion hours and 232 billion dollars only to comply with its code must be a miserable failure.

A pure flat tax with personal allowances, such as what Congressman Armey is proposing, is the kind of system that will simplify the lives of all Americans by creating a flat rate and taxing income only once; it will cut down on the tremendous tax bureaucracy; and, it will boost the American economy because of its favorable treatment toward savings and investments. The Armey flat tax would provide taxpayers with the relief that they are looking for and, at the same time, lead to higher productivity and economic growth for all.

I have studied this plan and listened to Mr. Armey with respect and admiration. I agree wholeheartedly with his flat tax premise. However, there are issues concerning a pure flat tax that concern me. That is why I, along with Congressman Solomon, the Chairman of the Committee on Rules, have introduced a proposal similar to the one made by Senator Specter of Pennsylvania. Our legislation is for a modified flat tax and we've given it the name "McFlat." In what sounds like an unusual name for a serious tax proposal, we've incorporated the meat of Congressman Armey's flat tax proposal along with deductions for mortgage interest and charitable contributions. What results is the ease, efficiency, and equity of McFlat.

Before I go into further detail about our plan, allow me a moment to explain the necessity of preserving the mortgage interest and the charitable contribution deductions. I will begin by incriminating myself a bit. When I came to Congress in January, my wife and I decided that she and my three children would continue to live back in the district in Fort Wayne, and I would rent an apartment here and commute home on the weekends. It was an arrangement made mostly because we did not want to remove our family from the home, schools, and community which we are so attached to.

Now, I live during the week in a high rise apartment building in an area called "Crystal City." For a long time I had no idea whether my address was in Alexandria or Arlington, Virginia. I don't know much about the schools here, I don't know who is on the city council, and I don't know my neighbors. Like most, but not all renters, since I do not own my apartment, I do not have the same level of concern about my surrounding community. That is because I do not have a direct stake in it.

Owning a home is one of America's greatest and oldest traditions. It is something that people aspire to all of their lives. The mortgage interest deduction in our current tax code enables many of those people to achieve that dream. However, if we adopt a new tax code and

some kind of deduction is not preserved, then home ownership could be placed out of reach of many Americans.

It is for similar reasons that I feel we must retain the charitable contribution deduction, as well. Charities and the poor and disabled obviously benefit a great deal from the deduction available in the current tax code. It enables many people to give as generously as they can to help the neediest among us. Although large contributors will still give and some individuals will still tithe, the general population of givers will likely decline if the deduction is taken away. The Cato Institute estimates that spending on welfare programs runs over $35,000 for every family of four below the poverty line. But the bulk of this money is spent on bureaucratic overhead, not on poor people. As we seek fiscal responsibility in government, increased private giving and volunteer involvement can fill a need that deficit spending cannot--and with more success, efficiency, and compassion. Therefore, retaining the charitable deduction will give average citizens the opportunity to do more for those in need than the government ever could.

McFlat is a proposal for modified flat tax system with a 20 percent tax rate. For the individual and families that means they will be taxed on their yearly income less capital gains, interest on savings, and dividends. They will be entitled to "personal allowances" for themselves and their children. $16,500 for a married couple filing jointly, $14,000 for a single head of household, $9,500 for a single person, and $4,500 for each dependent. Then they can deduct their mortgage interest for the first $100,000 in borrowing and deduct all charitable contributions.

For business owners, McFlat means that they are not taxed for wages, direct expenses, and purchases. All revenue is taxed only once at the 20 percent flat rate. Businesses will be allowed to expense 100 percent of the cost of capital formation, including purchases of capital equipment, structures and land in the year in which the investments are made rather than dragging out the tax benefits for those investments through complicated depreciation schedules.

As our Leader, Mr. Armey and Senator Specter have already demonstrated, simplicity is one of the key elements of this plan. Individuals and businesses will fill out a postcard-size form with ten lines:

Form 1 **Individual Wage Tax** **1995**

Your first name and initial (if joint return, also give spouse's name and initial) — Your social security number — —

Home address (number and street including apartment number or rural route) number — Spouse's social security

City, town, or post office, state, and ZIP code

1.	Wages, salary, pension and retirement benefits	1. _____
2.	Personal allowance (enter only one)	2. _____
	☐ $16,500 for married filing jointly	
	☐ $ 9,500 for single	
	☐ $14,000 for single head of household	
3.	Number of dependents, not including spouse, multiplied by $4,500	3. _____
4.	Mortgage interest on debt up to $100,000 for owner-occupied home	4. _____
5.	Cash or equivalent charitable contributions	5. _____
6.	Total allowances and deductions (add lines 2, 3, 4 and 5)	6. _____
7.	Taxable compensation (line 1 less line 6, if positive; otherwise zero)	7. _____
8.	Tax (20% of line 7)	8. _____
9.	Tax withheld by employer	9. _____

No longer will American taxpayers have to spend all of their time and money on compliance with I.R.S. regulations. The twin burdens of unnecessary bureaucracy and red tape will finally be removed.

It is well known that the U.S. has an abysmal savings rate. This savings rate has a direct and chilling relation to our economic growth. In order to create the capital that is necessary to future U.S. growth, we must raise our levels of private savings and investment. Instead of discouraging savings and investment by taxing the interest from savings accounts, dividends and capital gains, as our current tax system does, McFlat removes the tax on growth by eliminating capital gains taxes on the sale of investments. With the implementation of McFlat, businesses will invest more because they will be allowed to expense fully all sums invested in new equipment and technology. With greater investment and a larger pool of savings, interest rates and the costs of investment will also drop, generating even more economic growth.

The increase in American savings because of McFlat will also help decrease our dependence on foreign investors to finance our federal budget deficits and our private sector economic activity. Now, foreigners hold nearly 20 percent of our publicly held federal debt--our highest level ever. The massive interest payments--at least $40 billion per year--are the principle source of U.S. capital flowing abroad. This increase in foreign investment in Treasury debt pushes America further toward a debtor nation rather than a creditor, weakening the dollar and our international trade position. With McFlat, our supply of capital can be renewed, and we can return to the position of international creditor rather than debtor.

Lastly, Mr. Chairman, I will mention the issue of tax compliance. Our current tax code wrongheadedly uses tax policy to direct economic activity. The tax breaks are typically used for tax shelters which have no valid economic purposes, or to the activities which the tax laws were meant to promote. Even when the I.R.S. catches onto certain loopholes, tax experts are still able to outfox the bureaucrats. McFlat will close the loopholes and put a stop to tax avoidance and never ending battles between tax lawyers and I.R.S. bureaucrats.

I would like to emphasize the importance to all of my colleagues here that when we consider proposals for reform of our tax system that all plans--in the words of Chairman Archer--tear the current income tax system "out by its roots." Although Congressman Armey, Senator Specter, and I have varying flat tax proposals, our common point is simplicity of design. Our proposals promote economic growth by removing all the disincentives to savings and investments while enabling the income tax return to fit on a postcard.

Chairman Archer, I wish to thank you for your leadership in promoting tax simplification. It is exciting--after years of complaining about the tax system as a businessman and parent--to now be here in Congress working with you on revising our outdated and unfair tax system. I hope the McFlat tax proposal can help provide the arches, so to speak, among the various plans.

Chairman ARCHER. Thank you for your presentation.

Are there any questions for Congressman Souder?

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman. Thank you for joining us today for testimony, Congressman Souder. You have been probably the leading advocate in this Congress of the charitable deduction and its significance in the Tax Code. I wonder if you could comment on the importance of including an enhanced charitable deduction in any new alternative tax system that we consider.

Mr. SOUDER. Two of the biggest problems we have today are societal breakdown tied with the ever-increasing demand for expanding government. I believe that through the charitable deduction we will never totally replace government social programs, but we can replace part of them by giving incentives to the private sector, and that is important.

I also believe that the government shouldn't have a direct role in doing moral or other types of funding. It corrupts both churches and religious institutions, and I don't believe the government should take sides between different denominations. Because of that, we need to have other ways to make sure that our social fabric stays together, which I believe means much charitable giving.

Mr. Armey used a figure of 50 percent in some of the tax changes and many people tithing would do that, but much charitable giving would decline, both to the churches, which is important for us morally and spiritually, as well as for social welfare. We cannot, when justifying cutting government and talking about moral programs, I believe, gut those important financial incentives. It is a basic foundation that I think we need to have in our society.

Mr. ENGLISH. So your charitable deduction would be an incentive to people to contribute to local institutions in their community that provide services directly, and in a lean and very nonbureaucratic way; and it will be a tax deduction that will be broadly accessible to working families, the middle class and people throughout our society?

Mr. SOUDER. It is simple. It reflects what has happened in American history, like the fervor and effort made when starting the public school movement, foster care, and the prevention of child abuse. In 4 years, as a Republican staff director, the children and families showed me that the most effective programs, particularly in the urban centers and particularly in the black and Hispanic communities, are often religious based. Therefore, we need a charitable contribution because the government can't conduct religious-based efforts.

Mr. ENGLISH. Thank you. Your testimony, as always, is powerful, and we very much appreciate your efforts on this.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Earlier today Congressman Gibbons stated that Canada does not have any type of similar mortgage interest deduction to what we have in this country, and that they haven't had that stimulus and need to stimulate their housing industry and the first-time home purchases. Why do you believe that maybe we shouldn't adopt the Canadian model when it comes to their housing industry?

Mr. SOUDER. As we know, in health and other areas, different systems behave differently. I don't know a lot about the Canadian system, though we have vacationed there. I would guess that the city of Toronto behaves more like the American system. As you get a more urban population, rather than the traditional rural population that you see through much of Canada, you will see that.

Under our current system, we have an increasing rental condominium-type development. While I believe that in a free economy you should not stop that, I believe part of what we are seeing in the transients and the breakdown of the social system is because we don't have roots in the community. That is why Secretary Kemp, when he was at HUD, tried to promote home ownership in urban centers. We need to make sure that we don't accidentally accelerate social changes that have not been necessarily healthy for our economy. We are different enough and we also have a historic root in home ownership, which means you can't necessarily operate like Canada, even if we have the same demographics.

Mr. CHRISTENSEN. Which of the four—simplicity, equity, efficiency, administration—would you deem the most important in constructing a new Tax Code?

Mr. SOUDER. Politics is always the art of compromise. I believe the number one thing that is driving us now is simplicity. Because of the complexity, because the powerful always have more access to changing and getting amendments and doing the different things—that equity is closely related to simplicity. So those two things are both important, but in the process of achieving that, you can't throw everything else out. But that is why there is really more unity among the people presenting today. Hopefully you here on this Committee can help raise awareness and move us toward the simplicity, and the equity that comes from simplicity.

Mr. CHRISTENSEN. Thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Souder. We appreciate your input, and we are glad that you will be working with us in trying to find a resolution to this issue.

Our next witness is a former Congressman, former quarterback for the Buffalo Bills, a former Secretary of HUD, Hon. Jack Kemp, who has been given a new assignment, along with all the other things that he has to do, to head up a commission to make recommendations to us.

We are delighted you have taken the time to come and present to us your ideas about this. I hope at this point they are not crystallized inasmuch as the duty that you have been assigned should be an objective one, to seek out the best alternative. Please proceed.

STATEMENT OF HON. JACK KEMP, CHAIRMAN, ECONOMIC GROWTH AND TAX REFORM COMMISSION AND FORMER SECRETARY OF HOUSING AND URBAN DEVELOPMENT

Mr. KEMP. Thank you. I wish you could have said a former Member of the Ways and Means Committee. I never quite made it to this halcyon, august body, but my respect for the men and women of this Committee, the work of this Committee, both sides of the aisle of this Committee—you, Mr. Chairman, you, Mr. Rangel, an

old and dear friend, both of you, and the newer Members, I am thrilled to be here.

I approach it with objectivity, may I say to the Chair.

A Chinese philosopher said one time, there is a lot of wisdom in the world, but unfortunately it was all divided up among people. I just come with a slice of that pie of wisdom—my experience, my feelings; and I am going to approach this commission in which I was appointed by Majority Leader Bob Dole and Speaker Newt Gingrich to do, Mr. Chairman, what you have been talking about, and that is to tear up the system, put a blank sheet of paper out there, a tabula rasa as it were, and try to design in a post-cold war world for America a tax system that is, as I think most men and women of good will on both sides of the aisle would like for America—as we enter the 21st century, fairness, simplicity, efficiency that can expand this economy, give people hope that they can have access to capital and jobs, and that can do away with the Byzantine structure of tax policy that grew up not out of malevolence but out of a genuine attempt by men and women of good will to come up with a system that could have taken us through two world wars, two regional wars, a cold war and a highly centralized bureaucracy with which the American people are frustrated and which needs to be rethought, redesigned, restructured.

And I want to say I think today, or at least these few days that you have designated for these hearings could very well be the start of the 21st century of the United States of America, because I don't believe that we can go into the 21st century with this Tax Code. I don't think it is fair, including Dick Gephardt—did you think, Mr. Chairman, albeit the questions that were given to Mr. Gephardt by particularly my friend John Ensign from Nevada—but I think we should celebrate the fact that the Minority Leader of the Democratic Party said it is time for massive radical change.

He wants to offer his own proposal, and I respect that, for a fundamental overhaul of the entire Tax Code, so we will have fewer rates. I would like to have one rate, but fewer rates is better than a lot of rates; fewer loopholes, that is a good goal; less paperwork, that is a consensus opinion; and lower tax rates for all Americans.

So I think, Mr. Chairman, you have and your colleagues in both parties have come to these hearings with an absolutely imperative mission from the American people and that is to give us what we desperately need.

We are going to have three objectives in the tax commission. I would like to submit the names of the distinguished people from around the country who are going to serve on the tax commission for the record. I would like to submit for the record the statement of Speaker Gingrich and Majority Leader Dole.

[The following was subsequently received:]

Congress of the United States
Washington, DC 20515

FOR IMMEDIATE RELEASE
Wednesday, May 24, 1995

ECONOMIC GROWTH & TAX REFORM COMMISSION
GINGRICH & DOLE NAME MEMBERS

WASHINGTON -- House Speaker Newt Gingrich and Senate Majority Leader Bob Dole today named 13 distinguished Americans to serve on the National Commission on Economic Growth & Tax Reform, chaired by Jack Kemp. The Commission was established April 3rd by Gingrich and Dole to examine overhauling the tax system to make it flatter, fairer, and simpler. The panel is expected to make its recommendations to Gingrich & Dole later this year.

Named to the Commission were:

Loretta Adams
-- Founder & President, San Diego-based Market Development, Inc.
Ken Blackwell
-- Ohio State Treasurer
Herman Cain
-- CEO, Godfather's Pizza; Former President, National Restaurant Association
Carroll Campbell
-- Former Governor of South Carolina; former member House Ways & Means Committee; President & CEO, American Council of Life Insurance
Pete DuPont
-- Former Governor of Delaware; Policy Chairman, National Center for Policy Analysis
Jack Faris
-- President & CEO, National Federation of Independent Business
Ed Feulner
-- President, Heritage Foundation
Matt Fong
-- California State Treasurer
Ted Forstmann
-- Partner, Forstmann-Little
Dean Kleckner
-- President, American Farm Bureau Federation
Shirley Peterson
-- Former IRS Commissioner; former Assistant Attorney General for the Tax Division; President-elect, Hood College, Frederick, MD
John Snow
-- CEO, CSX Corporation; Chairman, Business Roundtable
John Weiland
-- President, Weiland Homes, Inc.

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Contacts: Tony Blankley (Gingrich) -- 202-225-2800
Clarkson Hine (Dole) -- 202-224-5358

There will be three goals of the tax commission and progrowth commission—I should say, three steps. One is to inventory the problems, which abound. Two is to inventory the solutions, which equally abound. This is not a partisan effort albeit there are partisan issues. Senator Long has been a champion of tax reform. Ross Perot talked about tearing up the system and drafting a new flat tax system for America. He never got around to it, but he talked about it. John F. Kennedy talked about tax reform; Ronald Reagan; you, Mr. Chairman, Charlie Rangel and I have spent many, many hours of conversation about what we do about our cities and urban problems of poverty and how to use the Tax Code to incentivize the formation of capital and jobs and educational training for young minority and majority working men and women.

So after we have inventoried the problems, we will inventory the solutions including consumption and VAT and sales and flat income tax rate systems, and then try to have as our conclusion a—I don't want to say a "consensus product," because you cannot absolutely reach consensus, but I think we could come up with an answer that matches the problem and take this country into the 21st century.

One last thought. I mentioned growth. I don't think we can meet the social goals of America or the fiscal goals of this Congress, Mr. Chairman, without a progrowth Tax Code. I am frustrated by the attention that is given to the numerator, that is, the spending side of the budget. Not enough people are thinking about the denominator, which is the size of the economy. And my goal, our goal will be to give a Tax Code to—as a facilitator to your work, Mr. Chairman, that will advance the potential of this economy to grow and create jobs and entrepreneurial opportunities for people while being fair and simple and profoundly progressive.

I will close with this thought. I don't think it is oxymoronic to suggest that you can have a flatter Code with progressivity. I accept the premise that we need a system that treats the poor and treats the young and treats the entry-level working man and woman family differently than it treats mature assets in America. I favor a flat tax. I have said that many times. But within a flat tax you can have de facto progressivity with the type of exemption that has been talked about, Mr. Chairman, not only in your approach but in other approaches to this problem.

So I enter this caldron, enter this debate, enter this issue with some experience in tax reform and with a goal of achieving the simplicity and fairness and flatness that we have alluded to in our party, but yet can accept that challenge from Mr. Gephardt or my friend Charlie Rangel that would respect the fact that the poor, the woman on welfare, the father who is unemployed, the people working their way out of poverty should face a tax system that on a first five or six or seven rungs of the ladder does not treat their income the same way as we would treat mature assets and older and wealthier—not to draw a class division—I know it could be done. I think it is one of the most exciting challenges facing our country today in this post-cold war period.

Chairman ARCHER. Thank you for your presentation. I know that you have a lot more on your mind, and I particularly compliment you for your brevity.

I would like to ask you a few things, and I think it is good to do it here in the forum of this Committee although we could do it another time, when I hope I will be asked to come and talk to your commission.

Mr. KEMP. Absolutely, Mr. Chairman.

Chairman ARCHER. From the way you have presented your views, the goals that you have and that, I think, the overwhelming majority of the Members of this Committee have, are not different. The question is, how do we get there? I share your view that we must look long term, which is unusual for this body, and we must have an agenda for the 21st century that will push America ahead in a very competitive global marketplace, or I believe that we will see the standard of living ebb for all Americans. We must compete, look out and not just inwardly; and it seems to me that our taxes can be a major vehicle in that regard, and that is a part of growth.

I have lost patience or hope that we can change this Tax Code so that it will be growth oriented. Many efforts have occurred, including yours initially with Kemp-Roth back in 1981.

Mr. KEMP. Right.

Chairman ARCHER. Inevitably we have failed to make this current tax system one of growth, job creation, and higher real family earnings for working Americans. I think that should be perhaps the major goal in what we are about today. I think simplicity is extremely important. I think cutting down the cost of compliance, reducing it from the current minimum of $300 billion a year is important, but I also think Americans are crying out for relief in their personal lives from the IRS.

Forty million Americans will have a confrontation with the IRS this year in some form or another, 40 million Americans. And that is an unpleasant thing for any American, even though it may be relatively minor. It is also interesting to note that the taxpayers will win over 50 percent of those confrontations. So they basically——

Mr. KEMP. I am surprised.

Chairman ARCHER. They proved to be unnecessary.

It seems to me that one of our goals should be to get the IRS completely and totally out of the lives of individual Americans. I think that should be a goal, to protect freedom and the right of privacy, to get the IRS totally and completely out of the lives of individual Americans. I hope you would share that goal because the American people are crying out for it today in every townhall meeting.

So just to speak of some of the goals, I think we have common ground.

I want to ask you about a comment that was just printed in the BNA Daily Tax Report—and give you an opportunity to respond to how you are quoted in this article. Kemp said he is opposed to Archer's plan to replace the current system with a broad-based consumption tax, "I heartily don't endorse Archer's plan."

Mr. KEMP. Mr. Chairman——

Chairman ARCHER. Is that an accurate——

Mr. KEMP. I don't know—where was it said and when——

Chairman ARCHER. This is listed in the Bureau of National Affairs publication which comes out every day, and it quotes you as

having been before the National Policy Forum press conference, and apparently a reporter talked to you; I don't know what reporter, but the reporter from BNA. That is today, June 8, 1995.

Mr. KEMP. I am squirming because I don't think I have ever said I was opposed to the Archer plan. First of all, I would be dumb to say that at a press conference going into hearings——

Chairman ARCHER. I would think so.

Mr. KEMP. I am admitting it. I appreciate your bringing this up in such a public forum. I would have appreciated, as an old friend, being told about it, but I don't think I said "Archer."

I might have said a VAT tax. I personally am not for a VAT tax. I am willing to look at a bill, but I don't know what your plan is. If it is in concrete, I don't even know what it is.

I have said nice things about Dick Armey, and I have said good things about Hall-Rabushka, I have said good things about a lot of general thrusts, conceptually speaking, but as the chairman of this commission, I pledge to you as open a mind as we humanly can have.

You have pretty strong feelings, Mr. Chairman, and I don't mean to suggest that you are not totally openminded about this. I just would admit that I probably have said that I don't favor going to a VAT tax, but I am willing——

Chairman ARCHER. You say that——

Mr. KEMP. I don't think I have ever said anything that you have ever done that I would be opposed to. You can put me on the spot for the rest of the hearing——

Chairman ARCHER. I just want to be sure you were misquoted.

Mr. KEMP. I hate guys that say they were misquoted all the time. I would not say that I am opposed to the Archer plan, the Armey plan, the Nunn-Domenici plan.

Chairman ARCHER. You have told me privately on two occasions that you have an open mind on this.

Mr. KEMP. Open to everything but raising taxes.

Chairman ARCHER. I would contemplate that as long as I am Chairman of this Committee none of these plans will raise taxes, or will raise the amounts of revenue that is being——

Mr. KEMP. I have a pretty good pedigree in this regard, almost as good as yours. We came to Congress together. I would not say I am opposed to the Archer plan. I don't know what the Archer plan is, to be perfectly frank. I know you are for a sales or consumption tax, but that is as much as I know about it.

Chairman ARCHER. That is true at this point, and I will, before the end of this year, come down on a specific method; but I am of a belief that in order to have the agenda for the 21st century to create growth, to create more jobs, to compete in the world marketplace, that we must replace the income tax system with a tax on goods and services in the form of some type of broad-based consumption tax, and your quote is here that you would not replace the current tax system with a broad-based consumption tax.

Mr. KEMP. I misspoke, I will say publicly and on C–SPAN in front of my old friends. You may have misspoken along the line in your career.

Chairman ARCHER. I am sure that I have.

Mr. KEMP. Let me make the point I was trying to make, and I alluded to it in my opening statement.

I believe in taxation of people based on their ability to pay. I do not think you should tax a family that is working their way out of poverty, that must use as much of its disposable income as possible for the same burden of taxation as you would tax an investor who has mature assets. You are talking to a radical on some of these things, because I have said that I would like to eliminate the capital gains tax, particularly in the inner cities.

In the commission, I plan to be as open and fair as I can, but I do think, as Adam Smith said in the book that he wrote that launched this effort, that taxation should be predicated upon the ability of people to pay consistent with efficiency, raising revenue and not discouraging the factors of production. I am as close to that as I can probably get. But I do think the Code needs some social engineering within certain boundaries.

I agree with Mark Souder, home ownership is important to America and to the American dream. Charitable contributions, we ought to look at that. We ought to look at municipal bond sales and will you hurt the ability to finance municipal bonds and infrastructure. So I want to look at it.

If I have made statements that are beyond the pale, I ask my old friends in the Congress to allow me some maneuvering room to come up openly and honestly and allow every side to be represented. That is why I came here today. That is why I called you to ask you if you would allow me to put on the record how I feel about this commission that Dole and Gingrich have appointed me to, so that we can work toward a consensus.

Chairman ARCHER. I am pleased that this is not an accurate quote and that you have an open mind.

Mr. KEMP. It is open to everything except a VAT tax. I don't like VAT taxes. If you go in, you have to listen to people who are for a VAT tax. I don't want to raise rates, but I am going to listen to the Nunn-Domenici bill that takes the tax up to 40 percent. So it is in that context, Bill, that I think I was quoted.

I have never mentioned your name, I remove the shoes from my feet when I mention your name.

Chairman ARCHER. I won't belabor it, but I am happy to have that on the record that you enter with an open mind, because I don't know how with a flat tax, which still is income-based, even at a lower rate, you can get the IRS out of peoples' lives.

I think if that is going to be the goal, I am terribly troubled that we will not get to that goal because one of the good things that you said in this quote is that "I endorse Archer's enthusiasm for getting the IRS out of our lives and off of our property."

Mr. KEMP. Thank God. You could have started with that and made me feel better.

Have you read Dale Carnegie's, "How to——

Chairman ARCHER. The problem is, I don't know how you do that unless you put a tax on consumption and goods and services rather than an income-based tax.

Mr. KEMP. You are putting me on the spot once again.

Chairman ARCHER. I just want you not to prejudge these issues as you go into this commission.

Mr. KEMP. As I know you haven't.

Chairman ARCHER. I am willing to accept anything.

Mr. KEMP. Let me just say one thing. If the rates were low enough and the system was efficient and fair and simple enough in a profound way, not unlike what we are talking about here today, the IRS would have a lot less intrusiveness. So metaphorically I favor these things.

I am not out to repeal the 16th amendment to the Constitution. I think we have to raise revenue. There are a lot of things we have got to do. But I promise you, I am going to go into this and give you and your staff a full, fair, complete hearing, just as you have given me such a full and fair and complete hearing here today.

Chairman ARCHER. There are basically, in my view, four goals that we should seek in this process, and I am willing to accept any device or any design or any approach that will give us these four goals.

One is, I want to get the IRS completely and totally out of every individual's life in this country. I want to tear the income tax out by its roots.

Mr. KEMP. You have said that many, many times.

Chairman ARCHER. That is a goal that is shared by the overwhelming majority of the American people as we have heard in town meeting after town meeting.

Two, we should have a Tax Code that has the goal of the greatest possible incentive for savings. Savings mean capital investment, which means more productivity, which means better paying jobs for Americans. I don't think you disagree.

Mr. KEMP. I don't disagree. I would add, savings without rates of return on investing those savings is meaningless. Russia had a lot of savings, but it went nowhere because there was no place to put their money because it was taxed away on the income stream. So if you tax income too heavily and tax risk taking too heavily, you can have all the savings in the country——

Chairman ARCHER. That is why I don't want to tax income at all.

Three, I think it should be a tax system that reasonably gets at the underground economy, at people who are not paying their fair share under our current system.

Mr. KEMP. I agree.

Chairman ARCHER. Four, I think it should give us the greatest fair advantage in competing in the world marketplace by being subject to removal of the cost of government from the price of product when it leaves these shores to compete as an export overseas and being able to be charged to a product entering this country so that foreign products bear their fair share of our cost of government.

Those are the four goals, and if you can get there with your commission, whatever vehicle you come up with, I will be excited about it.

Mr. KEMP. Let me ask you just a brief question for my edification.

If you relieve the burden of the tax at the border as it gets exported overseas, does that make the cost of products to American consumers relatively higher than it does on our exported items?

Chairman ARCHER. No, because they are higher today because the cost of taxation today must be factored through, and—you know this—must be included in the price of the product. And it is included today. It would just be included in a different way that can be removed to give us a fair advantage in the world marketplace. And we will talk more about this, at length.

Mr. KEMP. If every country in the world, though, moved to the same type of tax and every country in the world tried to get an advantage at somebody else's—what kind of world trade system——

Chairman ARCHER. We are already suffering with that disadvantage with every country except Australia in the world today. That is the reality of the world marketplace today.

Mr. KEMP. You and I are a lot alike. We love to argue.

Chairman ARCHER. Let me recognize now for questions—and I apologize for the length of time that I have taken—let me recognize your friend, Mr. Rangel.

Mr. RANGEL. You haven't said anything unkind about me anywhere, have you?

Mr. KEMP. Come to think of it, there was something the other day I said about you.

Mr. RANGEL. Let me tell you something, Mr. Secretary. I was about to say, it is very difficult for me to look at this in a bipartisan way. Then along comes you, talking about fairness and equity and remembering that we all don't have the same ability to pay, and you are really shattering my thoughts that there is some preconceived idea out there by the people on the other side that it really doesn't make any difference about fairness and equity, get rid of that tax collector.

Frankly, they have done so well at finding that button that just frustrates the American people, that the people go for getting rid of the IRS and really don't understand the impact of a sales tax as its relates to percentage of consumption by low-income people.

The worst thing I can think of is getting a call from the IRS saying, could you come down and go over your tax return with us, and while you are at it, bring your lawyer or accountant. The more you start having compassion, the more you start looking for ways to take care of that.

All I am saying is that if your commission can come up with a way to wipe out all of the loopholes that we have in the tax system—we put the loopholes in there because of the high rates that we have had for high-income people, but we also put some incentives in there, as you and I have worked on, saying if it can work for them for incentives, let it work for the charitable organizations. After all, it appears as though they are going to be the safety net for the Nation.

I guess my Minority Leader, has he seen any proposal that has come from the other side that even talks about equity? Forget progressiveness, because that sounds too close to being a Socialist. But fairness and equity doesn't have to be biblical; it is just the right thing to do. It is America.

And so I never thought I would see the day to applaud someone just for using those words when you are talking about tax reform, but as long as your commission is moving in that direction, I think there is even hope for a wretched soul like me to be bipartisan.

Thank you.

Mr. KEMP. May I respond?

Mr. HOUGHTON [presiding]. Please.

Mr. KEMP. I am going to approach this on the basis that I think most of us ultimately do in our heart of hearts, which is that America is one family, one people, we have got a stake in each other's well-being, and we wouldn't tax the young who are just beginning on that ladder of opportunity that we euphemistically call "American," but we know is Asian and Latino and African and European; it is universal.

I never liked tax credits for machinery. Why should we give tax credits in the Tax Code for machinery at the expense of human capital?

So I guess in my opening comments, I might have misstated the goal with regard to a sales tax. But in effect what I would like to see this country do—just as a human being, aside from being chairman of this commission, I didn't want to be disingenuous and say that I don't approach this with some built-in feelings about what do we do about the first job that somebody gets? Should they be taxed at 20 percent, and tax me at 20 percent? I don't believe that. I think the young and the bottom rung of the ladder and people beginning their climb should definitely pay—bear less burden. And my purpose has always been in getting the rates down, was not to give a benefit to capital at the expense of labor, but ultimately to recognize that the incidence of taxation is different than the burden of taxation, and that if you overtax capital, you don't hurt the rich, you end up hurting the poor who ultimately want to improve their lot in life as well.

So that is something that I have brought to the Kemp-Roth bill, and brought to the enterprise zone bill that I sponsored with you, Charlie; and I hope that we can come out with some form of radical yet progressive reform of the Tax Code.

I appreciate your comments.

Mr. RANGEL. I hope that the problem that I am having is just one of communication here, because what you are saying is so basic American that it lends itself to bipartisan support, and I want to work toward that end.

Mr. HOUGHTON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Thank you. Charlie, if the gentleman would yield, I didn't realize that there was any problem about whether it was bipartisan or not; I didn't realize that the Republican Party was un-American and the Democratic Party was—or the other way around. Maybe I have been wrong all these years.

Jack, I have known you a long time, read your articles and heard you speak several times, and it bothers me a little bit to have to take issue, but that is the name of the game. You obviously are in favor of a progressive tax of some type where the concept of ability to pay is a cornerstone. If you go back into the history of who came up with the idea of the progressive income tax, it doesn't make me too much in favor of a progressive tax.

You mentioned "mature capital," that the people that hold mature capital should pay more tax because they have accumulated that capital, so therefore they have more ability to pay. Now, what

about the owner of this mature capital who is an investor, who pledges his assets maybe to borrow money and takes the risk of losing every dime of that by loaning the money to people who need the investment capital? If you tax that mature capital to that extent, then you get rid of the entrepreneurs.

Mr. KEMP. I don't know whether you heard my testimony, but I was coming pretty close to suggesting that there ought to be a flat rate tax system with an exemption for the poor and the low income. There was the de facto progressivity; I did not testify on behalf of a progressive income tax, A. B, I favor a de facto level of progressivity, and I doubt very much whether you would even suggest that we ought to tax all people exactly the same irrespective of their ability to bear the tax burden.

There is no stronger supporter on this Earth than me in forming capital as the essence of creating jobs and growth and opportunity for people, so much so that I favor—as Jack Kemp now, not as the chairman of the commission, because I want to study all ramifications—but I think the capital gains tax is a stupid tax. It is not a tax on wealth, but a tax on creation of wealth. It is not a tax on the rich; it is a tax on the poor who want to get rich.

I don't favor estate taxes or double taxation of dividends. I favor total expense—I was there when you were in Illinois. So make sure that when you ask me a premise that you get it a little closer to the record as to what I——

Mr. HANCOCK. One of the reasons that I wanted to ask the question is because I have had people make comments in other areas, and I wanted to give you the opportunity to explain that you do not support that type of a tax.

Thank you.

Mr. KEMP. Thank you. I am glad we cleared it up.

Chairman ARCHER [presiding]. Mr. Zimmer is recognized.

Mr. ZIMMER. Thank you, Mr. Chairman. I don't have any prepared questions. I just want to tell you what a thrill it is to be here and see this exchange go on between the Chairman and Mr. Kemp, and remember that this is not taking place at some think tank or on "Firing Line" but actually before the Taxwriting Committee of the House of Representatives having testimony from a chairman of a commission who is going to have a great deal to say about what the future Tax Code of this country is going to be like.

You called yourself a radical because you want to abolish the tax on capital gains. That was considered a radical position when you first espoused it, but it is a common thread in every proposal that we are considering. Every one of these reforms that is before this Committee will treat investment and saving and job creation and growth much more kindly than the current Code, and I think any of the alternatives would be a great step in the right direction.

I am delighted and thrilled to be part of the process.

Could I ask you whether the meetings of your commission are going to be open, whether you are going to take testimony and have your considerations open to the public?

Mr. KEMP. The first meeting will be next Wednesday. Speaker Gingrich and Majority Leader Bob Dole will head it up. It will be open. All 13 commissioners will be there—14, I guess. I told the Chairman I would submit it for the record. They are men and

women of definite views. They all believe in entrepreneurial capitalism. They all believe in tax reform. They all believe in progrowth policies that are fair for the country. So it will be open.

There will not be formal hearings—there will be formal field hearings so that we can listen to men and women from all corners and backgrounds of this country who have something to say about both the problem, some solutions, and then finding the consensus that might unite the American people and the Congress and lend support to a platform for doubling the size of the American economy in the next, say, dozen years. That is my goal.

I think we talk too much about fiscal restraint, albeit that is important, but not enough people are talking about growing the size of the denominator, that is, the gross national product, and we cannot survive socially or economically or fiscally in this country with an economy that is growing at 2.5 percent per year for the next 10 years. You can't get from here to there. You can't balance the budget in an economy that goes into slow growth, and I think that issue has been lost. It needs to be recaptured and somebody has to fly that flag.

The Tax Code is a perfect place to discuss what Bill Archer talked about in terms of making the economy more competitive and getting the type of growth that can create the jobs and the new enterprises that can take this country into the 21st century.

Mr. ZIMMER. With you as chairman of the commission, the flag will be flown high, and I look forward to working with you.

Chairman ARCHER. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. Welcome. It is late in the day. I think this has been the most interesting part of the day, really.

I think that, Jack, your comments are very interesting and welcome. Everybody knows of your deep interest in this, and I think it is interesting how this discussion has revealed that when you go beyond the rhetoric, there are real differences of opinion, not only between parties, but within parties.

For example, your emphasis on fairness, Jack, is quite different, I think, from the emphasis of the Chairman, who in his four goals doesn't mention that. Your emphasis on growth, I think, is rather broadly accepted between the parties and within them. I think your concern, for example, about the mortgage interest deduction is something that shows a very strong difference from the Majority Leader, who would simply abolish it; similarly, your concern about the charitable deduction. Your statement that there should be not only taxation based on ability to pay, but also the Code needs some social engineering—I take it that is consistent with your long struggle to get some empowerment zones into the Code.

I find it refreshing, and I hope that those who are here, and perhaps the media, will take note of the different emphases that we have heard today; and I think these different emphases need some honest discussion and won't be resolved by putting horns on anybody or anything, whether it is one party or another, or a government agency or another. Because I take it I heard you right, you are concerned about eliminating the deduction on home ownership, on the——

Mr. KEMP. What I said, Sandy, is that we need to look at—the interest on the mortgage, the home ownership deduction right now is sacrosanct vis-a-vis the current Code. The rates are too high, so you have to have that there to protect people who want to own that piece of the American dream. I am going to look at the possibility of what it would be like to have the rates low enough and the system simple enough so that you can give up deductions; and as far as social engineering goes, I am not a social engineer, but I do think the Tax Code should reflect social as well as economic goals for the country. And one of the highest social goals for America is a chance to own a piece of the rock.

I don't want to be accused—I was almost accused of being for the progressive income system—I am not for social engineering.

Mr. LEVIN. I don't want you to get into too much trouble.

Mr. KEMP. Thank you.

Mr. LEVIN. There is a lot of talk about the squeeze on low-income families, but you know there has also been a major squeeze on middle-income families in this country. In fact, the charts show that the tax burden of low-income families has gone down, but the tax burden on middle-income families—it is not only a tax burden, but even more so, their standard of living has just been stagnant.

Mr. KEMP. Right, right.

Mr. LEVIN. So I just hope when we look at, for example, the flat rate tax proposal, we look at its impacts on middle-income families.

You can exempt families up to $35,000 in income, but what does that mean for middle-income families?

Mr. KEMP. It is unbelievable we are sitting here and talking about a middle-income family above $36,000. I mean, I thought I was middle income when I started out in pro football and made $6,000.

The point is, Sandy, when you and I—we are roughly the same age, I am probably older than you, I am having my 60th birthday this July. I just had my ninth grandchild, and I came to Congress with Archer back in 1970. When we came in 1970—before 1970, to be sure, in the sixties, in the sixties a family of four at a median income paid probably 4 to 5 percent of their income to the Federal Government.

Today, thanks to Archer's pointing this out in the record as well as other Members who are sitting in front of me, a family of four in a median income is paying 25, 26, 27, 28 percent. No wonder they are upset about their ability to save and ability to get access to income. We overtax people. The payroll tax is too high, in my opinion. Income tax rates are too high.

Why you guys don't repeal the surtax on income—did anybody vote for it? We never voted for it. That should be repealed. They took it off boats and they put it on the whole economy.

So there is going to be a lot of debate over this, and you are right, the American dream of upward mobility is being hampered, in my opinion, by the regulatory climate to a large extent and particularly the steep progressivity of the Tax Code which punishes people for working, saving, earning, and investing in new entrepreneurial opportunities, and that is what we want to help correct. Your comments are profoundly welcome.

Thank you.

Mr. LEVIN. Thank you.

Chairman ARCHER. The gentleman's time has expired.

I have on the list one last request for inquiry from the gentleman from Minnesota, Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

As an old friend, it is a pleasure to welcome you here today, Chairman Kemp, and as a fellow disciple of economic growth, I must say that nobody has been a more consistent advocate of economic growth or tax reform than you, and that is appreciated by a lot of us. Like many, I wish you were running for another job, but this seems to be an appropriate one at the present time.

Mr. KEMP. The Federal Reserve Board is not open at this time.

Mr. RAMSTAD. That is not the one I had in mind. The one I had in mind has an oval-shaped office downtown.

Mr. KEMP. The commissioner of the National Football League is not open, either.

Mr. RAMSTAD. Let me just ask you very briefly, Jack, what is the timetable for your commission and how are you going to interact with the House and the Senate? How are you going to function? Are you going to have regular meetings?

I know you said that Senator Dole and the Speaker are going to lead off. Just give us a little insight into the commission.

Mr. KEMP. Very quickly, they have charged us with coming up with a consensus approach, if possible, within 6 to 8 months, obviously prior to the primaries of 1996. I have talked to all the so-called—not so-called, I have talked to all the campaigns in the Republican Party. I would be happy to talk to anybody, including Bob Rubin, who is a fine man. He doesn't think that tax rates have anything to do with investment, which I find bizarre for a Secretary of the Treasury.

But having said that, we plan to come up with a statement/legislative agenda to show the nexus between monetary policy and tax policy by November at the latest. We will hold hearings, not formal testimony, but meet people, go to Silicon Valley, go to Houston, Tex., go around the country from Seattle to, you know——

Mr. RAMSTAD. Minneapolis?

Mr. KEMP. Minneapolis, right.

Mr. RAMSTAD. Thank you.

Mr. KEMP. And talk to people of all different backgrounds about what their problems are, to take an inventory of the problems, an inventory of the solutions, and then try to find a match between the problem and the solution, and I have made a lot of statements I know I will be hung around the neck with but, I hope to do it as objectively as I possibly can, knowing full well we live in a political environment and we have got to get something past our party, and I wouldn't be surprised if the Clinton administration is not looking surreptitiously at tax reform for 1996. If they are not, I would be quite surprised.

Mr. RAMSTAD. I certainly hope you will invite the President to submit his proposal. We tried to elicit at least something from Treasury's Assistant Secretary Samuels yesterday. They sent him to testify rather than Secretary Rubin, and I certainly hope that they will submit a proposal.

I am also glad to hear you say that you are going on the road and talking to real people and getting their input and not just those inside the beltway.

Mr. KEMP. Incidentally, there are real people on the commission, Loretta Adams, a young Hispanic woman, president of a San Diego-based market development company; Ken Blackwell, a friend of all of ours, Ohio State treasurer; Herman Cain, the chief executive officer of Godfather's Pizza; Carroll Campbell, former Governor, friend of the Chair and mine; Pete duPont, former Governor, former Congressman; Jack Faris of NFIB; Ed Feulner of Heritage; Matt Fong, State treasurer of California; Teddy Forstmann of Forstmann-Little, one of America's premier financiers and entrepreneurs; Dean Kleckner, president of American Farm Bureau; Shirley Peterson, former IRS Commissioner under Ronald Reagan; John Snow, chief executive officer of CSX Corp. and former chair of the Business Roundtable; and John Weiland of the American Home Builders, Weiland Homes in Atlanta.

So I can assure you, Jim, we will do the best we can to give some—facilitate the work that is being done by the Chairman and of course the Senate leadership.

Mr. RAMSTAD. As a Member of this Committee, I look forward to receiving your input. It would be helpful. Thank you very much, Jack.

Chairman ARCHER. For the last question, Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman.

Jack, it is great to see you here, and it is great that people have the wisdom to bring in your level of knowledge about these tax issues that you have been speaking of for many years. I want to offer you a formal invitation to come to Seattle to hold a hearing. It would be lovely if you could do that between now and November. We may have some other thoughts on the side if that is something you could fit in.

Mr. KEMP. I would get to see my grandchildren.

Ms. DUNN. That is right. It brings me to the one question I wanted to have your thoughts on. As a border State we are interested in exports and trade in Washington State and I am on the Trade Subcommittee of this Ways and Means Committee. I haven't heard you mention border adjustability and I am wondering what your thoughts are on that topic.

Mr. KEMP. Well, that is a subject that the Chairman is quite interested in, and I will be very frank and blunt. I have yet to give as much thought to that issue as you have and as our Chairman has done. I have personally never liked a VAT tax, so I kind of shied away from the discussion of having a border adjustment on the radical theory that—maybe I don't understand it well enough, but I have yet to come to the conclusion that that was the best way to make America more competitive, by simply adjusting our tax as we export.

I have never liked messing around with exchange rates to try to get an advantage on somebody else. That is why I was so opposed to the devaluation of the Mexican peso. They thought they could improve their exports and limit their imports by devaluing the peso. All they have done is destroy their economy and send it down a cliff. So that has been my general approach.

I have got a lot to learn on the subject and I plan to listen to you and also to Chairman Archer, but I just had a bias against VAT taxes because I knew they are so easy to raise and they have just about destroyed the European economies. Every European country has a VAT tax and the general unemployment rate in Europe is probably double that of the United States, and I don't think we should Europeanize the U.S. economy. And I know you don't want to or the Chairman. So I am going to stop right there and just save myself plenty of room for listening to the debate on both sides of that issue of border adjustment.

Chairman ARCHER. Jack, thanks a lot for coming and being with us. I wish you well, and all of us will be available to provide our input to your commission because it is very, very important.

Mr. KEMP. Mr. Chairman, you have been very gracious with me, not only today but throughout your whole career. I am thrilled that you are in the chair. I look forward to approaching this subject with the type of dedication to the job that you have shown.

I applaud your efforts. I think these are the most important hearings going on in the United States of America today, I really do, and I think with your help, Mr. Chairman, we can take this country into the 21st century not only with a competitive economy but with the type of a growing, expanding opportunity society that you have devoted your career to. So I hope I haven't trespassed on the Chair's feelings by coming up with——

Chairman ARCHER. I am just glad you had the opportunity to set the record straight, because I have been misquoted before myself. Thank you.

Mr. KEMP. Thank you.

Chairman ARCHER. Senator Lugar, I apologize to the Senator for keeping him in abeyance here, but we are pleased to have you with the Committee today. You are to be officially presented to our Committee by our friend Steve Buyer, so I recognize our friend Steve Buyer for the introduction.

Mr. BUYER. Thank you, Mr. Chairman. It always extends my faith in the American people when I see you sitting in this chair.

Mr. Chairman, and to my colleagues on the Committee, I have to agree with Jack Kemp that these are very important hearings, but you know as we want to flatten the Tax Code and simplify it and reform it, it is disappointing that I don't see any of my Democrat colleagues at this hearing, I guess in testament that we are not doing social engineering with the Tax Code.

I am honored to introduce to you one of the most respected individuals to serve in the U.S. Senate. As all of us well know, Mr. Lugar is a visionary not only in foreign policy, in agriculture and small business, but his counsel is sought out by past Presidents, the current President and world leaders.

Mr. Lugar is uniquely qualified to discuss the tax reform issues presently before this Committee. He has been an innovative policymaker in every phase of his life. Mr. Lugar brings to this debate a unique perspective, that not only of a father of four and a grandfather, but a small business owner, former mayor of Indianapolis, and former member of the Indianapolis school board. You also might recall he testified about UniGov. He is also an endangered

species, Mr. Chairman, endangered in that he is an owner of a family farm that turns a profit.

So Mr. Lugar's goal, though, is to reform our Tax Code so that it will grow our economy, increase our savings rate, and reduce the intrusiveness of the Federal Government. Having followed Mr. Lugar for many years, I have learned that when Senator Lugar speaks, he has something very important to say. And with that I want to introduce to you a distinguished Senator of the United States, a colleague and friend of mine, Senator Dick Lugar.

Chairman ARCHER. Senator Lugar, welcome to our Committee. You come with credentials that are unblemished, respected by all Americans, and we are delighted to have your presentation. But if you would suspend for one moment, I would say to my colleagues who are waiting, and I hate to keep you waiting, that I am informed we have two votes. We will then have 10 minutes and three additional votes, and I think it would probably be best for you to come back after the completion of those votes so that we cannot just keep you waiting here.

Senator Lugar, you may proceed. If you have a longer printed statement, without objection, it can be inserted in the record.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM THE STATE OF INDIANA

Senator LUGAR. I thank you, Mr. Chairman. I thank my colleague from Indiana.

Mr. Chairman, I thank you for your strong leadership in the tax reform arena. Your oft-quoted comment that our current tax system be pulled out by the roots has been an inspiration as I have traveled the country advocating the elimination of the Federal income tax.

I have found during my travels in America that American families are frustrated, even angry with their economic predicament. They feel like they are running on a treadmill and the treadmill is winning. The problem is that many Americans expect that there is diminishing hope for a better future.

The economic facts justify these beliefs. From 1950 through 1973, hourly compensation, including both wages and benefits, increased an average of 3 percent a year. But since 1973, the average wage increase has been less than one-half of 1 percent. During the past two decades economic growth has been cut in half, averaging only 2.4 percent annually, and if that is not depressing enough for the average American family, limiting growth to 2.5 percent is the stated economic policy of the Federal Reserve Board.

This we must change. The American public demands it.

The cause of America's economic doldrums is twofold: The huge Federal budget deficit that robs us of capital we need to grow; and a Federal tax system that not only discourages but confiscates our savings and investment.

Our national savings rate has reached alarmingly low levels. After averaging close to 9 percent in the sixties, we recently saw our Nation's savings rate bottom out at 1.1 percent in 1992. Because of this low rate of savings, capital to fuel our economy has become increasingly scarce. As a result, our annual productivity gain has averaged just 1.1 percent from 1974 to 1994. The Concord

Coalition estimates that had our productivity held even at its pre-1974 annual rate of 2.9 percent, the median family income in America would now be $50,000 a year instead of the current level of $35,000 a year.

Americans celebrate that both Houses of Congress have now passed budget resolutions that will bring us back to balance in 7 years, but we face the most difficult task of actually implementing the budget guide in our spending measures. We must be resolute in the endeavor and not fall victim to business as usual in Washington, but as a part of the effort to balance the budget, I support providing the American public with tax relief.

I strongly believe it is time, however, to stop working around the edges of the Tax Code. We must transform it completely.

The Federal income tax system is inherently flawed. By taxing savings and investment at least twice, it has become the biggest impediment to economic growth in the country. It represents the worst form of big government intrusion into the lives of all Americans.

Each year it costs Americans more than 5 billion hours of time to comply with it. That is equal to the total worker output of my State of Indiana. It is unfair, it is riddled with loopholes, it has been changed 31 times in the past 41 years. It doesn't work. By its own admission, the Internal Revenue Service fails to collect from nearly 10 million taxpayers with an estimated $127 billion in uncollected taxes annually.

Anything this bad, this broken, this ineffective should be ended decisively, and that is what I propose. I want to scrap the income tax completely and replace it with a national sales tax.

Mr. Chairman, you have outlined the criteria for evaluating an effective tax system. It must be simple, the least intrusive, fair, border adjustable, and friendly to savings and investment. I have added it also must be transparent.

I have studied all the recent tax proposals with these six factors in mind. Many are better than the current tax system, but if we are going to overhaul our current tax system we should choose the one that meets these criteria, and I have concluded that the national sales tax is the best alternative.

The first factor in choosing an effective tax system is its simplicity. Under a national sales tax, the burden of complying with the Income Tax Code would be lifted. There would be no records to keep or audits to fear. The money a person makes is his or her own. You don't have to report it, you don't have to hide it, you may decide if you want to save it, invest it or give it to your children. It is only when you buy something you pay a tax.

Although I applaud the efforts of the flat tax advocates to simplify tax forms, nothing could be simpler than no forms at all.

The national sales tax is the least intrusive of the tax proposals. The IRS would be substantially dismantled under my proposal. The IRS would no longer look over the shoulders of every American. There would be no audits. Americans would not waste time and effort worrying about recordkeeping, deductions or exemptions that are a part of the current Tax Code.

Although the flat tax proposal taxes consumption, they do so by giving the income tax a facelift and leaving the IRS largely intact.

As you have stated, Mr. Chairman, if the roots remain, the tree will grow back.

The national sales tax is the fairest. Everyone pays the tax, including wealthy individuals, criminals, illegal aliens, and those who avoid taxation. Wealthy Americans who consume more would pay higher taxes under the national sales tax. Individuals who save and invest their money will pay less. Gone are the loopholes and deductions.

The national sales tax would also tax the underground economy. When criminals and illegal aliens consume the proceeds of their activities, they will pay a tax. Foreign tourists will pay the tax. Tax systems that rely on income reporting will never collect any of this revenue.

Of course, the fairness test must also consider those with limited means to pay tax. An integral part of my plan is protection for Americans who need it—senior citizens, the unemployed, Americans with low-paying jobs. One strategy for addressing this problem would exempt a threshold level of goods and services consumed by each American from the Federal sales tax. Each citizen who has a Social Security number would receive this exemption. For example, if the exemption level was $5,000, a family of four would have its first $20,000 in spending exempt from the sales tax. That figure would be approximately 33 percent above the 1994 poverty threshold for a family of four.

Another strategy would be exempting of such items as housing or medicine. This is a method the majority of States have chosen and one advocated by you, Mr. Chairman. Americans understand and are comfortable with this practice.

In the end, it will be up to this Committee and the Finance Committee in the Senate to decide the most desirable path.

The national sales tax is the most transparent of the tax reform proposals. A Federal tax that is evident to everyone would bolster efforts in Congress to achieve prudence in Federal spending.

There should be no hidden corporate taxes that are passed on to consumers or withholding mechanisms that mask the amount we pay. Every year the public and Congress should openly debate the tax rate necessary for the Federal Government to meet its obligations. If average Americans are paying that rate every day, they will make certain that Congress spends public funds wisely.

American exports would also benefit from the national sales tax. In January, the United States registered one of the largest trade deficits in our Nation's history. We must adopt a tax system that encourages exports. Most of our trading partners have tax systems that are border adjustable. They are able to strip out their tax when exporting their goods.

In comparison, the income tax and, for that matter, the flat tax are not border adjustable. American goods that are sent overseas are taxed twice, once by the income tax and once when reaching their destination.

In comparison, the national sales tax would not be levied on exports. It would level the playingfield with our trading partners. Best of all, foreign imports would be taxed when they are consumed in the United States.

Mr. Chairman, the last and most imperative reason for replacing the income tax with a national sales tax is it would liberate the economy by encouraging savings. For the first time in the modern era the next generation of Americans may be economically worse off than the previous one. Despite a robust economic growth over the past several years, the average income of families has fallen. They feel trapped in a box without hope of escaping.

The bottom line is that as a nation, we do not save enough. Savings are vital because they are the source of all investment and productivity gains. Savings supply the capital for buying a new machine, developing a product or service, employing an extra worker. According to a recent poll, 72 percent of Americans——

Chairman ARCHER. Senator Lugar, I have only got 1½ minutes to go vote. They don't hold votes open anymore. Should you wish to come back at the end of all these votes, which might be as much as 45 minutes from now, we would be happy to welcome you back, but unfortunately at this time I am going to have to ask you to put the rest of your statement into the record, and I apologize for that.

Senator LUGAR. I will be pleased to do so, Mr. Chairman. I will attempt to return at that point. Thank you very much.

[The prepared statement follows:]

Testimony of Senator Richard G. Lugar
House Ways and Means Committee
Hearings on Tax Reform
June 8, 1995

Mister Chairman, I thank you for your strong leadership in the tax reform arena. Your oft quoted comment that our current tax system should be "pulled out by the roots" has been an inspiration as I have traveled the country advocating the elimination of the federal income tax.

What I have found during my travels is that American families are frustrated, and even angry, with their economic predicament. They feel like they are running on a treadmill and that the treadmill is winning.

The problem is that many Americans suspect that there is diminishing hope for a better future. The economic facts justify these beliefs. From 1950 through 1973, hourly compensation --including both wages and benefits-- increased an average of 3.0 percent per year. Since 1973, the average wage increase has been less than one half of one percent.[1] During the past two decades, economic growth has been cut in half, averaging only 2.4 percent annually. And if this isn't depressing enough for the average American family, limiting growth to 2.5 percent is the stated economic policy of the Federal Reserve Board.

This we must change. The American public is demanding it.

The cause of America's economic doldrums is twofold: the huge federal budget deficit that robs us of the capital we need to grow, and a federal tax system that not only discourages, but confiscates our savings and investment.

Our net national savings rate has reached alarmingly low levels. After averaging close to 9.0 percent in the 1960's, we recently saw our nation's savings rate bottom out at 1.1 percent in 1992.[2] Because of this low rate of savings, capital to fuel our economy has become increasingly scarce. As a result, productivity has averaged just 1.1 percent from 1974 to 1994. The Concord Coalition estimates that had our productivity held its pre-1974 annual rate of 2.9 percent, the median family income would now be $50,000 a year instead of the current level of $35,000 a year.

Americans celebrate that both houses of Congress have now passed budget resolutions that will bring us to balance in seven years. We now face the more difficult task of actually implementing this budget guide in our spending measures. We must be resolute in this endeavor and not fall victim to business as usual in Washington.

As part of the effort to balance the budget, I support providing the American public with tax relief. But I strongly believe it is time to stop working around the edges of the tax code. We must transform it completely.

The federal income tax system is inherently flawed. By taxing savings and investment at least twice, it has become the biggest impediment to economic growth in the country . It represents the worst form of big government intrusion into the lives of all Americans. Each year it costs Americans more than 5 billion hours of time to comply with it. That is equal to the total worker output of my state of Indiana. It is unfair. It is riddled with loopholes. It has been changed 31 times in the past 41 years. And finally, it doesn't work. By its own admission, the Internal Revenue Service fails to collect from nearly 10 million taxpayers, with an estimated $127 billion in uncollected taxes annually.[3]

Anything this bad, this broken and this ineffective should be ended decisively, and that is what I propose. I want to scrap the income tax completely and replace it with a national sales tax.

Mr. Chairman, you have outlined the criteria for evaluating an effective tax system. It must be: (1) simple, (2) the least intrusive, (3) fair, (4) border adjustable, and (5) friendly to savings and investment. I have added that it also must be transparent. I have studied all the recent tax proposals with these six factors in mind. Many are better than the current tax system.

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[1] U.S. Department of Commerce "Competing to Win in a Global Economy." (September 1994).

[2] Rudolph Penner, "Reducing the Tax Burden on Saving" KPGM Peat Marwick (December 1994).

[3] Internal Revenue Service, Pub No. 1415, Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates 2 (1990).

But if we are going to overhaul our tax system, we should choose the one that meets these criteria. I have concluded that a national sales tax is the best alternative.

The first factor in choosing an effective tax system is its simplicity. Under a national sales tax, the burden of complying with the income tax code would be lifted. There would be no records to keep or audits to fear. The money a person makes is his or her own. You don't have to report it. You don't have to hide it. You may decide if you want to save it, invest it, or give it to your children. It is only when you buy something that you pay a tax. Although I applaud the efforts of flat tax advocates to simplify tax forms, nothing could be more simple than no forms at all.

The national sales tax is the least intrusive of the tax proposals. The IRS would be substantially dismantled under my proposal. The IRS would no longer look over the shoulders of every American. There will be no audits. Americans would not waste time and effort worrying about record keeping, deductions, or exemptions that are part of the current tax code. Although the flat tax proposals tax consumption, they do so by giving the income tax a facelift and leaving the IRS largely intact. You have stated, Mr. Chairman, "If the roots remain, the tree will grow back."

The national sales tax is the fairest. Everyone pays the tax including wealthy individuals, criminals, illegal aliens, and others who currently avoid taxation. Wealthy Americans who consume more would pay higher taxes under the national sales tax. Individuals who save and invest their money will pay less. Gone are the loopholes and deductions.

The national sales tax would also tax the underground economy. When criminals and illegal aliens consume the proceeds of their activities, they will pay a tax. Foreign tourists will pay the tax. Tax systems that rely on income reporting will never collect any of this revenue.

Of course, the fairness test must likewise consider those with limited means to pay taxes. An integral part of my plan is protection for Americans who need it--senior citizens, the unemployed, and Americans with low paying jobs.

One strategy for addressing this problem would exempt a threshold level of goods and services consumed by each American from the federal sales tax. Each citizen who has a Social Security number will receive this exemption. For example, if the exemption level were $5000, a family of four would have its first $20,000 of spending exempt from the sales tax. This figure is approximately 33 percent above the 1994 poverty threshold for a family of four.

Another strategy might be the exempting of items such as housing or medicine. This is the method the majority of states have chosen and the one advocated by this Committee's Chairman. Americans understand and are comfortable with this practice. In the end, it will be up to this Committee and the Finance Committee in the Senate to decide the most desirable path.

The national sales tax is the most transparent of the tax reform proposals. A federal tax that is evident to everyone would bolster efforts in Congress to achieve prudence in federal spending. There should be no hidden corporate taxes that are passed on to consumers or withholding mechanisms that mask the amount we pay in taxes. Every year the public and Congress should openly debate the tax rate necessary for the federal government to meet its obligations. If average Americans are paying that rate every day, they will make certain that Congress spends public funds wisely.

American exports would also benefit from the enactment of a national sales tax. In January, the United States registered one of the largest trade deficits in our nation's history. We must adopt a tax system that encourages exports. Most of our trading partners have tax systems that are border adjustable. They are able to strip out their tax when exporting their goods. In comparison, the income tax, and for that matter the flat tax, are not border adjustable. American goods that are sent overseas are taxed twice--once by the income tax and once when reaching their destination. In comparison, the national sales tax would not be levied on exports. It would level the playing field with our trading partners. And best of all, foreign imports would be taxed when they are consumed in the United States.

Mr. Chairman, the last and most imperative reason for replacing the income tax with a national sales tax is that it would liberate our economy by encouraging savings For the first time in the modern era, the next generation of Americans may be economically worse off than the previous one Despite robust economic growth over the past several years, the average income of families has fallen. They feel trapped in a box with diminishing hope of escaping

The bottom line is that as a nation, we do not save enough. Savings are vital because they are the source of all investment and productivity gains--savings supply the capital for buying a new machine, developing a new product or service, or employing an extra worker.

According to a recent poll, seventy-two percent of Americans realize that they are not saving enough for the future.[4] Our net national savings rate in the 1990's has been 1.8 percent of Gross Domestic Product compared with a rate of 8.1 percent in the 1960's, 7.2 percent in the 1970's, and 3.7 percent in the 1980's.[5]

The Japanese save at a rate nine times greater than Americans and the Germans save five times as much as we do.[6] Today, many believe that Americans inherently consume beyond their means and cannot save enough for the future. Few realize that before World War II, before the income tax system reached its present form, Americans saved a larger portion of their earnings than the Japanese.

A national sales tax would reverse this trend by directly taxing consumption and leaving savings and investment untaxed. Economists agree that a broad-based consumption tax would increase our savings rate substantially. Economist Laurence Kotlikoff of Boston University estimates that our savings rate would more than triple in the first year. The implementation of a national sales tax is expected to create one million new jobs[7] over a ten year period and a three percent rise in wages over that same period of time.[8] Economist Dale Jorgenson of Harvard University has concluded that had a consumption tax like the national sales tax been put into place in 1986 instead of the current system, the United States would have experienced one trillion dollars in additional economic growth![9] Mr. Chairman, our citizens and our economy cannot afford to wait any longer.

As I have outlined here today, I believe the national sales tax is the best tax system to replace the income tax. It is simple. It protects privacy. It is fair and transparent. And it promotes economically beneficial behavior. For these reasons, I encourage its enactment.

Mr. Chairman, we live in an exciting time when the world is opening its arms to free enterprise. The Uruguay round of GATT significantly lowered the barriers to trade. Congress will soon open the telecommunications industry to competition, better enabling individuals and companies to interconnect across the globe. Goods and information are able to flow freely between countries with few obstructions. One of the last remaining barriers between countries is their tax systems. We must face the fact that America is competing with other countries whose tax systems are more friendly to investment than is our income tax.

If we enact a tax system that encourages investment and savings, billions of dollars of investment will flow into our country. During a recent poll taken by Princeton Economics International, executives of the top twenty Japanese companies stated unanimously that they would bring manufacturing to the United States if our country enacted a broad based retail consumption tax. It makes sense. America has the most stable political system, the best infrastructure, a highly educated workforce and the largest consumer market in the world. Our economic growth and prosperity would be unsurpassed.

There will be complex transitional issues to address. But in the end, our country will be stronger and more prosperous. That has to be our focus. Our vision must be for an America in which the American family enjoys better job prospects and more real income. Our paychecks will be bigger, our savings will be greater, and our hopes will abound. Let's give Americans this chance. Thank you.

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[4] Source. Competitiveness Policy Council/Congressional Economic Leadership Institute Poll, Feb. 1995.

[5] U.S. Department of Commerce "Competing to Win in a Global Economy." (September 1994).

[6] OECD Historical Statistics 1960-1990.

[7] John Qualls, "The Impact of a National Sales Tax on the United States Economy." Washington University (1991).

[8] Laurence Kotlikoff, "Savings and Consumption Taxation: The Federal Retail Sales Tax Example." Hoover Institution Conference Paper (May 1995).

[9] Dale Jorgenson, "The Economic Impact of Fundamental Tax Reform." Hoover Institution Conference Paper (May 1995).

Chairman ARCHER. All right, thank you.

[Recess.]

Mr. CHRISTENSEN [presiding]. Call the Committee back to order.

If Congressman Schaefer and Congressman Tauzin would begin their testimony, we are indeed honored to have you here testifying before this Committee, and look forward to your comments.

STATEMENT OF HON. W.J. (BILLY) TAUZIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. TAUZIN. Mr. Chairman, thank you.

Both Dan and I are pleased to participate in what I think are historic hearings on the central question of whether it is time, and we think it is, to scrap the whole system by which we tax income and investment in America and to replace it with the revenue neutral national sales tax, an alternative tax to the current system.

We should ask ourselves, I guess, first of all, what is wrong with the current system, and if you were to ask that question, I suppose at a townhall meeting, you would hear a chorus of complaints, but the chorus of complaints by citizens about the current system is also backed up dramatically by the facts, the facts are that we have got an income tax system that is out of control. In 1914, it was 14 pages long. Today, it is over 2,000 pages of law, 10,000 pages of regulations, and hundreds of thousands of pages of rulings and interpretations.

Today, our income tax laws have become so complex that over 70 percent of the tax returns filed by professional tax preparers are for citizens making less than $50,000 a year. Even the so-called experts have problems with the system.

In 1992, Money magazine gave 48 professional tax preparers a financial profile of one family and asked them to prepare an income tax return. The computed tax liabilities ranged from $16,219 all the way up to $69,000. Who was right? Money magazine made the case, the system is out of control.

We spend 5.4 billion hours merely to complete tax forms. In fact, Professor Walter Williams of George Mason University stated that the country spends more time complying with the Income Tax Code than it does manufacturing every automobile, van, and truck built in the United States in 1994, it is a wasted effort. And every time we touch this animal it gets more complex. Remember tax simplification in the eighties.

The 1986 law alone made over 2,500 changes in over 4,000 places in the Code. It resulted in 48 new forms. This was tax simplification. Every time we touch it, it gets worse. Americans are increasingly less compliant with the Tax Code. The IRS now has more than 10 million taxpayers who didn't file last year, over $200 billion in misstated payments.

We know the underground economy, the place where Americans try to avoid this awful system, is now about $500 billion strong, and that $125 billion is not collected to the Treasury from that underground economy. That is $125 billion that the other taxpayers of America are paying when they work through on April 15 the tax forms.

Mr. Schaefer and I think it is time, and we hope to file a bill by this summer that will replace the entire income tax system in America with a system instead of a simple retail sales tax.

What is the beauty of it? The beauty of it is that when we make that change, number one, Americans themselves will decide how much tax they want to pay by deciding how much they want to consume. That tax system can easily make room for the necessities of life at no or very low rates and tax the other things we purchase at the customary rate.

In short, citizens will decide whether to make income and save it and invest it or to pay taxes by consuming it. Citizens will make their own choice.

More importantly, figures indicate that if we stop taxing investment and income in our society, we encourage income and investment in our society. We encourage the work ethic, we encourage people to do in fact what most of us in this Congress are desperately trying to do, to put this country back to work.

A 2.5-percent increase in the savings accounts of America will yield us a 10-percent growth in GNP. Dramatic job increases, dramatic growth in the economy, dramatic changes in the way Americans in fact invest at home. You know the other good reasons, many of them cited already.

I want to add two quick things, I know my time has expired already. First, please look at several things we have also filed in addition to the bill we are going to file on an alternative tax system. One is a bill I have filed for many, many years.

If you are not ready to change the tax system, at least take the taxes off ordinary savings accounts in America, at least start rewarding citizens, children in America with a savings ethic that says in effect if you save in a passbook account, like we used to save, you won't pay taxes on it. We have got a bill called Save America. It is a plan to do just that.

Second, I would hope you would look, and maybe the Committee can do a study on a bill we have filed called the American dividend trust fund account, which is a system of rewarding Americans in a dividend trust fund much the way Alaska does it for its citizens on the simple theory that if Congress does its job and balances the budget, that the taxes collected on corporate America, a percentage of them, would be saved in a dividend trust fund that would be rebated to Americans for having supported a government that keeps its accounts in balance.

That idea has been around for some years now, and it ought to get looked at as we look at alternative tax systems as well, savings account exemptions for taxation, a whole new system, indeed, all these concepts are worthy of this historic examination by the Ways and Means Committee.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF HON. W.J. "BILLY" TAUZIN
A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

When I first came to Congress in 1980, I was not a fan of the income tax but, like many others, felt that it was a "necessary evil" in our lives. It wasn't long before I realized that many of my constituents who contacted me with problems were complaining about the same agency, the IRS, and the same law, the Internal Revenue Code. Constituents ask me, "Shouldn't our tax system be designed to raise the money that we need with the least amount of government interference into our lives?"

I believe the answer is yes. We must replace the present income tax with a revenue-neutral retail sales tax of between 16% to 18%. This is the only viable alternative that raises tax revenues, protects the economy and is least intrusive into our lives.

Look at our present income tax system. It has grown from 14 pages in 1914 to over 2000 pages of law, 10,000 pages of regulations and hundreds of thousands of pages of rulings and interpretations in 1995. Does anyone really understand it? Routinely tax preparers and income tax experts from the Treasury Department have testified before Congress and admitted that even they do not fully understand the Internal Revenue Code.

Does this complexity adversely affect only the wealthy? No. Our income tax laws have become so complex that over 70% of the tax returns filed by professional tax preparers are for citizens making less than $50,000 per year. Even the so-called experts have problems with our present income tax. In 1992, *Money* magazine gave 48 professional tax preparers a financial profile of one family and asked them to prepare an income tax return. The computed tax liabilities ranged from $16,219 to over $69,000.

And what about the incredible waste of productive time? According to a study commissioned by the IRS in 1985, it was determined that Americans spent 5.4 billion hours merely completing income tax forms. James Payne, of Lytton Research and Analysis, has calculated that the compliance burden of the federal income tax increased by at least 33% since 1985, which means, by some estimates, that Americans now spend a mind-boggling 8.6 billion hours each year completing income tax forms. None of this time is for productive enterprises that actually add to the social, economic or moral well-being of a society. Payne calculates the economic cost of the income tax to the American economy to be in excess of $600 billion

dollars per year-- in addition to the $600 billion per year we pay in taxes.

To put this in perspective and to illustrate the cost of the income tax to our country, Professor Walter Williams of George Mason University has stated that this country spends more total man-hours trying to comply with the income tax code than it does manufacturing every automobile, van and truck built in the United States in 1994.

And who do you think really pays for the tax compliance costs and taxes? Do businesses pay these costs? Again the answer is no. Businesses simply add them into the price of the products they sell. As a result, consumers pay between 10% to 15% more for retail goods and services.

Over the past 16 years, there have been thousands of changes to the income tax code. The Tax Reform Act of 1986 alone made nearly 2,500 changes to the income tax code and resulted in 48 new forms. These changes have made a horrible system even worse.

Some of these changes have actually eliminated jobs and devastated entire industries. Remember the luxury tax that virtually destroyed the yacht building business in the United States? I agree with the sentiments of Shirley Peterson, former Commissioner of the Internal Revenue under President Bush. Mrs. Peterson said, "My view is that we cannot 'fix' it with more tinkering at the margin. I believe that the only solution is to repeal the Internal Revenue Code and start over."

The two leading alternatives to the federal income tax are the national retail sales tax and the flat income tax. Both alternatives have similarities. Both proposals will not tax investment earnings or capital gains. Both proposals do not double tax the earnings of business. However, there are some fundamental differences between the flat income tax and the retail sales tax, and it is because of these differences that I support the replacement of the income tax with a revenue-neutral national retail sales tax.

Under the retail sales tax, we will pay our federal taxes when we make retail purchases just like most of us pay state sales taxes. As retailers make sales, they collect the national retail sales tax from their customers. The states then collect these taxes and sends a check directly to the U.S. Treasury. Sound simple? It is. The retail sales tax dramatically reduces the paperwork and time required by our antiquated system of taxation. There will only be around 10 million retailers filing federal tax returns each year.

But here's the real beauty of my plan: you "pay to play." The retail sales tax will give you the freedom to determine the amount of federal taxes you pay. For instance, if I decide to save part of my earnings and defer consumption to a later time then I will not pay taxes until I spend the savings. Even then I will be able to control the amount of tax that I pay. If I am saving to purchase a car then the amount of the car's purchase price will dictate the tax that I pay. I am suddenly in charge and no longer have to spend money in a way dictated by Washington to receive any tax breaks.

The problem with the flat income tax is simply this -- it is still an income tax! Under Congressman Armey's proposal, all of us will still file income tax returns. In fact, the Armey flat income tax requires that each wage earner in this country file a tax return each month and then a 13th return on April 15. If you own or operate in business this gets even more complicated.

Not only must the self-employed and business owners prepare 13 tax returns for their personal taxes, but they must also prepare 13 tax returns for their business. And these business tax returns won't be done on a postcard. Under the flat income tax, a business or self-employed person must still compute their "net" income. Sound familiar? It should because one of the most difficult things for the self-employed and the business owner is to determine "net" income. Imagine having to confront thirteen April 15's each year.

In 1992, Americans filed 113,604,503 individual income tax returns (including 15,495,419 nonfarm sole proprietor returns), 1,484,752 partnership returns and 3,869,023 corporation returns for a total of 118,958,278 tax returns. My staff estimates that enactment of the flat income tax will require a minimum of 1.5 billion tax returns. The flat income tax will create prosperity for the paper mills in my state but a lot of forests will have to be harvested to complete the additional paperwork.

Our current IRS system can't withstand the additional burdens imposed by a flat income tax. Although currently processing less than 10% of the number of potential flat income tax returns, IRS employees err on one of every ten income tax returns they enter into the IRS computers; the IRS now has more than 10 million taxpayers who didn't file last year; the IRS has more than $200 billion in misstated payments and

refunds; and, most troubling, the National Research Council predicts a major breakdown of the system could occur in the present income tax system before the year 2000.

Contrast this avalanche of flat income tax returns with the number of returns required by the national retail sales tax. The only tax returns required would be from providers of retail goods and services. This is estimated to be only 10 million. Everyone else will be free of any requirement to file tax returns. April 15 will be just another day, and we can finally dismantle and eliminate the IRS.

The flat income tax, on the other hand, requires retention of the IRS with all of its oppressive powers. In fact, the IRS may have to be given even more power. Professional tax preparers warn that under a flat income tax, the IRS may have to be enlarged to cope with the number of taxpayers who will not voluntarily remit their taxes each month. These same tax preparers fear that the already draconian methods presently used by the IRS will only intensify if people are forced to pay the flat income tax each month.

All of us understand that when we tax something we get less of it. The national retail sales tax does not tax income and therefore does not penalize you for working. The more you work the more you get to keep. What effect will this change have on our economy?

Professor Laurence Kotlikoff of Boston University studied the economic effects of a revenue neutral replacement of the federal income tax with a retail sales tax of between 16% to 18%. Kotlikoff concluded that this change would dramatically improve the economy and raise income and output by almost $500 billion a year or about $5,000 per family.

Martin Armstrong, chairman of Princeton Economic Institute, currently advises overseas investment funds with assets in excess of $3 trillion. Mr. Armstrong points out that the last time this country was a haven for investment capital was in 1940 when interest rates on government bonds dropped to 1%. He believes that the replacement of the federal income tax with a retail sales tax will attract, in real terms, even more investment capital than in 1940. Mr. Armstrong also predicts that many multinational companies will

locate their main offices in the United States. The result will be an unprecedented economic boom that will dramatically increase the economic prosperity of every American.

Will the flat income tax create the same economic boom? Like any income tax, the flat income tax means the more you work... the more taxes you pay. Like the present income tax, the flat income tax does not reward people for working. Yes, the flat income tax will not tax your investment earnings or capital gains. This will certainly help our ridiculously-low national savings rate. However, the flat income tax's impact on the economy will be less than the impact of the retail sales tax. People will still have to pay a flat income tax on the gross amount of their earnings and only be rewarded the next year if they invest part of what they have left. A flat tax is better than our present system, and I would support it over the status quo, but, in my opinion, a national retail sales tax is a much fairer way to go.

As I do talk radio shows across the country on this subject, many of the callers ask me how are we going to protect lower income people? Won't the sales tax be regressive? Economists tell me that, in the course of their lives, people generally spend all the money they make, so the retail sales tax is really not regressive. However, lower income people can be initially harmed by the switch from the present income tax system to the retail sales tax. There are a number of ways being discussed to create a safety net for them.

One method is by having a different rate of tax on different types of goods and services. Another method is to exempt certain of life's necessities. A third method is to consider giving rebates of the amount of the sales tax that lower income families pay. These methods are being studied now and the results will be available soon. One thing is certain: we will not implement the retail sales tax without providing for the disadvantaged people in our society.

There is another area where the retail sales tax will help create more jobs. Studies by the Department of Commerce's Bureau of Economic Analysis show that for every $1 billion of exports, 19,100 of jobs are created and most of these are higher-paying jobs. The retail sales tax will eliminate the bias against U.S. products in international trade. GATT allows countries to rebate consumption taxes at the border but not

income taxes. This amounts to as much as a 20% penalty when U.S. products are exported or when our products compete against imports.

A national retail sales tax would only be levied on retail sales in the U.S., not on exports. U.S. products will thus become more competitive in international trade. Imported goods into the United States will be forced to pay the same amount of federal tax as their domestic competitors.

One essential part of a fair tax system is that everyone shares the burden of paying for the cost of government. Unfortunately, the area of our economy that is growing most rapidly is the underground economy. Since the late 1970's, the underground economy has grown to an estimated $500 billion per year and the amount of income taxes lost is in excess of $125 billion per year and growing. The flat income tax doesn't really attack this growing problem. The national retail sales tax does.

Finally, despite all of the compelling economic reasons that favor replacement of the present income tax with a retail sales tax, there is an additional reason... FREEDOM. In 1954, the IRS could assess a total of 13 different tax-related penalties. In 1995, the number has increased to 150. Increasingly, the IRS must rely on coercion and threats to even collect 83% of the federal income taxes they calculate are due.

Baron de Montesquieu, whose writings were cited by our nation's Founders more than any other, and who inspired the very structure of our Constitution, emphasized the struggle between liberty and taxes. Direct taxes (like the income tax) would lead to slavery, but "a duty on merchandise (a retail sales tax) is more natural to liberty because it has not so direct a relation to the person."

An agency like the IRS, a tax on income, a presumption of guilt against the taxpayer, and the resulting tax tyranny are not consistent with the ideas on which this nation was formed. In *For Good And Evil*, Charles Adams' important work on the impact of taxes on civilization, Mr. Adams points out that the astute Greeks observed that tyranny (oppressive government) was the consequence of the wrong kind of taxation; and conversely liberty was the consequence of the right kind of taxation. And what was the right kind? Sales and customs taxes, said the Greeks. The wrong kinds of taxes that produced bad government were direct taxes like income and production taxes. The Greeks came to these conclusions, not from

reason, but from the examples of history. Our income taxes have proven that the Greeks were right. Much of our liberty has been lost to make our income taxes work, exactly as the Greeks predicted.

It is for these reasons that I support the replacement of the federal income tax with a national retail sales tax. It is time to make the federal government our servant again, instead of our master.

Mr. CHRISTENSEN. Thank you, Congressman, and thank you for your consistent conservative leadership in these areas.

Congressman Schaefer, we would be pleased to hear your testimony.

STATEMENT OF HON. DAN SCHAEFER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. SCHAEFER. Well, I thank you, Mr. Chairman, and I will add a little bit to what my good friend Mr. Tauzin has had to say. I very well remember, I know he does, the 1986 tax bill. If you really go back into the history, it started as a flat tax, and as time went on more and more things became deductible and pretty soon it was no longer fair or equal or simple, and we had a real mess on our hands when it passed.

I did not vote for it at the time, and it stands out as one of my best no votes, I believe, because it certainly has proven not to work. So, therefore, what we have been doing in Congress over a period of years has been looking for quick fixes, some way to fix this, some way to fix that, and all we ultimately do, as Billy said, is add to the Tax Code.

As a matter of fact, just since the tax reform of 1986 Congress has amended, repealed or added to more than 4,000 sections of the Income Tax Code, hoping that if we can change this section, eliminate that deduction, revise this rate, some way, somehow we are going to come up with a perfect Tax Code.

Now, I think it is obvious that the current system is beyond repair, and it should be repealed completely. My written testimony goes into great detail about the faults of the income tax.

I would ask the Chairman that it be allowed to be printed as part of the record.

Chairman ARCHER [presiding]. Without objection, your entire statement will be printed in the record.

Mr. SCHAEFER. Thank you, Mr. Chairman.

Now, for several years I as well as others, including Mr. Tauzin, have advocated replacing this flawed income tax with a national sales tax. This would be a tax on the retail level on goods and services between, say, 16 and 17 percent. This is not a VAT, this is not a VAT tax. A VAT tax, as Mr. Kemp indicated, is what is dismantling a lot of the economic system in Europe. The sales tax is simply a tax on the final finished product that a consumer purchases in one form or another.

The national sales tax could be primarily collected by the State governments, which already have the mechanisms in place. To overcome the supposed regressivity of the sales tax, I propose giving a rebate to cover a base level of tax-free consumption.

Some have suggested exempting food, medical services, and so forth, and I am not sure we are going to get to that point because then we get into a situation where if some wealthy person is throwing big parties, should that food not be taxed. We don't really think so.

There are other ways to go about that to treat that income level, say, between the $15,000 and $20,000 different than those who make more than that. So I would just say that if you want to talk about simplicity, you really have it here. A sales tax is very easy

to comply with. An individual knows every time they purchase something exactly what they are paying on their taxes. The mechanisms are already set into place in 45 different States, which would be very simple to figure out exactly what it is that that person is going to be paying.

Now, the other thing is that this sales tax is going to help us get at the underground economy. At this point in time we have millions and millions of dollars out there that are not being taxed and revenue is not coming into the Federal Government simply because it is either laundered money, it is drug money or it is from all cash operations.

These people still, however, buy clothes, they buy cars and they buy other types of products that they would ultimately be paying taxes on. The IRS, I think, on a conservative estimate, says that we are losing about $130 billion a year on the underground economy, and I think that that probably is very conservative, it is probably even higher than that.

So I would just say—I know my time is up, Mr. Chairman—I know you are very familiar with this whole approach, and as Bill says, we are in the process of drafting legislation that we hope will be ready for this summer or early into the fall.

We know this is not an easy thing to do, to dismantle something as huge as this. Billy said something about in 1914 the tax form was like 10 pages long, 14, the first tax form was 1 page. I have a copy of it, 1-page form, that first tax form that ever came out. I dare say I don't even want to look—my accountant does all my taxes now—I don't know how much it is now.

I thank the Chair and the rest of the Committee for listening to us today and hopefully we will be back to you sometime in the near future.

[The prepared statement follows:]

Statement of Representative Dan Schaefer

Before the

House Ways and Means Committee

On

Replacing the Federal Income Tax

June 8, 1995

Thank you Mr. Chairman and members of the committee for holding this hearing and inviting me to speak on replacing the federal income tax system with a national sales tax.

With this week's hearings, we in Congress are embarking on a tried-and-true Washington ritual: reforming the income tax. In fact, rarely is Congress not talking about reforming the income tax code. Washington has been on a decades-long quixotic search to "fix" the income tax; each time hoping that if it changes this section, eliminates that deduction, or raises this rate that somehow we will produce The Perfect Income Tax Code.

Since 1954, Congress has passed substantial amendments to the federal tax code an average of every 1.3 years. Since passing the Tax Reform Act of 1986, Congress has amended, repealed, or added to over 4,000 sections of the income tax code.

Taxpayers are now telling Congress: Give it up! The income tax code is beyond repair, and should be repealed completely.

But what should we replace the income tax with? Let us imagine, just for a moment, that April 15th were just another spring day -- not the dreaded Tax Day. What if our tax system required no Internal Revenue Service (IRS), had no loopholes for the rich, weakened special interests' hold on the U.S. Congress, increased Americans' paltry personal savings rate, and encouraged economic investment? And suppose the federal government could still collect at least as much tax revenue as it does today?

This is not some kind of fantastic Utopia I am describing. It could be reality if America eliminated the personal and corporate income tax system and replaced it with a national retail sales tax.

To understand the need for a national sales tax it is important to understand why the income tax code must be replaced completely. Everyone dislikes paying taxes, but the income tax makes financing government expenditures excruciatingly painful.

When the income tax was originally proposed, its backers assured the nation that it would never exceed a few percentage points. In fact, the income tax imposed after the passage of the Sixteenth Amendment had a maximum rate of seven percent, could be filled out with just a two-page form and fewer than one percent of Americans actually had to file an income tax return. This seductive, little tax was promoted as not only fair, but also as the elixir for all that ailed the country. Consider the 1913 House committee report on the legislation establishing the income tax:

> "We recommend the passage of...[the income tax]...in the confident belief that as soon as this tax and its administrative machinery become fairly understood by the people...[it] will meet with as much general satisfaction as any tax law...All good citizens, it is therefore believed, will willingly and cheerfully support and sustain this, the fairest and cheapest of all taxes."

Few predictions have been as disastrously wrong as these euphoric hopes expressed by the authors of the income tax. During the past 80 years, the income tax has become a behemoth which former President Jimmy Carter accurately described as "a disgrace to the human race."

With its myriad deductions, rules, regulations, liens, forms, withholding instructions and compliance costs, the income tax is understood by only a small coterie of tax lawyers and accountants, and is despised by almost all other Americans. And average citizens have many reasons to hate the income tax. It is expensive to administer and comply with; it is complex; it is constantly changing; it encourages rent-seeking corporations to search out special exemptions; it has resulted in a shocking loss of personal liberty; and it discourages the savings, investment and productivity needed for economic growth.

Cost and Compliance

If the income tax were evaluated as a product, we would first look at its costs. During Fiscal Year 1995 alone, Congress spent $7.6 billion on the administrative costs of the IRS. Even here in Washington that is a lot of money. However, that $7.6 billion price tag is a drop in the bucket compared to the true, hidden costs of the income tax.

In the book, Costly Returns: The Burdens of the U.S. Tax System, Dr. John L. Payne, director of Lytton Research and Analysis, identified six separate costs associated with the tax system: compliance, enforcement, disincentives, evasion, avoidance and government costs. These costs include the money and time most businesses and individuals spend to comply with the income tax, the effort and energy many other companies put into evading the income tax, the concomitant resources the government spends to catch, prosecute and incarcerate these evaders, plus much, much more. Dr. Payne found that, when all these hidden factors are all added up, the income tax "cost" $618.1 billion in 1990 alone. This makes the income tax the most expensive government program of all -- larger than Social Security, Medicare, or defense. Yet, unlike most government programs, the costs of which show up on the government's ledgers, the cost of the income tax is paid for almost entirely by the private sector.

Complexity

Much of the public's disgust with the income tax is caused by its complexity. Years of congressional tinkering and IRS rulemaking have created a monstrous set of laws and regulations that intimately affect the finances of every American family and business. The income tax code's complexity has made calculating one's taxes both time consuming and frustrating. In fact, congressional testimony has revealed that it takes businesses and individuals over 5.4 billion hours annually to comply with the income tax. That is equivalent to hiring 2.7 million people working full-time on tax compliance!

Unfortunately, the tax code is both large and growing. Since 1954, the number of sections in the income tax code has increased by 578 percent, from 103 sections to over 690. During that same time, there was a 369 percent increase in just the number of words in the code. Today, there are over 800,000 words in the income tax code. To clarify this voluminous code there are currently on the books more than 45 million words of income tax regulations!

Who can understand all this? Certainly not the average family or small business. Most can barely comprehend only a few of the IRS's 480 tax forms. Only

the most specialized super-lawyers and accountants can even pretend to understand the entire code. This legion of tax lawyers, accountants and purveyors of tax-avoidance schemes now constitute an entire industry of professionals who wade through the income tax code to help their clients figure how much taxes they owe, and often how to avoid paying those taxes. Estimates of persons working full-time to comply with the tax code reach as high as 500,000.

Uncertainty

Federalist Paper Number 62 observed two centuries ago:

> "It will be of little avail to the people, that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant change that no man, who knows what the law is today, can guess what it will be tomorrow."

These words could easily serve as the epitaph of the income tax. As was predicted so many years ago, a law that changes with the wind will only earn the public's hatred.

Just look at the mutability of the income tax. As I mentioned earlier, since 1954 Congress has passed substantial amendments to the federal tax code every 1.3 years. Since the mammoth income tax reforms of 1986, 4,000 provisions of 40 acts have either added, amended or repealed sections or subsections of the income tax code. The GATT implementation legislation alone contained 91 changes.

What are the results of all this tax uncertainty? For one, there is a real economic cost associated with these changes. Uncertainty requires businesses to spend time, money and effort on economically unproductive activities such as tax research, tax planning, tax compliance and tax litigation. In today's tax environment, one of the few reliable forecasts a business can make is that tax law will change before any new investment comes to fruition. Additionally, businesses have to defer decisions as Congress makes up its mind about raising rates and adding deductions. The Tax Foundation has estimated that the 1993 Clinton tax package alone cost the U.S. economy over $20 billion because of uncertainty -- that is $20 billion worth of potential research, development and job training.

Not only does the constantly changing tax code create economic losses, but, as we were warned in The Federalist Papers, uncertainty carries a civic cost. Citizens become cynical and suspicious when they see tax law changed with little concern for rational economic policy. Indeed, as former IRS commissioner Shirley Peterson declared, "today, changes in the tax law are driven by political considerations and revenue constraints and wise tax policy has nothing to do with it." Is it any wonder that citizens are suspicious of the tax code?

Rent-Seeking

There are few tools more valuable to the rent-seeking corporation than the income tax. Over the past 80 years, Congress has granted special deductions and transitions rules to an array of politically-favored industries and organizations. In the process, Congress has radically skewed rational business decision-making, directing resources to politically powerful but inefficient industries, handicapping those businesses which lack access and influence in the halls of Congress and, in the process, shrinking the income tax base.

Gary S. Becker, 1992 Nobel Laureate in economics, correctly observed, "In modern economies, profits are often determined more by government subsidies, taxes and regulations than by traditional management or entrepreneurial skills." Long before Dr. Becker identified the pernicious impact of rent-seeking taxation, James Madison observed in Federalist Paper Number 10:

"The apportionment of taxes on various descriptions of property is an act which seems to require the most exact impartiality; yet there is, perhaps, no legislative act in which greater opportunity and temptation are given to a predominant party to trample on the rules of justice. Every shilling with which they overburden the inferior number, is a shilling saved to their own pockets."

All can agree that Congress has not acted with "the most exact impartiality" when bestowing the benefits of the income tax code. Once Congress abandoned the principle of a single rate applicable to all, it headed down the road to rampant rent-seeking.

The solution? While we can never eliminate the desire of industries to seek special tax breaks, we can establish a powerful bulwark against rent-seeking taxation: uniformity. Unfortunately, the current code's only uniformity is the uniformity with which citizens despise it.

Civil Liberties

The income tax has also ushered in a revolting assault on our civil liberties. Thomas Jefferson would spin in his grave if he knew that every American is required to report to the federal government not only how much he or she earns, but also a variety of other personal financial information. Today, banks, savings and loans and employers are required to report some 81 specific types of personal financial transactions. This has given the federal government an enormous amount of sensitive data about the economic activities and private lives of every citizen.

This information is not always used lawfully. A 1994 U.S. Senate hearing found widespread unauthorized snooping in taxpayer records by IRS employees. IRS bureaucrats are not the only ones who have misused IRS files and the income tax. Former New York Times investigative reporter David Burnham, in his book A Law Unto Itself: Power, Politics and the IRS, found that "Almost every [presidential] administration since the end of World War I has one way or the other used the selective enforcement of tax laws and the information contained in tax records for improper political purposes."

Savings, Investment and Productivity

The income tax penalizes those things we need most for long-term economic growth: savings, investment and productivity. Currently, investments are taxed three times: once when the money is earned as income, again when the investment earns dividends and finally when the investment is sold for a capital gain. Consumption, however, is taxed only once: when the income is earned. This encourages citizens to engage in excessive spending. Why save if you will be taxed thrice for doing so? With the income tax code's perverse incentives, is it any wonder the U.S. has one of the lowest savings rates (2.5 percent) in the industrialized world? Our poor savings rate has deprived companies of the capital needed to invest in new technologies and job-training, crippling our ability to compete overseas. This capital crunch has damaged U.S. companies' ability to expand, preventing them from creating more good, high-paying jobs.

Additionally, the income tax's high marginal tax rate discourages new production and economic growth. Today, the highest marginal income tax rate at the federal level is 42 percent. Marginal tax rates are normally sold as a way to make the rich "pay their fair share," but even middle-class families are hurt by today's high marginal tax rates. Most middle-income earners pay a 28 percent federal income tax, a 15 percent payroll tax and a five percent state/local tax. This means that the government takes 48 cents of every dollar middle-income workers earn. Economist Robert Genetski has shown in his study Taking the Voo Doo Out of Economics that high marginal tax rates are inversely related to productivity growth. Productivity and wages tend to rise when marginal rates are low, but productivity falls or grows more slowly when marginal income tax rates are high. The income tax code's high marginal tax rates, coupled with the disencentives to savings and investment, is an unnecessary, government-imposed hurdle to economic growth.

The income tax is expensive; it is complex; it changes without warning; it has spawned numerous lobbyists who massage the code to benefit the politically powerful; it has invaded our privacy; and, it discourage the savings, investment and productivity needed for renewed economic growth. Despite the good intentions of the fathers of the income tax code, we now know that the income tax is not the "fairest and cheapest of all taxes." We in Congress need to recognize that the income tax has failed. It is now time look at a totally different way of financing government spending -- before it is too late.

Luckily, Washington, and this committee in particular, is considering radical tax restructuring. What I mean by restructuring is a complete and total overhaul. America has had tax "reform" for decades. What the country needs is not well-meaning yet ineffectual reform, but a complete and total rethinking of tax policy.

One of the most popular tax restructuring proposals is House Majority Leader Dick Armey's "flat tax" proposal. To "flatten" the code by eliminating its numerous deductions and distortions would create a much better tax system. But a "flat" income tax is still an income tax. Under even the simplest flat tax, "income" must be defined, personal financial information disclosed to the IRS and income taxes collected. This will require much of the same rules, regulations, liens, forms, withholding instructions and compliance costs that exist under the current system.

Flattening the income tax code would help simplify the system and lessen some of the deterrents to savings and investment. However, if history is any guide, a flat tax would stay flat for all of one Congress. I am sure you all remember the debate on the 1986 Tax Reform Act, the mother of all tax reforms. That process began with a discussion of flattening the tax code. The final legislation, to its credit, created a tax code with fewer deductions and only two personal income tax rates, 15 and 28 percent. Since then numerous bills have revised, reformed and thrown out much of the 1986 tax bill, so that today the tax code has five rates: 15.0, 28.0, 31.0, 36.0 and 39.6 percent -- not to mention many new deductions and loopholes.

Clearly, the impulse to "fix" the income tax code would not abate once a flat tax is passed. Inevitably, exemptions and "corrections" would find their way back into the law. America would soon find itself saddled with a loophole-ridden and expensive income tax code once again. In fact, Senator Arlen Specter, who has made the flat tax a part of his presidential campaign, has already incorporated several deductions into his supposedly "flat tax" proposal. Congress' constant urge to fix the income tax code is one of the many reasons why real reform can only come with replacing the income tax structure with a simpler, more just and economically efficient system.

I propose that we replace the current system with a national retail sales tax. This would be a tax (somewhere between 16 and 19 percent) on all goods and services sold at the retail level. As part of the transition to a national sales tax, I propose abolishing the corporate and personal income tax, the gift and estate tax and the excise tax. The IRS would be retained to dispose of pending tax evasion matters, but it would also be abolished.

To finance the spending of the federal government, a national sales tax on all goods and services would be imposed. Since the states have extensive experience with sales taxes, they would be charged with administering the national sales tax. Appropriate compensation would be given to the states and to retailers to ensure that the national sales tax does not become an unfunded mandate.

The national sales tax would be imposed on all goods and services purchased for consumption. Goods purchased for resale and for the production of other taxable goods or services would be excluded. A de minimus exemption would be allowed for small transactions between individuals, such as yard sales. The national sales tax would also be imposed on all imports into the U.S., in accordance with GATT.

To combat "regressivity," a rebate would be given to taxpayers and their dependents to cover a base level of tax-free consumption. This rebate could be set to

provide tax-free consumption up to the poverty level or could be set at the zero tax rate of the current income tax. Some have suggested exempting food and/or medical services to address regressivity. However, I believe that the sales tax rate should be as uniform as possible and should have the fewest number of exemptions. Thus, I believe a rebate structure is a better way to handle regressivity.

This rebate could be distributed to citizens in one of two manners. One option would be to give all citizens monthly or quarterly checks to pay for the covered level of tax-free consumption. Another option would be to give all citizens a "smart card." This card, similar to a credit card, would be used by citizens when they purchase a good. Every time a purchase is made the taxes would be deducted from the citizen's account of tax-free consumption.

Let me be clear about what I am advocating. First, I believe we must wholly replace the income tax with a national sales tax -- not just add it on top of the existing tax structure. Second, I do not support a so-called Value Added Tax (VAT), as is used by many European countries. A VAT would simply represent another hidden level of taxation to be abused by the government. I believe a national sales tax would only work if it completely replaced the existing income tax system and if it remains a visible and simple tax.

The national sales tax would dramatically change not only tax policy, but also the way citizens live their lives. Instead of a hidden withholding income before pay day, Americans would receive all the money they earn. Instead of filing confusing forms and complying with mystifying regulations, Americans would simply pay a set tax every time they buy a good or service. Instead of a government-determined level of taxation based on income, Americans would determine how much taxes they pay based on how much they choose to consume. Gone would be the IRS bureaucracy and its assaults on the rights of taxpayers. In its stead would be a straightforward and simple tax, administered primarily at the state level. To get a feel for the advantages of a national sales tax, just ask any of the citizens of the 45 states with a sales tax: Is it easier to comply with the federal income tax or the state sales tax?

Also, a national sales tax, unlike a flat tax, would help get at the underground economy. The U.S. Treasury Department estimates that it is unable to collect over $125 billion in income taxes every year. A national sales tax would help recoup this loss, ending evasion and lessening the tax burden on hard-working, law-abiding citizens. While even under a national sales tax there would still be some evasion, a point-of-sale retail tax will be much more effective at tapping the underground economy than today's despised, loophole-ridden income tax.

In addition, under a national sales tax, American exports would skyrocket. Without taxes built into the cost of American goods, they would be much more competitive on the world market. Our companies would no longer be forced to move American jobs abroad in order to compete globally. Further, foreign companies, which often avoid paying U.S. income taxes altogether, would have their imports subjected to the same sales tax as everyone else.

Some have claimed that a national sales tax would be more "regressive" than the current income tax code. They are right, to a certain extent. The poor consume a greater percentage of their income on basic necessities and would, thus, pay a higher proportion of taxes than some of the wealthy. This problem, however, could be addressed by giving citizens rebates to cover a base level of tax-free consumption, as I described above.

In a larger and more important sense, it is the current income tax which is regressive. It cripples the economic growth needed to give the poor the opportunity to move into the middle class. In that sense, the income tax is the most regressive tax because its triple taxation of investment and high marginal rates prevent the economic growth necessary for a true opportunity society.

Moreover, the poor already pay a large "consumption" tax because they pay the corporate taxes that are currently hidden in the price of every good and service they purchase. To understand the logic of the national sales tax, it is first important

to realize that businesses do not pay taxes. I don't mean this in sense that companies find enough loopholes to avoid paying taxes. I mean taxes are simply a cost of doing business that is reflected in the final price of the product or service offered by the company. The consumer of that product or service, pay these hidden taxes. Only consumers have no one else to whom they can pass the tax. Unfortunately, the regressive aspects on the current system are hidden. Low-income families actually pay a disproportionate share of businesses' income taxes and costs of compliance. While the poor may not pay taxes on April 15th, they do every time they buy food or clothing.

Adopting a national sales tax would end this corporate tax shell-game. And, because it would eliminate the disincentives to savings and investment and the current high marginal taxes rates, the sales tax would spur robust economic growth. Dr. Lawrence Kotlikoff's study of the national sales tax predicted that a national sales tax would more than double the nation's savings rate, from 2.5 percent to 7.6 percent. This would increase U.S. citizens' standard of living between seven and 14 percent. Thus, by changing the incentives in the tax system, Congress would usher in a period of enormous economic growth and opportunity.

Many used to claim that replacing the income tax with a national sales tax was just an economist's pipe dream, but the stars are aligning in favor of the sales tax. I have joined with Representative Billy Tauzin to draft a national sales tax bill, and we are organizing congressional support for this proposal. Senator Dick Lugar has made the national sales tax a major plank of his presidential campaign. Additionally, this week's hearings before the Ways and Means Committee demonstrate the widespread desire to examine alternatives to the current tax system. I believe these hearings are the vital, first steps on the long road to a complete restructuring of the tax code.

I and taxpayers across the country believe that as we once again head down tax reform lane that Congress should not sell the country short by tinkering with the our current disastrous income tax. Instead, we should end the era of tax "reform" by completely eliminating the income tax and replacing it with a national retail sales tax.

Chairman ARCHER. My thanks to both of you for, number one, coming and having to wait, and then having to come back, and I apologize for that, but the Committee is very grateful for your testimony and for the work that you have done on this.

I wish there were more Members here to both listen to you and to inquire because we need to have this exchange as colloquy going back and forth and probing advantages and disadvantages of these various options before we can finally, I think, reach a resolution.

I, for one, have not completely decided what form of consumption tax I believe would be the best, but I do worry that those who wish to continue some form of the income tax, albeit restructured, perhaps with a reduced rate, whether you call it flat or semiflat or whatever else, is simply déjà vu.

Mr. SCHAEFER. It is still a tax on income.

Chairman ARCHER. But we have been there before, as you pointed out, and we know what happens. We know what human nature does to that kind of a system.

Mr. TAUZIN. Mr. Chairman, if you will, there is another—we don't talk about it in these terms but we need to think about it in these terms—there is another good reason to move away from income taxes. In the book "For Good and Evil," Charles Adams presents a very important work on the impact of taxes on civilization in general. He points out that the astute Greeks observed the tyranny of oppressive government was a consequence of the wrong kind of taxation; that conversely liberty was a consequence of the right kind of taxation, and what was right, and what was wrong?

Well, the Greeks had it figured out. The Greeks said that sales and custom taxes were the correct form, that provide people as much liberty as possible. You decide how much taxes you are going to pay by deciding how much you consume instead of the government saying you are guilty, you owe us money unless you can prove you are innocent, as we have the rule under the current income tax system.

The Greeks came to that conclusion, Mr. Chairman, not from reason but from examples in history, and our income tax system has proven the Greeks were right. It is a tyrannical system as opposed to one that respects and in fact enlarges the freedoms of our people.

Chairman ARCHER. I particularly appreciate your comments on that. I think maybe it was Mr. Adams who started his testimony before this Committee this week by saying that 1 page of history is worth 200 pages of logic, or maybe more than 200 pages of logic, and I thought that was a superb statement because Santayana is right when he says that if we don't learn the lessons of history, then we must relive them.

And I wonder a little bit, too, as we enter this process, how much value we place on liberty and freedom and privacy, because that is something that hadn't been discussed too much until you two people came before the Committee this afternoon. What value do you place on liberty and what value do you place on privacy, and if in fact we have this great opportunity, perhaps a once-in-a-lifetime opportunity to get the IRS completely and totally out of the lives of every individual in America, what is the value of that? I, for one, would attach a very high value to that.

Mr. TAUZIN. And you would be right, sir.

Mr. SCHAEFER. Priceless.

Chairman ARCHER. Let me ask you, if I may, do you have any specificity to how you would overcome the argument of regressivity?

Mr. TAUZIN. Well, obviously, Mr. Chairman, there are a number of ways you can overcome it. One is a complete, outright exemption, as Mr. Schaefer has talked about, of certain basic essentials that you do not tax a certain level of consumption that is essential in people's lives.

The other is to tax it at a lower rate so that everyone is contributing to their government and to the benefits of the government but at a lower rate on the things that are essential—food, clothing, shelter—and then a different rate on the things that you choose to consume that aren't necessarily essential in your lives.

There are a number of ways of treating that, and one of the things that I hope the Committee does is literally examine the various structures that will yield the same revenue neutral amount of money and yet have that element of progressivity in it.

Chairman ARCHER. But you do not at this time have a preferred method that you would like to propose to the Committee?

Mr. SCHAEFER. Well, Mr. Chairman, we do not have at this point, we are still fine tuning it, and of course, as you know, with a subject matter such as this, it would be fine tuned over a long period of time, even after it would come to this Committee. But in answer to your question, you know, the national sales tax is not regressive, it is proportional really, and that simply means that those with the most income will consume the most and therefore pay the most in taxes. And as Bill said, with those in the low-income levels, a rebate system can be—there is a lot of things we can do to fit that in. So I would have to argue just the opposite. It is not a regressive-type tax.

Mr. TAUZIN. There is another thing that you can't miss, Mr. Chairman, and that is when you do encourage income production and investment in your economy again, you create, according to the estimates we have seen, 1.6 million new jobs with this change. It literally creates economic benefits for all of us in our society, many of whom can't find a good job today. And so in the end, if it is a tax that lifts more people off the bottom and gives them a chance to succeed, encourages income and rewards savings, then it is a system that we ought to move toward as rapidly as we can.

I want to give you one example of what is absolutely outrageously outlandish in our current Code. My two sons are in college today. They both have part-time jobs. They both earned slightly under the amount, I think it is $3,000, so where taxes come into play in their lives, income taxes, but one of them took their father's advice and saved part of his income. The interest he earned on his savings account was taxable even though his total income was still under the cap.

We, as a government, are telling my son, We are going to penalize you if you do what your father suggested you do, be frugal and save some money and help our economy, your own economy. That is an awful message. But we do it not just for our children, we do it for every working family in America. If you save money, we will

tax it when you earn it, and we will tax it again when it earns revenues for you at the bank. What an awful message.

At a time when this country is trying to say to people, Get off of welfare, go to work, be productive, at a time when we are worried about interest rates being too high, not being able to afford a home, shouldn't we say we are going to reward you for producing income, reward you for saving money that is going to yield lower interest rate money available to us to build homes, reward you for investing in jobs instead of penalizing you?

It is about time, Mr. Chairman.

Chairman ARCHER. I don't think you would find any argument with the three of us who are here today because Mr. Ensign pursued that line of questioning to a witness earlier, and I have exhausted my questioning.

Mr. Ensign, would you like to comment or question?

Mr. ENSIGN. Yes, I would, simply because I didn't get a chance to question Mr. Gibbons earlier in the day, and he brought up something when we are dealing with, this regressivity question, and it seems to me that that is where the simplicity goes out of the consumption taxes. First of all, an example that was given one of the other days in Europe when they started talking about taxing different items in the economy. Maybe we don't want to tax medicine. Well, how was Head and Shoulders taxed—and this was a real debate, was Head and Shoulders taxed as a medicinal shampoo or was it taxed as a cosmetic and therefore it should be taxed.

These are legitimate—I mean, all of the different health products that we sell in the health food stores now, are those foods or vitamins or are those medicinal products? Depending on the marketing today, they want them as medicinal products. If we change the Tax Code, they may change the way that they want to label them.

So that seems to me where some of the complexity gets in the way, but also he mentioned trying to correct some of the problems because he favors obviously a progressive tax system. He mentioned that you would give, because he doesn't want to see those types of problems, some sort of tax credit for poor people, but he also wanted to see wealthier people pay something instead of having their taxes cut, so he would do like a reverse tax credit or a negative tax credit.

Well, isn't a negative tax credit an income tax? So how do you satisfy somebody like Mr. Gibbons without getting the complexities in the Tax Code with a consumption tax?

Mr. SCHAEFER. Well, let me go first, Bill, but it seems to me, and I keep going back to this, my history in this 1986 tax bill, Mr. Archer very well knows, I keep going back to that. Once you open the door and you allow this exemption on medicines or whatever, pretty soon you have got everything in the world in there that there is an exemption on.

I would much prefer to see it come down to the point where it is according to the income level of the individual, that they would have a rebate that would cover whatever they had to pay and their cost of medicine or whatever else it would be, and therefore then the other people would still be charged and would not be open for a rebate on these things. I think that this is probably the simplest

way to do it because I remember the history of this, all three of us do, and it was a mess.

Mr. TAUZIN. That is a valid concern. We were wrestling with that as we approached drafting.

Let me make a point, however, that is lost very often in the current system. Economist John Quiles in 1991 reported to this Committee this fact, that the current cost of compliance with the current income tax system, the hidden taxes involved in that cost of compliance, is currently adding 10 to 15 percent to the cost of every retail item in our economy, including Head and Shoulders, and other medicines and foodstuffs that are purchased by the poor and the elderly in our society, a 10 to 15 percent hidden tax of wasted resources, unnecessary cost of compliance.

So if we start with the notion that we are going to replace that messy system with a simple one that has some national retail tax element in it, you can start with the notion that you have got a 10 to 15 percent base already there.

Second, either the rebate technique or, as I suggested, two levels, two rate techniques can accomplish the kinds of concern—can overcome the concerns of regressivity that you and I and others are very concerned about without necessarily getting us into the complexities of tax simplification of the eighties like we saw.

Mr. SCHAEFER. The income tax we have now is truly regressive.

Mr. ENSIGN. The other problem that I see with some of the proposals that are out there dealing with regressivity or progressivity, first of all, is, how do we get to where it is neither regressive or progressive? That seems to be the fair system, is if we get, where fairness is that it is neither regressive nor progressive, and striking a balance there seems to be a very difficult task to achieve.

Mr. SCHAEFER. Well, my way of thinking is that on an NST it probably is as much middle ground as you can possibly get between the regressive and the progressive type of thing because this is all a choice that people make, and just think if you are out making $100 a week, you get a paycheck for $100, you don't get a paycheck for $75 or $76 or whatever, and therefore you have that.

Mr. ENSIGN. Just one last quick comment, and that is, the only thing that scares me about this is that it is so easy to raise this tax, any kind of consumption tax because it is almost a hidden tax. One of the ways they talked about was making it hidden in the price of the good and if it is hidden in the price of the good, and some people say even our State sales taxes are hidden taxes simply because nobody really pays attention to that tax that they are paying. They pay attention to the tax that is taken out of their paycheck but they don't pay attention to the tax that they pay at the grocery store, so in effect it is much easier to raise this type of a tax in the future, the rates on this, than it is the income tax.

Mr. SCHAEFER. Well, I would certainly agree with the gentleman if it would be concerning a VAT, but not when you are considering an NST. They are two different things. The VAT is truly hidden, as Billy said, in our current system, there is some 12, 15 percent in there that is hidden, but that 16 or 17 percent that is tacked on to the final suit that you buy, you know exactly what that is, and that is set by Congress. And here we are, we change the Tax

Codes all the time, and we are changing the brackets and we are doing all this.

Sure, with an act of Congress you can change it from 17 to 18 percent, but you think you are going to hear some squawking and squealing? You bet you will. So therefore I think as long as the revenues are coming in——

The final thing, Mr. Chairman, I would just say is that Bill and I are going to create a national sales tax caucus, and the purpose of it is for all those individuals who wish to know more about it and become involved and disseminate the information, I think this will be a good step.

Chairman ARCHER. We welcome your input, and we really do have to move along. We still have a number of additional witnesses today. I really do thank you for the work you have done and for your presentation today. We are going to be moving along with this and having more hearings and more deliberations in this Congress, and we will really be looking for whatever counsel and suggestions that you can give us.

Thank you very much.

Mr. TAUZIN. Thank you, Mr. Chairman.

We didn't get a chance to say this when we got here, Mr. Archer. I want to personally thank you. You stepped out in an extraordinarily courageous way to begin this debate, and if we arrive at that awfully wonderful point and America does in fact come up with an alternative system, it is simple, it works, April 15 can just be another day in our lives instead of the awful day it is. America will have you to thank, sir.

Thank you very much.

Chairman ARCHER. Thank you. I hope we can get there.

Our next witnesses are Professor Hall and Alan Reynolds.

Gentlemen, thank you for being so patient today. I apologize for the length of time that you have had to wait in order to be able to come and make your presentation, and I am very grateful to you and I look forward to what you have to tell the Committee. Welcome. And, Dr. Hall, will you proceed.

STATEMENT OF ROBERT E. HALL, PH.D., SENIOR FELLOW AND PROFESSOR OF ECONOMICS, HOOVER INSTITUTION, STANFORD UNIVERSITY

Mr. HALL. Thank you, Mr. Chairman. I am honored to have this opportunity to discuss the plan to replace the income tax with a flat consumption tax. No one is more conscious of the hour than I am, so I will be very brief. My prepared testimony is about 25 pages, and I invite anyone who wants to learn more to read that.

Chairman ARCHER. Without objection, your entire testimony will be printed in the record.

Mr. HALL. Thank you, Mr. Chairman.

This Committee has heard a number of meritorious plans for replacing the income tax with a consumption tax. Those include a national sales tax, a VAT or an income tax with unlimited deduction for saving, and I want to be clear that I am a supporter of any of those consumption tax plans.

By far the most important national priority, I believe, should be to switch to a consumption tax. It is almost to the detailed level which of those we choose.

My testimony will hit the high points as to why the Hall-Rabushka flat tax plan is the best way to move to consumption taxation, but again, I stress that all of these are good plans, and if this Committee were to decide to push ahead with any one of them, I would welcome the opportunity to come back and say exactly how an economist would see that VAT, a sales tax, a value-added tax, or a flat tax could be set up in a most economically successful way.

First of all, simplicity. I think it is well known now and I don't go through what I used to do of showing off tax forms because I think these tax forms have been published everywhere, and Congressman Armey, in particular, has been spreading them far and wide, but we do have just two postcard tax forms. And the virtue of simplicity is something I have learned more and more I think is part of the appeal of both the flat tax and other consumption taxes, but it is terribly important, the fact that a good tax is also a simple tax is a lesson that I think we should push very, very hard.

A second thing that I would stress is that either the value added principle or the sales tax principle is a very good one for setting up consumption taxes, it is really—something like a value-added tax or a sales tax is the right way to go about taxing consumption. First of all, it is obvious that it taxes consumption. That is particularly true of the sales tax, but it is also true of the value-added tax.

The Hall-Rabushka flat tax is a value-added tax. It is just a rearrangement of a value-added tax to provide some other benefits, but at its core it is a value-added tax, and again a value-added tax and a sales tax are very, very close relatives as a matter of economics; they are both consumption taxes.

A third point is that the flat tax is progressive and fair. One of the most important challenges that faced us in 1981 in designing the flat tax was exactly this question: How do we make it progressive and fair? And the answer is an exemption.

The reason that we are not strictly a value-added tax is that we figured out a way to slightly rearrange it in order to make it progressive and fair, and that is by providing an allowance. Our allowance is $25,500 for a family of four. Of course, other allowances are possible, and Congressman Armey has proposed a larger family allowance, and that is fine. That is something that certainly should be discussed further.

A fourth point and one that I have recently been doing more research on has to do with transition problems.

I didn't used to worry about transition because it never occurred to me that the flat tax would be taken seriously in Washington, but now that it is, I have been looking at transition issues seriously.

One transition issue that has gotten too little attention is that a sales or value-added tax would create a burst of inflation in the U.S. economy. This is not an idle possibility. When Britain adopted a VAT tax in 1979, their economy went into a tailspin associated with the burst of inflation that accompanied it. There would be no inflation with Hall-Rabushka.

A second related point is that the border adjustment which might go with a value-added tax would bring a sharp appreciation of the dollar, and I would see that as a giveaway to speculators who guessed right about the reform.

I have run out of time, but I think I have hit the high points as far as why, among all the good consumption taxes, this is, I believe, the best consumption tax.

Let me just—one of the topics that I wanted to cover is the topic of border adjustments. That is one I have thought through carefully recently. Border adjustments are not the cosmic issue that I think earlier witnesses suggested. I see that as an option that we have, and we should think seriously about doing it one way or the other. The thing I would stress is that if we adopt a VAT tax with border adjustments or a sales tax with border adjustments, with the rebate of the exports, there would be an immediate appreciation of the dollar that would offset it.

There is no improvement in competitiveness associated with a border adjustment and there is no dumping through the Tax Code. It is a neutral issue, and we ought to decide it on other grounds.

Now my time is up.

Chairman ARCHER. Thank you for living within the time constraints. I know 5 minutes is not long compared to the complexity of these subjects.

[The prepared statement follows:]

THE FLAT TAX

Testimony of Robert E. Hall
Senior Fellow, Hoover Institution, Stanford University
Professor of Economics, Stanford University
before the
House Committee on Ways and Means
June 8, 1995

Tax forms really can fit on postcards. A cleanly designed tax system takes only a few elementary calculations, in contrast to the hopeless complexity of today's income taxes. My Hoover colleague, Alvin Rabushka, and I have developed a complete plan for a whole new tax system. Our system puts a low tax rate on a comprehensive definition of income. Because its base is so broad, the tax rate is an astonishingly low 19 percent but raises the same revenue as does the current tax system. The tax on families is fair and progressive—the poor pay no tax at all, and the fraction of income that a family pays rises with income. The system is simple and easy to understand. And the tax operates on the consumption-tax principle—families are taxed on what they take out of the economy, not what they put into it.

Our system rests on a basic administrative principle: income should be taxed exactly once, as close as possible to its source. Today's tax system violates this principle in all kinds of ways. Some kinds of income—like fringe benefits—are never taxed at all. Other kinds, like dividends and capital gains, are taxed twice. And interest income, which is supposed to be taxed once, escapes taxation completely in all too many cases, where clever taxpayers arrange to receive interest beyond the reach of the IRS.

Under our plan, all income is taxed at the same rate. Equality of tax rates is a basic concept of the flat tax. Its logic is much more profound than just the simplicity of calculation with a single tax rate. Whenever different forms of income are taxed at different rates or different taxpayers face different rates, the public figures out how to take advantage of the differential.

PROGRESSIVITY, EFFICIENCY, AND SIMPLICITY

Limiting the burden of taxes on the poor is a central principle of tax reform. Some ideas for tax simplification and reform flout this principle—neither a federal sales tax nor a value-added tax is progressive. Instead, all citizens, rich and poor alike, pay essentially the same fraction of their spending in taxes. We reject sales and value-added taxes for this reason. The current federal tax system avoids taxing the poor, and we think it should stay that way.

Exempting the poor from taxes does not require graduated tax rates rising to high levels for upper-income families. A flat rate, applied to all income above a generous personal allowance, provides progressivity without creating important differences in tax rates. Graduated taxes automatically create differences in tax rates among taxpayers, with all the attendant opportunities for tax-avoidance tricks. Because it is high-income taxpayers who have the biggest incentive and the best opportunity to use special tricks to exploit tax-rate differentials, applying the same tax rate to these taxpayers for all of their income in all years is the most important goal of flat-rate taxation.

Our proposal is based squarely on the principle of consumption taxation. Saving is untaxed. We solve the problem that has perplexed the designers of the current tax system, which now contains an incredible hodgepodge of savings and investment incentives. As a general matter, the current system puts substantial taxes on the earnings from savings. On that account, the economy is biased toward too little saving and too much consumption. But Congress has inserted a number of special provisions to spur saving. Most importantly, saving for retirement is excused from current taxation. Workers are not taxed on the amount their employers contribute to pension funds, and the employers can deduct those contributions. The self-employed can take advantage of the same opportunity with Keogh, IRA, and SEP plans. The overall effect of the existing incentives is spotty—there are excessive incentives for some saving-investment channels and inadequate incentives for others. In our system, there is a single, coherent provision for taxing the return to saving. All income is taxed but the earnings from saved income are not taxed further.

We believe that the simplicity of our system is a central feature. Complex tax forms and tax laws do more harm that just the deforestation of America. Complicated taxes require expensive advisers for taxpayers and equally expensive reviews and audits by the government. A complex tax invites the taxpayer to search for a special feature to exploit to the disadvantage of the rest of us. And complex taxes diminish confidence in government, inviting a breakdown in cooperation with the tax system and the spread of outright evasion.

AN INTEGRATED FLAT TAX

Our flat tax applies to both businesses and individuals. Although our system has two separate tax forms—one for business income and the other for wages and salaries—it is an integrated system. When we speak of its virtues, like its equal taxation of all types of income, we mean the system, not one of its two parts. As we will explain, the business tax is not just a replacement for the existing corporate income tax. It covers all businesses, not just corporations. And it covers interest income, which is currently taxed under the personal income tax.

In our system, all income is classified as either business income or wages (including salaries, and retirement benefits). The system is airtight. Taxes on both types of income are equal. The wage tax has features to make the overall system progressive. Both taxes have postcard forms. The low tax rate of 19 percent is enough to match the revenue of the federal tax system as it existed in 1993, the last full year of data available as we write.

Here is the logic of our system, stripped to basics: We want to tax consumption. The public does one of two things with its income—spend it or invest it. We can measure consumption as income minus investment. A really simple tax would just have each firm pay tax on the total amount of income generated by the firm less that firm's investment in plant and equipment. The value-added tax works just that way. But a value-added tax is unfair because it is not progressive. That's why we break the tax into two pieces. The firm pays tax on all of the income generated at the firm except the income paid to its workers. The workers themselves pay tax on what they earn. And the tax they pay is progressive.

To measure the total amount of income generated at a business, the best approach is to take the total receipts of the firm over the year and subtract the payments the firm has made that are not part of the income generated. This approach guarantees a comprehensive tax base. The successful value-added taxes in Europe work just this way. The base for the business tax is the following:

Total revenue from sales of goods and services

less

purchases of inputs from other firms

less

wages, salaries, and pensions paid to workers

less

purchases of plant and equipment

The other piece is the wage tax. Each family pays 19 percent of its wages, salary, and pension income over a family allowance. The allowance makes the system progressive. The base for the compensation tax is total wages, salaries, and retirement benefits less the total amount of family allowances.

In 1993 the revenue from the corporate income tax, with a tax rate of 34 percent, was $118 billion. The revenue from our business tax at a rate of only 19 percent would have been $362 billion, just over three times as much, even though the tax rate is not much over half the current corporate rate. There are three main reasons that the flat business tax yields much more revenue than does the existing corporate tax. First, slightly more than half of business income is from non-corporate businesses—professional partnerships, proprietorships, and the like. Second, our business tax does not permit the deduction of interest paid by businesses, whereas the corporate income tax does permit that deduction. Third, the business tax puts a tax on fringe benefits, which escape any taxation in the current system.

The substantial revenue the government would derive from the flat business tax is the key to the fairness of our tax system. Because most business income goes to the rich, putting an airtight tax of 19 percent on that income permits a lowering of taxes and tax rates on working people.

The other side of the coin, of course, is that our wage tax would have yielded less revenue than does the current personal income tax—$265 billion in 1993 as against $510 billion. We are not proposing a massive shift in taxes from wages to capital income. Our wage tax applies just to wages, salaries, and private pensions, whereas today's personal income tax includes unincorporated business income, dividends, interest, rent, and many other kinds of income that we tax as part of business income. The switch to the more reliable principle of taxing business income at the source, rather than hoping to catch the income at the destination, is the main reason that the business tax yields so much more revenue than does the corporate tax.

The Individual Wage Tax

The individual wage tax has a single purpose—to tax the large fraction of total income that employers pay as cash to their workers. It is not a tax system by itself, but is one of the two major parts of the complete system. The base of the tax is defined narrowly and precisely as actual payments of wages, salaries, and pensions.

The tax form for our wage tax is self-explanatory. To make the tax system progressive, only earnings over a personal or family allowance are taxed. The allowance is $25,500 for a family of four in 1995, but would rise along with the cost of living in later years. All the taxpayer has to do is report total wages, salaries, and pensions at the top, compute the family allowance based on marital status and number of dependents, subtract the allowance, multiply by 19 percent to compute the tax, take account of withholding, and pay the difference or apply for a refund. For about 80 percent of the population, filling out this postcard once a year would be the only effort needed to satisfy the Internal Revenue Service. What a change from the many pages of schedules the typical frustrated taxpayer fills out today!

Form 1 — **Individual Wage Tax** — **1995**

Your first name and initial (if joint return, also give spouse's name and initial) | Last name | Your social security number

Present home address (number and street including apartment number or rural route) | Spouse's social security no.

City, town, or post office, state, and ZIP code | Your occupation> | Spouse's occupation>

1	Wages and salary	1	
2	Pension and retirement benefits	2	
3	Total compensation (line 1 plus line 2)	3	
4	Personal allowance		
	(a) ☐ $16,500 for married filing jointly	4(a)	
	(b) ☐ $9,500 for single	4(b)	
	(c) ☐ $14,000 for single head of household	4(c)	
5	Number of dependents, not including spouse	5	
6	Personal allowances for dependents (line 5 multiplied by $4,500)	6	
7	Total personal allowances (line 4 plus line 6)	7	
8	Taxable compensation (line 3 less line 7, if positive; otherwise zero)	8	
9	Tax (19% of line 8)	9	
10	Tax withheld by employer	10	
11	Tax due (line 9 less line 10, if positive)	11	
12	Refund due (line 10 less line 9, if positive)	12	

For the 80 percent of taxpayers who don't run businesses, the individual wage tax would be the only tax to worry about. Many features of current taxes would disappear. We will discuss these disappearances in detail later. They include charitable deductions, mortgage interest deductions, capital gains taxes, dividend taxes, and interest taxes. Anyone who is self-employed or pays expenses directly in connection with making a living will need to file the business tax in order to get the proper deduction for expenses. Fortunately, the business tax form is even simpler than the wage tax form.

Again, we stress that the wage tax is not a complete income tax on individuals. It taxes only wages, salaries, and pensions. The companion business tax picks up all other components of income. Together they form an airtight tax system.

The Business Tax

It's not the purpose of the business tax to tax businesses. Fundamentally, people pay taxes, not businesses. The idea of the business tax is to collect the tax that the owners of a business owe on the income produced by the business. Collecting business income tax at the source of the income avoids one of the biggest causes of leakage in the tax system today: Interest can pass through many layers where it is invariably deducted when it is paid out, but not so frequently reported as income.

Airtight taxation of individual business income at the source is possible because we already know the tax rate of all of the owners of the business—it is the common flat rate paid by all taxpayers. If the tax system has graduated rates, taxation at the source becomes a problem. If each owner is to be taxed at that owner's rate, the business would have to find out the tax rate applicable to each owner, and apply that rate to the income produced in the business for that owner. But this is only the beginning of the problem. The IRS would have to audit a business and its owners together in order to see that the owners were reporting the correct tax rates to the business. Further, suppose one of the owners made a mistake, and later was discovered to be in a higher tax bracket. Then the business would have to refile its tax form to collect the right tax. Obviously this wouldn't work. Business taxes have to be collected at the destination, from the owners, if graduated rates are to be applied. Source taxation is only practical when a single rate is applied to all owners. Because source taxation is so much more reliable and inexpensive, there is a powerful practical argument for using a single flat rate for all business income.

The business tax is a giant, comprehensive withholding tax on all types of income other than wages, salaries, and pensions. It is carefully designed to tax every bit of income outside of wages, but to tax it only once. The business tax does not have deductions for interest payments, dividends, or any other type of payment to the owners of the business. As a result, all income that people receive from business activity has already been taxed. Because the tax has already been paid, the tax system does not need to worry about what happens to interest, dividends, or capital gains after these types of income leave the firm. The resulting simplification and improvement in the tax system is enormous. Today, the IRS receives over a billion Form 1099s to keep track of interest and dividends. It takes an overwhelming effort to match these forms to the 1040s filed by the recipients. The only reason for a Form 1099 is to track income as it makes its way from the business where it originates to the ultimate recipient. Not a single Form 1099 would be needed under a flat tax with taxation of business income at the source.

The way that we have chosen to set up the business tax is not at all arbitrary—on the contrary, it is dictated by the principles we set forth at the beginning of this testimony. The tax would be assessed on all the income originating in a business, but not on any income that originates in other businesses, nor would it tax the wages, salaries, and pensions paid to employees. All of a business's income derives from the sale of its products and services. On the top line of the business tax form (our Form 2) goes the gross sales of the business—its proceeds from the sale of all of its products. But some of the proceeds come from the resale of inputs and parts the firm purchased; the tax has already been paid on these items because the seller also has to pay the business tax. So the firm can deduct the cost of all the goods, materials, and services it purchases for the purpose of making the product it sells. In addition, it can deduct its wages, salaries, and pensions, for the taxes on these will be paid by the workers receiving them, under our wage tax. Finally, the business can deduct all its outlays for plant, equipment, and land. A little later we will explain why this investment incentive is just the right one.

Form 2	Business Tax		1996
Business Name			Employer Identification Number
Street Address			County
City, State, and ZIP Code			Principal Product
1	Gross revenue from sales	1	
2	Allowable costs		
	(a) Purchases of goods, services, and materials	2(a)	
	(b) Wages, salaries, and pensions	2(b)	
	(c) Purchases of capital equipment, structures, and land	2(c)	
3	Total allowable costs (sum of lines 2(a), 2(b), 2(c))	3	
4	Taxable income (line 1 less line 3)	4	
5	Tax (19% of line 4)	5	
6	Carry-forward from 1994	6	
7	Interest on carry-forward (6% of line 6)	7	
8	Carry-forward into 1995 (line 6 plus line 7)	8	
9	Tax due (line 5 less line 6, if positive)	9	
10	Carry-forward to 1996 (line 6 less line 5, if positive)	10	

Everything left from this calculation is the income originating in the firm, and is taxed at the flat rate of 19 percent. In most businesses, a lot is left, so the prospective revenue from the business tax is the $362 billion we computed earlier. Many deductions allowed to businesses under current laws are eliminated in our plan, including interest payments and fringe benefits. But our exclusion of these deductions is not an arbitrary move to increase the tax base. In all cases, the elimination of deductions, when combined with the other features of our system, moves toward the goal of taxing all income once at a common, low rate and to achieve a broad consumption tax.

Eliminating the deduction for interest paid by businesses is a central part of our general plan to tax business income at the source. It makes sense because we propose not to tax interest received by individuals. The tax that the government now hopes (sometimes in vain) that individuals will pay will assuredly be paid by the business itself.

We sweep away the whole complicated apparatus of depreciation deductions, but we replace it with something more favorable for capital formation, an immediate 100 percent first-year tax write-off of all investment spending. Sometimes this approach is called expensing of investment; it is standard in the value-added approach to consumption taxation. In other words, we don't deny depreciation deductions, we enhance them. More on this shortly.

Fringe benefits are outside the current tax system entirely, which makes no sense. The cost of fringes is deductible by businesses, but workers are not taxed on the value of the fringes. Consequently, fringes have a big advantage over cash wages. As taxation has become heavier and heavier, fringes have become more and more important in the total package offered by employers to workers—fringes were only 1.2 percent of total compensation in 1929 when income taxes were unimportant, but reached almost 18 percent in 1993. The explosion of fringes is strictly an artifact of taxation, and fringes are an economically inefficient way to pay workers. Were the tax system neutral, with equal taxes on fringes and cash, workers would rather take their income in cash and make their own decisions about health and life insurance, parking, exercise facilities, and all the other things they now get from their employers without much choice. Further, failing to tax fringes means taxes on other types of income are all the higher. Bringing all types of income under the tax system is essential for low rates.

Under our system, each business would file a simple form. Even the largest business—the General Motors Corporation in 1993, with $138 billion in sales—would fill out our simple postcard form. Every line on the form is a well-defined number obtained directly from the business's accounting records. Line 1, gross revenue from sales, is the actual number of dollars received from the sales of all the products and services sold by the business, plus the proceeds from the sale of plant, equipment, and land. Line 2a is the actual amount paid for all the inputs bought from other businesses necessary for the operation of the business (that is, not passed on to its workers or owners). The firm could report essentially any purchase provided the purchase was actually needed for the business's operations and was not part of the compensation of workers or owners. Line 2b is the actual cash put in the hands of workers and former workers. All the dollars deducted on this line will have to be reported by the workers on their Form 1 wage tax returns. Line 2c reports purchases of new and used capital equipment, buildings, and land. Note that the firm won't have to agonize over whether a screwdriver is a capital investment or a current input—both are deductible, and the IRS won't care which line it will appear on. The taxable income computed on line 4 bears little resemblance to anyone's notion of profit. The business tax is not a profit tax. When a company is having an outstanding year in sales and profits but is building new factories to handle rapid growth, it may well have a low or even negative taxable income. That's fine—later, when expansion slows but sales are at a high level, the income generated will be taxed at 19 percent.

Because the business tax treats investment in plant, equipment, and land as an expense, companies in the start-up period will have negative taxable income. But the government will not write a check for the negative tax on the negative income. Whenever the government has a policy of writing checks, clever people abuse the opportunity. Instead, the negative tax would be carried forward to future years, when the business should have positive taxable income. There is no limit to the number of years of carry-forward. Moreover, balances carried forward will earn the market rate of interest (6 percent in 1995). Lines 6 through 10 show the mechanics of the carry-forward process.

INVESTMENT INCENTIVES

The high rates of the current tax system significantly impede capital formation. On this point almost all experts agrees. The government's solution to the problem has been to pile one special investment or saving incentive on top of another, creating a complex and unworkable maze of regulations and tax forms. Existing incentives are appallingly uneven. Capital projects taking full advantage of depreciation deductions and the deductibility of interest paid to organizations exempt from income tax may actually receive subsidies from the government, rather than being taxed. But equity-financed projects are taxed heavily. Investment incentives severely distort the flow of capital into projects eligible for debt finance.

Our idea is to start over by throwing away all of the present incentives and replacing them with a simple, uniform principle—the total amount of investment will be treated as an expense in the year it is made. The entire incentive for capital formation is on the investment side, instead of the badly fitting split in the current tax system between investment incentives and saving incentives. The first virtue of this reform is simplicity. Businesses and government need not quarrel, as they do now, over what is an investment and what is a current expense. The distinction doesn't matter for the tax. Complicated depreciation calculations, carrying over from one year to the next, driving the small business owner to distraction, will vanish from the tax form. The even more complicated provisions for recapturing depreciation when a piece of equipment or a building is sold will vanish as well, to everyone's relief.

Expensing of investment has a much deeper rationale than simplicity. Every act of investment in the economy ultimately traces back to an act of saving. A tax on income with an exemption for saving is in effect a tax on consumption, for consumption is the difference between income and saving. Consumption is what people take out of the economy; income is what people contribute. A consumption tax is the exact embodiment of the principle that people should be taxed on what they take out, not what they put in. The flat tax, with expensing of investment, is precisely a consumption tax.

Expensing investment eliminates the double taxation of saving; this is another way to express the most economically significant feature of expensing. Under an income tax, people pay tax once when they earn and save and again when the savings earn a return. With expensing, the first tax is abolished. Saving is, in effect, deducted in computing the tax. Later, the return to the saving is taxed through the business tax. Although economists have dreamt up a number of other ways to eliminate double taxation of saving (involving complicated record keeping and reporting by individuals), the technique exploited in our flat tax is by far the most straightforward.

In our system, any investment, in effect, would have the same economic advantage that a 401K, IRA, or Keogh account has in the current tax system. And we achieve this desirable goal by reducing the amount of record keeping and reporting. Today, taxpayers have to deduct their Keogh-IRA contributions on their Form 1040s and then they have to report the distributions from the funds as income when they retire. Moreover, proponents of the "cash-flow" consumption tax would extend these requirements to all forms of saving. Our system would accomplish the same goal without any forms or record keeping.

CAPITAL GAINS

Capital gains on rental property, plant, and equipment would be taxed under the business tax. The purchase price would be deducted at the time of purchase, and the sale price would be taxed at the time of the sale. Every owner of rental real estate would be required to fill out the simple business tax return, Form 2.

Capital gains would be taxed exclusively at the business level and not at the personal level. In other words, our system would eliminate the double taxation of capital gains inherent in the current tax system. To see how this works, consider the case of the common stock of a corporation. The market value of the stock is the capitalization of its future earnings. Because the owners of the stock will receive their earnings after the corporation has paid the business tax, the market capitalizes after-tax earnings. A capital gain occurs when the market perceives that prospective after-tax earnings have risen. When the higher earnings materialize in the future, they will be correspondingly taxed. In a tax system like the current one, with both an income tax and a capital gains tax, there is double taxation. To achieve the goal of taxing all income exactly once, the best answer is to place an airtight tax on the income at the source. With taxation at the source, it is inappropriate and inefficient to tax capital gains as they occur at the destination.

Another way to see that capital gains should not be taxed separately under the flat tax is to look at the national income accounts. Gross domestic product, the most comprehensive measure of the nation's command over resources, does not include capital gains. The base of the flat tax is GDP minus investment, that is, consumption. To include capital gains in the flat-tax base would depart from the principle that it is a tax on consumption.

Capital gains on owner-occupied houses are not taxed under our proposal. Very few capital gains on houses are actually taxed under the current system—gains can be rolled over, there is an exclusion for older home sellers, and gains are never taxed at death. Exclusion of capital gains on houses makes sense because state and local governments put substantial property taxes on houses in relation to their values. Adding a capital gains tax on top of property taxes is double taxation in the same way that adding a capital gains tax on top of an income tax is double taxation of business income.

IMPORTS, EXPORTS, AND MULTINATIONAL BUSINESS

With NAFTA and the growth of trade throughout the world, U.S. companies are doing more and more business in other countries, and foreign companies are increasingly active here. Should the U.S. government try to tax business operations in other countries owned by Americans? And should it tax foreign operations in the United States? These are increasingly controversial questions. Under the current tax system, foreign operations of U.S. companies are taxed in principle, but the taxpayer receives a credit against U.S. taxes for taxes paid to the country where the business operates. Because the current tax system is based on a confused combination of taxing some income at the origin and some at the destination, taxation of foreign operations is messy.

Under the consistent application of taxing all business income at the source, the flat tax embodies a clean solution to the problems of multinational operations. The flat tax applies only to the domestic operations of all businesses, whether of domestic, foreign, or mixed ownership. Only the revenue from the sales of products within the United States plus the value of products as they are exported would be reported on line 1 of the business tax Form 2. Only the costs of labor, materials, and other inputs purchased in the United States or imported to the United States would be allowable on line 2 as deductions for the business tax. Physical presence in the United States is the simple rule that determines whether a purchase or sale is included in taxable revenue or allowable cost.

To see how the business tax would apply to foreign trade, consider first an importer selling its wares within the United States. Its costs would include the actual amount it paid for its imports, valued as they entered the country—this would generally be the actual amount paid for them in the country of their origin. Its revenue would be the actual receipts from sales in the United States. Second, consider an exporter selling goods produced here to foreigners. Its costs would be all of the inputs and compensation paid in the United States, and its revenue would be the amount received from sales to foreigners, provided that the firm did not add to the product after it departed the country. Third, consider a firm that sends parts to Mexico for assembly and brings back the final product for sale in the United States. The value of the parts as they leave here would count as part of the revenue

of the firm, and the value of the assembled product when it was returned would be an expense. The firm would not deduct the actual costs of its Mexican assembly plant.

Under the principle of only taxing domestic activities, the U.S. tax system would mesh neatly with the tax systems of our major trading partners. If every nation used the flat tax, all income throughout the world would be taxed once and only once. Because the basic principle of the flat tax is already in use in the many nations with value-added taxes, a U.S. flat tax would harmonize nicely with those foreign tax systems.

Application of the wage tax, Form 1, in the world economy would follow the same principle. All earnings from work in the United States would be taxed, irrespective of the worker's citizenship, but the tax would not apply to the foreign earnings of Americans.

Choices about the international location of businesses and employment are influenced by differences in tax rates. The United States, with a low tax rate of 19 percent, would be much the most attractive location among major industrial nations from the point of view of taxation. Although the flat tax would not tax the overseas earnings of American workers and businesses, there is no reason to fear an exodus of economic activity. On the contrary, the favorable tax climate in the United States would draw in new business from everywhere in the world.

THE TRANSITION

In this testimony, we lay out a good, practical tax system. We have not made concessions to the political pressures that may well force the nation to accept an improved tax system that falls short of the ideal we have in mind. One area where the political process is likely to complicate our simple proposal is the transition from the current tax to the flat tax. The transition issues that are likely to draw the most attention are depreciation and interest deductions. In both cases, taxpayers who made plans and commitments before the tax reform will cry loudly for special provisions to continue the deductions.

Congress will face a choice between denying taxpayers the deductions they expected before tax reform or granting the deductions and raising the tax rate to make up for the lost revenue. Fortunately, this is a temporary problem. Once existing capital is fully depreciated and existing borrowing paid off, any special transitions provisions can be taken off the books.

Depreciation Deductions

Existing law lets businesses deduct the cost of an investment on a declining schedule over many years. From the point of view of the business, multiyear depreciation deductions are not as attractive as the first-year write-off prescribed in the flat tax. No business will complain about the flat tax as far as future investment is concerned. But businesses may well protest the unexpected elimination of the unused depreciation they thought they would be able to take on the plant and equipment they installed before the tax reform. Without special transition provisions, these deductions would simply be lost.

How much is at stake? In 1992, total depreciation deductions under the personal and corporate income taxes came to $597 billion. At the 34 percent rate for most corporations (which is close to the rate paid by the individuals who are likely to take deductions as proprietors or partners), those deductions were worth $192 billion. At the 19 percent flat rate, the deductions would be worth only $108 billion.

If Congress chose to honor all unused depreciation from investment predating tax reform, it would take about $597 billion out of the tax base for 1995. In order to raise the same amount of revenue as our original 19 percent rate would, the tax rate would have to rise to about 20.1 percent.

Honoring past depreciation would mollify business interests, especially in industries with large amounts of unused depreciation for past investment but little prospect of large first-year write-offs for future investment. In addition, it would buttress the government's credibility in tax matters by carrying through on a past promise to give a tax incentive for investment. On the other had, the move would require a higher tax rate and a less efficient economy in the future.

If Congress did opt to honor past depreciation, it should recognize that the higher tax rate needed to make up for the lost revenue is temporary. Within five years, the bulk of the existing capital would be depreciated and the tax rate should be brought back to 19 percent. From the outset, the tax rate should be committed to drop to 19 percent as soon as the transition depreciation is paid off.

Interest Deductions

Loss of interest deductions and elimination of interest taxation are two of the most conspicuous features of our tax reform plan. Shortly we will discuss the important economic changes that would take place once interest is put on an after-tax basis. During the transition, there will be winners and losers from the change, and Congress is sure to hear from the losers. Congress may well decide to adopt a temporary transitional measure to help them. Such a measure need not compromise the principles of the flat tax or lessen its contribution to improved efficiency.

Our tax reform calls for the parallel removal of interest deduction and interest taxation. If a transitional measure allows the continuation of deductions for interest on outstanding debt, it should also require the continuation of taxation of that interest as income of the lender. If all deductions are completely matched with taxation on the other side, then a transition provision to protect existing interest deductions would have no effect on revenue. In that respect, interest deductions are easier to handle in the transition than are depreciation deductions.

If Congress decides that a transitional measure to protect interest deductions is needed, we suggest the following. Any borrower may choose to treat interest payments as a tax deduction. If the borrower so chooses, the lender must treat the interest as taxable income. But the borrower's deduction should be only 90 percent of the actual interest payment, while the lender's taxable income should include 100 percent of the interest receipts.

Under this transitional plan, borrowers would be protected for almost all of their existing deductions. Someone whose personal finances would become untenable if the mortgage-interest deduction were suddenly eliminated can surely get through with 90 percent of the earlier deduction. But the plan builds in an incentive for the renegotiation of the interest payments along the lines we discussed earlier. Suppose a family is paying $10,000 in annual mortgage interest. They could stick with this payment and deduct $9,000 of it per year. Their net cost, after subtracting the value of their deduction with the 19 percent tax rate, would be $8,290. The net income to the bank, after subtracting the 19 percent tax it pays on the whole $10,000, would be $8,100. Alternatively, the family could accept a deal proposed by the bank: The interest payment would be lowered to $8,200 by rewriting the mortgage. The family would agree to forego their right to deduct the interest, and the bank would no longer have to pay tax on the interest. Now the couple's cost will be $8,200 (instead of $8,290 without the deal) and the bank's income will be $8,200 (instead of $8,100 without the deal). The family will come out $90 ahead and the bank will come out $100 ahead. The deal will be beneficial to both.

One of the nice features of this plan is that it does not have to make any distinctions between old borrowing, existing at the time of the tax reform, and new borrowing, arranged after the reform. Lenders would always require that new borrowers opt out of their deductions and thus would offer a correspondingly lower interest rate. Otherwise, the lender would be saddled with a tax bill larger than the tax deduction received by the borrower.

As far as revenue is concerned, this plan would actually add a bit to federal revenue in comparison to the pure flat tax. Whenever a borrower exercised the right to deduct interest, the government would collect more revenue from the lender than it would lose from the borrower. As more and more deals were rewritten to eliminate deductions and lower interest, the excess revenue would disappear, and we would be left with the pure flat tax.

THE FLAT TAX AND THE ECONOMY

Tax reform along the lines of our simple tax will influence the American economy profoundly: Improved incentives for work, entrepreneurial activity and capital formation will substantially raise national output and the standard of living. Everyone would favor such an economic renaissance. But what about some of the other effects of tax reform? Is it a giveaway to the rich? Will it destroy the housing market by ending mortgage deductions? Can charitable institutions survive without tax deductions for gifts? Can the flat tax end the federal deficit?

Stimulus to Growth

The flat tax at a low, uniform rate of 19 percent will improve the performance of the U.S. economy. Improved incentive to work through increased take-home wages will stimulate work effort and raise total output. Rational investment incentives will raise the overall level of investment and channel it into the most productive areas. And sharply lower taxation of entrepreneurial effort will enhance this most critical input to the economy.

Work Effort

About two thirds of taxpayers today enjoy the low income tax rate of 15 percent enacted in 1986. Under the flat tax, over half of these taxpayers would face zero tax rates because their total family earnings would fall short of the exemption amount ($25,500 for a family of four). The others in this group would face a slight increase in their tax rate on the margin, from 15 percent to 19 percent. The remaining third of taxpayers in 1991 were taxed at rates of 28 and 31 percent, much higher than the flat rate of 19 percent. And the addition of the 39.6 percent bracket in 1993 worsened incentives further. Heavily taxed people earn a disproportionate share of income: In 1991, 58 percent of all earnings were taxed at rates of 28 percent or higher. The net effect of the flat tax with marginal rates of zero and 19 percent would be a dramatic improvement of incentives for almost everyone who is economically active.

One point we need to get straight at the very start is that a family's marginal tax rate determines its incentives for all types of economic activity. There is much confusion on this point. For example, some authors have written that married women face a special disincentive because the marginal tax on the first dollar of her earnings is the same as the marginal tax on the last dollar of her husband's earnings. It is true that incentives to work for a woman with a well-paid husband are seriously eroded by high tax rates. But so are her husband's incentives. What matters for both of their decisions is how much of any extra dollar of earnings they will keep after taxes. Under the U.S. income tax, with joint filing, the fraction either of them takes home after taxes is always the same, no matter how their earnings are split between them.

For the switch from the current tax law to our proposed flat tax, a reasonable projection, in the light of the research on labor supply, is an increase of about 4 percent in total hours of work in the U.S. economy. The increase of 4 percent would be about 1.5 hours per week on the average, but would take the form of second jobs for some workers, more weeks of work per year for others, as well as more hours per week for those working part time. The total annual output of goods and services in the U.S. economy would rise by about 3 percent, or almost $200 billion. That is nearly $750 per person, an astonishing sum. Of course, it might take some time for the full influence of improved incentives to have their effect. But the bottom line is unambiguous: tax reform would have an important favorable effect on total work effort.

Capital Formation

Economists are far from agreement on the impact of tax reform on investment. As we have stressed earlier, the existing system puts heavy tax rates on business income, even though the net revenue from the system is small. These rates seriously erode investment incentives. Erratic investment provisions in the current law and lax enforcement of taxes on business income at the personal level, however, combine to limit the adverse impact. The current tax system subsidizes investment through tax-favored entities such as pension funds, while it taxes

capital formation heavily if it takes the form of new businesses. The result has been to sustain capital formation at reasonably high levels but to channel the investment into inefficient uses.

The most important structural bias of the existing system is the double taxation of business income earned in corporations and paid out to shareholders. Double taxation dramatically reduces the incentive to create new businesses in risky lines where debt financing is not available. On the other side, the existing system places no current tax on investments that can be financed by debt and where the debt is held by pension funds or other nontaxed entities. The result is a huge twist in incentives, away from entrepreneurial activities and toward safe, debt-financed activities.

The flat tax would eliminate the harmful twist in the current tax system. The flat tax has a single, uniform incentive for investment of all types—businesses would treat all purchases of capital equipment and buildings as expenses. As we noted earlier, allowing immediate write-off of investment is the ideal investment incentive. A tax system that taxes all income evenly and allows expensing of investment is a tax on consumption. Two leading public finance economists, Alan Auerbach and Laurence Kotlikoff, estimated that the use of a flat-rate consumption tax in place of an income tax would raise the ratio of capital stock to GDP from 5.0 to 6.2. Other economists are less optimistic that the correction of the double taxation of saving would provide the resources for this large an increase in investment. But all would agree that there would be some favorable effect on capital formation.

In terms of added GDP, the increase in the capital stock projected by Auerbach and Kotlikoff would translate into 6 percent more goods and services. Not all of this extra growth would occur within the seven-year span we are looking at. But, even allowing for only partial attainment in seven years and for a possible overstatement in their work, it seems reasonable to predict a 2 to 4 percent increase in GDP on account of added capital formation within seven years.

Entrepreneurial Incentives and Effort

U.S. economic growth has slowed in the past decade, and surely one of the reasons is the confiscatory taxation of successful endeavors and the tax subsidy for safe, nonentrepreneurial undertakings. There aren't any scholarly studies with quantitative conclusions on the overall benefits from a fundamental shift, but they could be large.

Today's tax system punishes entrepreneurs. Part of the trouble comes from the interest deduction. The people in the driver's seat in the capital market, where money is loaned and borrowed, are those who lend out money on behalf of institutions and those individuals who have figured out how to avoid paying income tax on their interest. These people don't like insecure loans to new businesses based on great new ideas. They do like lending secured to readily marketable assets by mortgages or similar arrangements. It's easy to borrow from a pension fund to build an apartment building, buy a boxcar, put up a shopping center, or anything else where the fund can foreclose and sell the asset in case the borrower defaults. Funds won't lend money to entrepreneurs with new ideas, because they are unable to evaluate what they could sell off in case of a default.

Entrepreneurs can and do raise money the hard way, by giving equity interests to investors. An active venture-capital market operates for exactly this purpose. But the cost to the entrepreneur is high—the ownership given to the financial backers deprives the entrepreneur of the full gain in case things work out well.

So far we have just described the harsh reality of trying to get other people to put money into a risky, innovative business. Even with the best tax system, or no taxes at all, entrepreneurs would not be able to borrow with ordinary bonds or loans and thus capture the entire future profits of a new business. Equity participation by investors is a fact of life. But it is the perverse tax system that greatly worsens the incentives for entrepreneurs. The combination of corporate and personal taxation of equity investments actually is close to confiscation. The owners of a successful new business are taxed first when the profits flow in, at 34 percent, and again when the returns make their way to the entrepreneur and the other owners. All of them are likely to be in the 40 percent bracket for the personal income tax—the combined effective tax rate is close to 60 percent. The entrepreneur first gives a large piece of the action to the inactive owners who put up the capital, and then surrenders well over half of the remainder to the government.

The prospective entrepreneur will likely be attracted to the easier life of the investor who uses borrowed money. How much easier it is to put up a shopping center, borrow from a pension fund or insurance company, and deduct everything paid to the inactive investor.

Today's absurd system taxes entrepreneurial success at 60 percent while it actually subsidizes some leveraged investments. Our simple tax would put the same low rate on both activities. A huge redirection of national effort would follow. And the redirection could only be good for national income. There is nothing wrong with shopping centers, apartment buildings, airplanes, boxcars, medical equipment, and cattle, but tax advantages have made us invest far too much in them, and their contribution to income is correspondingly low. Real growth will come when effort and capital flow back into innovation and the development of new businesses, the areas where confiscatory taxation has discouraged investment. The contribution to income from new resources will be correspondingly high.

Total Potential Growth from Improved Incentives

We project a 3 percent increase in output from increased total work in the U.S. economy, and an additional increment to total output of 3 percent from added capital formation and dramatically improved entrepreneurial incentives. The sum of 6 percent is our best estimate of the improvement in real incomes after the economy has had seven years to assimilate the changed economic conditions brought about by the simple flat tax. Both the amount and the timing are conservative.

Even this limited claim for economic improvement represents enormous progress. By 2002, it would mean each American will have an income about $1900 higher, in 1995 dollars, as a consequence of tax reform.

INCOME DISTRIBUTION AND FAIRNESS

The flat tax would not make everyone better off straightaway. Today, heavy taxation of successful salary earners and entrepreneurs yields quite a bit of revenue, pushing these people out of their most productive undertakings and diverting their attention to tax avoidance. Until a response to improved incentives takes place, it is an obvious mathematical law that lower taxes on some people will have to be made up by higher taxes on others. If tax reform were a zero-sum process, giving relief to some by raising taxes on others, it would be politically unlikely to occur. Revitalization of the economy, with more income to divide between the big earners and the rest, is the point of tax reform. Our flat tax, however, is designed to be fair from the start. It will insulate the poor from all taxation. It will dramatically limit the taxation of wages and salaries, especially among those who are most successful and productive. It will pay for these tax reductions by imposing on business income a sensible tax at a low rate, thus raising the amount of federal revenue collected from businesses.

The current personal and corporate taxes tax wages heavily and business income lightly. The flat tax would reverse this inequity and benefit the great majority of Americans, whose income comes almost entirely in the form of wages. In comparison to the current personal income tax on wages, the flat tax would impose a lower burden on both low earners and high earners. We can't tell if there are any income groups who would pay significantly higher taxes, including the wage taxes they would pay directly and the business taxes they would pay indirectly. This group could not include the poor, who receive almost no business income.

If we are right that improved incentives will actually raise real incomes by 6 percent after seven years, then it won't take too long for the taxpayers who lose at the outset to come out ahead. The worst immediate impact of the flat tax is to reduce after-tax incomes of people who have been aggressive and successful in keeping business income out of the hands of the IRS. The tax rates on their business incomes will rise to 19 percent. But these people are particularly likely to be able to take advantage of the growth of the economy stimulated by improved taxation.

Interest Rates

The flat tax would pull down interest rates immediately. Today's high interest rates are sustained partly by the income-tax deduction for interest paid and the tax on interest earned. The tax benefit ameliorates much of the pain of high interest, and the IRS takes part of the income from interest. Borrowers tolerate high interest rates and lenders require them. The simple tax would permit no deduction for interest paid and put no tax on interest received. Interest payments throughout the economy will be flows of after-tax income, thanks to taxation of business income at the source.

With the simple tax, borrowers will no longer be so tolerant of interest payments, and lenders will no longer be concerned about taxes. The meeting of minds in the credit market, where borrowing equals lending, will inevitably occur at a lower interest rate. Potentially, the fall could be spectacular. Much borrowing comes from corporations and wealthy individuals, who face marginal tax rates of 34 and 40 percent. On the other hand, the wealthy, almost by definition, are the big lenders in the economy. If every lender and every borrower were in the 40 percent bracket, simple logic shows that a tax reform eliminating deduction and taxation of interest would cut interest rates by four tenths—for example, from 10 to 6 percent. But the leakage problem in the United States is so great that the actual drop in interest would be far short of this huge potential. So much lending comes through the devices by which the well-to-do get their interest income under low tax rates that a drop of four tenths would be impossible. Lenders taxed at low rates would be worse off if taxation were eliminated but interest rates fell by that much. The meeting of the minds in an economy with lenders enjoying low marginal rates before reform would have to come at an interest rate well above six tenths of the pre-reform level. But the decline would be at least a fifth—say from 10 percent to 8 percent. Reform would bring a noticeable drop in interest rates.

The decline in interest rates brought about just by putting interest on an after-tax basis would not by itself change the economy very much. To Ford Motors, contemplating borrowing to finance a modern plant, the attraction of lower rates would be offset by the cost of lost interest deductions. But the flat tax will do much more than put interest on an after-tax basis. Tax rates on corporations will be slashed—to a uniform 19 percent from the double taxation of a 34 percent corporate rate on top of a personal rate of up to 40 percent. And investment incentives will be improved through first-year write-off. All told, borrowing for investment purposes will become a better deal. An investment boom is likely to occur. As the boom develops, borrowing will rise and will tend to push up interest rates. In principle, interest rates could rise to their prereform levels, but only if the boom is vigorous. We can't be sure what will happen to interest rates after tax reform, but we can be sure that high-interest, low-investment stagnation will not occur. Either interest will fall or investment will take off.

As a safe working hypothesis, we will assume that interest rates fall in the year after tax reform by about a fifth, say from 10 to 8 percent. We assume a quiescent underlying economy, not perturbed by sudden shifts in monetary policy, government spending, or oil prices. Now, take a look at borrowing decisions made before and after reform. Suppose a pre-reform entrepreneur is considering an investment yielding $1 million a year in revenue and involving $800,000 in interest costs at 10 percent interest. Today the entrepreneur pays a 40 percent tax on the net income of $200,000, giving an after-tax flow of $120,000. After reform, the entrepreneur will earn the same $1 million, and pay $640,000 interest on the same principal at 8 percent. There will be a 19 percent tax on the earnings ($190,000), without deducting interest. After-tax income is $1,000,000 - $640,000 - $190,000 = $170,000, well above the $120,000 before reform. Reform is to the entrepreneur's advantage and to the advantage of capital formation. Gains from the lower tax rate more than make up for losses from denial of the interest deduction.

How can it be that both the entrepreneur and the government come out ahead from the tax reform? They don't—there is one element missing from this accounting. Before the reform, the government collected some tax

on the interest paid by the entrepreneur—potentially as much as 40 percent of the $800,000, but, as our stories about leakage make clear, the government is actually lucky to get a small fraction of that potential.

To summarize, the flat tax automatically lowers interest rates. Without an interest deduction, borrowers require lower costs. Without an interest tax, lenders are satisfied with lower payments. The simple flat tax will have an important effect on interest rates. Lower interest rates will also stimulate the housing market, a matter of great concern to almost everybody.

Housing

Everyone who hears about the flat tax, with no deductions for interest, worries about its effect on the housing market. Won't the elimination of the deduction depress the prices of existing houses and impoverish the homeowner who can only afford a house because of its interest deductions? In all but the long run, house prices are set by the demand for houses, because the supply can only change slowly. If tax reform increases the cost of carrying a house of given value, then demand will fall and house prices will fall correspondingly.

If tax reform had no effects on interest rates, its adverse effect on carrying costs and house values would be a foregone conclusion. Inevitably, the prospective purchaser faced with the loss of the interest deduction would have to settle for a cheaper house. Collectively, the reluctance of purchasers would bring house prices down so that the buyers could afford the houses on the market. But, as we stressed earlier, our tax reform will immediately lower interest rates. And lower rates bring higher house prices, a point dramatically impressed on homeowners in reverse in the early 1980s when big increases in interest severely dampened the housing market. The total effect of reform will depend on the relative strengths of the contending forces—the value of the lost interest deduction against the value of lower interest. There are good reasons to think interest rates would fall by about 2 percentage points—say from 10 to 8 percent for mortgages.

We won't argue that tax reform will stimulate the housing market. But we do feel that the potential effects on house prices are small—small enough to be lost in the ups and downs of a volatile market. Basically, reform has two effects—to reduce interest rates and related costs of funds (and so to stimulate housing and other asset markets) and to deny interest deductions (and so to depress housing). To a reasonable approximation, these influences will cancel each other out.

If tax reform sets off a rip-roaring investment boom, interest rates might rise in the years following the immediate drop at the time of the reform. During this period, when corporations will be competing strongly with home buyers for available funds, house prices would lag behind an otherwise brisk economy. The same thing happened in the great investment boom of the late 1960s. But to get the strong economy and new jobs that go with an investment boom, minor disappointments in housing values would seem a reasonable price. In the long run, higher incomes will bring a stronger housing market.

What about the construction industry? Will a slump in new housing accompany a tax reform that banishes interest deductions, as the industry fears? The fate of the industry depends intimately on the price of existing housing. Were tax reform to depress housing by raising carrying costs, the public's interest in new houses would fall in parallel with its diminished enthusiasm for existing houses. Because tax reform will not dramatically alter carrying costs in one direction or another, it will not enrich or impoverish the construction industry.

So far, we have looked at the way prospective buyers might calculate what value of house they can afford. These calculations are the proximate determinants of house prices. But they have no bearing on the situation of an existing homeowner who has no intention of selling or buying. To the homeowner, loss of the tax deduction would be pure grief.

Our transition proposal takes care of the problem of existing mortgages without compromising the principles of the flat tax or diminishing its revenue. Homeowners would have the right to continue deducting 90 percent of their mortgage interest. Recall that the bank would then be required to pay tax on the interest it received, even though interest on new mortgages would be untaxed. Homeowners could expect to receive attractive propositions from their banks to rewrite their mortgages at an interest rate about three percentage points lower, but without tax deductibility. Even if banks and homeowners could not get together to lower rates, the homeowner could still deduct 90 percent of what he deducted before.

CHARITABLE CONTRIBUTIONS

Deduction of contributions to worthy causes would be a thing of the past under our tax reform. Will the nation stop supporting its churches, hospitals, museums, and opera companies when the tax deduction disappears? We think not. But we should also be clear that incentives matter—the current tax system with high marginal rates and tax deductions provides inappropriately high incentives for some contributions. The immediate effect of tax reform may be a small decline in giving. Later, as the economy surges forward under the impetus of improved incentives for productive activity, giving will recover and likely exceed its current levels.

Tax reform will be a tremendous boon to the economic elite from the start. After all, those with high salaries will benefit directly and immediately from the reduction in the tax rate from 40 percent to 19 percent. Those with lightly taxed business income stand to benefit more indirectly. Their economic activities are severely distorted by the devices and activities they have adopted to avoid taxes. Freed from these distortions, they may well become better off even though they are paying more taxes. For both groups, removal of tax deductions from their favorite cultural activities is a reasonable price to pay. With substantially higher after-tax incomes among their customers as well as donors, the universities and other institutions will make up part or perhaps all of the ground they will lose when tax deductions disappear. □

Chairman ARCHER. Mr. Reynolds, you may proceed.

STATEMENT OF ALAN REYNOLDS, DIRECTOR, ECONOMIC RESEARCH, HUDSON INSTITUTE

Mr. REYNOLDS. Thanks.

A tax system that is friendly to economic progress must, number one, impose the lowest possible marginal tax rates on both capital and human capital, and two, be as neutral as possible between savings and consumption. That applies to both of the major proposals we have heard here today. The Nunn-Domenici proposal has high marginal tax rates, so I score it on one of the two criteria not so well.

No economist who is remotely familiar with research or tax policy really denies that either of these flat taxes on a consumption base would improve long-term economic growth. What the usual claim is, they say there is a tradeoff between efficiency and equity and between growth and fairness. It is as though the tax system should hold the economy back in order to make sure that nobody speeds ahead of anybody else. As the Australians like to put it, mow down the tall poppies; don't sow more seed.

The trouble with this idea of sort of playing Robin Hood with the Tax Code is, there is no evidence that it has ever worked. There was an OECD study in 1985 that concluded, "the evidence for almost all countries suggests that the tax overall has relatively minor effects on income distribution." They found zero effect in the United States. Yet any time any proposed tax change is made that would be conducive to savings, any change—capital gains, lower rates, anything—they are routinely dismissed out of hand by income statistics that are quite primitive.

These tax distribution tables that we use are highly misleading, an exercise in partial equilibrium accounting or bookkeeping. At best, even if they could be purged of errors about how do you handle the corporate tax and that sort of thing, they would only show the immediate, most visible impact of tax changes on annual income and ignore completely the longer run impact on lifetime income.

Punitive tax rates on the return from saving must result in capital becoming more scarce relative to labor. When anything becomes more scarce, capital included, it also becomes more valuable. So before tax returns to capital it must rise by at least enough to compensate for the tax.

For example, if lendable funds become more scarce, those who have already accumulated financial assets can command higher interest rates. If fewer apartments are built because of high taxes on rental income, then the landlords can charge higher rents on the remaining apartments. If fewer young people invest time and tuition on advanced degrees, then those who already have those professional credentials can charge higher fees or command higher managerial salaries.

In short, the tax burden on human capital has shifted to labor and, particularly, unskilled labor. When the ratio of capital to labor falls, so also do productivity and real wages.

This was very well explained by CEA member Joe Stiglitz as early as 1978 in his critique of the estate tax, and as also expanded

in his 1988 textbook. I don't quote him simply because he is a Democrat. Some of my best friends are Democrats, including Bob Hall here.

This is Stiglitz' quote, part of it:

> General equilibrium effects have important distributional consequences. A tax on interest may reduce the supply of savings and this, in turn, may reduce the productivity of workers and their wages. A tax on capital may reduce the supply of capital, thereby increasing the return on capital. The degree of inequality may be increased by such a tax. If, as a result of the income tax, skilled workers supply less labor and investment is discouraged, unskilled labor's productivity and hence their wage will decline.

In short, what Stiglitz is saying here is that what passes for soak the rich taxes on capital or on skills, in the static distribution tables and in media articles are really soak the poor taxes in disguise. We have to consider what happens in the long run to the wages of less skilled workers if tax policy makes savings and skills more scarce. There is nothing particularly fair about an economy that is stagflation prone, deeply dependent on the mercy of foreign savers, and is offering inferior job opportunities.

A flat tax, by contrast, will increase the economy's stock of capital and of human capital, will encourage investment in both, and that reduces the relative income shares of those already endowed with those assets. We are spreading and expanding the wealth at the same time while greatly increasing real tax receipts.

Thank you very much.

Chairman ARCHER. Thank you. That is a lot of excellent information. I wish that I could digest all of it at once.

Mr. REYNOLDS. I do have a prepared testimony which I hope you will look at.

Chairman ARCHER. If your prepared testimony is available, it will be inserted in the record without objection.

[The prepared statement follows:]

TESTIMONY OF ALAN REYNOLDS
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Modern developments in economic theory, such as "optimal tax" and "new growth" theories, stress the importance of incentives to economic progress, emphasizing that (1) marginal tax rates must be kept as low as possible on both capital and human capital, and that (2) tax policy should be as neutral as possible between consumption and savings. Unlike the current tax regime, or some proposed alternatives, the Hall-Rabushka "flat tax" meets both criteria.[1]

Empirical research in the nineties has confirmed what economic logic has long suspected. There is no longer any room for reasonable doubt that, as Mendoza and Tesar put it, "a well conceived tax reform can improve the economy's savings, investment, and growth rates and result in sizable welfare gains."[2] That study cited eight others to demonstrate that point. Another survey by Engen and Skinner referred to a dozen more papers supporting their own finding (based on 107 countries over 15 years) that "a ten percentage point tax increase is predicted to reduce output growth by 3.2 percentage points per annum."[3] World Bank economists Easterly and Rebelo looked at evidence going back to 1870 and recent comparisons between 28 countries, finding "a negative association between [economic] growth and . . . the marginal income tax rate."[4] They also found that "about two thirds of the countries in our sample generated less revenue than would be collected by implementing a linear [flat rate] tax with a rate that coincides with the lowest statutory rate."

I have cited numerous other studies in previous testimony before this committee (January 17, 1995) on the importance of marginal tax rates to labor force participation, intensity of work effort, and investment in human capital (education and training).[5] Work and education incentives are strongly affected by high marginal tax rates resulting from the loss of transfer payments if incomes rise, as well as from the tax code *per se*.[6] Researchers at the IMF, for example, estimate that "an increase of 1 percentage point in either consumption or labor income taxes may induce a reduction in the hours of work between ½ and 1 ½ percentage points."[7]

Skepticism on this power of tax policy to improve the quantity and quality of labor and capital is now largely confined to a few agencies advising Congress and the Executive branch, such as the Congressional Budget Office, Congressional Research Service, Council of Economic Advisers and U.S. Treasury. Economists at these agencies cannot deny that lower marginal tax rates are quite likely to improve capital formation and work incentives. Instead, they typically engage in a highly selective review of obsolescent studies (e.g., neglecting most or all of the recent work just mentioned) in order to insinuate that any beneficial effects from lower marginal tax rates on labor and savings are highly uncertain and not worth the trouble of estimating.[8] The inference that Congress should not act in the absence of a total "consensus" among economists amounts to saying that Congress should never do anything (because there will always be a few stubborn or ill-informed economists).

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[1] The Nunn-Domenici "USA Tax" imposes extremely high *marginal* tax rates at quite modest income levels, on both labor income and returns on savings, though amounts saved would be exempt.

[2] Enrique G. Mendoza & Linda L. Tesar, "Supply Side Economics in a Global Economy," National Bureau of Economic Research [NBER] Working Paper No. 5986, April 1995.

[3] Eric M. Engen & Jonathon Skinner, "Fiscal Policy and Economic Growth," NBER Working Paper No. 4223, December 1992.

[4] William Easterly and Sergio Rebelo, "Fiscal Policy and Economic Growth: An Empirical Investigation," paper presented to a World Bank conference, Washington D.C., February 8-9, 1993.

[5] Another even newer example of this large body of evidence is Nada Eissa, "Taxation and Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experiment," NBER Working Paper No. 5023, February 1995.

[6] Marginal tax rates of 49-75% for most recipients of the Earned Income Tax Credit are a serious disincentive to work, but would be alleviated by the enlarged personal exemption under a flat tax. See Edgar Browning, "Effects of the Earned Income Tax Credit on Income and Welfare," *National Tax Journal*, March 1995, and John Karl Scholz, "The Earned Income Tax Credit" *National Tax Journal*, March 1994.

[7] E. Mendoza, A. Razin & L. Tesar, "An International Comparison of Tax Systems in Industrial Countries," *Staff Studies for the World Economic Outlook*, IMF, December 1993, p. 101.

[8] In a paper presented to the National Tax Association, Arlington VA, May 22, 1995, Jane Gravelle of the Congressional Research Service says a 1987 paper by Mroz "suggests that errors in statistical techniques *may* be responsible for large responses [of female labor supply to tax rates] found in many previous studies." As Triest points out, "it is important to recall that Mroz's results apply only to [hours worked by] working women," *not* to whether or not marginal rates affect the decision to work. Robert K. Triest, "The Efficiency Cost of Increased Progressivity," in Joel Slemrod, ed., *Tax Progressivity and Income Inequality*, Cambridge University Press, 1994, p. 142.

This sort of appeal to ignorance is often buttressed by faulty theoretical speculations. It is often said, for example, that people may decide to work less, rather than more, in response to lower taxes, because they could have just as much after-tax income as before with less work. However, that argument confuses a revenue-neutral reduction in *marginal* tax rates with a revenue-losing "tax cut" that is unrelated to productive behavior. If average tax burdens remain the same while marginal rates decline, any "tax cut" applies only to *increases* in income (e.g., from saving or improving skills). If a majority of people worked less and/or saved less, the economy would produce less real income per person, leaving no possibility for a so-called "income effect" for the economy as a whole.[9]

Partial Equilibrium Revenue Estimates

> The information and advice that policy makers receive often ignores valuable lessons that academic research, and indeed very basic economic reasoning, can provide. . . . There is little rationale for discarding partial information in favor of ignorance.[10]

The misinformation that Congress often has to cope with is most mischievous in the case of partial equilibrium analyses of the effect of tax changes on revenue and income distribution. In the process of drafting 1986 Tax Reform Act, for example, faulty estimates of revenue and tax incidence led to the notion that lower marginal tax rates on labor income must be offset by higher tax rates on the returns to capital -- pension contribution, profits and capital gains. Yet revenue growth turned out to be unexpectedly rapid where tax rates were reduced (the individual income tax) and surprisingly disappointing where tax rates were increased (corporate profits and capital gains). In this case and many others in the eighties (e.g., passive loss provisions, alternative minimum taxes for corporations), estimated revenues from highly inefficient "tax increases" were greatly exaggerated, if not invisible, due to inadequate consideration of behavioral responses.[11] After two seemingly large increases in marginal tax rates on upper-income individuals, enacted in 1990 and 1993, revenues from the individual income tax fell from 8.6% of GDP in 1989 to 8.2% in 1994.

> To avoid accounting for behavioral savings and labor supply responses when making policy forecasts . . . cannot be justified based on existing studies.[12]

In the process of estimating revenues (and also of estimating the *distributional* effects of tax changes), it is *always* assumed that tax policy has no effect at all on real GDP, labor supply, savings, interest rates, stock prices, capital flows, exchange rates, or any other "macroeconomic" variables. Although revenue estimators have begun to include a few *micro*economic behavioral responses (such as capital gains realizations), no microeconomic efficiency gain or loss is ever permitted to have any effects on the overall economy, or even on the extent of tax avoidance. For such reasons, revenue estimates *always* exaggerate gains from higher tax rates, and *always* exaggerate losses from lower tax rates. The reasons for these systematic errors go far beyond the question of whether the estimates are static or dynamic. Although revenue estimating procedures remain unduly secretive (the mysterious "black box" technique), they do not appear to ask even the most obvious questions -- such as the impact of estate planning on receipts from the income tax, the impact of corporate taxes on debt-equity ratios (leverage), or the impact of capital gains taxes on asset values and national wealth.

When estimating what tax rate would be needed under a flat tax, even proponents of such a reform adopt the usual "static" procedure. That is, they start with some recent measure of *existing* labor and business income, subtract exemptions and business deductions, and then calculate what average rate on the remaining tax base would yield as much revenue as current taxes on incomes and estates. This technique wrongly assumes that the amount of income earned and reported would be no higher

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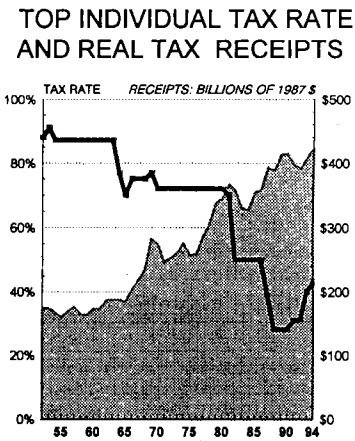
[9] Alan Reynolds, "Marginal Tax Rates" in David R. Henderson, ed., *The Fortune Encyclopedia of Economics*, Warner, 1993.

[10] Alan J. Auerbach, "Public Finance in Theory and Practice," *National Tax Journal*, December 1993.

[11] Alan J. Auerbach, "Tax Projections and the Budget: Lessons from the 1980s," NBER Working Paper No. 5009, February 1995.

[12] William C. Randolph & Diane Lim Rogers (Congressional Budget Office) "The Implications for Tax Policy of Uncertainty About Labor Supply and Savings Responses," paper presented at the National Tax Association, Arlington VA, May 22-23, 1995.

than it is now. A huge body of research on the behavioral response to taxation tells us with great certainty that the assumption of unchanged income is incorrect. A *maximum marginal tax rate of 20% or less is going to result in a very significant increase in the amount of money income that is reported* for tax purposes.[13] Part of that increase will be due to reduced tax avoidance, and from a shift into cash income and out of perks, stock options and deferred compensation schemes. Some additional increase in the tax base will be due to increased work, savings and investment.[14] There is some controversy over which effect is most important, but there is no doubt at all that the tax base of both individual and business income taxes will expand as the marginal tax rate falls.



Tax Foundation; OMB; Historical Statistics of the U.S.

Figure 1

If "static" estimates conclude that a 19-20% tax rate would be revenue neutral, the reality is that such a rate would actually result in a very substantial increase in real tax receipts over time. As Figure 1 shows, past reductions of high marginal tax rates on individual income (1965-68 and 1982-89) were followed by sustained increases in real receipts from this tax (and other taxes), while periods of higher tax rates (1952-64, 1969-70 and 1990-94) saw little or no lasting increase in real receipts.

Figure 2 shows a similar pattern for the capital gains tax, with real receipts rising whenever the marginal rate fell, and vice-versa.

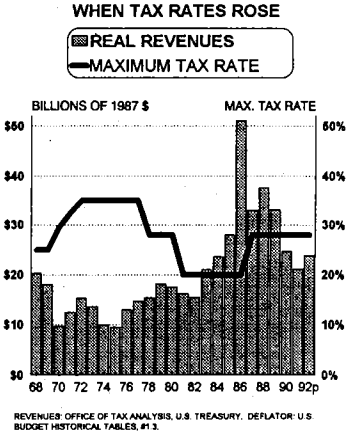


Figure 2

Increases in revenue resulting from a reduction of deadweight losses (such as not trading securities to avoid capital gains tax) or implicit taxes (such as accepting the lower return on tax-exempt bonds) are welcomed by taxpayers. The top 1% gladly paid 27.6% of all federal income tax in 1988, up from 17.9% in 1981. Nobody will gain when "the rich" now pay a shrinking share of taxes in response to the 1993 increase in tax rates. "If, for example, a taxpayer responds to reductions in the marginal tax rate on wages by increasing taxable wage income (e.g., by spending more hours in paid work, or bargaining for a higher share of cash wages in total compensation), then this response increases taxes paid and is also associated with an increase in the taxpayer's well-being."[15]

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[13] Martin Feldstein, "The Effects of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act," NBER Working Paper No. 4496, October 1993.

[14] Hall and Rabushka estimate, quite conservatively, that added work effort and capital formation would raise real GDP by 5-7% within a few years. For any given average tax rate (typically around 19% of GDP), *real* tax receipts would rise by a similar amount, even aside from reduced evasion and substitution of cash income for perks, stock options and the like. Robert Hall & Alvin Rabushka, *The Flat Tax*, Hoover, 1995, pp 86-87.

[15] Richard Kasten, Frank Sammartino & Eric Toder, "Trends in Federal Tax Progressivity, 1980-93," in Slemrod, *op. cit.*, p. 35.

A static approach to estimating a national sales tax suffers the opposite miscalculation from that affecting the flat tax. While static revenue estimates are sure to *over*estimate the tax rate required under a flat tax on labor income and business capital, the same techniques are very likely to *under*estimate the flat rate that would be required on sales. Any additional tax on sales would certainly *reduce sales* and thus shrink the tax base, requiring a substantially higher tax rate than would be assumed by calculating a percentage of today's sales, in the absence of that tax. Since exports are excluded from taxation, any increase in the ratio of exports to GDP would further shrink the base of a sales tax and require a still higher tax rate on domestic consumers. High rates of sales tax, even VAT, are also notoriously prone to smuggling and "bootlegging" (offering a lower price for cash, with no receipt). It is instructive that when Mexico increased the VAT from 10% to 15% in 1995, the tax was left at 10% near the border to avoid losing sales and revenues to the U.S.

The flat tax, by contrast, is as leakproof as can be imagined. Under current law, employers deduct the cost of benefits but employees do not pay taxes on those perks (17% of compensation). Corporations deduct the cost of interest paid, but corporate bonds and commercial paper are often held by tax-exempt institutions or foreigners, who pay no tax on the interest income. Two huge and growing loopholes are effectively closed by applying a low flat tax to gross business income, minus only the cost of wages and capital equipment. The taxation of benefits at the employer level and reduction of marginal tax rates on employee salaries would reverse the trend of negotiating for overly-generous medical benefits, making the flat tax the most cost-effective health reform proposal ever devised. Although the *individual* income tax is conceptually equivalent to a consumption tax, the flat tax on business cash flow is more comparable to a profits tax. And because perks and interest expense are not deductible, the flat business tax is far more *inclusive* than the present tax on business profits (albeit at a lower rate and with expensing for capital).

> The uniformity of [flat] marginal tax rates . . . means that income can be taxed at its source; taxing income at its source will reduce compliance costs and increase compliance rates. . . . Many of the advantages of a flat-rate tax come only from a pure flat-rate tax, not from its modified form. . . . Nick Stern, of the London School of Economics, calculated that the . . . optimal flat-rate tax was 19 percent. . . . Jerry Hausman of M.I.T. claims that by introducing a flat-rate tax, it may be possible to lower the tax rate facing almost all income groups, because the reduction in the distortions would generate such a large increase in labor supply[16]

Alternative proposals for replacing individual and corporate income taxes with a national sales tax do not include *any* direct tax on business income, as the flat tax does. As a result, the sales tax rate would have to be much higher on labor in order to totally exempt income from capital. There would also have to be extremely stern inspection of imports and exports, and of retailing (including flea markets, garage sales and sales of used cars).[17]

Distribution Tables Ignore Tax Shifting

It is unfortunate that tax policy changes that would improve incentives to add to savings or labor income are often blocked by opinions and statistics that give a highly misleading impression about who is really hurt by high tax rates that ostensibly fall on "the rich." There have been complaints, for example, that taxpayers earning more than $100,000 would receive 52% of the benefits from the recent House tax bill.[18] This is scarcely surprising since 43% of all individual income taxes are paid

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[16] Joseph E. Stiglitz, *Economics of the Public Sector*, Norton, 1988, p. 619.& 489. See also why "it may be desirable to have a flat-rate tax" on p. 502, and why a flat rate tax is politically more stable on p. 160n.

[17] "The general view among experts, a view obviously shared by most governments, is that 10 percent may well be the maximum rate feasible under a retail sales tax." Vito Tanzi, *Taxation in an Integrating World*, Brookings Institution, 1995, pp. 50-51.

[18] Steven Pearlstein, "Widening the Income Gap: Tax, Spending Cuts May Add to Inequality," *The Washington Post*, May 29, 1995. An accompanying chart shows that the 22% of families earning more than $75,000 receive 50% of pretax income, which is just another way of saying they produce 50% of national output.

by the 4% of tax returns reporting incomes above $100,000.[19] A distribution-neutral tax reduction, which returned taxes in the exact proportion paid, would undoubtedly be attacked as conferring 43% of the benefits to "the rich," and doing nothing for those who pay no taxes. Any change in the tax code designed to improve savings is bound to be most helpful to those who save. And those who save are bound to have higher incomes later in life (e.g., dividends, interest income, and capital gains) than those with similar salaries who do not save. Any proposal that hopes to increase saving without benefitting those who do most of the saving is sure to fail.

What is most misleading about the typically emotional, non-analytical popular discussions of the "fairness" issue is the failure to consider *what happens to wages of less-skilled workers if tax policy makes savings and skills more scarce than otherwise*. There is nothing particularly "fair" about a stagnant economy with inferior job opportunities.

The official "distribution tables" that play such a big role in tax policy debates are fundamentally flawed -- to the point of being essentially meaningless. This is not a question of doing a better job with constructing such tables, but of discarding them as unrepairable. The whole concept of distribution tables does not even begin to ask the right questions, so it cannot possibly lead us to the right answers. It is simply an effort to substitute bad accounting for good economics. Even the unquestioned habit of dividing "families" into, say, the highest and lowest fifths of the income distribution is quite suspect when the income floor defining the top 20% is rising because of a larger portion of families earning higher incomes (see Appendix A).

Distribution tables involve many dubious technical problems, such as arbitrarily deciding what share of the corporate tax to assign to labor or to capital (some tables used in the 1986 tax reform debates totally ignored the corporate tax), or how to "impute" the rental value of homes. Arbitrary assumptions, however, are the least of many problems making distribution tables quite useless.

A more serious problem is that annual incomes are a notoriously poor measure of longer-term living standards, or lifetime income. The group with the lowest income in any single year includes, as Fullerton and Rogers point out, "some young workers just starting their careers who will likely earn more later, some retirees who had earned more earlier, [and] some people with volatile incomes who just had a bad year . . ." They found that if you label the top 30% of the population as rich, and the bottom 30% as poor, then *13.8% of those who appear to be poor in any given year will actually be rich over their lifetimes*, while 2.6% of the annually rich are actually poor.[20] Many of today's "poor" are just young people who are trying very hard to become tomorrow's "rich." *High marginal tax rates on the returns to schooling and saving make climbing the income ladder very difficult for newcomers, greasing the rungs on the ladder of opportunity.* Looking at taxes from a lifetime perspective also shows that any consumption-based tax (e.g., the individual flat tax or a single-rate VAT) is proportional, not regressive, because lifetime income is virtually identical to lifetime consumption for most people (the difference is bequests, which make consumption a better tax base than income, because heirs can consume in excess of income by tapping wealth).

Another issue likely to be ignored by any distribution tables is how to account for the very real savings from making the tax code extremely simple. With a flat tax, taxpayers are going to save real money and valuable time -- perhaps $200 billion a year or more -- from not having to keep complicated tax records, buy tax books and software, and hire accountants and tax attorneys. How should that benefit be distributed among income classes?[21] The biggest savings go to those with the most complicated tax forms, but that includes many small businesses and small investors. The biggest losers from tax simplification are an affluent bunch -- lawyers, accountants and tax lobbyists -- but their skills could usually be adapted to more productive pursuits. *All* taxpayers benefit from reduced collection costs. The IRS staff and budget could be greatly reduced and many offices leased or sold.

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[19] The top 4% of tax returns paid 43% of federal income tax in 1993, according to Associated Press calculations But note that the percentage of *tax returns* with incomes above $100,000 is much smaller than the percentage of working people with incomes that high, because millions of people pay *no* income tax, while most joint returns with incomes above $100,000 have at least two full-time salaries per tax return.

[20] Don Fullerton & Diane Lim Rogers, *Who Bears The Lifetime Tax Burden?*, Brookings Institution, 1993, pp. 2 & 26.

[21] I am indebted to Alvin Rabushka for raising this question.

The most fundamental problem with distribution tables, however, is that the longer-run "incidence" of high marginal tax rates on savings and human capital -- who is actually hurt -- is quite different from what the general public has been lead to believe. Distribution tables are an inherently misleading exercise in "*partial equilibrium*" accounting, representing only the *immediate*, most visible impact of tax changes on annual incomes, and totally ignoring the longer-run effects on lifetime incomes.

> Changes in labor supply, savings and investment . . . would affect wage rates and interest rates, which in turn feed back to employment and savings decisions, and then in turn to wage rates and interest rates. . . . It requires a "general equilibrium" model to account for all these effects.[22]

High tax rates on the returns from saving (such as dividends, interest income and capital gains), or on stocks of accumulated capital (estates), must result in capital becoming more scarce, relative to labor. This may even happen fairly quickly, due to "capital flight" to other countries. *When anything becomes more scarce -- including capital or exceptional skill -- it also becomes more valuable.* Before-tax returns to capital rise by at least enough to compensate for the tax, leaving after-tax returns unchanged or higher in the long run (partly because net returns to capital have to be competitive with returns available on international markets).

The ways in which capital taxes raise the pre-tax return to capitalists may be thought of in terms of physical capital (if apartments become more scarce, landlords charge higher rents), or as financial capital (if lendable funds become more scarce, those who have accumulated savings can charge higher interest rates). The main point is that those who already own increasingly scarce capital do not bear the tax in the longer run. In the short run, capital taxes fall more heavily on those who are trying to acquire capital, such as young people trying to start a business or buy a house. The ultimate burden of capital taxes, however, is clearly on labor. *When the ratio of capital to labor stops growing, so do productivity and real wages*

The idea that capital taxes are likely to be shifted to labor should not be surprising to anyone familiar with general equilibrium economics. The point was stated most clearly by Joseph Stiglitz many years ago, in his classic critique of the estate tax:

> The reduction in savings and capital accumulation will, in the long run, lead to a lower capital-labor ratio; and the lower capital-labor ratio will . . . lead to an increase in the share of [national income received by] capital. Since income from capital is more unequally distributed than is labor income, the increase in the proportion of income accruing to capital may increase the total inequality of income.[23]

Stiglitz generalized this important point in his 1988 textbook, *Economics of the Public Sector*:

> General equilibrium effects have important distributional consequences . . . A tax on interest may reduce the supply of savings and . . . this in turn may reduce the productivity of workers and their wages. . . . A tax on capital may reduce the supply of capital, thereby increasing the return to capital . . . the degree of inequality may actually be increased by such a tax. . . .
>
> If as a result of the income tax, skilled workers supply less labor and investment is discouraged, unskilled laborers' productivity and, hence, their wage, will decline.
>
> The long-run incidence of a tax on savings (or capital) may be on workers.[24]

In short, what appear to be "soak the rich" taxes on capital or skills (in static, partial equilibrium distribution tables) may well turn out to be "soak the poor" taxes in disguise. This general equilibrium result applies to taxes on estates, capital gains, dividends, and high marginal rates in general.

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[22] Jane G. Gravelle, "Behavioral Feedback Effects and the Revenue Estimating Process," *op. cit.*

[23] Joseph E. Stiglitz, "Notes on Estate Taxes," *Journal of Political Economy*, April 1978

[24] Stiglitz, *Economics of the Public Sector*, op. cit., pp. 393, 493 & 430.

A similar mechanism is at work with high tax rates on *human* capital. Today's steep marginal tax rates on joint returns with incomes above $140,000 are, to a considerable extent, aimed at reducing the return on past investments made in MBA, MD, JD and PhD degrees. The trouble is that fewer people will invest so much time and tuition in higher education in the future if they believe they will face punitive tax rates later, when they finally reap the rewards at mid-life. Trostel estimates that a 1% increase in tax rates eventually leaves the economy with nearly a 1% smaller stock of human capital, with a much stronger effect if marginal tax rates are "progressive" (thus falling most heavily on returns to advanced schooling).[25] Proposed deductions for tuition do not address the main incentive, which is the after-tax *return* on schooling, not the up-front cost. The main cost of schooling is time spent not working. Moreover, a tuition deduction would be useless to less affluent students who pay their own way (through scholarships, loans and work), because they rarely have enough taxable income to benefit from a deduction.

Just as tax-induced scarcity of capital results in the tax burden falling on labor, in the form of lower wages, tax-induced scarcity of human capital is shifted to consumers. Scarce professionals charge higher fees, and scarce managerial talent can command higher salaries. Although the full impact of discouraging investment in human capital may not be felt for a generation, some occurs more quickly through reduced immigration of high skilled and talented people, and increased emigration of such people ("brain drain"). Talent may also be diverted from highly-taxed productive activity toward "underground" activities or rent-seeking (lobbying for government favors, such as import quotas).

Because high tax rates on highly skilled people tend to make skills *relatively* scarce and thus raise *before-tax* incomes for those who already possess such skills, Stiglitz has speculated that a flat tax (though a very big improvement) might not be flat enough:

> If the labor supply of the skilled is relatively elastic, and of the unskilled relatively inelastic, then a uniform [flat] marginal rate on both might increase the before tax relative wage of the skilled; to offset this, one might wish to have a lower marginal tax rate on the skilled.[26]

General equilibrium theory predicts that *as a result of the tax-induced relative scarcity of skilled people, before-tax salaries and fees in skilled occupations will be bid up.* An increased supply of people with professional and managerial skills, by contrast, "places downward pressure on the return to skills, easing, rather than exacerbating, distributional concerns."[27] Ironically, punitive tax rates on "the rich" (i.e., on savers and on human capital) go a long way toward explaining why the distribution of *before-tax* incomes has become less equal in every major "welfare state" of Europe and North America, but not in most Asian NICs, where marginal tax rates are quite low (particularly on capital).

It is not easy to earn a high income. Steeply rising marginal tax rates have a demoralizing impact on those who might otherwise make that difficult struggle, thus making capital and skills artificially scarce and valuable.

By increasing the incentive to save, and to invest time and money in education and training, a flat tax would enlarge the economy's stock of capital and human capital, thus reducing the relative income shares of those who are already endowed with such assets, while increasing real tax receipts and enlarging national wealth in the process.

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[25] Philip A. Trostel, "The Effect of Taxation on Human Capital," *Journal of Political Economy*, April 1993.

[26] Joseph E. Stiglitz, "Pareto Efficient and Optimal Taxation," in Alan Auerbach & Martin Feldstein, eds., *Handbook on Public Economics*, North Holland, 1988.

[27] Mary E. Lovely, "Economic Development in a Global Context," National Tax Association, Arlington VA, May 22-23, 1995.

Appendix A: Income Distribution Statistics Are Fatally Flawed

The 1994 *Green Book*, from the House Ways and Means Committee, shows "average family cash income by family type and income quintile" (Table H-23) for 1973, 1979, 1989 and 1992. The figures for married couples with children are less misleading than total family income, because unmarried mothers have been a rising percentage of all families, making comparisons of family income invalid over long periods of time.

The choice of years is less than ideal, because 1973 and 1979 were cyclical peaks, followed by inflationary recessions that hurt the poor quite badly. Price controls in 1973 also understated measured inflation and thus overstated real incomes. Because inequality always increases in recessions, it would be more reasonable to compare 1992 with other years just after recession, such as 1976 or 1983.

There are many problems with Congressional Budget Office adjustments to Census figures. The CBO includes things that are not real income (realized, nominal capital gains) and excludes things that are (in-kind transfer payments). As a result, "CBO shows income falling in the bottom two quintiles [from 1980 to 1993], while Census shows income rising."[28] Also, any annual snapshot of income ignores wealth and is a poor measure of actual living standards; using consumption or an average of income over several years shows far more "equality" than annual income data.

Taking these figures at face value, with all their flaws, still does not show what many people suppose.

Among married couples with children, the mean average of cash income in the top fifth rose by 16% from 1973 to 1992, which many interpret as proof that "the rich got richer." This is incorrect. Aside from the top 20% (or 1% or 5%) of the income distribution, every other "fifth" has both a floor and a ceiling (the maximum is obviously unlimited at the top). The income floor defining the top 20% is determined by income growth at lower income levels.

As Figure 3 shows, the percentage of families earning more than $50,000 a year (in constant 1992 dollars) rose sharply from 1980 to 1989, and remained fairly high in 1992. The much discussed "vanishing middle class" has been precisely matched by a rising percentage of families earning what had previously been considered a high income.

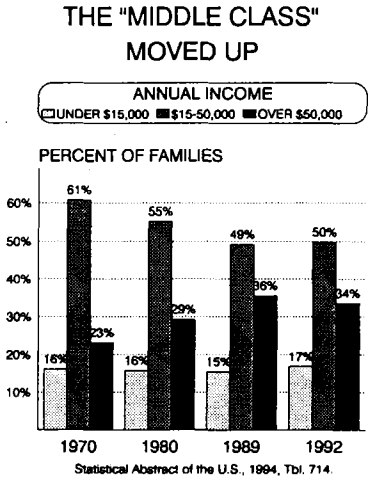


Figure 3

One result of so many more families earning relatively high incomes was to push up the minimum income needed to be counted among the "top 20%." According to the Green Book, the amount of income needed to make it into the top fifth rose from $52,937 in 1973 (measured in 1989 dollars) to $60,895 in 1992. We should scarcely be surprised that a mean average of all income above $60,895 is larger than the average of all income above $52,937. The average in 1992 was 16% larger than it was in 1973 in large part because the floor had been raised by 15%. Since the 1992 average excludes all income between $52,937 and $60,895, while the 1973 figures include those lower incomes, the average had to increase substantially. The "top fifth" turns out to be a moving target.

[28] William G. Gale, "Comments," in Joel Slemrod, ed., *Tax Progressivity and Income Inequality*, Cambridge, 1994, pp. 51-57.

Whenever real wages and salaries are rising, the incomes of those who work are bound to gain relative to those on relatively fixed "cash" incomes (as opposed to in-kind incomes, such as Medicaid and food stamps), including welfare mothers who now dominate the bottom fifth. Comparisons of average real incomes between the top fifth (where the average number of workers exceeds two), and the bottom fifth (where the average number of full-time, full-year workers is close to zero) must necessarily show widening "inequality" whenever employed people are receiving any pay increases that exceed inflation -- unless cash transfer payments are also rising in real terms.

Since there is no ceiling on the income included in the top 20% or 1%, dividing all income above the rising floor by a fixed percentage of the population will necessarily show an increase in mean income in that group whenever a rising percentage of families are earning higher real incomes, thus pushing up the minimum amount of income needed to be counted among the top group. This flaw is fatal. It means that the whole exercise of comparing real income growth by fifths is a statistical hoax.

Appendix B: Attempting To Use Tax Policy To Favor Exporters

One argument in favor of a value-added or retail sales tax (over an income tax that exempts income saved or returns from saving) is that GATT rules would allow such a tax to be rebated when goods were exported. This is supposed to favor exports and thus reduce the U.S. trade and current account deficit. In reality, the current account deficit would decline only if the sales tax proposal was more effective in promoting savings than in encouraging investment (i.e., if U.S. savers invested abroad).

Suppose it was feasible to impose, say, a 16% sales tax on all goods and services. Like any other price increase, this tax would indeed reduce demand for imports, but it would equally reduce demand for domestic products. Rebating the tax at the border (a very costly procedure) would not make U.S. exports any cheaper than they are today, because they do not bear such a tax at the present time.

Because the larger domestic market would shrink as a result of the sales tax, the incentive to invest in capacity for domestic sales would be reduced. Businesses would tend to shift production toward exports -- e.g., making more cars with right-hand drive and fewer with left-hand drive. If the U.S. was operating close to capacity, however, shifting output toward exports would require that a larger share of domestic demand be filled by imports. The U.S. might export more Hondas from Ohio, but also import more Fords and Chryslers from Canada and Mexico.

The U.S. has a chronic current account deficit because savings have been inadequate to finance investment. That investment-savings gap (about $160 billion last year) is filled by an inflow of foreign capital from private investors and/or foreign central banks, so long as they are willing to accumulate dollar-denominated securities and real property. *The impact of any tax reform proposal on the capital surplus and matching current account deficit ultimately depends on its impact on savings and investment.* The flat tax encourages investment through low tax rates on the returns, and through treating purchases of capital equipment no differently than wages (both are immediate expenses). The flat tax also encourages savings by eliminating the double taxation of dividends and triple taxation of capital gains and estates. In my judgement, the longer-run effect on savings is likely to be larger, thus reducing the need to finance investment with foreign savings.

In the short run, though, the value of U.S. stocks, bonds and nonresidential property would undoubtedly rise, reflecting the discounted present value of the reduced marginal tax on returns to capital. Such a bull market would attract considerable foreign investment for a few years, pushing the dollar up (as happened with the capital-friendly tax reform of 1981). The Fed could prudently limit the potentially deflationary impact of the rising dollar by accommodating the demand for dollars at lower interest rates (long-term rates would fall anyway, due to elimination of the "tax premium," making all bonds and mortgages equivalent to tax-exempt bonds). The medium-term effect of a flat tax will be a dramatic increase in U.S. wealth, a reduction of interest rates, and a roaring boom in business investment, tax receipts, domestic savings, and inflows of foreign savings. In the longer run, as the capital stock expands toward a new equilibrium -- increasing capacity to meet both domestic and export demand -- added domestic savings and wealth will begin to displace capital inflows, pushing the current account toward surplus.

Chairman ARCHER. There are so many things I would like to ask you because I think both of you are great resources to this Committee, and we would like to continue to work with you in the months ahead so that we can get your input to try to resolve the best alternative to accomplish the goals that all of us want to see happen.

I am a little bit curious about your comment, Dr. Hall, about border adjustability. I don't have the expertise of an economist like you. I have a business background, and I think some degree of common sense, but certainly not the degree of expertise that you have on economic issues.

If I am able to produce a product in my business and by some fell swoop reduce the price of that product by 15 to 20 percent, so that suddenly I am able to export it for 15 to 20 percent less than what I was charging in the last month, how does that increase the value of the dollar?

Mr. HALL. Well, the dollar, Mr. Chairman, is a price in this instance that is determined relative to other currency, for example, the German deutsche mark in a fluid market. In that market, the value that Germans get for the deutsche mark in exchange for dollars is determined every few minutes and is driven very much by their opportunities to purchase. If suddenly American goods are much cheaper to Germans and, correspondingly, German goods more expensive to Americans because the counterpart border adjustment says that we tax the imports at the VAT tax rate as they come in, and say it is a 20 percent tax rate, then the exchange rate can change by 20 percent instantaneously and leave us where we were before.

That is precisely what will happen. That is what happened, for example, in the British experience.

Chairman ARCHER. I am not speaking now in my hypothetical example of border adjustability of a tax. I am just speaking about the price of my product that I am able to sell now because I have been able to eliminate a certain expense in my operation; therefore I am more efficient, and therefore I am able to sell that product at a 15 to 20 percent lower price.

What I worry about in the macroeconomic description that you give to all of this is that if that is true, then we don't have to worry about countries that have cheaper labor rates that can produce a product that is cheaper, because the currency exchange rates will take care of all that and there is no problem. And I don't think the real, practical, day-to-day economic world works that way.

If, for example, it was going to be taken care of as you say, then when we went through this massive increase in the price of oil in the seventies, the exchange rates would have taken care of that and it would not have had any impact. The relative price of products between what our selling price is as we go overseas and what the price of the incoming foreign product is when our consumers have to purchase it, it seems to me, have not historically been offset. Changes in those relations have not been offset by the value of the currencies.

Let me add one other thing, and maybe this is overly simplistic, but if in fact by border adjustability removing the expense of government, which is an expense of doing business, from the price of the product when we sell it is going to increase the value of the

dollar, don't we need a more stable, more valuable dollar today? Would that not help us? All the complaints I hear from economists today is that the dollar is too soft. We have been talking about artificial means to bolster it and to improve its value.

Mr. HALL. You have raised some very interesting questions. On the last point, I would certainly not be one to say that we should try to do something artificial to the dollar. The mechanism that I described——

Chairman ARCHER. I am not suggesting we should either. But if we had border adjustability in the price of our products and the result was that the dollar improved in value, it seems to me we would be reaching for a goal that right now most economists I have talked to believe would be healthy.

Mr. HALL. Well, it would be a very artificial way to do it, because if we put in border adjustment and then appreciation of the dollar occurred, that would leave us back where we are today. It would just be an artifact of that change that the dollar is worth 20 percent more. It wouldn't really mean anything because when we try to purchase something with those dollars, they turn out to be worth what they used to be worth because we now have to pay a 20 percent import duty that we didn't used to have to pay. So the purchasing power of our dollars in the world market is exactly the same, and that is why the change occurred in the first place.

The other question you raised was, for example, when oil becomes more scarce, as it did when OPEC cut back oil production. There is no way that an exchange rate by itself can deal with the scarcity. Border adjustment doesn't create any scarcity, doesn't affect supply or demand of anything. It is something that can just be immediately accommodated by exchange rates.

On the other hand, when there is less oil being produced, that is something that makes us worse off as an oil consumer, and there is nothing that exchange rates can do. So there is no suggestion here that exchange rates completely insulate us from the world market. That would be impossible. But they do completely offset the effect of border adjustments.

Again, I want to stress I am not against border adjustments. They don't have any harmful effect. It is a neutral issue. I just want to caution anyone against the notion that somehow the U.S. position in the world economy would be different if we had border adjustments as opposed to not having border adjustments. To economists, it is a nonissue. It is not harmful, but it is a nonissue.

Chairman ARCHER. Thank you very much for your response to that.

I had a colloquy with my friend Jack Kemp earlier today, and he said that there is no way that his commission—at least he is reported to have said, and he somewhat confirmed it today—that his commission would recommend a value-added tax and you have described the flat tax that Dick Armey introduced as a VAT tax. Where does Mr. Kemp go?

Mr. REYNOLDS. Maybe I should answer that. I will probably be the research director on his commission.

A lot of this has to do with the way you describe things. Consumption is the base of all the taxes we are talking about in the sense that we are exempting savings, so by definition, that is a con-

sumption tax. That is sort of the sense in which he means, it is much like a value-added tax.

The business portion of—I would not describe the business portion of Hall-Rabushka as a VAT, although that is the portion most would call a VAT. The other part, I certainly would call a consumption-based income tax or an income minus savings tax. The returns from savings at the individual level are gone and the returns from savings at the business level are taxed. One of the biggest loophole-plugging parts of it is that business can no longer deduct interest expense, so leverage is no longer a way to escape business taxation.

I wouldn't worry much about the terminology. We will come up with a good plan and will certainly look at anything you have prepared, or any of the other congressmen who have talked about a consumption tax. Whether a tax is explicitly levied on what we buy as opposed to what we earn is a rather subtle distinction in an economist's mind because all taxes fall on individuals as workers or suppliers of capital. So where we collect it is an issue, but not a critical issue, and it shouldn't be as divisive an issue as it has become.

Chairman ARCHER. I hope that your counsel will be accepted and heard by the members of this commission, because I think that the points that you are making are extremely important.

We could go on forever on this. I am going to recognize Mr. Christensen for inquiry.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. I have one quick question. Yesterday, late in the day, we heard a panel, all four pretty much agreed that a consumption tax would not go after the underground economy as we have been saying it would.

Mr. Reynolds, what is your take on that? What would they base their opinion on?

Mr. REYNOLDS. They seem to equate the underground economy with drug dealers and that is probably a pretty small piece of the puzzle. There is avoidance and evasion by even sophisticated people wearing business suits that testify before this Committee. I wouldn't know of any people like that, but for example, I increased my mortgage, increased my deferred compensation, switched from NASDAQ stocks to munis when this Congress increased the marginal tax rate to 36 percent. This is all perfectly legal tax avoidance strategy.

How do any of these proposals affect that? You are lowering my marginal rate, so I have less incentive to do that sort of thing. When the marginal rate was 28 percent, I didn't even keep records of my business lunches and things of that sort. So really you are getting at the incentive.

There is enormous evidence that tax evasion activity is highly responsive to the tax rate involved. This isn't true of illegal activities, but the sales tax is not going to fix that. You are not going to report the sale of an illegal drug any more than you are going to report the income from it. That is, I think, a poor way to sell that proposal. There will be avoidance of sales with a high sales tax and there will be avoidance of income with a high income tax, and our task is to keep the tax rates down to minimize either type of avoidance.

Does that help?

Chairman ARCHER. Not really. Will you yield to me briefly?

Mr. CHRISTENSEN. Yes.

Chairman ARCHER. It seems to me in that equation you leave out one aspect. It is true that the sale of the drug would not be subject to the tax because it is still illegal and underground, but the proceeds from the sale of the drug, when spent by the recipient of those proceeds, is going to bear a share of the cost of government. If the person who is pushing the drugs illegally gains the money from the sale and buys a Mercedes, they are going to pay a share of the cost of government; whereas today, under the current system or even under the flat tax, they will not pay. Isn't that a fair——

Mr. REYNOLDS. Yes. All of these tax reforms that lower rates, including a sales tax, will reduce avoidance and evasion. That is more important in terms of revenue, vastly more important than the issue of illegal activity.

What is wrong with your example is that most of the customers of the drug lord, if you will, are earning their income in the legal economy and paying income tax, so we are going to free the customer of the tax and get the pusher—that would be OK, but it probably doesn't yield any revenues. Somebody who is a Wall Street broker snorting coke is using aftertax income to buy the coke now. You are going to alleviate his income tax and go after the seller. I see that as a wash and as a nonissue.

Chairman ARCHER. Let's talk about an area that is not, it seems to me, a wash, although you may be able to elucidate it. All of the various members of our economic society that deal in cash are paying no income tax when they are recipients of cash, nor is there a deductibility under the current income tax system for the person who pays that money. The person who receives that cash irrespective of the activity, whether it be—I won't isolate names, but you know the various types of activities that deal in cash—when they spend that money they are going to pay part of the consumption tax if it is a tax on goods and services.

Mr. REYNOLDS. True.

Chairman ARCHER. Whereas today they pay nothing, nor is there a deduction under the current Code for those people who make the payment in cash to them.

Mr. REYNOLDS. Yes. I will give you some examples since you are being nice enough not to—home repair and home cleaning. If someone comes and cleans your house, you pay cash; you don't report Social Security either by the way. I suspect that might be a minor advantage of sales tax.

But the major advantage of both proposals, including this one, is that a lot of the reason people avoid taxes is, the rates are too high. You get the marginal rates down and that is going to be a much more copious revenue generator than the other thing.

The other issue you are raising has a lot to do with people's perception of fairness, and I can't comment on that. I didn't do that well in moral philosophy.

Chairman ARCHER. You are a very excellent witness, and I am very grateful to you. I don't want to get into an argument with you because I am trying to learn.

The GAO testified that the loss, not including illegal activities, to the cash economy, where we were not getting any income tax, was somewhere around $120 billion a year. Now, I don't think that is insignificant, and that is a cumulation of all of these activities that we were talking about. It's not the money going into tax-exempt bonds.

I would submit that one of my concerns is that if we are going to try to get at that and create the feeling of fairness on the part of all Americans, lowering the rate won't get them. If I am paying zero percent today and you come to me and say you can pay 20 percent, isn't this a wonderful deal, I am a human being, I am going to say, I don't want to pay 20 percent. That was the argument in 1986, that if we reduced the rate to 28 percent, people would say, that is so much less so I will be so delighted to pay it. But if they were paying zero, they didn't.

Mr. REYNOLDS. It worked to some extent, too. You had a revenue windfall after the 1986 bill partly as a result of that and partly as a result of people like me reporting higher cash income. That is correct, and I accept your point as far as it goes, but I think we have to weigh the fact that with the sort of sales or VAT tax rate that we will be talking about—and I am afraid the numbers will be higher, because when we look at what is going to get left out, like hospital rooms and financial services and so on, the rate will be pretty high; you have to offset against that savings—that there will undoubtedly be smuggling and selling under the counter at wholesale to evade that tax too.

Basically, people will evade taxes. In countries where they have very high sales tax, such as Brazil, that is the one that is avoided and that is where the underground economy is. Where they have high income tax, like this country, that is the one that is avoided and that is where the pressure is.

Chairman ARCHER. I yield back to the gentleman from Nebraska if he has further comments.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you for yielding the time.

Mr. Collins.

Mr. COLLINS. Only one or two questions.

You mentioned those who tried to maybe successfully evade reporting some income or switching their income to nontaxable areas, as you did with bonds. What percentage of the taxpayers would fit into that category? Because most working people receive a W–2 or 1099 for services rendered.

What percentage of the taxpayers would actually fit into your bracket, not your income bracket, but would have the means——

Mr. REYNOLDS. Before the rate went up, I was targeted to be in the 36 percent bracket. Because I am clever, it will probably be 31 percent. I think that with the spread of 401(k)s which is a way to defer compensation, and municipal bonds that are held by people in tax brackets as low as 28 or 31, these are significant revenue losers.

All of the itemized deductions people are complaining about losing are mostly an advantage to fat cats like me, and I will gladly give them up for a low marginal rate even if you keep my average rate as high as it is.

Mr. COLLINS. Would you make it 5 percent of the taxpayers being able to shift funds around——

Mr. REYNOLDS. I think it is bigger than that, more like 10 is a possibility. Investments, pension deferral; it is usually only low-income people who can use IRAs.

Mr. COLLINS. One question about the cash economy mentioned: If someone receives in cash, they don't hoard that cash. They probably spend that cash on a consumer good somewhere or another service, so the cash revolves again within the private sector economy, whereas if the government were successful in taxing that cash transaction, then they would take a portion of that transaction out of the private sector into the government till.

So it is which comes first, the chicken or the egg?

Mr. REYNOLDS. They will either take it out of what you spend or out of what you earn. By the time you die, it doesn't matter much because we tend to spend everything we earn and that is why income tax and consumption tax really aren't that different.

Mr. COLLINS. Thank you.

Chairman ARCHER. Thank you very much. We look forward to having further contact and input from you as the months go on. We appreciate your coming.

Mr. REYNOLDS. Thank you, Mr. Chairman.

Chairman ARCHER. Our last panel is Hon. Paul Craig Roberts, Dr. Richard Rahn, Stephen Moore, Steven Hayes and Michael Rothschild.

Mr. Rahn.

STATEMENT OF RICHARD W. RAHN, PH.D., CHAIRMAN OF THE BOARD, BUSINESS LEADERSHIP COUNCIL

Mr. RAHN. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Committee, thank you for giving me the opportunity to testify today. My testimony is delivered on behalf of the Business Leadership Council for whom I am pleased to serve as chairman of the board of directors. I am also president of the Novecon companies, which create and operate businesses in the former Soviet Union and Eastern Europe.

Mr. Chairman, you have been quoted as saying you are "committed to tearing out the income tax by its roots." Your goal is not only desirable, but now a necessity as a result of advances of electronic money and the smart card. Thoughtful observers understand that the present income tax system is increasingly dysfunctional and must be replaced. The rising complexity and costs of the management of compliance with the existing tax system have made it not only unfair but increasingly uneconomic.

The present income tax system is strongly biased against productive savings and investment, which in turn has sharply reduced our rate of capital formation and, hence, the standard of living for most Americans. New technologies such as electronic money and the smart card will make the existing tax system increasingly difficult to manage and easy to escape for those who so choose. The existing system is intrusive, subject to, and all too often abused by, government officials as not compatible with a free society in which citizens should be considered innocent until proven guilty and not have to fear their own government.

My testimony can be summarized in the following four points:

The new electronic money and smart card technologies which will operate on a global basis outside the control of any government make the replacement of the existing income tax in the very near term an absolute necessity, because anyone who chooses to do so will be able to escape taxes on interest dividends and capital gains with virtually no danger of being caught.

The new technologies can solve many of the problems in providing desired social safety for the poor or elderly and in eliminating the regressivity problem with a tax reform proposal such as a national sales tax.

Any new tax system must rely on what is possible without excessive regulation or intrusion into the private lives of its nation's citizens, because an intrusive system is not only incompatible with a free society, but given the rapidity of technological progress, will always be destined to fail.

All the major new alternative tax proposals, including the Armey flat tax, Nunn-Domenici and a national sales or VAT are vastly superior to the existing tax system, but it is imperative they be designed to be fully compatible with the new technologies.

The revolution taking place in electronic money means that banks and other organizations will be able to create their own money for transactional or investment purposes and literally move these moneys around the globe at the speed of light. Definitions of income and money will be increasingly blurred, presenting an impossible task to the tax collector who tries to tax things which can be transformed instantaneously into something else and move anyplace in the world with no paper or electronic trail. Public key cryptography, which has already been developed, means electronic banknotes can be certified without the issuer knowing to whom it was issued. Smart cards used as an electronic purse can have the same anonymity as paper cash.

Government authorities cannot stop this revolution because it is a worldwide revolution, with too many people having the knowledge. Censorship and regulation will not work because progress in developing the means of evasion will always be far ahead of those who are trying to restrict it, in the same way that most totalitarian governments have largely given up trying to control flow of information because technology has made it an impossible task.

As responsible Members of the Congress you have only one choice and that is, design a new tax system which provides adequate revenue for the government without attempting to tax what cannot be involuntarily taxed. Fortunately, the task is not only doable, but if correctly done will result in much higher rates of growth and a simpler, less intrusive system.

New technologies will greatly assist the management of many government programs. For instance, smart cards are already being used in some food stamp programs to reduce fraud. Smart cards could be used to provide low-income people or everyone with a tax-free consumption allowance each month to offset the regressive features of a national sales tax.

Smart cards will also prove to be much better vehicles for the elderly to receive and spend their Social Security and Medicare

funds, given they can be uploaded or downloaded through the telephone and can be used only by the intended recipient.

In conclusion, those who believe envy to be a virtue rather than a sin will begin with their familiar whine about the distributional impact of any replacement for the current tax system. Given that the income data will be increasingly less reliable, so in turn will the distributional data. We urge the Congress to ignore the envy crowd and instead concentrate your energies on designing a tax system which raises the required amount of revenue with the least amount of economic damage, so all Americans will benefit from resulting higher rates of economic growth.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

TESTIMONY OF RICHARD W. RAHN
THE BUSINESS LEADERSHIP COUNCIL

Mr. Chairman and Members of the Committee, thank you for giving me this opportunity to testify today on replacing the income tax. My testimony is delivered on behalf of the Business Leadership Council, for whom I pleased to serve as Chairman of the Board of Directors. The Business Leadership Council is a new association of entrepreneurial business leaders who are committed to working to limit the size of government and to expand economic growth. Its members believe that the central purpose of all economic policy should be to promote a higher standard of living for the American public and that among the most important means of achieving this goal is the adoption of sound tax policies. In addition, I am President of the Novecon companies, which create and operate business joint ventures in the former Soviet Union and Eastern Europe. Relevant to my testimony is the fact that one of our companies is engaged in a project to market smart card technology in the former Soviet Union.

Mr. Chairman, you have been quoted as saying you are "committed to tearing out the income tax out by its roots". Your goal is not only desirable, but now a necessity as a result of the advances in electronic money and the smart card.

Thoughtful observers understand that the present income tax system is increasingly dysfunctional and must be replaced. The rising complexity and costs of the management of and compliance with the existing tax system have made it not only unfair but increasingly uneconomic. The present income tax system is strongly biased against productive saving and investment, which in turn has sharply reduced our rate of capital formation and hence the standard of living for most Americans. New technologies, such as electronic money and the smart card, will make the existing tax system increasingly difficult to manage and easy to escape for those who so choose. Finally, the existing system is intrusive, subject to, and all too often abused by, government officials, and is not compatible with a free society, in which citizens should be considered innocent until proven guilty and not have to fear their own government.

At your request, the focus of my testimony today will be on the impact of new technologies on the tax system. Rather than go into great detail on these technologies, I am appending the cover story from ***Business Week*** (June 12, 1995), and an article I wrote for the **Washington Times,** entitled *The Death of the Income Tax?* (March 6, 1995). These articles give sufficient background on the relevant technologies.

<u>Summary</u>

My testimony can be summarized in the following four points:

1. The new electronic money, or E-money, and smart card technologies, which will operate on a global basis outside the control of any government, make the replacement of the existing income tax, in the very near term, an absolute necessity because anyone who chooses to do so will be able to escape taxes on interest, dividends, and capital gains with virtually no danger of being caught .

2. The new technologies can also solve many of the problems in providing desired social safety nets for the poor or elderly and in eliminating the regressivity problem with tax reform proposals such as the national sales tax.

3. Any new tax system must rely on what is possible without excessive regulation or intrusion into the private lives of its nation's citizens, because an intrusive system is not only incompatible with a free society but, given the rapidity of technological progress, will always be destined to fail.

4. All of the major new alternative tax proposals, including the Armey flat tax, Nunn-Domenici (but at lower rates), and national sales tax or VAT, are vastly superior to the existing tax system; but it is imperative that they be designed to be fully compatible with the new technologies.

Importance of E-Money

The revolution taking place in electronic money means that banks and other organizations will be able to create their own money for transactional and/or investment purposes and literally move these moneys around the globe at the speed of light. The definition of money as a government-created legal tender will become less and less relevant. The existing distinctions between money, goods, services, and assets will increasingly disappear as they become more interchangeable.

Definitions of income and money will be increasingly blurred, presenting an impossible task to a tax collector who tries to tax things which can be transformed instantaneously into something else and moved to anyplace in the world with no paper or electronic trail. Public-key cryptography, which has already been developed, means electronic bank notes can be certified without the issuer knowing to whom it was issued. Smart cards used as an electronic purse can have the same anonymity as paper cash.

Government authorities cannot stop this revolution, because it is a worldwide revolution with too many people having the knowledge. Censorship and regulation will not work because progress in developing the means of evasion will always be far ahead of those who are trying to restrict it. In the same way that most totalitarian governments have largely given up trying to control the flow of information, because technology has made it an impossible task, governments need to realize that the old central bank monopolies on the issuance of money will also go the way of the buggy whip.

Government officials have two choices: to redesign their tax and monetary systems to reflect technological reality, or to try to create a system in which every investment and every expenditure by every person is known throughout their lives. In the new world of monetary freedom there is no halfway ground. Either the government will know everything, or the government will only know what is voluntarily revealed. An all-knowing government is doomed to fail, practically and politically, and attempts to impose a "big brother" government could impoverish the Nation and trample our liberties.

Thus, as responsible Members of Congress, you have only one choice, and that is to design a new tax system that provides adequate revenue for the government without attempting to tax what cannot be involuntarily taxed. Fortunately, the task is not only doable but, if correctly done, it will result in much higher rates of growth and a simpler, less intrusive tax system.

The new technologies will greatly assist the management of many government programs. For instance, smart cards are already being used in some food stamp programs to reduce fraud. Smart cards could be used to provide low income people (or everyone) with a tax free consumption allowance each month to offset regressive features of any national sales tax. Smart cards will also prove to be much better vehicles for the elderly to receive and spend their Social Security and Medicare funds, given that they can be uploaded and downloaded through the telephone and can be used only by the intended recipient.

An important practical consideration when designing a replacement for the existing income tax is whether the proposed tax base is realistically subject to tax in the aftermath of the electronic revolution. This is because as a general principle, what cannot be taxed efficiently should not be taxed at all. The converse, however, does not hold.

If taxpayers may easily avoid reporting particular types of income or transactions with virtually no danger of being caught because of technological innovations, then the tax on that type of income or transactions is, quite literally, voluntary and will only be paid by those conscientious citizens who abide by our tax laws out of a sense of duty and honor rather than the threat of civil or criminal penalties. Establishing a genuinely voluntary tax is not a formula for fairness and will lead to a disproportionate burden being borne by those who choose not to evade.

The tax base of the future will need to be tied to long-term relationships, real estate, tangible property or other high-profile or public assets or activities. Income flows that may be effected in secret, electronically and anywhere in the world are bad candidates for taxation in the electronic age. Taxes tied to real property or tangible personal property or the sale of goods and services to the public are much more difficult to evade. Taxes tied to the employer-employee relationship are enforceable because of the stability, length and visibility of the relationship. Taxes tied to the operation of businesses dealing with the public or with many business customers are more easily enforced because of the necessarily public and open nature of such businesses.

The electronic age with virtually instantaneous international financial transactions and with encrypted confidential smart cards substituting for money will make the taxation of capital transactions, interest and dividends increasingly problematic. In an age where most people can today transfer money and pay bills with an ordinary telephone, enforcing taxation on these types of transactions will become virtually impossible. The cost of trying to enforce them may well exceed the revenue collected and certainly will exact a price in terms of lost economic efficiency and lost privacy rights that exceeds the benefits of their continued taxation.

Those who believe envy to be a virtue rather than a sin will begin their familiar whine about the distributional impact of any replacement for the current tax system. Given that income data will become increasingly less reliable, so in turn will tax distributional data. We urge the Congress to ignore the "envy crowd", and instead concentrate your energies on designing a tax system which raises the required amount of revenue with the least amount of economic damage, so that all Americans will benefit from the resulting higher rates of economic growth.

Size of Government

Congress cannot properly determine what type of tax system we should have until it is determined what the revenue goals for the new system should be.

From the end of World War II until the late 1970s, there was a common belief that our economic and societal ills could be cured by increasing the role of government. As a result, government grew larger and larger both in absolute and relative terms, not only in the United States but in much of the rest of the world. Fair-minded people increasingly understood that the Keynesian economists were wrong, and that distinguished economists, such as Frederick von Hayek and Milton Friedman, had both a better understanding of how the economy operates and better prescriptive solutions. They taught us that beyond a certain point increasing taxes, government spending, and regulations did more to reduce the social welfare than to improve it. The increasingly widespread recognition that government could, and indeed had, become counterproductive ushered in the Reagan revolution. The result has been that government taxation and spending have not grown relatively over the past twelve years, even though regulation has continued to grow in both relative and absolute terms.

During the past twenty years, serious academic work has been done on the appropriate size of government, not only for the United States, but for the rest of the world as well. The empirical evidence that government taxing, spending, and regulation is well beyond the optimum point is now overwhelming, and all Americans are suffering as a result. Specifically, we now know that social welfare and economic growth would be maximized if government were one-quarter or less of Gross Domestic Product, as contrasted with the present more than one-third.

Knowing this, it makes no economic or political sense to design a new tax system to raise as much money on a static revenue basis as the existing system. We know that as we downsize government in relative terms, economic growth rates will increase. We know that as we reduce high marginal tax rates and the current tax bias against saving and investment, we will increase the supply of productive labor and have a higher level of

capital formation, which will lead to higher rates of economic growth. (Please see charts at back of testimony.)

Because the majority in this Congress has had the courage to develop a path to a balanced budget that slows the rate of growth of government spending, the federal government share of GDP should fall to 18% by 2003. History tells us that economic growth will increase as a result. This means that you can generate the same tax revenue at reduced tax rates. At the same time, because of higher growth, there will be fewer people in poverty, thus reducing the demands on government assistance programs, and hence government spending.

Fair-minded people understand that the reason you wish to slow the growth of government spending is not because you are mean-spirited or tools of the rich. It is because you understand that a smaller government will mean that most Americans, and particularly poor Americans, will have much greater opportunity and live much better. It is too bad that some in the media cannot distinguish between the "name" of government programs and the cost-effectiveness of these programs. Eliminating a government program with a compassionate name, but whose cost to the taxpayers is greater than the benefits to the recipients, is the compassionate and responsible thing to do. Because some of your political opponents and some in the media are irresponsible is no reason for you to stoop to their level. For America's sake, continue to have courage.

Unfortunately, the Congress has let itself get trapped by budget rules that make no sense. Again, I am referring to the requirement of "relatively static" revenue estimates for tax and spending changes. These rules make no economic sense, and they make no political sense, now that a majority in Congress favors economic growth and opportunity over static redistributionism. When the rule makes no sense, change it. (The left in the media and their academic and political allies will scream; but the American people vote on performance, not on arguments about whose tax forecast model is correct.)

The reason it is important not to be slaves of the wrong rule is that the current rule will force you to have higher tax rates. This is equally true for consumption-based income tax plans, the flat tax, and the national sales tax proposals. Because of the static revenue trap, all of the proposed plans will increase taxes on some sizable portion of the population, thus causing for them unnecessary hardship and their justifiable political opposition.

Designing a New Tax System

There are three politically viable and economically sound alternatives that could replace the existing income tax: a so called consumed income or cash flow tax (Nunn-Domenici, but at a lower rate), a national sales tax, and a flat rate income tax (Armey.) Each of these proposals would simplify the existing tax system, eliminate the tax bias against savings and investment, reduce the disincentive to work, and promote economic growth and a higher standard of living for the American public.

Each of these proposals has distinct advantages and disadvantages, which this Committee must address over the next few years as it meets the challenge of developing a replacement for the income tax. The Business Leadership Council is establishing a Tax Alternatives Working Group to work systematically through these issues, and we look forward to working with this Committee as the debate unfolds.

Even though all of the major proposals for a replacement tax are vastly superior to the existing tax system, none is perfect, and all will have problems in the transition period. These problems can largely be mitigated by reducing the maximum marginal tax rate from that which their proponents are proposing. This can be done responsibly, by further reducing the growth in spending so that eventually all levels of government are absorbing less than 25% of GDP. This would entail reducing federal spending to the neighborhood of 15-17%. In effect, virtually all businesses and individuals would be getting a "tax cut", thus mitigating their political opposition and reducing the

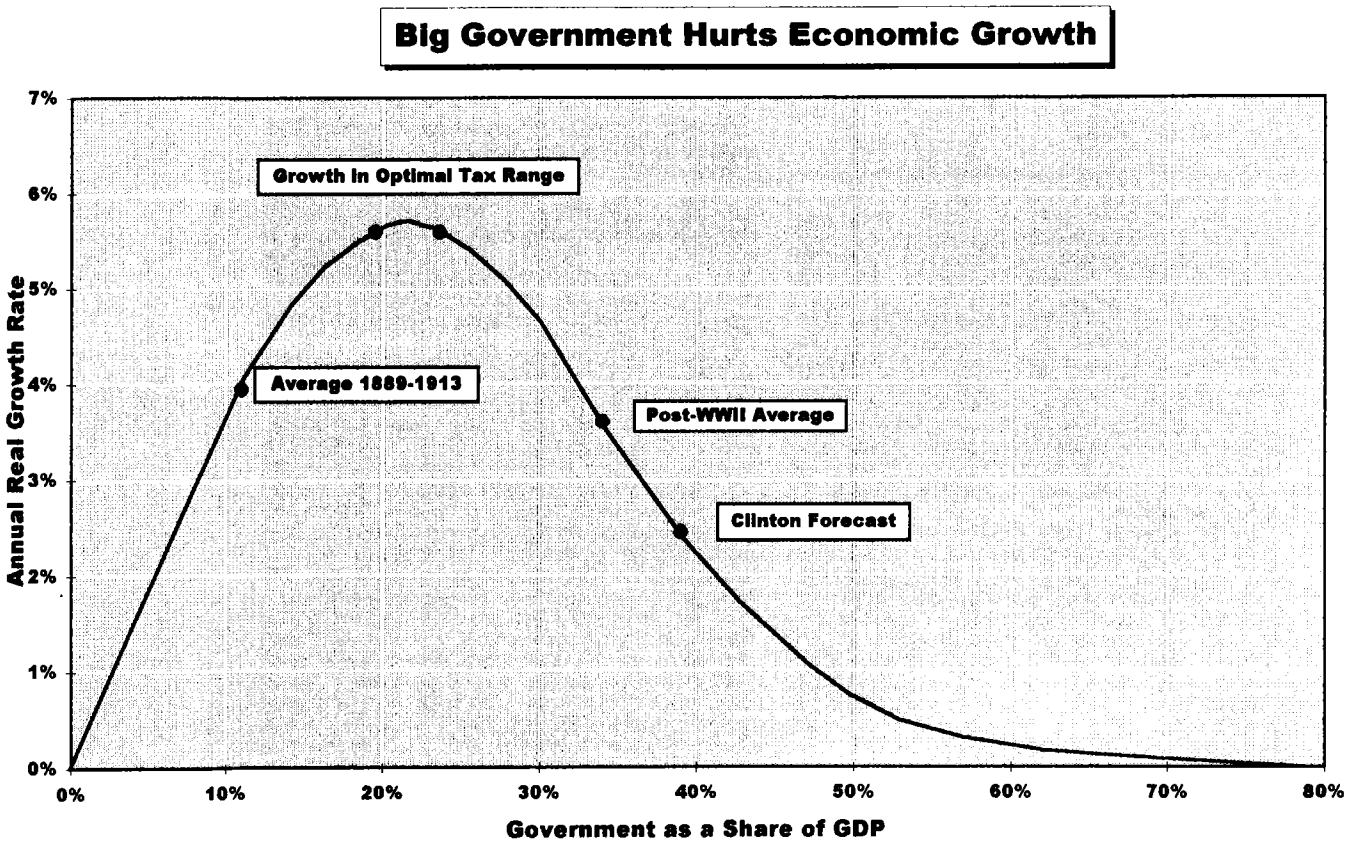
impediments to work, save, and invest. In fact, the higher economic growth engendered by the spending growth reductions and the less destructive tax system is likely to increase the absolute revenues for government to spend.

For the full benefits to occur from any of the income tax replacement plans now being discussed, they must be accompanied by drastic changes in the operations of the IRS. While it will indeed cause some revenue loss to restrict the IRS' ability to take actions without first proving willful wrongdoing, and to reduce the paperwork and documentation the IRS can require, it is a small price to pay for a free society. In addition, a national sales tax ought not to be enacted without the repeal of the 16th Amendment, because without such a repeal there is a great danger that some future Congress will inflict on us both an income tax and a national sales tax. At the same time, a flat tax ought not be enacted without the Congress' curtailing the IRS.

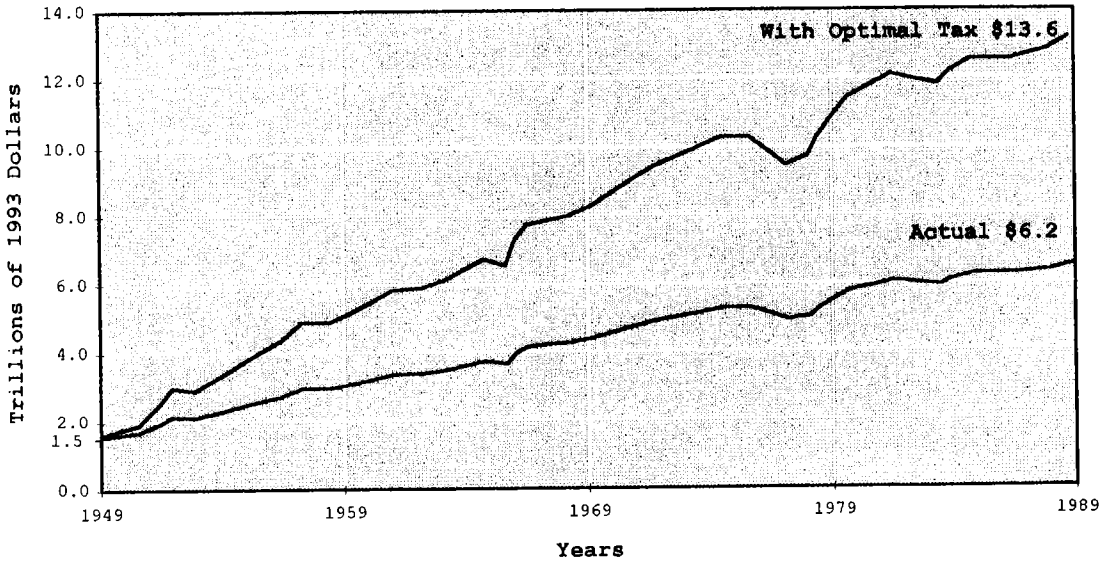
Conclusion

In conclusion, a new tax system should be designed to generate the optimal revenue, and government should be scaled back accordingly. The new tax system should be simpler and fairer. The IRS should be eliminated or sharply curtailed.

It is no longer optional whether we should scrap the current dysfunctional income tax: electronic money makes that a necessity, because interest, dividends, capital gains, and some other income will be able to be hidden. The silver lining is that E-money and smart cards can solve the regressivity problem and will force us to design an unobtrusive, pro-growth tax system which will benefit all Americans.


Big Government Hurts Economic Growth
Growth in Optimal Tax Range
Average 1889-1913
Post-WWII Average
Clinton Forecast
Annual Real Growth Rate
7%
6%
5%
4%
3%
2%
1%
0%
0%
10%
20%
30%
40%
50%
60%
70%
80%
Government as a Share of GDP

Path of Real Gross National Product



OP-ED PAGE A20 / MONDAY, MARCH 6, 1995 ★ The Washington Times

The death of the income tax?

By Richard Rahn

Death and taxes are among life's certainties. Far less common, but much more enjoyable to contemplate, is the death of a tax.

In fact, a little-known technology may be about to accomplish what generations of Americans have joked and dreamed about —and both the new Ways and Means Committee Chairman Bill Archer and his predecessor, Chairman Sam Gibbons have said they desire: the annihilation of the income tax. But now it is becoming possible, and perhaps even necessary.

Before proceeding to describe — in loving detail — its imminent demise, let's remember why the murder is justifiable. The income tax discriminates against savings and investment. Economic growth and job creation are penalized. As the tax system grows ever more complex, and changes pile on changes, the cost of compliance grows even more rapidly — unalloyed economic dead weight.

Think of the resources that would be freed, and the human happiness that would accrue, if all the tax lawyers and accountants were put to work doing something useful. Think of all the gains to taxpayers once they were freed from the burden of compliance.

The cost is more than economic. The complexity of the system also causes fear. One rarely knows what the proper tax liability is. For most large businesses and many individuals, the only thing they know for certain is that the amount they paid is wrong. And though the media reports every April — the stories of leading accounting firms and Internal Revenue Service offices each calculating a different liability from the same data — may be amusing, the reality is otherwise. Each year the IRS tries to send people to jail for not determining a liability that is, by the very nature of the system, almost impossible to calculate.

The gains to the American people, economically and psychologically, will be magnificent.

Unfortunately, also, the very Congress that claims to want to get the government off people's back is complicating things even further. Among the various tax-cut bills that have been introduced, only Rep. Dick Armey's flat tax bill will produce significant simplification. Left to themselves, it is unlikely that the legislators, buffeted as they are by the lobbyists and lawyers, will ever summon the courage to put the IRS out of its, and our, misery.

Fortunately, computer hardware and software may soon do what representatives and Senators will not. For centuries, people have paid their bills, and received their income, by cash or check. These costly methods of payment may be coming to a rather abrupt end.

Electronic transfers greatly reduce the cost of transaction and the possibility of loss. Americans are now starting to pay their bills by using credit cards, and by inexpensive "Smart Phones." These systems provide customers with a full record of income and payments: good for record-keeping, but bad for privacy. In fact, the IRS is already working on a system to gather all your financial information electronically and prepare your tax return for you. That might crimp the tax lawyers and accountants a bit, but the Big Brother police state aspects are at least as unpalatable.

There is, however, a technological alternative. An experiment now under way, called "E-cash," operating in Amsterdam by a company named DigiCash. The electronic version of the anonymous paper dollar is now with us. Individuals will be able to move their funds around the world, literally at the speed of light, from one bank to another or to a creditor, without the bank knowing to whom the money was paid, or the creditor knowing from which bank or even country the money came.

Through the use of cryptographic technology (scrambled numbers for personal codes), the ease of conducting electronic transaction would be combined with the elegant anonymity of paying in cash. The two most important features of the "E-cash" system — security and anonymity —will be ensured by using cryptographic digital signatures to establish the authenticity of the payer, while at the same time assuring his anonymity and untraceability. The virtual electronic dollar bills will, at the same time, be assigned individual electronic serial numbers, which will also be checked for authenticity. The bank will know how much to pay and what code to pay it to, but will not know the owner of the receiving code, hence the payee too remains anonymous.

Naturally, the IRS doesn't like it. But the matter may be beyond its control. In the next few months, Americans will be offered two competing versions of the future. The first is the society in which all of your transactions can be monitored by the government (and other interested parties). The second is where you as an individual choose which of your transactions will be made available to curious eyes, and which will remain anonymous.

Many in the government and other organizations will argue for a ban on anonymous systems, contending that such capabilities benefit primarily drug traffickers, money launderers, assorted terrorists and plain old tax dodgers. Libertarians, on the other hand, will warn of the dangers that accrue when government has almost total scrutiny of individuals. One doesn't have to envision what a Hitler or Stalin could have done with such a system; just try to imagine the kind of ordeal investigators could inflict on anyone trying to get Senate confirmation for government service.

The fact is that the fears of both sides are correct. But some of the legitimate fears of the government can be mollified by repealing the income tax and substituting a value-added or business-transfer tax. Anonymous systems will make it easier for criminals and evaders to do what they are already doing successfully, especially as private encryption protocols are developed.

But without an income tax, it won't matter. The gains to the American people, economically and psychologically, will be magnificent. Even the government, which relies on public trust, will gain. An on such terms, that would be a very good thing.

Richard Rahn is President of Novecon Ltd. in Washington and a fellow of the Seattle-based Discovery Institute.

THE FUTURE

In his pinstriped suit and wire-rimmed glasses, Timothy L. Jones looks every bit the traditional British banker. Sure enough, he has spent a dozen years at National Westminster Bank PLC. But ask Jones what he is doing now, and he responds with an intensity worthy of a Silicon Valley entrepreneur. Leaning across a table, he waxes eloquent about his new enterprise, Mondex, and the future of the product he's selling: a new kind of electronic money.

Mondex, which was launched by NatWest, is not alone: A raft of companies are developing their own forms of electronic money, known as E-cash. E-cash is money that moves along multiple channels largely outside the established network of banks, checks, and paper currency overseen by the Federal Reserve. These channels enable consumers and businesses to send money to each other more cheaply, conveniently, and quickly than through the banking system.

Cover Story

Some of the E-cash players are faceless, dubious outfits that exist in cyberspace and can be traced only to a post-office box—in the physical world. But there are plenty of others, ranging from techno-savvy startups with names such as DigiCash and CyberCash, to corporate icons including Microsoft, Xerox, and Visa. Citicorp is even developing what it calls the Electronic Monetary System, an entire infrastructure for using electronic money to be issued by Citi and other banks.

These companies are part of a mass experiment that could transform the way we think about money. In the process, it could change consumers' financial lives and shake the foundations of global financial systems and even governments.

Digital money is the ultimate—and inevitable—medium of exchange for an increasingly wired world. With E-cash, you'll no longer need to carry a wad of bills in your pocket or fumble for exact change. Instead, you might carry a credit-card-size piece of plastic with an embedded microchip that you will "load" up with E-money you buy with traditional currency. Or, you might store your digital coins and dollars—downloaded over phone lines from your bank or other issuer of E-money—on your PC or in an electronic "wallet," a palm-size device used to store and transmit E-money.

This digital money will let you shop online, zapping money to a merchant over the Internet, or perhaps paying for a movie on demand over an interactive-TV network. It also has the potential to replace cash and checks for everyday purchases—in stores, restaurants, or taxis that accept E-cash. Businesses could also keep a stash of E-cash on hand for buying office supplies, or use it to transact directly with each other instead of going through banks and electronic funds transfers.

THE START OF A REVOLUTION. In many ways, E-cash, which can be backed by any currency or other asset, represents the biggest revolution in currency since gold replaced cowrie shells. Its diversity and pluralism is perfectly suited to the anarchic culture of the Internet and the evolving web of networks known as the Information Superhighway. "Electronic commerce will literally change the way business is done worldwide," says James G. Cosgrove, vice-president and general manager for business multimedia services at AT&T. "We're about to see another revolution similar to the Industrial Revolution." Adds Richard K. Crone, senior manager in the financial-services group at KPMG Peat Marwick: "We're in the beginning stages of the cash-replacement cycle."

But the advent of E-cash raises all sorts of questions, most of which remain unanswered: Who should be allowed to issue E-cash, and who will regulate those issuers? How will taxes be applied in cyberspace, which transcends physical boundaries? Who will set the standards? How do you ensure that payments made over the Net will be secure? How will consumers be protected?

EARLY MONEY

Seashells, odd rough-hewn coins—the first money was flexible, highly distinctive, and exchanged in multifarious ways. Objects were gradually replaced by standardized commodities such as gold and silver, and these in turn by paper money. Yet even early currency was at first issued by private banks, local governments, and others—usually backed by gold and silver. Diversity abounded.

OF MONEY

E-cash could transform the world's financial life

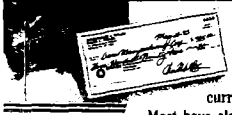
How will regulators police money laundering and counterfeiting on private networks?

While regulators wrestle with these questions, technology is remaking the monetary system. That's what Microsoft CEO William H. Gates III had in mind when he bid for personal-finance software maker Intuit Inc. He saw programs such as Intuit's as the gateway that would draw millions of consumers onto his online network where they could pay bills, get financial advice, or shop, perhaps paying him for access. But the Justice Dept. worried about Microsoft's reach, and he abandoned the deal on May 20.

Tough break, but it will hardly slow Gates down. Microsoft is working with Visa on a system for securing credit-card transactions over the Net. But that's just one piece of a much bigger problem Microsoft is trying to solve. Gates has dozens of programmers busy devising a sweeping system, Microsoft Network, to help people do business safely in cyberspace—or more specifically, in Microsoft's own network and interactive-TV systems—using a range of payment options. Microsoft won't reveal much about its E-cash plans, but, says Nathan P. Myhrvold, Microsoft's top advanced-technology expert, "we're very interested in the area."

They should be. The stakes are enormous. Seamus McMahon, a vice-president at Booz, Allen & Hamilton, sees as

BANK MONEY



The current money system is largely monolithic. Nearly all major countries have a single system of national currencies and bank checks. Most have elaborate infrastructures built around commercial banks and a central governing body such as the Federal Reserve Board. That entity is usually the only facility allowed to issue money. Perhaps because of their monopoly structures, money systems tend to resist change and innovation. Traders can move millions of dollars around the globe at the touch of a button. But the small check-based transactions of consumers can take days to clear. And chartered airplanes physically transport billions of checks around the country every workday.

E-CASH

E-cash may be technologically light-years ahead of early money. But in many ways, it is closer to seashells than greenbacks. E-cash is digital money that moves through a multiplicity of networks instead of the current bank system. It comes in lots of guises, is created by lots of individual parties, and is backed by anything constituents demand as an accepted medium of exchange: gold, dollars, yen, whatever. It is the ultimate, and inevitable, currency for the wired world. Competition is intense, producing rapid innovations. Using money downloaded to your PC or a palm-size electronic "wallet," you'll be able to zap money to merchants on the Net—or buy a newspaper faster than you can grab a greenback. If you're a business owner, you can bypass banks and move E-cash directly to customers and suppliers. The advantages: convenience, speed, cost savings. The technology is complex, but to the user, E-cash is as easy as pushing a button.

much as 20% of total household expenditures taking place on the I-way just 10 years from now. If any operation, whether Citicorp or a startup such as Mondex, gained control of a new medium for even part of those exchanges, it would have the opportunity to charge royalties or fees for its use and earn interest on the E-money sitting in its accounts. Even a tiny charge, when applied to millions of transactions, would be highly lucrative.

Cover Story

E-cash could also create a competitive free-for-all. Because the Internet knows no boundaries, a company offering E-money can gain direct access to millions of consumers and businesses—no matter what state or country they are in. "The retail banking market will collapse and give way to global competition," says Eric Hughes, president of Open Financial Networks, a Berkeley (Calif.) consulting firm. "Those [regional] separations don't work on the Internet."

WINNING CONSUMERS' TRUST. Governments' and central banks' control of money flows has already been loosened, as shown by recent currency and market crises in Mexico and elsewhere. But with the growth of E-cash, money could flow in and out of countries at lightning speed without being traced, weakening governments' ability to monitor and tax. "Over the long haul, this is going to lead to the separation of economy and state," declares Bill A. Frezza, president of Wireless Computing Associates and co-founder of the advocacy group DigitalLiberty.

The growth of E-money could also be bad news for banks. If other companies successfully offer their own brand of digital cash, they could bypass banks as primary providers of consumer financial services. The companies, not the banks, might be consumers' first contact when they wanted to obtain some digital money. "Banking is essential to the modern economy, but banks are not," says J. Richard Fredericks, senior managing director at Montgomery Securities.

Commercial banks are, of course, entrusted with the creation of money through the fractional reserve system. They lend out more than they have on deposit, and they are the only companies authorized to do so. If each unit of E-cash had to be backed by a corresponding unit of traditional currency, that would mean that lending out E-cash wouldn't create new money. But if nonbank money suppliers started backing just a fraction of their digital cash with traditional money—just as commercial banks today keep on hand only a fraction of the deposits on their books—nonbanks, which are largely unregulated, could create money just as commercial banks do now.

This could be bad news for banks. What if phone companies offered their own brand of E-money?

Bankers must move fast to keep up. Ronald A. Braco, head of electronic banking at Chemical Bank, estimates that banks have less than five years to come up with viable E-money products before other players carve out the biggest chunks of the market for themselves. "No question, it's for real," says Richard M. Rosenberg, chairman and CEO of BankAmerica Corp. In a couple of years, "it will take off fairly dramatically." The issues now: winning consumers' trust and getting them to change their buying habits.

The first step in that direction could be to get consumers used to using credit cards for purchases on the Internet. Once that happens, the thinking goes, they may be willing to start using E-cash systems.

One of the first purveyors of a Net credit-card system is First Virtual Holdings, run by onetime celebrity manager Lee Stein. Stein has launched a relatively simple system using E-mail that lets consumers use credit cards on the Internet without fear that their account numbers will be misappropri-

The New World Of E-Cash

THE GOOD

convenient and flexible than traditional money. It can be used by consumers and businesses, and for everything from buying wares on the Internet to lending a pal five bucks.

- Banks that issue E-cash could find it much cheaper than handling checks and the paper records that accompany traditional money.
- Consumers doing business on the Internet will find some forms of electronic money afford much greater privacy than using ordinary credit cards.

THE BAD

- Uncontrolled growth of E-cash systems could undermine bank- and government-controlled money systems, giving rise to a confusing and inefficient Babel of competing systems.
- E-cash may be less secure than bank money: Money stored on a PC could be lost forever if the system crashes.
- E-cash could foster a have and have-not society: Those with PCs would have ready access to the stuff, while those without, many of them low-income consumers, would not.

AND THE UGLY

- Money laundering and tax evasion could proliferate in stateless E-money systems as criminals use untraceable cyberdollars to hide assets offshore.
- Counterfeiters could create their own personal mints of E-cash that would be indistinguishable from real money.
- If computer hackers or other criminals were to break into E-cash systems, they could instantaneously filch the electronic wealth of thousands or even millions of innocent consumers.

DATA: BUSINESS WEEK

ated. The card numbers are stored away on a protected computer system and never pass over the network. Instead, consumers register with First Virtual by phone and receive I. D. numbers in exchange for their card numbers. When they want to buy something electronically, they simply supply their I. D. number to the merchant.

First Virtual, which became the first secure payment system on the Net when it handled its first transaction last October, is growing fast. Stein won't disclose activity levels, but he says volumes are increasing by 16% a week. "If you make it simple and safe, people will use it," he says. First Virtual has enlisted such merchants as Apple Computer, Reuters, and National Public Radio—which sells transcripts of programs.

Most electronic extensions of the credit-card system, though, are built around encryption—scrambling card numbers so they can pass safely on electronic networks. For example, CyberCash Inc., a Reston (Va.) startup, is cutting its teeth on a deal with Wells Fargo & Co. for encrypted credit-card transactions over the Internet.

Visa and MasterCard, not surprisingly, are also working to make credit cards usable on the I-way. Visa is, among other things, developing with Microsoft a system using encryption technology that they hope will become an industry model. "We want to be sure that the industry as a whole has certain standards," says Carl F. Pascarella, president and CEO of Visa USA. Meanwhile, MasterCard has teamed with Netscape Inc., a maker of security and browsing software for the Internet, to pursue a similar goal.

WILTSHIRE EXPERIMENT. Credit-card-based systems have the advantage of seeming familiar to consumers. But the card systems don't do everything cash can: They're not anonymous, they do not work person-to-person, and they have credit limits. They're also not suited for the grassroots economy the Internet makes possible, where any outfit or individual can sell its wares, whether a newsletter or a stock tip.

That's where E-cash comes in. But E-cash needs to be just as secure as credit cards for people to use it. David Chaum, CEO of pioneer DigiCash in Amsterdam, has done the most to solve this problem. He has devised a clever system that uses so-called public-key cryptography that, like encryption, makes it possible to send sensitive information over the Net. But Chaum's big breakthrough was "blinding" technology, which lets the issuing bank certify an electronic note without tracing whom it was issued to. The result: Your E-cash, unlike an encrypted credit-card transaction, is as anonymous as paper cash.

Chaum has yet to announce firm deals with companies to issue his E-money. But in a pilot, some 5,000 consumers are part of a DigiCash marketplace, using the equivalent of $1 million in E-money to do business with 50 companies, from Encyclopaedia Britannica Inc. to Ricky's Junk Shop. Chaum's technology is also at the heart of CAFE, a European Commission-sponsored project to develop an electronic wallet for pan-European use.

CAFE's setup is similar to Jones's Mondex system. "Imagine it's the same as physical money, and you won't be far off," says Jones. Mondex money will be created initially by NatWest and a partner, Midland Bank PLC, which will then "sell" it to customers. The E-money is loaded onto credit-card-size "smart" cards with embedded microchips. The cards can be used in point-of-sale terminals or fit into electronic wallets that can transmit money to merchants or—just as with traditional cash but not with credit cards—to other consumers. Mondex money is still in pilot form, but the company has signed up 40,000 consumers and over 1,000 retailers in the Wiltshire town of Swindon to test Mondex money beginning in July.

CREDIT CARDS IN CYBERSPACE

"If you make it simple... people will use it"

— LEE STEIN, CEO, First Virtual Holdings

CyberCash, too, is experimenting with E-cash in addition to its credit-card-based system. In the E-cash system, consumers will set up E-money accounts at their banks. Then, using proprietary software provided free of charge by CyberCash, they can go about their business on the Net. At the end of the day, CyberCash will clear all the E-money transactions and convert E-cash balances back to dollars.

No matter who develops the best E-cash, consumers and businesses alike stand to reap sizable benefits. No longer will consumers have to wait for change or scurry to automated teller machines for cash—out of sight, they hope, of the nearest mugger. E-cash will let businesses carry out transactions around the world without transferring bank funds—and they will be better able to reach a large population of technologically savvy, often affluent consumers.

Moreover, because E-money is basically software, it can be programmed to do things that paper money could never do. Microsoft's Myhrvold explains that electronic money could be

earmarked for special purposes, with conditions on where it can be spent. For example, a business could have an electronic version of petty cash to be used for supplies at an Office Depot—but not a beer at the local tavern. Or parents could wire to a college student E-money that is designated for rent or books. "There will be new forms of smart money and payment systems that can only be done online," says Myhrvold.

Along with the opportunities, though, comes huge uncertainty. Existing monetary regulations don't cover all of the potential uses of E-cash. Nathaniel S. Borenstein, a computer scientist and co-founder of First Virtual, says: "One of the hardest questions merchants ask us is, 'When do we owe taxes?'" That's not a trivial question: With E-money, the merchant could be in Guam and the buyer in Canada, while First Virtual's computers are located in Ohio. So whose sales tax do you pay? Borenstein's advice to merchants: "I tell them to consult a lawyer."

There's also a major potential for crime (page 78). E-money can be easily sent in and out of a country undetected, facilitating money laundering on a grand scale. Tax evasion could become a matter of pushing a button. And without foolproof cryptography, counterfeiters could replicate the series of digits that constitutes E-money. Governments would be hard pressed to monitor or control stateless E-money. "Digital cash is a threat to every government on the planet that wants to manage its currency," says David E. Saxton, executive vice-president of Net1, a startup that has developed a secure way to send electronic checks across the Internet.

BATTLE OF THE LOGOS. Even law-abiding citizens and companies using E-money could be victims of sophisticated hacker attacks. Says Colin Crook, senior technology officer for Citicorp: "We have to assume electronic money will be the subject of sustained attack from all kinds of people."

Another open question—and a large one—is the role of banks in the new electronic world. "E-cash will be offered by both banks and nonbanks," says Chaum. Sure enough, DigiCash or CyberCash could join forces with AT&T or Microsoft just as easily as with Citibank. Having one of those companies dispensing E-cash directly to consumers could do serious damage to banks' main link with their customers.

Even if banks are involved, they could find other players taking center stage. Early entrants to the E-money business could set the operating standards for digital cash. And the nonbanks could even devise systems that would make their logos the first thing people see. William M. Randle, senior vice-president at Huntington Bancshares, warns that banks could become "buttons on a network operated by other entities."

THE FLEXIBILITY OF CASH

"Imagine it's the same as physical money, and you won't be far off"

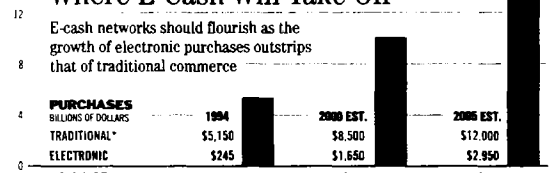
— TIMOTHY JONES, CEO, Mondex

Improbable? Not really. Take a look at credit-card processing. Twenty years ago, banks owned the card-transaction-processing business. Now, close to 80% of card transactions are processed by nonbanks such as First Data Resources Inc., says KPMG's Crone.

A similar erosion has occurred in wholesale banking, where banks have ceded to such outfits as General Electric Information Services and Electronic Data Systems Corp. nearly the entire market for transferring payment data to corporations, leaving themselves the mundane, low-margin service of transferring money between corporations. Today, says banking consultant

Where E-Cash Will Take Off

E-cash networks should flourish as the growth of electronic purchases outstrips that of traditional commerce



PURCHASES BILLIONS OF DOLLARS	1994	2000 EST.	2005 EST.
TRADITIONAL*	$5,150	$8,500	$12,000
ELECTRONIC	$245	$1,650	$2,950
• TV/CABLE TV	$ 45	$400	$650
• BUSINESS-TO-BUSINESS	140	450	650
• INTERNET	Negligible	600	1,250
• OTHER ONLINE COMMERCE	60	200	400
SHARE OF ALL PURCHASES	4.5%	16.2%	19.7%

*INCLUDES RETAIL, WHOLESALE, SERVICE, AND MAIL-ORDER PURCHASES

DATA: COMMERCE DEPT., ALLEN & ASSOCIATES

Edward E. Furash, although the situation is improving, fewer than 100 banks offer full-service electronic data interchange, as the data part of payments transmission is known. "We should do more of that," says Richard Matteis, head of Chemical Banking Corp.'s Geoserve unit.

Cover Story

Banks have one key advantage: a near lock on consumers' trust when it comes to depositing money. For that reason, many bankers tend to dismiss the threat implicit in E-money. "The reason financial institutions are going to win in the long run is trust," says Kawika Daguio, the American Bankers Assn.'s federal representative on operations and banking. Indeed, many E-cash makers are choosing to partner with banks because of that consumer trust. "We've positioned ourselves to work with the banking industry and make sure that if there are heroes in this, it is the banks," says William N. Melton, CEO of CyberCash.

But Microsoft's bid for Intuit last fall gave bankers a collective scare. And even though the deal did not work out, banks worry that Microsoft could hook its 70 million Windows customers into the electronic-commerce networks that

CALL IT E-MONEY MANAGEMENT

It's a Saturday morning sometime in the not-too-distant future, and you sit down at your PC to do a little end-of-the-month planning. First, you call up the balances from your various accounts—credit-card, checking, savings, and E-cash—and break down your spending by category. Oops, better cut down on those pricey dinners.

Your investments are offsetting some of those expensive habits—at least you hope so. Finding out is as easy as a few clicks of a mouse button, as you call up your investment portfolio. Hmmm, it may be time to get into a more aggressive mutual fund. So you quickly dispatch a software "agent" to rustle up profiles for the top-performing funds. By filling out an online form, you transfer some of your holdings into a hot overseas fund.

Just as technology is revolutionizing money, it is also set to transform the way we manage our money. "Complexity has gotten beyond the level that people can deal with," says Scott D. Cook, the founder and chairman of Intuit Inc. With programs like Quicken, Intuit's best-selling personal-finance software, Cook aims to make that complexity easier to deal with.

"AUTOMATIC AGENTS." Indeed, today's programs for personal-finance management and home banking are giving consumers unprecedented control over their financial life. But this is just the beginning. Gradually, programs are linking users to banks, electronic bill-paying services, and a broad array of vendors of financial advice that is starting to be offered online. Colin Crook, head of technology at Citibank, says software programs will be constantly at work for you, for instance, using information gleaned on the Net to optimize your portfolio. "You're going to hand off your personal affairs in cyberspace to automatic agents who represent you," says Crook.

A QUICKENING PACE

"Complexity has gotten beyond the level that people can deal with"

— SCOTT COOK, Chairman, Intuit Inc.

The competition to supply these services will be heated. Microsoft Corp.'s Bill Gates saw the potential—one reason why he was willing to shell out $2 billion for Intuit. With that deal blocked by the Justice Dept., Microsoft is throwing its considerable resources behind Microsoft Money, a home-grown personal-finance package already offered by Chase Manhattan and others. From Money, Microsoft expects to link customers to a variety of online financial services, including electronic bill-paying. Bank of America and NationsBank recently paid $35 million for Meca Software, which makes Managing Your Money. And Intuit, for its part, has just released new programs for selecting mutual funds and planning for retirement and children's college education.

Expect banks to jump into the fray. They are sitting on a gold mine of valuable data: their customers' payment information. The statements they send out, though, typically offer little value, and consumers' credit-card, checking and savings, and investment accounts are handled separately. "There is an opportunity to consolidate that," says Richard K. Crone, a banking consultant at KPMG Peat Marwick.

With so much available to help you manage your financial affairs, someday you may be able to bag those Saturday mornings at the computer and instead just take a long weekend.

By Amy Cortese in New York

it is developing—with or without banks' help. If Microsoft becomes a utility, "it will take a lot of business from the banks," says Montgomery's Fredericks.

Cover Story

Now several of the biggest banks are pushing hard to develop E-money. Citibank's Electronic Monetary System is one of the most advanced bank offerings, although officials there stress that it is still in development. It would allow retail and business customers of Citi—or any other bank that paid to use Citi's system—to convert money in their accounts to electronic cash. Citi customers would also have access to a credit line they could draw down in E-money, just as they would use a credit card. Banks "should be experimenting," says Sholom Rosen, vice-president for electronic commerce at Citi. "That's what we're doing."

Beside NatWest and Midland, Bankers Trust Co. has a group dedicated to electronic commerce. And even some regional banks see opportunities. There is Wells Fargo's work with CyberCash. First Union Corp., based in Charlotte, N.C., has created an electronic mall for Internet transactions. Even Cardinal Bankshares Inc., a $607 million Lexington (Ky.) bank, on May 24 formed a new subsidiary, Security First Network Bank, which aims to grow into a full-service interactive bank on the Internet. "We'll be a one-branch bank in Kentucky with potential customers all over the U.S.," says CEO James S. Mahan III.

While it's not clear who the players will be 10 or even 5 years from now, it is inevitable that much E-money will originate outside the purview of central banks such as the Federal Reserve or the Bank of England, which are largely responsible for traditional monetary regulation. And that has major policy implications.

To begin with, consumers using the stuff could be extremely vulnerable. When consumers lose their credit cards, they are only liable for the first $50 of charges on the card. But for now at least, if a consumer misplaced, say, a Mondex card, it would be like losing cash. Similarly, if your digital coins are stored on the hard drive of your PC, a system crash could wipe out your electronic savings.

HIP TO HACKERS' HEISTS

"We have to assume electronic money will be the subject of sustained attack"

— COLIN CROOK, technology chief, Citicorp

Electronic money also creates vast opportunities for tax evasion, money laundering, and other financial crime. "There is an imaginable potential for a serious challenge to the whole political and social order," says First Virtual's Borenstein. "I am not all that sanguine that the government has the control they think they do." For people trying to avoid paying taxes to a national government, the lure of a stateless currency would be powerful indeed. Already, "virtual currencies" serving electronic communities of people are springing up on the Internet.

Then there's the issue of the volatility of money. The effects of high-speed electronic trading have been painfully apparent in market crises over the past several years. Market swings could be magnified if consumers and businesses could send their money around the globe with the touch of a button on a PC.

The monitoring of national money supplies will also change. While some regulators dismiss the issue, arguing that E-money will inevitably convert back to traditional money and get counted, other experts disagree. Martin Mayer, a guest scholar at the Brookings Institution, says that he expects the Fed to lose control of a significant portion of the money supply.

One of the most pitched debates is likely to be over privacy. As a society, we have relied on a system that allows us to keep some transactions private by using cash, while others, such as big-ticket purchases, are entrusted to a credit-card company or a bank. Competing forms of E-cash offer wildly differing degrees of privacy: DigiCash's E-money offers virtually complete anonymity, while every dollar you spend using the credit-card-based systems would leave a trail. The problem will be balancing individuals' rights to privacy with government's need to monitor money flow and trace criminal activity.

BREAKING INTO THE E-MINT. More dire is the possibility of major break-ins to E-money systems—the electronic equivalent of penetrating the U.S. Mint. If someone were to crack the sophisticated code of, say, the DigiCash system, he could start minting unlimited amounts of his own DigiCash money.

That's why it is all the more alarming that some regulators and even some central bankers still seem unconcerned

Not for Sale

with the advent of E-cash. After a breakfast speech to several hundred business leaders in San Francisco last March, Fed Vice-Chairman Alan Blinder was asked whether the Fed is studying the regulatory issues surrounding digital cash. His answer: "Digital what?" Then, after pausing a moment, he added: "It's literally at the thinking stage."

Cover Story

Slowly, though, some regulators are beginning to explore the concept of E-money so they can set policies. The Federal Reserve's payment-systems committee is meeting with Chaum of DigiCash and other E-money pioneers. State tax collectors are looking at the issue of taxing electronic commerce. The Financial Crimes Enforcement Network is also weighing in. Even the White House technology office is taking a big interest.

It's not a moment too soon. "There's no going back," says DigitaLiberty's Frezza. "The genie's out of the bottle. The Internet doesn't have an off switch." And no amount of wishing by regulators will change that.

By Kelley Holland and Amy Cortese in New York, with bureau reports

PATROLLING THE BLACK HOLES OF CYBERSPACE

At first glance, the offer sounded legitimate. First Bank of the Internet began advertising to Net browsers in March, offering a new way to pay for goods over the Net. By sending First Bank a check for at least $20, cybershoppers would get a Visa automated teller machine card "loaded" with their money—less a hefty 5% commission—which they could then use to obtain cash or pay for their cyberwares.

First Bank got numerous inquiries—but it also drew some unwanted scrutiny. State banking regulators warned that it couldn't call itself a bank. The Office of the Comptroller of the Currency sent an advisory to banks and regulators warning them about FBOI. First Bank CEO Vinn K. Beigh, a 34-year-old computer technician in Des Plaines, Ill., says he will soon pull his Net listing. But he is still looking for a way to cash in on the wave of electronic commerce. "There is quite an interest in buying on the Internet," he insists.

TANGLES FOR THE TAX MAN

"If you go to a cashless society, it makes it very difficult tracking... reportable income"

— JOHN GIBBONS, President Clinton's top technology adviser

He's got that right. First Bank isn't the only upstart trying to cash in on the demand. Consider World Trade Clearinghouse Ltd., which offers a gold-backed cybercurrency with cashlike anonymity that offers "protection from bureaucratic snoops, nasty ex-spouses, and lawsuit-hungry lawyers." And officially opening this month is the Internet Online Offshore Casino, run out of the Turks and Caicos Islands, which says it will accept all manner of E-money and pay customers 10% annual interest on the balances they leave in an offshore bank the company recently bought.

These enterprises may never draw in a meaningful number of customers. And many raise red flags to regulators. But the government is also a long way from getting a good fix on the activities of the much larger number of ostensibly legitimate E-money players.

MONEY LAUNDERERS. The regulatory gaps are sizable. For example, Stanley E. Morris, director of the Treasury Dept.'s Financial Crimes Enforcement Network (FinCEN), points out that there are no laws that limit the balance of electronic currency that can be loaded onto an E-cash card. That could create a major opportunity for money launderers. And no one has determined how to define whose tax laws apply to transactions in cyberspace (page 8). Says John H. Gibbons, assistant to the President for science and technology: "If you go to a cashless society, it makes it very difficult tracking cash income or reportable income.

Right now, regulators are simply trying to understand the new technology and how the market is evolving. Last April, the Federal Trade Commission held a conference to examine the impact of electronic commerce on consumer protection. FinCEN is organizing a colloquium on electronic currency to be held later this fall. "We are nowhere near the issue of regulating it," warns FinCEN's Morris. "We're one step back." Given the speed with which the market is advancing, regulators don't have much time to close that gap.

By Amy Barrett in Washington

Chairman ARCHER. Thank you, Dr. Rahn.

Hon. Craig Roberts, you may proceed.

STATEMENT OF HON. PAUL CRAIG ROBERTS, INSTITUTE FOR POLITICAL ECONOMY AND FORMER ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY

Mr. ROBERTS. Thank you, Mr. Chairman. I would like to congratulate you on holding these hearings. It is leadership that the American people have not seen in their lifetime.

The income tax must be abolished for two reasons. The first reason is that Americans will not again be a free people until they are shorn of the requirement to report their income and wealth to the IRS. The second reason is that the disincentives associated with income taxation make it the most costly method of raising revenues. Faced as we are with a new phenomenon, the rise of global capitalism, the United States will not be able to afford for much longer a tax system that reduces the rates of investment and productivity and makes the United States a relatively unattractive place to invest financial, physical and human capital. In the 21st century, we will not be protected against the folly of our own policies by the prevalence of socialism everywhere else on the planet.

To those born under the income tax, it might seem as American as apple pie. However, for most of our history, the United States had no income tax. One hundred years ago last April 8, the Supreme Court struck down the income tax as an unconstitutional measure. Justice Steven J. Field, a Democrat, went further. He condemned it as class legislation. He compared it to a 1691 English statute that taxed Protestants, Catholics and Jews at different rates. It required a constitutional amendment, the 16th, to establish the income tax in 1913, which is a relatively recent time for a country whose origin was 1776.

The 16th amendment passed as a political act directed at the Northeast. In other areas of the country, incomes were not large enough to produce any liability under the tax. In 1910, for example, William Shelton of Georgia wrote that southerners favored ratification of the amendment "because none of us here have $4,000 incomes."

The income tax is not as American as apple pie. It is a discriminatory tax. It discriminates against success, it discriminates against savings and investment and subsidizes consumption, it discriminates against work and subsidizes pleasure. There is nothing good that can be said about the leisure tax.

Socialist-minded folk used to say that the income tax was fair because it was a rich man's tax, but the income tax ceased to be a rich man's tax more than half a century ago. It is a mass tax. Some people still say the income tax is fair because it redistributes income. However, today income is redistributed through the expenditure, not the revenue side of the budget.

The method by which revenues are raised is independent of the question of redistribution. Sales tax revenues can be redistributed just as easily as any other kind. Not even regressive forms of taxation prevent redistribution of income to the poor.

For example, revenues from a tax that fell disproportionately on the poor could be used to provide food stamps, housing subsidies

and Medicaid only to the poor. Everyone would pay some tax, but only the poor would get the benefits of the expenditures. So even if income redistribution were a moral imperative, it does not require income taxation to achieve it.

Many of the income tax's unique disadvantages can be addressed by eliminating progressivity, lowering the rate and exempting saving from the tax base. A low rate flat tax that exempted from taxation all income that is saved would be a vast improvement over the current tax system. However, people would still have to report their income to the IRS, and this Committee should not underestimate the value to people of freedom from the requirement that they report their income to the IRS. I, for one, would be willing to pay a higher sales tax rate in order to ransom my freedom from the IRS. And I wouldn't be surprised if many people felt the same way.

How much time do I have, Mr. Chairman?

Chairman ARCHER. You technically have 1 minute, but we are not going to limit you rigidly to that.

Mr. ROBERTS. I am not going to go through the questions of the collection problems of the retail sales tax versus a VAT. If we adopt a value-added tax that calculates the tax liability by the credit or the invoice method that is used by the member countries of the EEC, then it would be a self-policing tax because businesses are refunded VAT paid on the inputs, and buyers and sellers would have no common interest to collude in falsifying invoices. This credit method would also make the border tax adjustment or the export rebate easy to calculate, as each firm would have a record of VAT paid on its purchases.

The great disadvantage of VAT is that unless the net of tax sales price is listed, VAT is an invisible tax, and therefore it is easy to raise it to excessive rates to support pork barrel spending. In contrast, an excessive sales tax rate would encourage massive evasion and be self-defeating. It is very difficult to evade a VAT calculated on the credit method.

Perhaps a solution would be to repeal the 16th amendment and substitute in its place a constitutional amendment that limits VAT to, for example, 10 percent. Simply limit VAT constitutionally to a fixed rate and then conduct the government with whatever revenues the economy brings in. This would guard against the gradual escalation over time of what could be a hidden tax.

In your deliberations, please keep in mind that the 20th century is not the norm but a departure from the ideal sought by the vast struggles in the 17th and 18th centuries to curtail rapacious government and make it accountable to the people. In the 19th century, we gathered fruit from these achievements, but the 20th century brought a return to big government with all-inclusive claims akin to the divine right of kings. Fascist, Nazi, Communist, Socialist and welfare states are the 20th century's contribution to misgovernment and human misery.

In the United States, Franklin D. Roosevelt finished off federalism with his New Deal, supposedly to save us from the failures of capitalism. All this proved to be a fraud, a turning away from modernity to a reactionary past.

Everywhere big government has failed. There is no longer any doubt of it. If we are to be an economically successful country in the 21st century, we need a tax system that does not discourage saving, deprive families of businesses that they create, disadvantage exports and impose large compliance costs. So in place of the existing taxes on income and wealth, a retail sales tax or a constitutionally limited VAT would be a great improvement.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of Paul Craig Roberts
before the
Committee on Ways and Means
U. S. House of Representatives
June 8, 1995

Mr. Chairman, members of the Ways and Means Committee, I congratulate you for holding these hearings. It is leadership that the American people have not seen in their lifetime.

The income tax must be abolished for two reasons: The first reason is that Americans will not again be a free people until they are shorn of the requirement to report their income and wealth to the IRS. The second reason is that the disincentives associated with income taxation make it the most costly method of raising revenues. Faced as we are with a new phenomenon, the rise of global capitalism, we won't be able to afford for much longer a tax system that reduces the rates of investment and productivity growth and makes the U.S. a relatively unattractive place to invest financial, physical, and human capital. In the 21st century, we will not be protected against the folly of our own policies by the prevalence of socialism everywhere else.

It is fitting that this reassessment is coming from the House. The House of Representatives was conceived by our Founding Fathers as the body of government closest to the people. They endowed the House with the initiative power of government. The function of the House as the expression of popular will was destroyed by the income tax. The money from the income tax turned representative government into a vote-buying operation that obliterated the integrity of Congress. The House must now reclaim the government for the people.

It will not be easy to do. The status quo takes advantage of reasonable people and uses compromise to stifle change. However, change is coming, because it has already been initiated elsewhere--in Latin America, Europe and the far East. Even in what used to be called communist China, stock markets have displaced the Communist Party as the arbiter of investment. In Europe privatizations are creating competitive firms and industries in the place of nationalized sloth. Even the British Labour Party has officially abandoned its 77-year-old commitment to nationalized industry. We can adapt to these world-wide changes by again becoming capitalist ourselves, or we can attempt to hide behind protectionism and sink.

To those of us born under the income tax, it might seem as American as apple pie. However, for most of its history the U.S. had no income tax. One hundred years ago last April 8, the Supreme Court struck down the income tax as an unconstitutional measure. Justice Stephen J. Field, a Democrat, went further and condemned it as class legislation. He compared it to a 1691 English statute that taxed Protestants, Catholics, and Jews at different rates. It required a Constitutional Amendment, the 16th, to establish the income tax in 1913, a relatively recent time for a country whose origin was 1776.

The amendment passed as a political act directed at the Northeast. In other areas of the country incomes were not large enough to produce any liability under the tax. In 1910 William Shelton of Georgia wrote that Southerners favored ratification, "because none of us here have four-thousand dollar incomes."

This view proved to be short-sighted. The income tax ceased to be a rich man's tax and became a mass tax. Once this happened, economists found it easier to acknowledge its defects, and politicians could garner middle class votes by cutting tax rates. The two most popular presidents in the postwar era, John F. Kennedy and Ronald Reagan, are associated with income tax rate reduction. However, reductions in tax rates have not altered the share of income that Americans have to turn over to the IRS. The unrelenting burden of the tax, together with widespread public disillusionment with the waste and ineffectiveness of government programs and increased recognition of the income tax's harmful economic effects, have stripped the income tax of its hegemony over public policy thinking.

The income tax is not as American as apple pie. It was a crude act of class and regional warfare and was explicitly

recognized as such. Its terrible costs were not easily seen. Other countries lacked sensible economic policies, and there was no standard for comparison.

The income tax is a discriminatory tax. It discriminates against success and subsidizes failure. It discriminates against saving and investment and subsidizes consumption. It discriminates against work and subsidizes leisure. There is nothing good that can be said about an income tax.

Socialist-minded folks used to say that the income tax was fair because it was rich man's tax, but the income tax ceased to be a rich man's tax more than half a century ago. Some people still say that the income tax is fair because it redistributes income. However, today, income is redistributed through the expenditure, not the revenue, side of the budget. The method by which revenues are raised is independent of the question of redistribution. Sales tax revenues can be redistributed just as easily as any other kind. Not even regressive forms of taxation prevent redistribution of income to the poor. Revenues from a tax that fell disproportionately on the poor could be used to provide food stamps, housing subsidies, and medicaid only to the poor. Everyone would pay some tax, but only the poor would get the benefits of the expenditures. Even if income redistribution were a moral imperative, it does not require income taxation to achieve it.

Many of the income tax's unique disadvantages can be addressed by eliminating progressivity, lowering the rate, and exempting saving from the tax base. A low rate flat tax that exempted from taxation all income that is saved would be a vast improvement over the current tax system.

However, people would still have to report their incomes to the IRS. This committee should not underestimate the value to people of freedom from the requirement that they report their incomes to the IRS. I, for one, would be willing to pay a higher sales tax rate in order to ransom my freedom from the IRS, and I would not be surprised if most others felt the same way.

The virtues of a consumption tax over an income tax are now widely understood. I doubt if there is a single respected economist any place on earth who would deny them. However, the greatest advantage of a sales tax is not that it is a consumption tax, but that it gets the IRS out of the lives of most people.

As long as the government collects revenues from any source, there will be an IRS. Under a sales tax, the extent of the IRS's involvement in private life would depend on the sales tax base, and this would depend on the rapaciousness of the government. If services are subjected to the sales tax, then professionals who sell services would have to serve as sales tax collection agents for the government. Evasion is possible, and the higher the sales tax rate, the greater evasion would be.

It is sometimes suggested that states could serve as the collection mechanism for a federal sales tax. However, five states do not have a sales tax, and there is variability among the states as to the tax base. It is likely that the IRS would confront more collection problems from a federal sales tax than it does from the current system of income tax reporting. However, convenience for the IRS should never be the standard by which we design our tax system. Indeed, the convenience for the tax authority is the last consideration that representatives of a sovereign people should address. If we are to remain a free people, it is the IRS, not the taxpayer, who must awake each morning wondering if it is going to be drawn and quartered.

The collection and evasion problems of a sales tax and the problem of cascading or taxing items in the chain of production more than once--minimal in the case of a retail sales tax--can be avoided by moving to a value added tax (VAT). A value added tax that calculates tax liability by the credit or invoice method used by member countries in the European Economic Community is self-policing, because businesses are refunded VAT paid on their inputs and buyers and sellers have no common interest to collude in falsifying invoices. The credit method also makes the border tax adjustment or export rebate easy to calculate as each firm would have a record of VAT paid on its purchases. The subtraction method

used in the Nunn-Domenici tax bill is simpler for companies but not self-policing, and calculating the VAT rebate on exports would be complex.

However, VAT can have one great disadvantage: If the net-of-tax sales price is not listed, VAT is an invisible tax; therefore, it is easy to raise it to excessive rates to support pork-barrel spending. In contrast, excessive sales tax rates would encourage massive evasion and be self-defeating.

Perhaps a solution would be to repeal the 16th Amendment and pass a Constitutional amendment that limits VAT to, for example, a 10 percent rate and then conduct the government with the revenues that the economy brings.

In your deliberations, keep in mind that the 20th century is not the norm, but a departure from the ideal sought by the vast struggles in the 17th and 18th centuries to curtail rapacious government and make it accountable to the people. In the 19th century we gathered fruit from these achievements. But the 20th century brought a return to big government with all-inclusive claims akin to the divine right of kings. Fascist, nazi, communist, socialist and welfare states are the 20th century's contribution to misgovernment and human misery. In the U. S. Franklin D. Roosevelt finished off federalism with his New Deal, supposedly to save us from the failures of capitalism. All of this has proved to be a fraud, a turning away from modernity to a reactionary past. Everywhere big government has failed. There is no longer any question of it.

If the United States is to be economically successful in the 21st century, the country needs a tax system that does not discourage saving, deprive families of businesses that they create, disadvantage our exports, and impose large compliance costs. In place of the existing taxes on income and wealth, a retail sales tax or a constitutionally limited VAT would be a great improvement.

A retail sales tax or a VAT would be easier to comply with than our complex income tax system that forces taxpayers to hire experts to compute their tax liabilities. A retail sales tax or a VAT would end the tax bias against saving and, thereby, encourage more investment and a higher saving rate. A tax that can be legally rebated on exports under GATT would improve the international competitiveness of U.S. labor and goods. A retail sales tax or a VAT would also pick up revenues from the cash economy, for example, illegal drug profits that are spent on consumption items, but not reported as income. When the further advantages of more freedom and less government intrusiveness are added, the case for a retail sales tax or a VAT is overwhelming.

Chairman ARCHER. Thank you.

Mr. Hayes, you may proceed.

STATEMENT OF STEVEN L. HAYES, PRESIDENT, CITIZENS FOR AN ALTERNATIVE TAX SYSTEM, LOS ANGELES, CALIF.

Mr. HAYES. Thank you, Mr. Chairman.

I would like to start off and tell you that I really believe the country owes you a great debt of gratitude for bringing this issue to the fore. I want to thank you personally and on behalf of the organization I represent, Citizens for an Alternative Tax System. We are truly a grassroots organization. None of us are paid; we are all volunteers, devoting our time because we believe very firmly that this country needs the elimination of the income tax, the elimination of the IRS, and its replacement with a retail sales tax as a way of gathering revenue for the government.

I have worked as an attorney for a number of years, and I have spent time dealing with the Tax Code. I became so disgusted with the Tax Code that in 1986 I decided I wasn't going to do it anymore, and I started looking at alternatives.

What I think is important, having dealt with the system, is that we look at an alternative that does a number of things. We look at an alternative that is simple. We look at an alternative that is fair, because the devotion of the people to any law is what makes it enforceable; if it is not perceived to be fair it will not be enforceable. We must look for something that really helps savings and helps work, instead of penalizing savings and work. And we look at something that, perhaps most importantly, gets the IRS out of our lives, that totally, as the Chairman says, tears the income tax up by its roots and throws it away. Because, Members of the Committee, I believe that no matter what is said about a flat income tax, one of the problems, perhaps the greatest problem, is that it keeps the IRS mechanisms in place and it keeps the ability for you gentlemen, for other Members of Congress, to be replaced at some point, and then it would be very simple to reinstitute the dreaded system that we have. We need to get rid of the income tax and we need to get rid of the IRS.

Now, all of the tax proposals are calling themselves consumption taxes. They are all saying, obviously we need to be a consumption tax. A consumption tax which like the Nunn-Domenici program, requires all of us to fill out essentially the same 1040 that we do now and requires 120 million tax returns to be filed this year isn't really much of an improvement.

The flat income tax, as proposed by Congressman Armey, requires us to fill out a tax return every month. If you do the math on that, that is over 1.5 billion tax returns per year that have to be filled out. All of those require, in order to be enforced and collected, the retention of the IRS and the retention of the mechanisms which they use to collect the income tax, the mechanisms which you hear complaints about on a daily basis. Under the IRS rules, the only way you can collect an income tax in this country, is you have to be guilty until you are proven innocent by yourself. That is just not right in a free society.

We have heard some talk about the underground economy and how we are going to get at the underground economy. The Chair-

man has stated that we have to get at the underground economy because the conservative estimate by the IRS is that $120 billion of income taxes are being evaded each year. I have worked in the tax area and I suspect that the real estimate of cost of the underground economy is probably closer to $200 billion a year, and any tax system we have needs to address the underground economy.

The national retail sales tax, I believe, does the best job because it taxes what a person buys. A quick example: In California, 90 percent of the revenues raised by the sales tax, 90 percent, are paid by 8 percent of the merchants. So you are talking about most of the revenues coming from merchants where they don't have much of an evasion problem. We are going to get at the underground economy.

I do a lot of radio shows. I talk to a lot of Americans who call up and who say, How are you going to get rid of the income tax?

One of them called me and said, You know, Congress has put us in slavery. I said, What are you talking about? He said, We have to fill out an income tax return. I said, Well, how is that slavery? He said, Slavery as far as I am concerned is being compelled to do something you don't want to do for which you are not compensated and for which you are punished severely if you do it wrong.

Well, Members of the Committee, I believe you certainly have the power to continue a system that requires Americans to fill out and spend not 5.5 billion hours but probably 8 billion hours now, but you don't really have the right to compel us to do so. What I believe you have the obligation to do is to free us from the income tax, get rid of the IRS and tear the income tax out by its roots so it won't come back.

With a retail sales tax in place, we will become a magnet for capital from around the world and we will see a boom in this country the likes of which we have never known because instead of taxing incentive, instead of taxing savings, we are going to reward them. You get to keep what you earn, you get to keep what you save, and you get to make the choice for the first time since we have had an income tax.

Thank you.

[The prepared statement follows:]

REVITALIZE THE AMERICAN ECONOMY

REPLACE THE INCOME TAX WITH A NATIONAL RETAIL SALES TAX

By Steven L. Hayes

Mr. Chairman and Members of the Committee, it is a privilege to be asked to testify. My name is Steve Hayes. I am an attorney who dealt with the Internal Revenue Code for over 20 years. For most of those years, I complained about the insanity of the income tax and how it was damaging not only our economy but also our American way of life. In 1987, after the passage of the 1986 Tax Reform Act, I made the decision that it was indefensible for me to continue practicing in an area of law which I believed was wrong. Accordingly, I phased out the tax law portion of my practice and now our firm only practices business law and business litigation.

I am also serving as the president of Citizens For An Alternative Tax System ("CATS"), a grass roots organization formed in 1990. We are all volunteers. Neither our officers, our chapter directors nor our members receive salaries or cars or other perks. All of us are taking time away from our families and jobs because we believe that the current income tax system must be changed. Our supporters can be found at all points of the political spectrum, but we have one common goal—the replacement of the individual and corporate income tax and the estate and gift tax with a national retail sales tax. This change is vital to reviving our nation's economy and freeing each of us from the tyranny of the income tax.

In response to the over 5,000 radio and TV appearances made by our spokespersons in the past five years, thousands upon thousands of people have called and written us asking for information about our proposal to replace the detested income tax with a national retail sales tax. Americans are demanding a tax system that causes the least amount of government intrusion in our lives and that has the least negative impact on the economy. The American people are frustrated, impatient and angry because they know that the income tax system is beyond repair and believe that this should be obvious to everyone but, until recently, no one in Washington seemed to hear.

As these hearings so eloquently state, Washington is now listening. Many Members of Congress are commenting that when they return to their districts and conduct town meetings, their constituents are demanding tax reform. When they explain the alternatives, these Members are finding that an alternative that provides for the elimination of the income tax and eradication of the Internal Revenue Service is preferred by margins of more than 2 to 1.

In its January 8, 1995 issue, *Parade* magazine ran an article entitled "What If We Abolished the Federal Income Tax?". This article discussed replacing the income tax with a national retail sales tax and invited readers to comment. In response, over 40,000 letters were received. 96% were in favor of abolishing the income tax and replacing it with a national retail sales tax and 4% were opposed.

Although many in Washington seem to doubt this, Americans really do understand the effects of taxes on their lives. They know that the right type of federal tax will encourage savings and investment, reward hard work, remove an enormous and expensive compliance burden from businesses and individuals, be perceived as fair, tax the underground economy, be obvious and not hidden, and get the IRS out of our lives. Our alternative, the national retail sales tax, meets the above criteria better than any of the other alternatives being discussed. The national retail sales tax is simple—a flat rate applied to all retail consumption of goods and services, and obvious—when you make a retail purchase of a good or service, the national retail sales tax is clearly shown on the sales receipt. If you want to know how much federal tax you paid, all you have to do is look at the receipt.

What national retail sales tax rate would be needed to replace the revenue currently generated by the individual and corporate income tax? Dr. John Qualls, adjunct Professor of Economics and International Affairs at Washington University in St. Louis, Missouri, used the COREMOD policy simulation model to delineate the economic effects of replacing the income tax with a national retail sales tax. He found that a 16 to 17 percent sales tax rate was needed to replace the income tax collections of $587 billion in 1990, given a consumer spending level of $3.605 trillion in that year.

There has been a lot of discussion about the fairness of one alternative or another. The national retail sales tax has been labeled "regressive" and the income tax alternatives have been labeled "progressive." This is a distortion. Some people are concerned that the national retail sales tax

will collect most of its tax revenues directly from lower income groups. This is not true. According to the Current Population Reports published by the Department of Commerce, American families with annual incomes under $18,149 account for only $500 billion of the $3.605 trillion of consumer retail spending. As with the present income tax, middle- and higher-income families will pay the great majority of the national retail sales tax.

Economists maintain that the regressivity of the national retail sales tax is overstated because it should be measured over a person's lifetime not each year. Although in some years consumption will not equal income, the consumption of most households roughly equals their lifetime income. The national retail sales tax is really a proportional tax.

However, replacement of the income tax with a national retail sales tax will have initial effects on people with fixed or lower incomes. There are simple ways to prevent unwanted burdens on these people. With the national retail sales tax, the federal government collects our taxes in the simplest and fairest way. While there are a number of proposed methods for creating a safety net for our citizens, we believe that the most effective will be through cash rebates. Through the use of cash rebates we can ensure that a family of four would essentially pay no national retail sales tax on the first $15,000 of retail purchases in a year, approximately the equivalent of the standard deduction and the personal exemptions currently allowed by the present income tax system.

My testimony will address the national retail sales tax, the flat income tax proposal sponsored by Congressman Armey and the consumed income tax proposal sponsored by Senator Nunn and Senator Domenici.

Chairman Archer has asked that our testimony address the following points:

1. Is the proposed alternative easy to comply with and does it reduce the role of the Federal Government in our lives?

2. Does the proposed alternative encourage greater savings and investment?

3. Does the proposed alternative improve the international competitiveness of American workers and businesses?

4. Does the proposed alternative pick up revenue from the underground economy and others who currently do not comply with the tax laws?

5. Does the proposed alternative tear the income tax out by its roots?

IS THE NATIONAL RETAIL SALES TAX EASY TO COMPLY WITH AND DOES IT REDUCE THE ROLE OF THE FEDERAL GOVERNMENT IN OUR LIVES?

Compared to the income tax, all three alternatives promise a reduced compliance burden. However, the national retail sales tax is clearly the easiest with which to comply and will most reduce the role of the federal government in our lives.

While on a radio talk show, a caller told me that preparing tax returns was government-imposed slavery. He explained that slavery was being compelled to do work that you didn't want to do without being paid for it and being punished severely if you did not obey. He was right. The foremost goal of any alternative to the present income tax should be the freeing our citizens from government-enforced "slavery." Our intention to free Americans from the slavery of an insane tax system has led some journalists to label us as the "New Abolitionists." This is a label of which we are proud.

As a professional well acquainted with the problems of complying with our present income tax system, it is frustrating to me when "experts" attempt to show the costs of a tax system by merely compiling the costs of the government agencies collecting the tax and enforcing the tax law. This method only reflects a small portion of the actual costs. Compelling taxpayers to amass records and prepare any type of tax return takes taxpayer time that is, in essence, an additional cost of the tax system. Time thus expended could have been devoted to productive activities. According to the Tax Foundation, corporations with assets of $1 million or less (more than 90 percent of all corporations) paid a minimum of $387 in compliance costs for every $100 they paid in income taxes ($14 billion in compliance costs for $3.7 billion in income taxes). Ironically, if this time and money could have been devoted to the production of goods and

services and not to the preparation of non-productive paperwork, the economy would grow even more which would in turn lead to more taxes being collected.

Our current federal income tax system is beset with administrative problems. In 1992, Americans filed 113,604,503 individual income tax returns (including 15,495,419 nonfarm sole proprietor returns), 1,484,752 partnership returns and 3,869,023 corporation returns for a total of 118,958,278 tax returns. According to GAO reports, IRS employees err on one out of every ten income tax returns they enter into the IRS computers, and the IRS has more than $200 billion in misstated payments from taxpayers and refunds. Most troubling, the National Research Council predicts a major breakdown could occur in the present income tax system before the year 2000.

Which of the three alternatives is the easiest with which to comply and most reduces the role of the federal government in our lives? Each of the three alternatives should answer the following questions:

(a) What is taxed, who files the return and who administers the tax system?

(b) Who files the tax return and how often?

(c) How complex is the tax return?

WHAT IS TAXED, WHO FILES THE RETURN AND WHO ADMINISTERS THE TAX SYSTEM?

National Retail Sales Tax

Under the national retail sales tax, most Americans will not file any type of tax return. Only an estimated 10 million providers of retail goods and services will be required to file sales tax returns. Most of them will file monthly sales tax returns but the larger retail establishments will, as they do with state sales taxes, file more frequently. The states will collect the national retail sales tax and send the taxes collected directly to the U.S. Treasury. The Internal Revenue Service is not involved and will no longer interfere in the lives of ordinary Americans.

Flat Income Tax

Each American must file a tax return each month and then a thirteenth return on April 15. Owners of businesses must prepare thirteen tax returns for their personal taxes and thirteen more tax returns for their businesses. Enactment of the flat income tax will require Americans to file a minimum of 1.5 billion income tax returns each year. The flat income tax is collected through the IRS which will at least retain the powers it now has under the federal income tax. However, many tax practitioners believe that the IRS will have to be granted even more coercive powers because many people will not make their monthly tax payments on time. Obviously, this does not get the IRS out of our lives but ensures a continuing and ever-increasing involvement of the IRS in our lives. This is just the opposite of what any alternative should do.

Consumed Income Tax

Under the consumed income tax system, everyone must file a tax return with the IRS, which will still retain the powers it now has under the federal income tax. Enactment of the consumed income tax will require about 118,900,000 income tax returns in the first year. Like the flat income tax, the consumed income tax does not get the IRS out of our lives but ensures a continuing and ever-increasing involvement of the IRS in our lives. This is just the opposite of what any alternative should do.

HOW COMPLEX IS THE TAX RETURN?

National Retail Sales Tax

The national retail sales tax return will be simple. For example, the Texas sales tax return measures 3.5" x 8.5". Revenue from retail sales for the period is totaled, returns are subtracted, and the remaining balance is multiplied by the rate of the retail sales tax. The only record keeping required will be to total the retail sales, the amount of sales returns or refunds and the amount of the national retail sales tax collected from customers.

Flat Income Tax

Except for having to prepare tax returns thirteen times per year, the flat income tax return will be simple for wage earners if they have no self-employment income. The self-employed and all businesses must add up their total revenue from operations, subtract the inputs from other firms, subtract the amount of wages, salaries and pensions paid to workers and subtract the purchases of plant and equipment. The remaining amount is then taxed at the flat rate.

How complex will business returns be? The business returns will be much more complex in actual practice than in theory. Are we simply going to let businesses fill in a total amount for goods and services purchased from other firms or for the purchases of plant and equipment? It seems naive to me that, in the interest of fairness, we aren't going to enforce diligently the limits of what is deducted from income. Is it acceptable for a business to purchase cars for personal use through the business or for the owner to purchase computers for each of his twelve children through the business and thus reduce the taxes of the business?

Consumed Income Tax

The consumed income tax return for individuals will be very similar to the tax returns we are now used to preparing. An individual will calculate his gross income from wages, interest, dividends and amounts received from the sale of assets. From gross income the individual will subtract a family allowance, all "qualified savings and investments", a higher education deduction, and home mortgage interest, charitable contributions and alimony paid. Then the initial tax is calculated and a credit for social security taxes is deducted. The resulting amount is then paid to the IRS.

Businesses total the revenues received, deduct the amounts paid to other firms for the goods and services purchased from them, including plant and equipment as well as inventory, parts, supplies, outside services and utilities but not wages paid to employees. This resulting amount is multiplied by 11%. Then a credit for the 7.65% employer portion of FICA for its employees is deducted and the resulting amount is the tax owed.

This is the most complicated of the three alternatives being discussed. It will require individuals to keep extensive records to be able to file income tax returns. It will also require all businesses, not just those providing retail goods and services, to file income tax returns.

Summary

Clearly the alternative that is the easiest with which to comply and that most reduces the role of the federal government in our lives is the national retail sales tax. Over 90 million Americans file no tax return of any kind under this system. The 10 million returns to be filed will be much simpler than the tax returns retailers must file under either the flat income tax or the consumed income tax. The IRS is required to enforce and collect the flat income tax and the consumed income tax but can be dismantled under the national retail sales tax.

DOES THE NATIONAL RETAIL SALES TAX ENCOURAGE GREATER SAVINGS AND INVESTMENT?

The rate a nation saves is directly correlated with its rate of economic growth and the health of its economy. More savings reduces the cost of investment capital and increases its availability. Our people are taxed when they earn income, and if they then manage to save or invest some of it, they are taxed again on the earnings from the savings and investments. When income tax and inflation are subtracted from the earnings on savings and investments, many Americans are actually losing purchasing power when they choose to save and invest. Therefore, it should be no surprise that the U.S. has had the lowest personal savings rate of any industrialized nation for the past 17 years.

This lack of availability of capital directly affects our productivity. To become more productive, American businesses must continually modernize their plant and equipment, which requires capital. The Office of Technology Assessment estimated that each year from 1977 to 1988 the cost of capital in America averaged 3.4 percent higher than the cost of capital in Japan for investments in machinery and equipment with a physical life of 20 years, 4.9 percent higher for a factory with a physical life of 40 years and 8 percent higher for a research and development project with a 10-year payoff. It is not merely a coincidence that countries with higher savings rates have higher rates of sustained productivity growth.

Productivity is important to America. Dr. Qualls calculated that if the rate of productivity growth had continued at the same rate in the 1970's and 1980's as it was for the period 1950 to 1967, we would live in a much different America today. At current levels of spending, there would not be a budget deficit or a national debt and the average family would have $10,000 more each year in real disposable income.

Although there are some significant differences, each alternative would encourage savings and investment and allow for increased productivity much better than the current income tax.

National Retail Sales Tax

Under the national sales retail tax, savings and investment will dramatically increase. In a study by Dr. Laurence J. Kotlikoff, Professor of Economics at Boston University, entitled *THE ECONOMIC IMPACT OF REPLACING FEDERAL INCOME TAXES WITH A NATIONAL SALES TAX*, Dr. Kotlikoff stated, "The shift in tax structures is predicted, in the long run, to raise the stock of U.S. capital by at least 29 percent and potentially by as much as 49 percent and to raise U.S. living standards by at least 7 percent and potentially by as much as 14 percent.." Dr. Kotlikoff calculated that a 16.9 percent national retail sales tax rate would be needed but that it could decrease to 11 percent as the economy grew.

Both Dr. Kotlikoff's and Dr. Qualls' studies found that the national retail sales tax causes the private savings rate (both personal and business savings) to rise substantially and produces faster economic growth and higher productivity. In both studies, the higher level of capital stock created under the national retail sales tax results in more job creation. More earnings by employees in the private sector fuels more consumer spending. Consumer spending thus rises from its current level but actually declines as a percentage of GNP.

There will also be what some economists call the "sponge effect". The U.S. is the world's largest market and has the best infrastructure of any country on earth. When the income tax is replaced with the national retail sales tax, it will become the world's largest tax haven and a "sponge" for capital from around the world. According to Martin Armstrong of the Princeton Economic Institute, replacing the income tax with a national retail sales tax will create an inflow of foreign capital into this country like we have never seen. Mr. Armstrong points out that the nearest comparable period in modern history was in 1940. Seeking to avoid the ravages of World War II, capital flooded into the United States and government bond rates were at one percent.

A more conservative estimate is that the adoption of the national retail sales tax will lower interest rates between 200 and 300 basis points. Overnight we will see the debt service on our national debt reduced, perhaps enough to bring the budget in balance. Our businesses will be more able to purchase equipment and rapidly increase productivity. Our citizens will be able to refinance their homes and save hundreds of dollars per month. In short, the United States will experience the greatest economic boom in our history.

Flat Income Tax

Under the flat income tax savings and investment will increase because income from savings and investment will not be taxed. However, the rate of increase in savings and investment will be slower than under the national retail sales tax because all income and business profits are taxed as the money is earned. Only the amount remaining after the income tax is deducted will be available for savings and investment. While there will be an influx of foreign capital under the flat income tax, the complexity of the tax and the concern that it will revert back to a regular income tax will cause the increase to be less than under the national retail sales tax.

Consumed Income Tax

Savings and investment will increase under the consumed income tax. The consumed income tax allows taxable income to be reduced by the amount of money saved or invested. While there will be an influx of foreign capital under the consumed income tax, the complexity of the tax and the concern that it will revert back to a regular income tax will cause the increase to be less than under the national retail sales tax.

Summary

As the economic studies show and as common sense predicts, savings and investment will grow much faster under the national retail sales tax than under either of the other alternatives.

DOES THE NATIONAL RETAIL SALES TAX ENCOURAGE INTERNATIONAL COMPETITIVENESS OF AMERICAN WORKERS AND BUSINESSES?

The income tax seriously harms our ability to compete in the global marketplace. Our major trading partners around the world rely heavily on consumption taxes that are applied to all products sold in their countries, whether domestically made or imported, and are "border-adjustable," meaning that the taxes on exported goods are rebated to manufacturers within their borders. (GATT does not allow rebates of income taxes.)

Congressman Sam Gibbons (D-FL) has stated that our income tax system has caused us to be a nation of exporters of jobs. High-paying American jobs are vanishing overseas at an alarming rate. Without a border-adjustable tax, we handicap our exporters because their goods contain the cost of our government, whereas imported goods do not contain any cost of our government. Therefore, the income tax penalizes American products and exports and subsidizes imports.

To illustrate the problem, assume that an American-made product and an identical foreign-made product each have a selling price of $1.00. Both products have, as a component of that price, built-in tax increases of approximately 20 percent or $0.20. (In the U.S. this 20 percent is due to income taxes; in countries such as European Common Market countries the increase is due to consumption taxes.)

When the foreign-made product is exported to the U.S., the consumption taxes are rebated to the foreign manufacturer as the product leaves the country. It thus arrives in the U.S. at a net cost of $.80 and the U.S., for all practical purposes, does not require the product to pay any income tax. (Former Congressman Richard Schulze stated that in 1989 the $600 billion of imports that year paid an income tax of only 0.1 percent.) Thus, this product with a cost of $0.80 competes against U.S.-made products costing $1.00.

Further inequities occur when a U.S. product is exported to a foreign country. U.S. manufacturers receive no rebate of the income tax component of the cost, and to compound the problem, the foreign country will tack on their consumption tax (say an average of 20 percent) to the cost of the good. So the $1.00 exported item now costs $1.20 and is competing against similar foreign products at $1.00.

Why is this important? It is estimated that each $1 billion in exports supports 19,000 jobs in the U.S. While our OECD competitors' exports range from 15 percent to 30 percent of their GDP, our exports only total 6 percent of U.S. GDP. By increasing exports, the U.S. can create hundreds of thousands of the type of high-wage jobs that our country desperately needs.

Our international competitiveness will be affected by each of the three alternatives but in widely disparate ways.

National Retail Sales Tax

With the national retail sales tax, our international competitiveness will be greatly enhanced. The national retail sales tax is only levied on sales in the U.S. Our exports will pay no U.S. tax nor include U.S. taxes in their prices. Imports into our country that are sold at the retail level will be taxed in the same manner as U.S. retail products. Our companies will no longer be forced to locate factories in other countries in order to compete in a global economy. More higher-paying jobs that would have otherwise gone to foreign citizens will stay in the U.S. With the national retail sales tax , we will no longer be exporting jobs to foreign countries, and our economy will rapidly grow.

Flat Income Tax

Like the current income tax and the consumed income tax, the prices of U.S. exports will include income taxes. Unlike the national retail sales tax, the flat income tax does not prevent imports from utilizing transfer pricing to largely avoid paying U.S. taxes. Under the flat income tax a company can still produce a product for $.25 in country Y but sell it to its U.S. subsidiary for $.80 and then sell it in the U.S. for $1.00. The only portion of the profit taxable under the flat income tax will be the difference between $.80 and $1.00.

Consumed Income Tax

Under the consumed income tax, a U.S. company's earnings on exports are not taxed. Like the

current income tax and the flat income tax, the prices of U.S. exports will include the cost of consumed income taxes paid by all the company's suppliers in the U.S. The consumed income tax imposes a flat 11% import tax on the sale in the U.S. of foreign imports.

Summary

In the arena of international commerce, the national retail sales tax is the clear winner. U.S. exports are not taxed at all and imports will be subject to the same 16% to 18% national retail sales tax that U.S. products carry. In addition, unlike the flat income tax and the consumed income tax, U.S. exports will not have to include in their prices the amounts of income tax paid by everyone in the chain of production.

DOES THE NATIONAL RETAIL SALES TAX PICK UP REVENUE FROM THE UNDERGROUND ECONOMY AND OTHERS WHO CURRENTLY DO NOT COMPLY WITH THE TAX LAWS?

We must remember the old adage that laws are no stronger than the devotion of the people to them. The present income tax is increasingly viewed as being anything but fair and the devotion of the people is becoming severely strained. Once our voluntary compliance rate was the envy of the world. Now, even many in the IRS admit that substantial voluntary compliance with the federal income tax is a thing of the past. In 1994, an estimated 10,000,000 taxpayers elected to drop out of the system altogether.

The underground economy is the fastest growing segment of our economy. It is estimated that $127 billion of taxes went uncollected in 1992 due to the underground economy. Many analysts believe that estimate is too conservative and that a figure of $200 billion is closer to the truth. The underground economy encompasses not only illegal sources of income, such as drug dealing, gambling and prostitution, but also the average ordinary citizen who accepts a lower price for cash payments and doesn't report the income; the businessman who keeps two sets of books and pockets a portion of the sales or takes improper deductions; or the self-employed person who charges personal expenses through the business.

National Retail Sales Tax

There will be an element of noncompliance under any tax system, but the national retail sales tax will be much harder to evade. Taxpayers who take improper deductions, drug dealers and people who refuse to file income tax returns or report all of their income have one thing in common--they all purchase goods and services. The national retail sales tax ensures that each of these groups pay their fair share when they buy their automobiles, yachts, televisions, etc.

Will there be people who refuse to pay the national retail sales tax? Yes. There are always going to be people who refuse to pay any tax. However, it is much more difficult to avoid the national retail sales tax than any income tax. In California, the State Board of Equalization's statistics show that 90% of the state sales taxes are paid by 8% of the providers of retail services. California sales tax officials believe that there is little or no evasion from this 8% of the retailers because of their size and their accounting systems. Since it is unlikely that all of the remaining 92% of the retailers will be dishonest, the amount of evasion, even if the rate was increased to 18%, will likely be between 5% to 7%—far better than the 17% to 25% experienced under an income tax.

Flat Income Tax and Consumed Income Tax

To the extent that deductions are eliminated, the flat income tax or the consumed income tax may have some effect on reducing the portion of the underground economy that is caused by people who take improper deductions under the present income tax. However, there is a high likelihood that this reduction may be offset by an increase in improper business deductions because of the way both alternatives propose to tax business. In addition, the only way for either alternative to even tax a small part of the remainder of the underground economy is to increase the coercive powers of the IRS against all citizens whether they are honest or dishonest, and our country will slide further away from freedom toward "Big Brother."

Summary

The national retail sales tax is clearly better at ensuring that all Americans pay federal taxes and it accomplishes this without having to increase the harassment of our citizens or involve the IRS.

DOES THE NATIONAL RETAIL SALES TAX TEAR THE INCOME TAX OUT BY THE ROOTS?

The IRS has the ability to summons nearly all of our financial records without our consent and pry into each of our private lives. Taxpayers are presumed "guilty" until they can prove their "innocence". Yet, it has become apparent that the only way the IRS can continue to collect the income tax from our citizens is to become more and more coercive and intimidating. This is unacceptable and cannot be tolerated if we really are a free society.

National Retail Sales Tax

The national retail sales tax is the only one of the alternatives that allows us to "tear the income tax out by its roots." The national retail sales tax will be administered by the states. Over 100 million Americans will be freed from the obligation of filing tax returns and being subjected to IRS harassment and audits. The remaining 10 million will file much simpler and easier tax returns than under the flat income tax or the consumed income tax.

Flat Income Tax and Consumed Income Tax

The flat income tax and consumed income tax are still income taxes. They require all of us to file income tax returns with the IRS. All of the IRS apparatus and computers and dossiers will still be in place. A future Congress will only have to slightly modify this and change that and suddenly we have the same type of horrible income tax system that we are eagerly discussing eliminating at these hearings because the forms, the computers and the enforcement apparatus will still be in place.

Is this an unlikely scenario? I think not. Since the 1986 Tax Reform Act, Commerce Clearing House has counted more than 5,000 changes to the Internal Revenue Code. If there is an income tax, there will be a huge temptation to direct investment or activities and there will be an unlimited amount of contributions to be reaped from constituents and lobbyists who want tax favors.

Summary

The national retail sales tax allows for the elimination of the IRS. The flat income tax and the consumed income tax ensure that the IRS will continue to be involved in our lives.

CONCLUSION

We believe that repealing the income tax and tearing the IRS out by its roots is the most important ingredient in an alternative tax system. An income tax and the IRS are anathema to a free society. In *For Good And Evil*, Charles Adams' important work on the impact of taxes on civilization, he points out that the astute Greeks observed that tyranny (oppressive government) was the consequence of the wrong kind of taxation; conversely liberty was the consequence of the right kind of taxation. And what was the right kind? Sales and customs taxes, said the Greeks. The wrong kinds of taxes that produced bad government were direct taxes like income and production taxes. The Greeks came to these conclusions, not from reason, but from the examples of history.

Our income tax has proven that the Greeks were right. Much of our liberty has been lost to make our income tax system work, exactly as the Greeks predicted. Selection of the best alternative to the income tax is important to the cause of freedom and man's dignity.

America has remained free because men and women have been unwilling to allow tyranny and oppression to dim the light of freedom. Citizens For An Alternative Tax System believes that the opportunity to eliminate a system of taxation that has become oppressive everywhere it has been used in history—the income tax— exists today.

We must not let this chance be lost. If we allow the income tax to continue, we will be harshly judged not only by Americans living today but also by future generations. Replacement of the income tax system with a national retail sales tax is the solution that is needed by America.

Chairman ARCHER. Mr. Moore, you may proceed.

STATEMENT OF STEPHEN MOORE, DIRECTOR OF FISCAL POLICY STUDIES, CATO INSTITUTE

Mr. MOORE. Thank you, Mr. Chairman. I am Stephen Moore, director of fiscal policy studies at the Cato Institute. I thank you for holding these truly historic and revolutionary hearings. I must say that I never thought I would see what we have seen in the last 3 days in this room any time in my lifetime or at least any time in this century.

I also thank you for coming up with a proposal that I think is probably the most liberating public policy idea that this country has seen in several decades—Ronald Reagan, God bless his heart, never came up with an idea—this liberating idea of getting rid of the income tax, and I use that word purposefully, "liberating," because that is what this idea is about.

About 4 years ago the Cato Institute got very involved in the issue about whether we should abolish the income tax. Interestingly enough, when we came up with this idea we had Larry Kotlikoff, whom you heard from earlier, do a study for us looking at the impact of this. People used to roll their eyes and say, there goes the Cato Institute with one of their utopian fantasies.

It is very interesting to me how this issue has developed. We don't see it as a utopian fantasy anymore. In fact, what we used to say, to borrow a phrase from a fellow Texan of yours, if we adopted a national sales tax idea and had zero tax on corporate income, zero tax on personal income and zero capital gains tax, that that giant sucking sound you would be hearing would be capital from all over the world flowing into the United States.

Imagine that there was no income tax, that there was no April 15 to dread any longer, that there was no H&R Block to deal with every year. Our cities would begin to look like gleaming versions of Hong Kong. I truly believe that our problem in this country would be that we would have a shortage of stocks and businesses to invest in, a shortage of workers. We would make Japan and Germany look like they were standing still. And I think that our foreign rivals would be forced to either comply and join us in getting rid of their income taxes, or fall further and further behind economically.

I think this is an issue where the public, notwithstanding you, Mr. Chairman, is way ahead of the politicians. I have worked with Steve Hayes and CATS over the last 4 years and have been amazed at the extent to which this is a populous issue, very much like term limits. You see very strong, deeply rooted interest and support for this issue among grassroots Americans.

It is interesting, because I have heard over the last 3 days a lot of the opponent talk about how this is an idea that will just help the rich "fat cats." If you go to a CATS meeting in Cleveland, Ohio or Houston, Tex., and you go to one of their townhall meetings, it is not rich Wall Street "fat cats" that want to get rid of the income tax; it is busdrivers and schoolteachers and grandmothers, real people with real jobs, and they are very concerned about our current system.

So let me say, the proposal that we have come up with—and everyone has a different version of the national sales tax, but there are basically four features of the proposal that we have come up with. First, we would eliminate the entire personal income tax, corporate income tax, capital gains tax and the estate tax. And by doing that, you can replace that with about an 18 percent flat rate national sales tax. This would apply to all final-use goods and services. The only thing that would be exempted would be housing, under our plan.

The second feature of our proposal—and this is important because it gets to the idea of regressivity of a sales tax—is that we would provide a $5,000 per person exemption or what you should call a "rebate." So if you are talking about a family of four, $20,000 of their first purchases would be exempt from the tax in a given year. This makes the system a nonregressive tax.

In a sense, what we are coming up with is the equivalent of what Mr. Armey has in his plan with the zero bracket up to $36,000, although we would make it $5,000 per person. His is, I think, $36,000 for a family of four. But if you wanted to make your exemption as generous as his, you could do that very easily. Just make the exemption $9,000 per person. The bottom line is that there is no reason that a national sales tax has to be regressive.

The third feature of this is that we would bring about the dismantling of the IRS by having the States collect the sales tax. As you know, Mr. Chairman, 45 States already have sales taxes in place, and one of our worries is that we want to make sure that we don't get a sales tax and an income tax. One of the ways of doing that, I think, is when you bring in place the national sales tax, we dismantle the infrastructure of the income tax in Washington, to have the States collect it, and I think the States would simply then piggyback off of the Federal tax system. By the way, this would not be an unfunded mandate. Under our plan, we would reimburse the States for the cost of collecting the tax.

Finally, and I think most importantly—and I haven't heard too much talk about this over the last 3 days—we would require a supermajority vote to either raise the sales tax or to reintroduce any other of the taxes that have been eliminated. I think that a very key feature, if you want to get support for this idea, is a supermajority, something like a two-thirds vote requirement in both Houses.

I am sure you are familiar with the Kotlikoff plan we have come up with. I am not going to go over the economics of that. Let me conclude by saying this, and this is one area where I may disagree. If you look over the last 3 days of these hearings, there is vast similarity between the plans that have been introduced—the Armey plan, the Nunn-Domenici plan and the Archer idea. While I am totally committed to a national sales tax, I also don't think we should let the ideal be the enemy of the good. If you can pass an Armey flat tax plan this year, do it. I think that would certainly be a very strong movement in the right direction, and I think that this is one of those canyons; to get to a national sales tax, we may have to leap this canyon in two leaps, go to the Armey flat in leap one, and once we have established the principle, both flat rate tax systems

with no deductions, then I think it is a logical conclusion to say, what do we need an income tax system for?

Thank you very much for holding these hearings, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF STEPHEN MOORE
CATO INSTITUTE

Thank you Chairman Archer for the opportunity to testify during these three days of congressional hearings on radical overhaul of the U.S. tax code. I commend your leadership and courage for convening these historic hearings.

A revolutionary change in our tax system is fundamental to re-energizing the American economy and restoring the American dream. Although Congress may not be ready quite yet to enact a flat tax or a national sales tax, let me assure you that the public is. Americans are entirely exasperated with the current income tax--they want a system that is simpler, fairer and more pro-growth. A recent article in Parade Magazine asked readers whether they would favor a national sales tax over the current income tax. More than 50,000 responses have been received. They are running 50 to 1 in favor of abolishing the income tax. Even IRS agents are writing in saying we should scrap the income tax.

Let me state my overall conclusions from the start.

1) The entire personal income tax, corporate income tax, capital gains tax, and estate tax can and should be replaced with an eighteen percent national sales tax that protects the poor. Eventually, as we cut down on the size and scope of the federal government and accrue the dynamic revenue feedback effects of hyper-charged economic growth that would result from abolishing the income tax, the sales tax rate could be lowered to well below 15 percent.

2) We ought to consider enacting the Armey flat tax plan as an intermediate step to abolishing the income tax completely. Although there is much disagreement over the merits of a flat tax versus a sales tax, what is most remarkable in this debate is not how different these two plans are, but how similar they are. For example:

* The Armey plan and the sales tax plan both vastly simplify the tax code.

* The Armey plan and the sales tax plan both have a 17 to 20 percent flat tax rate.

* The Armey plan and the sales tax plan both eliminate all deductions in the tax code. This means that both plans are fighting a common enemy: the army of special interest groups who have spent decades carving out their special interest exemptions and loopholes.

* The Armey plan and the sales tax plan both have virtually an identical tax base: consumption. The economic impact is very similar and explosively positive.

Mr. Chairman, it is my view that you and Mr. Armey agree on far more than you may think.

The only real dispute--and this is certainly an area of enormous consequence--is whether we should collect the tax through a postcard income tax return or at the cash register. This is where the sales tax in my opinion is far superior in the longterm to the flat tax. I favor a national sales tax because I believe that the income tax is incompatible with a free society. The IRS routinely intrudes on our basic civil liberties and privacy rights--and it's intrusions are getting worse all the time. I want an America where it is no longer the government's business how much money you make and what you do with it.

Still, it may make sense to enact the flat tax immediately and the sales tax later--as Cato has advocated in our Handbook for Congress. Once we have established the principles of a low flat rate tax on consumption with no deductions--and all the special interest lobbies have been steamrollered--it is a logical

next step to scrap the income tax entirely. This may be a canyon that needs to be crossed in two leaps. The first leap should be the flat tax. The second the sales tax.

In earlier testimony the case against the income tax and for a national sales tax has been eloquently presented. I will therefore discuss not the issue of whether a national sales tax, but how. I also want to debunk some of the common myths circulating about the alleged impracticalities of a national sales tax.

The Cato Institute has developed a national sales tax plan with the following four features:

* An 18 percent sales tax on all final use goods and services (this is not a retail sales tax) except housing and securities. Over time the rate would gradually decline to below 15 percent.

* Every American would receive an annual rebate on the tax paid on the first $5,000 of purchases. This would mean that for a family of four, the first $20,000 of consumption during the year would be tax free.

* The states--45 of which already have an income tax--would be responsible for collecting the national sales tax. (The federal government would reimburse the states for the cost of collection. This would not constitute an unfunded mandate.) With the states collecting the tax, the federal IRS police force would be largely disbanded. With the infrastructure of the income tax system dismantled, it would be very difficult for a new income tax to be reinvented.

* A two-thirds supermajority requirement in both houses to raise the sales tax or any other federal tax.

The national sales tax is the only plan that fixes all of the defects of the current income tax system. Here is how:

1) Because the sales tax exempts all savings and investment, the double taxation problem would be eliminated. Because the sales tax is a single flat rate, the disincentive effects from high marginal rates would be eliminated. That giant sucking sound you would be hearing would be investment capital from across the globe sweeping into the United States.

2) By eliminating the income tax entirely, compliance costs--estimated at $200 billion a year--would be substantially reduced.

3) The sales tax would virtually eliminate the Internal Revenue Service. The sales tax is the only plan that solves the intrusiveness of the current system.

4) A sales tax would be paid by consumers every time they purchased a good or service at the cash register. Because the tax would appear on the receipt, the sales tax would be highly visible to taxpayers. All purchases--from an 89 cents grape slurpee at seven-11 to a $20,000 Ford Bronco--would be taxed. Taxpayers would be constantly reminded of what a hefty price we pay for government in America today.

A common question that I am asked about this plan is: Do the numbers really add up for the sales tax to raise as much revenue as the income tax does? To answer that question, in 1993 the Cato Institute commissioned a study by economist Lawrence Kotlikoff of Boston University to examine the economic impact of replacing federal income taxes with a national sales tax--roughly as described above. The purpose of the Kotlikoff study was to determine a) What would be the impact of the sales tax on

economic variables such as savings, wages, and output? and b) What is the necessary sales tax rate to completely replace on a revenue neutral basis the federal personal income, corporate income, and estate tax?

Kotlikoff discovered that to completely replace federal income taxes would require an initial sales tax rate of 17.4 percent. After five years the rate could be reduced to 15.4 percent, and after ten years the rate could be lowered to 13.9 percent. The reason the rate can be lowered is that the study finds a very positive economic feedback from the tax change. Specifically, the Kotlikoff study finds that after ten years, a national sales tax would:

1) More than double the national savings rate.

2) Increase the capital stock by 8 percent above the level attained under the current tax system.

3) Raise income and output by 6 percent more than would be achieved under the current tax system. That would increase national output by almost $400 billion per year.

4) Lift the real wage rate by 3 percent.

5) Reduce interest rates by 50 to 100 basis points.

Kotlikoff concludes the Cato study by issuing the following endorsement for a sales tax: "A shift to a national sales tax has the potential for dramatically improving incentives to save. The distortion to save is so great under our current system of income taxation, that it appears we could switch to consumption taxation...and end up with much higher rates of saving and capital accumulation and a higher level of per capita income."

What then, are the arguments against the national sales tax? Here are the most common objections, and the reasons these objections are exaggerated, or in some cases, just plain false.

Objection 1. The sales tax is regressive.

The rebate feature of the national sales tax makes this proposal nonregressive. Remember, a family of four would pay no tax on its first $20,000 of purchases each year. This is the equivalent of a zero bracket under the income tax. It is similar to the Armey personal deduction--though not as generous.

There are various ways of providing this rebate. Assuming that the sales tax were set at 18 percent, a family of four would be entitled to a rebate of $3,600 ($20,000 x 18 percent) for the year. The government could send a quarterly rebate check of $900 to every family of four; a $450 check to every family of two; and so on.

Another possibility would be to provide every family with an annual "smart card" that would have a sales tax credit based on family size. A married couple with no kids would receive a $10,000 credit on its card. Each time the couple made a purchase, the smart card would deduct that amount until the card's $10,000 credit was used up. After the first $10,000 of purchases, the family would begin to pay the sales tax.

So it dead wrong to argue that a sales tax is inherently regressive.

Objection 2: A sales tax of 18 percent would entail large-scale evasion.

A national sales tax of 18 percent, when added to the existing states sales taxes, would bring the total sales tax to

between 20 and 25 percent.

Critics are right when they argue that a sales tax this high would encourage evasion. But compared to what? Evasion is already a huge problem with the income tax. An estimated $150 billion of income tax goes uncollected each year--according to the IRS's own calculations. Moreover, states report that the their sales taxes are generally easier to collect than their income taxes, because there are so fewer points of collection.

I believe that much of the evasion that goes on with our tax system is a result of the correctly perceived unfairness of the system. Once we move to a national sales tax that is perceived as fair, simple and just, compliance rates will climb substantially. This is also true of the Armey flat tax as well.

Objection 3: the sales tax may not be a replacement, but rather an add-on to the current income tax.

A very legitimate concern voiced by many conservatives is the danger that America will end up with both a sales tax and an income tax. This has been the experience with the consumption tax VATs in Europe. For this reason, some critics argue that the sales tax is only acceptable if the 16th Amendment to the Constitution authorizing a federal income tax were repealed. That would certainly be highly desirable, but is not necessary. To protect against the reintroduction of the income tax, I would insist on a supermajority tax raising requirement.

Objection 4: The national sales tax has been a political and economic disaster in Europe and Canada.

VATs have had highly negative consequences in Europe. They have not raised savings rates, they have not reduced income tax burdens, and they have been an engine of growth of government. For these reasons, I strongly oppose a value-added tax. But no European nation has implemented a national sales tax as a complete replacement for the income tax. This is the critical difference between our proposal and what has occurred in Europe and Canada.

I believe that the national sales tax is the superior tax reform proposal on the table. Many of the reform ideas now in the mix--including the Nunn-Domenici plan--will soon fall out of the picture and the national debate will begin to revolve around just two proposals: the flat tax and the national sales tax. My preference is the sales tax, but either of these would be vast improvements over the current system.

Chairman ARCHER. Thank you, Mr. Moore.

Our last witness of the day is Michael Rothschild.

STATEMENT OF MICHAEL ROTHSCHILD, PRESIDENT, BIONOMICS INSTITUTE, SAN RAFAEL, CALIF.

Mr. ROTHSCHILD. Thank you, Mr. Chairman. My name is Michael Rothschild; I am president of the Bionomics Institute located in San Francisco. Our work is to help both the general public and policy leaders such as yourselves understand the profound nature of the changes taking place in our economy because of the invention of the microprocessor. I also work as a consultant and as a businessperson in Silicon Valley.

Let me cite one fact to you. Since 1971, when the microprocessor was invented, the cost of dealing with information has fallen 10 millionfold. That is like dropping the price of a barrel of oil from $20 to 2 cents. That is like being able to buy a brandnew 747 for the price of a large pizza. This collapse in the cost of information is leading to a complete and total transformation of our economy. We are leaving the machine age and entering the information age, and because of that, are now in a period in our country and indeed around the world where we have literally an unlimited number of investment opportunities for a complete transformation of the economy and a much higher level of prosperity than any of us can really imagine. But to bring that into existence, we have to have a level of savings to marry up with new ideas, because you can't just have a new idea and turn it automatically into products. You have to be able to invest capital to create the laboratories, to write the software to create those new products. In that regard, we have done grievous harm to ourselves over the years by punishing savings tremendously through the income tax system.

As a matter of fact, I do not even like to use the phrase, "the income tax." I call it a "family savings tax"; it is not an income tax, it is a family savings tax system. Think of it this way, the first $15,000 or $16,000 of income to a family is not taxed. That is about the level computed as required to have a minimum level of existence. It is only when a family has enough revenue to begin to be able to save, has potential savings, that the so-called "income tax" kicks in.

So, in effect, our system really exists as a tax on family savings. And it is no wonder that we have among the lowest saving rates among industrialized nations, and we are near our all-time low in savings rates. This is, in my view, a catastrophic condition at a time when we face virtually unlimited investment opportunities.

The problem with the flat tax—and I must disagree with my friend Steve Moore—is that it is still a family savings tax, in my view, even though the rate starts off being flat. It will inevitably lead to great complexity. As you have pointed out, Chairman Archer, we have to pull the income tax system out by its roots or it will grow back.

I brought this chart to show why it is so essential to change the basis of tax to consumption rather than taxable income. What I show is that when you try to compute taxable income, the larger circle representing a family, salary comes in, a portion of it is

saved, becomes investment, spins off interest, dividends, capital gains and the rest is consumed.

When you have four flows in the middle of the chart, it is through that area that we try to calculate so-called "taxable income," and that is where the special rules, regulations and loopholes come in.

It is inevitable that people will always have a good reason why a certain piece of their income or their savings ought to be exempted. That is why we generate such incredible complexity in the Tax Code. It is only when you go to the end of the system, to the final purchases level, that it is quite clear what the basis of the tax ought to be. The cash register receipt for a sales tax system automatically calculates that. There is no definitional problem, and we have not seen an issue of creeping definitional complexity in any of the 45 States which has a sales tax.

I am concerned that even though the proponents of the flat income tax talk about being able to file on a postcard, that that postcard sized tax return would soon grow to poster size.

Last, I would like to talk about fairness and morality. I agree with Steve Moore's idea of what I call a universal rebate, not to exempt certain types of items, food, medicine, what have you, but simply to say that perhaps for the first 15,000 dollars' worth of spending that there is a full rebate. So for a 16 percent rate, that would be 2,400 dollars' worth of taxes, so every quarter we would automatically send back $600. What would the family have to do in order to get that? Simply send in an honest to God postcard size filing like the top half of the 1040 which simply lists the people in the family, and their Social Security numbers, that is it.

After a universal rebate takes regressivity out of the problem entirely, then you are in a true ability-to-pay system. Obviously, if I go out and buy an $80,000 Mercedes, which I have never done, but if I were to do so, I am demonstrating my ability to pay in the process of making that kind of consumption. So this is the fairest of systems in that sense.

And finally, let me close on this point. Some would have us believe that it is not good enough to simply have taxes proportionate, if you would, depending on one's ability to pay as demonstrated by the rate of consumption. Their concern is that some people simply shouldn't get richer than other people, that getting wealthier, saving your money, and making something for your family is somehow immoral. I believe this can be traced back to thinking of the machine age, of Karl Marx, who believed that the economy was a zero sum game. In the machine age view, for you to get richer I had to get poorer, the great steam engine of the economy could only run so fast and produce so much.

But we have entered the information age. It is a positive sum economy because of the vast technological change I alluded to earlier. You can get richer as I get richer. There is no limit unless we are unable to save money. Today, we are unable to save in America because of the family savings tax system we call an income tax, and I hope that you are very successful in your leadership on this issue and bring us into the 21st century with a national sales tax.

Thank you.

[The prepared statement and attachment follow:]

Redesigning the Federal Tax System for the Informaton Age Economy

by Michael Rothschild
President, The Bionomics Institute

Introduction

Mr. Chairman and Members of the Committee, it is a great privilege to testify at these hearings on fundamental tax reform. My name is Michael Rothschild. I am president of The Bionomics Institute, an educational foundation based in San Rafael, California. The mission of The Bionomics Institute is to help policy makers and the general public understand how the radical technological breakthroughs of our age are transforming the fundamental nature of economic life. Our work is supported by hundreds of private individuals, including many high-tech entrepreneurs, committed to helping bring about a new era of freedom, opportunity, and prosperity for all Americans.

We believe that recent breakthroughs in information technology have created an historically unprecedented opportunity for an explosive increase in human prosperity. Not all nations, however, will seize this moment and make the most of the stunning opportunities presented by the rise of the Information Age. Indeed, we believe that unless the United States quickly abandons obsolete economic policies-like the federal income tax-that were originally designed for the conditions of the Machine Age, the American people may miss their chance to achieve the great prosperity promised by the Information Age. Along with balancing the federal budget, we believe that replacing the federal income tax with a non-regressive National Sales Tax is the single most vital economic reform Congress can make in creating an environment that nurtures rapid and sustained economic growth.

The Microchip Revolution: From the Machine Age to the Information Age

Just as the fall of the Berlin Wall marked a new epoch in world affairs, last November's election (following the Wall's collapse five years to the day) opened a new era in American political life. Almost no one predicted it, but we are now living through a period of sudden, discontinuous change-a radical transformation of human society. We are leaving the Machine Age and entering the Information Age.

Grasping the economic policy implications of this transformation must begin with an understanding of its root cause: a technological innovation of unprecedented magnitude. Consider this fact: Every week, without pause, one billion new microchips flow from factories around the world. A billion a week. By the year 2000, that number will be two billion a week. Just 25 years ago, the number was zero.

Microprocessors, DRAM memory, SRAM memory, ASIC chips, microcontrollers, electro-optical converters, and a menagerie of other specialized chips pour out of assembly facilities to be immediately stuffed into personal computers, cellphones, pagers, fax machines, satellites, CAT scanners, camcorders, cars, and an ever-expanding list of intelligent machines.

Services that we already take for granted-paying by credit card at the gas pump or drawing cash from an automatic teller machine-were inconceivable in 1969, when Neil Armstrong set foot upon the moon. The Internet. Desktop videoconferencing. Genetically engineered foods. Direct satellite broadcasting. The future is coming on so fast it seems like someone's jammed history's fast forward button. What was technically impossible yesterday is here now and it's cheap-all because of the microchip.

Since the computer-on-a-chip was invented in 1971, the cost of handling information has plunged ten million-fold. That's like being able to buy a brand new $175 million Boeing 747 for the price of a large pizza. Never before in human history has the cost anything dropped so far so fast. And given what the semiconductor technologists already know how to do, we will witness another thousand-fold cost plunge in the next five years.

If the price of crude oil were projected to drop a thousand-fold—from $20 to 2c a barrel, every economic forecaster would predict an enormous boom. Lower prices for gasoline, heating oil, and the energy absorbed in making industrial products would free consumers to shift their consumption to goods and services now beyond their reach. As the cost of basic necessities collapsed, living standards would surge.

Airlines and electric utilities, among the major oil users, would have a field day. But energy-producing competitors, like coal mines and solar energy firms, would be wiped out. Job losses and bankruptcies would devastate the energy sector, while the rest of the economy grew by leaps and bounds.

No oil price plunge is on the horizon, but the collapsing of cost information is working in much the same way. From biotechnology to finance to the media, America's information intensive industries are experiencing stunning rates of growth. At the same time, traditional industrial organizations are going through wave after wave of downsizing and consolidation. The Sunday classifieds are choked with ads begging for workers with advanced information-technology skills, while unskilled workers have precious few options. In effect, the American economy is spontaneously reorganizing itself around the profits generated by cheap information just as it once organized itself around cheap land or cheap energy.

Like the steam engine that ended the Agricultural Age and ignited the Machine Age, the microchip deserves both the blame and the praise for these ineluctable trends. But it is not widely appreciated that the forces unleashed by the microchip dwarf even the transformative power of the steam engine. The development of a more powerful engine had only a marginally positive impact on the rate of progress in other fields. But faster computers and enhanced software help improve engines as well as all other technologies.

To recast a conventional economics term, of all technologies, it is information technology which has the highest "multiplier effect." Because better information technology accelerates the rate of innovation in every field of science and technology, and because the cost of information technology is imploding, the microchip's multiplier effect is magnified, unleashing the most powerful wave of economic growth in all human history. In a way not seen since the last great information technology breakthrough-Gutenberg's printing press-ended the Dark Ages and launched the Renaissance, the microchip is an epochal technology with the most profound economic, social, and political consequences. For decades to come, our economy has the potential to grow far faster than our population-if we do not cling to outmoded economic policies that unintentionally stymie this growth.

The Bionomic View: From "Economy as Machine" to "Economy as Ecosystem"

Since economic growth of such magnitude is beyond our historical experience, it is hard to imagine. But our inability to grasp the economic implications of the microchip revolution is rooted in something more subtle than a lack of comparable experience. My own view is that most of us are blinded by an outmoded economic mindset, a worldview that we inherited from the Machine Age, a paradigm that I call "economy as machine."

Just consider the language that circumscribes conventional economic discourse-on the Left as well as the Right. The economy is always "losing steam" or "picking up speed." Congress uses subsidies, taxes, and regulations to tinker with "broken market mechanisms," while the Federal Reserve "primes the pump," "fine-tunes the engine," and "brakes inflation." Indeed, every time new technology shows signs of creating too many new jobs and rewarding workers for higher productivity with higher real wages, all the experts nod and agree that "the economic engine is overheating."

The philosopher Ludwig Wittgenstein once wrote that "The limits of our language are the limits of our reality." By this he meant that human beings cannot conceive, much less discuss, an idea unless that concept has first been made accessible through language. If we don't have a word to convey an insight, that insight simply doesn't exist. How can we possibly hope to understand the nature of economic growth when we insist on describing the economy as a machine? Have you ever seen a machine grow?

At a time when mind-boggling new technologies make possible unheard of economic growth rates, we remain trapped inside a Machine Age metaphor that precludes any intelligent discussion of economic growth. As The Economist recently put it, "Economists are interested in growth. The trouble is that, even by their standards, they have been terribly ignorant about it. The depth of that ignorance has long been their best-kept secret." The culprit, in my view, is the "economy as machine" paradigm.

Making sense of the Information Age economy will require more than a minor revision of this old economic paradigm. We need radically new thinking. As the social commentator Peter Drucker put it in a recent Atlantic Monthly, "We need to develop an economic theory appropriate to a world economy in which knowledge has become the key economic resource and the dominant, if not the only, source of comparative advantage."

Recognizing this challenge and the inherent limitations of "economy as machine" thinking, I put forward a radically new view of economic life in my book Bionomics: Economy as Ecosystem (Henry Holt & Company, 1990). Bionomics argues that a market economy is remarkably similar to an evolving rainforest. Populated by organizations rather than organisms, the economic rainforest is a staggeringly complex network of feedback loops, relationships that are competitive, symbiotic, predatory, and parasitic.

Just as the genetic code inside organisms evolves through mutation and natural selection as those organisms adapt to particular ecologic niches, the technologic code inside organizations-blueprints, databases, algorithms, check lists, and procedure manuals-evolves through innovation and competition as those organizations reshape themselves to fit specific market niches. In the most abstract sense, both rainforests and economies are self-organizing information networks.

Neither the natural nor the economic rainforest was planned. Both economies and ecosystems evolved spontaneously. The mind-numbing complexity of each system means that neither can be planned or controlled by some central authority.

>From the bionomic perspective, technological evolution is the ultimate source of all progress and economic growth. By applying an ever expanding stockpile of scientific knowledge to real world problems, human beings discover ways to squeeze better results from less input. More from less-without limit. For example, instead of devastating the planet by smelting the mountains of copper that would have been required to create a global communications network, we've turned beach sand into microchip-packed satellites and optical fibers. In a bionomic economy, new technical know-how substitutes for labor, energy, and materials. Units costs fall. Living standards rise. In the final analysis, the growth of the economic rainforest is constrained only by human creativity.

Recycling Today's Profits and Savings Sustains Tomorrow's Economic Rainforest

In practical terms, however, a great new idea cannot generate economic growth on its own. Until that new idea has matured into a product that yields a stream of profits, the business organization nurturing that idea must keep investing capital its development. We see the same phenomenon in nature. Every seed has two parts: an embryonic plant and the sugar-packed tissues of the fruit that surrounds it. Until that seedling has spread its first leaves and begins producing energy from sunlight, it must draw all of its sustenance from surplus energy that was stored by the previous generation.

In the economy, the savings of families and the profits of businesses are the surplus economic energy essential to the continuing evolution of the economic rainforest. If the stream of savings and profits being recycled from one economic generation to the next is diminished, the economic rainforest of the future will shrivel.

Needless to say, the existence of taxes makes for a crucial distinction between nature and in the economy. Of course, human societies are not ecosystems. They are communities of conscious beings who have established governments to deal with problems that cannot be managed effectively through private means. Like all other organizations, governments must have revenues. Taxes imposed by law meet that need. Nonetheless, since past savings and profits support technical innovation, and since new technology is the ultimate source of rising living standards, does it make good sense to tax savings and profits as the primary source of government revenue?

Students of taxation might properly point out that companies don't actually bear the ultimate burden of taxes. Through higher prices for the goods they sell, firms shift the final tax cost onto their customers. In the end, individual Americans bear all the costs of government. Firms serve as tax collectors, but they do not actually pay taxes.

The So-Called "Income" Tax is Actually a "Family Savings" Tax

Though it is labeled an "income" tax, the federal system actually taxes potential family savings. To calculate the tax bill, total family revenues (all sources of income) are offset by various allowances, exemptions, and deductions which in effect represent the government's estimate of basic living costs. At present, tax law adjustments work out to roughly $15,000 for a family of four. Four member households pay income taxes only on revenues over $15,000, because that is when they start generating potential savings. Since tax payments could be saved if they were not taxed away, the "income" tax is, in reality, a tax on potential family savings.

Consequently, the U.S. government's single most potent economic policy is designed to discourage family savings and encourage consumption. Few Americans have much day-to-day control over their earnings. Wages levels are determined largely by one's previous investment in education and skills. But people can control how much they consume and how much they save. Teenagers decide between more stylish clothes and a larger college savings fund. Families choose between larger homes and more retirement money. Congress chooses between farm subsidies and scientific research. A single consume/save decision may redirect a few dollars or a few billion dollars, but all decision-makers face the same basic trade-off: now or later.

Of course, economic choices are rarely "all or nothing" decisions. Teenagers don't choose between no clothes and too much college savings. Few families opt for opulent mansions but no retirement funds. Economic choices are made at the margin, as decision-makers to try to find the best mix. Should your revenues be allocated 95 percent consumption/5 percent savings or 92 percent consumption/8 percent savings?

The design of the tax system is crucial to an economy's long-term growth rate, because it powerfully influences countless millions of consume/save decisions. The tax on family savings raises the effective price of those savings, making it harder to accumulate wealth. When people save less, they must consume more. There's nothing else to do with the money.

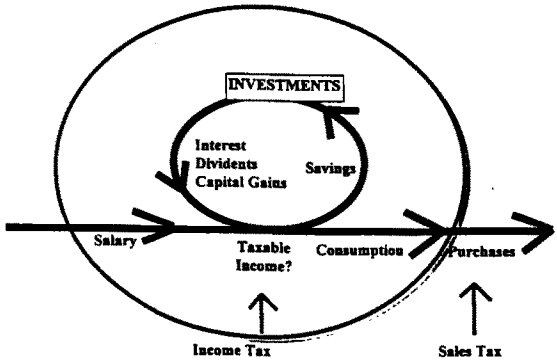
The Urge to Avoid the "Family Savings" Tax Drives Ever Increasing Tax Law Complexity

When the federal income tax was first enacted, it was a simple "flat tax" on the wealthiest Americans. But as federal spending grew, particularly after World War II, people further down the income ladder began to be taxed. Gradually, an income tax designed for the wealthy became a tax on everyone. Today, "income" taxes, together with social security taxes, comprise over 90 percent of all federal revenues. A nation that began the 20th century without taxes on household savings ended up with a government utterly dependent on such taxes.

As the income tax began to impact more Americans, the tax law's complexity grew. Today, the Internal Revenue Code and regulations weigh in at one million words and 5000 pages. On average, the law is "reformed" once every 1.3 years. Just since the 1986 flattening of tax rates, several thousand sections have been added.

Evil special interests, their Gucci-shod lobbyists, and PAC hungry politicians take the blame for punching loopholes in the tax code. But these folks are merely acting out roles made inevitable by a tax system that is based on the word "income" but works to choke off the accumulation of family savings.

Virtually anyone can make a reasonable case as to why at least some of their "income" should not be defined as taxable "income" or why some of their expenses ought to be deducted from the calculation of "income." Is it fair to treat as taxable "income" money saved for retirement? What if it's "too much" savings? What about mortgage interest? Or college tuition? Or equipment depreciation? Or research and development?



Setting a tax rate is easy. But if it's an "income" tax, the hard part is defining precisely what that rate should apply to. This is why virtually every word in the tax rules attempts to distinguish "taxable income" from "non-taxable income." Rules and exceptions. Exceptions to exceptions. This is the shadowy domain inhabited by tax accountants, tax lawyers, tax lobbyists and Congressional staffers, who like Talmudic scholars, pour over holy IRS texts, contorting the language to free their clients from tax hell.

Because an "income tax" is in reality a tax on potential family savings, taxpayers will be endlessly creative in arguing why some of their own savings should properly be excluded from the tax calculation. No matter how "flat" it is when it starts out, an "income" tax, by its very nature, must inexorably evolve into hideous complexity, political corruption and public cynicism. Year after year, the loophole-ridden income tax law erodes the public trust on which our democracy is founded-even as it shrinks the flow of savings.

Too few of the experts seem to realize that if a tax system must be riddled with loopholes to make it economically workable and politically tolerable, then perhaps its basic design is wrong to begin with.

A National Sales Tax Would Promote Family Savings

The only way to stop taxing family savings and end the politically corrosive effects of tax law complexity is by abolishing the federal income tax. In its place, we should enact a consumption tax; specifically, a non-regressive National Sales Tax on final retail purchases of products and services.

A National Sales Tax would end the present tax law's assault on family savings. Every dollar a family saves would be tax free. Obviously, such a radical reversal in tax policy change would have a dramatically positive impact on the national savings rate. As depicted in a frightening front-page story in this Monday's Wall Street Journal, the share of disposable income saved by American families is near its all-time low. Millions of baby boomers, only a decade or so away from retirement, have virtually no savings.

Precisely at the moment in history when stunning breakthroughs in information technology hold the promise of a great new era of American prosperity, we as a nation stand at the threshold of the future with our pockets empty. The only way to completely

reverse the bias against savings, take advantage of the extraordinary investment opportunities before us, and rescue the baby boom generation from financial oblivion is by switching over to a National Sales Tax as soon as possible.

A National Sales Tax Would End the Cycle of Ever Increasing Tax Law Complexity

A National Sales Tax would not only stimulate a vast surge in family savings, it would also put an end to the politically destructive process of ever increasing tax law complexity. Forty-five states, home to 98% of all Americans, already rely on sales taxes and not one state has suffered from the creeping definitional complexity that has characterized the federal income tax system. Every final retail purchase triggers a known tax. Cash registers figure it out and merchants send it in.

Many consumption tax supporters endorse the VAT (Value-Added Tax), instead of an NST. Under this system, taxes are added into a product's price as it moves through each stage of production. Two problems weaken this approach. First, the VAT requires a large bureaucracy to handle the paperwork. Second, and more important, the VAT is buried in the price of final goods and services. The car buyer cannot tell what portion of the car's price is for the car itself and what portion reimburses the dealer for the VAT. In a democracy, taxes-like prices-should be clearly labeled. For a society's financial signaling system to work effectively, citizens must know how much tax they are paying for a given quality and quantity of government services.

Only a National Sales Tax offers the kind of profound, transformative change that Speaker Gingrich and his colleagues promised the American people last November. No matter how well-intentioned, any reform of the "income" tax-whether its labeled flat, simplified, or consumption-based-will come back to haunt those who champion it. Back in Gorbachev's time, such economic reforms were called "half-measures." Rather than face up to the need for genuine change, these so-called "reformers" sought to rescue the destructive system they had inherited. This Congress must not repeat this mistake.

A Universal Rebate Will Make the National Sales Tax Non-Regressive

If a National Sales Tax is so dramatically superior to any form of income tax, why are so many otherwise clear-thinking people so afraid of it? Simply put, because they see no way to avoid the harsh impact that sales taxes typically impose on low-income families. Since lower-income families spend virtually all their earnings on basic consumption, critics contend that an NST would be severely regressive, taxing away a larger share of the income of the poor than of the rich.

But this problem easily solved with a universal rebate. Assuming a family of four spends $15,000 (or $3750 per person) on basic consumption, at a 16% rate, the NST would cost them $2400. But that $2400 would be rebated in quarterly payments of $600. Simply listing their names and social security numbers on a postcard would qualify a family for a rebate adjusted by family size. Regardless of income level, every family would get a rebate that made their basic consumption free of federal tax.

Some older Americans argue that instituting an NST would be unfair, because they spent their whole lives paying taxes on income and now that they're only consuming, they'd be hit again. This problem is easily handled. Instead of a rebate based on the first $3750 of per person consumption, that amount could be higher for those born before certain cut-off dates. As these seniors die off, this transitional feature would disappear, and all Americans would then get a universal rebate based on the same per person amount.

With the universal rebate in place, the NST would be completely non-regressive. Taxes would be based on a clearly demonstrated ability to pay. If you splurge on that $80,000 Mercedes, you'll pay $12,800 in NST, while I pay just $1600 on my $10,000 Plymouth Neon. With elegant simplicity, the NST punishes the spendthrift while rewarding the saver.

Rethinking the Morality of Taxation

For some, even a non-regressive NST is not "fair" enough. These critics contend that tax system must not only be non-regressive at the low end of the income spectrum, it must be progressive at the high end. And if not progressive in the sense of higher tax rates at higher income levels, then at least those with higher incomes should pay a "flat" rate on all their incremental income. Or, to put it more accurately, we should tax potential family savings and slow the accumulation of wealth. The unspoken, but widely shared belief among those who take this position is that becoming rich is somehow evil.

When Karl Marx published the Communist Manifesto in 1848, "a heavy progressive income tax" was his second priority after the "abolition of property." Marx opposed the accumulation of wealth because he saw the economy as a zero-sum game. Like some thundering steam engine, Marx's economy could only run so fast and produce so much. For me to win, you had to lose. Win-win outcomes were impossible. Income-the accumulation of wealth-was inherently evil, because it could only be gained by grabbing it from the weak. All profit came from exploitation. This is the very essence of "economy as machine" thinking.

Today, we know better. Or at least we should. Though zero-sum, class war rhetoric still shapes the mindset of liberal democrats, the Information Age economy is a positive-sum game where win-win outcomes are the norm. New wealth flows from higher performance at lower cost, a phenomenon driven by technological innovation. Newt Gingrich's recent comparison of an optical fiber and wire cable leaps to mind. More like a rapidly evolving rainforest than a steam engine, the economy is a complex, living system whose growth is limited only by human creativity and the availability of the savings needed to turn new ideas into reality.

Rejecting Marxist envy and zero-sum, Machine Age thinking, the moral message conveyed by a National Sales Tax is, "No matter how rich you get, if you continue to save and help grow the economic rainforest by financing new technologies and jobs, you'll pay no tax. You only pay when you take resources out of the economy and consume above a basic level."

If Congressional leaders truly mean it when they promise Americans a new "Opportunity Society," they must begin by eradicating the federal income tax . Notwithstanding Karl Marx, there is no shame in getting rich. There is only shame in "reforming" an income tax designed to prevent all Americans from doing so.

THE BIONOMICS INSTITUTE

The Economist

MAY 27TH-JUNE 2ND 1995

Down in the jungle, something stirs

WASHINGTON, DC

COMBINE a clever name with a receptive market, and you have the makings of an entertaining new trend. The name is "bionomics", which has nothing to do with giant greenhouses, artificial limbs or releasing the awesome power of the mind. It is about the economy. The receptive market consists of politicians of various stripes, eager to be seen as catching the wave of the future.

Bionomics is the creation of Michael Rothschild, a Harvard MBA and lawyer-turned-consultant. In a book of the same name, published by Henry Holt & Co in 1990, he complains that people have grown used to thinking of the economy as a huge machine, always either heating up, cooling off, or humming along. Mr Rothschild argues that, because machines are man-made and static, these images are confusing. A better metaphor is the economy as rainforest, in which a wondrous variety of species (firms), in fierce competition for limited resources, endlessly mutate and adapt to carve out new niches for themselves.

Uncontentious ideas, you might suppose. The fun begins when politicians get hold of them. The appeal of rainforestry is evident to both ends of the spectrum. Its implications are decidedly pro-market, while its emphasis on natural forces and interconnectedness appeals to many voters on the left.

Both Republicans and Democrats are now claiming the language of bionomics as their own. Newt Gingrich included it on his reading list. And when the Bionomics Institute of San Francisco held a forum in Washington on May 18th, both the Progressive Policy Institute (the New Democrats' think-tank) and the

Progress & Freedom Foundation (Mr Gingrich's) turned out to sponsor it.

Yet when it comes to the rainforest itself, the two camps hold very different views. Is the marketplace a happy habitat that has been invaded by a parasitic government virus? Or is it a Darwinian jungle, full of dangerous predators that must be hunted? Bill Archer, the Republican chairman of the House Ways and Means Committee, wants to "create an entrepreneurial society in the rainforest", whereas Will Marshall, president of the PPI, stresses that "we still need rules in the rainforest."

Who says that politicians are unable to adapt to exploit niches in the market? Already, 1996 promises to be full of steaming undergrowth and Tarzan-style ululations.

Chairman ARCHER. I thank each of you gentlemen for your input. I think you have all given us a lot to think about, and we certainly want to stay in contact with you as we move forward with this process.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. I will be brief because I know it is getting late in the day.

Mr. Rahn, you mentioned the term "cash flow." You don't hear cash flow around here very often, but truthfully that is what this whole system is about, is cash flow. That is the reason we have $5 trillion in debt is because of shortage of cash flow and the overexpenditure or writing of bad checks. I am pleased to hear someone other than me and the Chairman mention cash flow.

Mr. Roberts, you seemed adamant about not having to report anything to the IRS, but as I hear others talk about national sales tax and rebates, would that not require some type of reporting?

Mr. ROBERTS. If the sales tax is, for example, applied to professionals who sell services, then they become collection agents for the government, but still it is not their income that they have to report, and for the majority of the people there would be no reporting requirements. As long as the government collects revenues from any source, there will be an IRS.

It is sometimes suggested——

Mr. COLLINS. But on the lower income level, though, it has been mentioned a rebate to those who are lower income. Would that not require some type of reporting to some Federal agency so they know who to send a rebate to and how much?

Mr. ROBERTS. Yes, you would have to send your postcard to the Treasury. I think these proposals of rebates are excessively defensive. They are letting Socialists define the issue, which is we can't have a regressive form of taxation.

I don't think it matters because, as I pointed out, you can redistribute all the income you want to the poor, regardless of the form of taxation. It can be a very regressive form of taxation, and you can still achieve redistribution as we do, and most of it is in kind, you know, housing subsidies, food stamps, Medicaid. And therefore I am not defensive the way two of the witnesses are about a value-added tax or a retail sales tax. So I would myself just dispense with the rebates, but if you are going to have them, yes, someone has to get the postcard and write the check.

Mr. COLLINS. Mr. Moore.

Mr. MOORE. First of all, if you wanted to deal with the regressivity issue, you could do it the way Craig is suggesting. You could just deal with all income redistribution efforts that the Federal Government undertakes on the spending side. That would be one way to do it.

What I am suggesting, though, is a $5,000 per person rebate that goes to everyone, regardless of their income, because under this system we don't know what anyone's income—you know, we are going to put the whole income distribution argument out of business because nobody in Washington is going to know how much money anyone is making anymore, so what is going to happen under this system is that every American gets a rebate every quarter as long as they—and it doesn't require any information except

for a Social Security card. So it does put the IRS out of business to that extent.

Mr. COLLINS. That would not require a reporting of income to do what you are talking about.

Mr. MOORE. Right.

Mr. COLLINS. How would you handle Social Security?

Mr. MOORE. Well, under our plan—we should have another whole hearing about Social Security. We want to privatize Social Security and deal with that icon later, but under our plan we would not make any changes to Social Security.

Mr. COLLINS. You would still have the FICA tax?

Mr. MOORE. That is right. I don't know, maybe someone else has some ideas about that. There are some plans that have been developed, Mr. Collins, that would actually fold in a Social Security payroll tax into the payroll, into the national sales tax, and that would require you to go from about an 18 percent national sales tax up to about, what, a 25 percent or so.

Mr. COLLINS. We are back to the reporting thing then, with the FICA tax.

Mr. MOORE. Yes.

Mr. COLLINS. That is all.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Two quick points. One, I want to thank you, Mr. Roberts, for your testimony. It definitely was something that I will want to get the transcript on because I appreciated your rhetoric.

My question would be for Mr. Moore and Mr. Roberts, though. What do you tell the National Federation of Retailers and those Main Street shopowners when they start hollering about the fact that the price of their goods has now been increased 18 to 20 percent?

I see a potential problem there. I generally favor what I have heard today from your testimony. I truly believe that we are heading in the right direction, but I see that as a potential problem, and I also see possibly the simplicity of getting there, the transitional problem that we have talked about earlier today rather than going cold turkey, as Mr. Gibbons said, which I am in favor of, that there might be a transitional problem. I would like your comments on those two issues.

Mr. ROBERTS. I think the retailers, like everyone else, will see the advantage of not having to report their incomes to the IRS, and the fact that the prices of the goods will be higher by the amount of the tax is offset by the fact that everyone's take-home pay will be higher by the absence of withholding. So I don't think it puts them at any unique disadvantage or somehow alters the rules against them in any way.

The transition problems could be varied, but we should never let a transition problem keep us off the path of progress, and we should never get bogged down into whether or not it is convenient for the tax collection agency. The convenience for the IRS should be the last thing that this House considers.

The House is endowed by the Founding Fathers with the initiative power of government. It is the House that is closest to the peo-

ple, and it is supposed to be an expression of the popular will. Therefore, you don't want to be tools of the IRS and permit the IRS to tell you how difficult it will be for them to do this or that or the other thing. That is not our problem. It is not a problem for the House.

Mr. MOORE. Mr. Christensen, you are quite right that the retailers are going to put up a bit of a fight on this. In fact, we have been hearing from the retailers a bit already. We have to find a way of compensating them for the cost of collecting the tax because as a matter of fairness, we have to find a way, if only a small portion of the business is charged with collecting the tax, then I think in all fairness they should be reimbursed for some of that cost of collecting that tax.

But I would agree with Craig on one thing, that when you look at small business generally, I have heard the argument made that, well, small businesses wouldn't like to have to collect a sales tax, if you ask small businesses, if you had small businesses before this Committee, if you ask them to compare about the compliance costs of sales tax versus an income tax, I mean, there is no comparison. They think the sales tax is much easier.

Do you have something to add to that?

Mr. HAYES. We have a number of Members that have small businesses. I think a lot of it is just education. Whenever you tax something, you take something away from someone, and he has less money to spend. So we have under the income tax. By withholding, we already have a tax on consumption. We have reduced the amount you can consume by whatever the tax rate is, period.

Under the retail sales tax we are giving, Mr. Roberts said, we are giving all of the money to you, and we are letting you make the choice, how do you want to consume. I think when you look at that, when the retailers start to see that, that a lot of those objections are going to go away, particularly when you tie it in with the fact that most of them are collecting the State sales tax now and all of our proposals contemplate having the State collect the Federal sales tax, and therefore not have to have an IRS and not have to have an enforcement agency at the Federal level.

Mr. ROBERTS. May I just make one point about that. You see, under the kind of income tax system we currently have, you can't save by being frugal because you are taxed on your income and not your expenditures. So being frugal doesn't permit one to build up a nest egg, but under a retail sales tax or a VAT a person can be careful in his expenditures and therefore rapidly accumulate capital.

Mr. CHRISTENSEN. Thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Gentlemen, thank you to each and every one of you. I again apologize for how long you had to wait, but we are very grateful for your input.

Mr. HAYES. Thank you very much.

Chairman ARCHER. The Committee will be adjourned.

[Whereupon, at 5:45 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

6-7-95

Mr P. De Mossely "Hello from Eriberto, Jacob & Crystal Acedo."

As a conserved tax payer and formerly self employed car painter, the first year of work I was penalized for being self sufficient? My taxes were very strict on me, and my family at that time where prospering in all areas. I put people to work sanding, masking, preparing surfaces for color. Not that this is for the betterment of people who want to be self employed the thing that bugs me is the method of the IRS tactics! I would like to see a tax program dedicated to people like myself (trying to make it for the better interest of my children & Grandchildren). A flat tax program & users tax? Could work well for people like myself? Now that I'm 45 years old two children, single parent. I would try my venture once-more but time isn't on my side. Mr De Mossely Please consider people like myself in dealing with a "new tax program" for our children's sake! Also (Please completly do away with the IRS completly.) Small Government is in order. (Keep in mind the poor people)

Respectfully

Mr E.C. Acedo & Family

6566 Lanston St Apt B

San Diego, Ca 92111

(619) 565-7527.

P.S. Help us, help them by small taxs. to government.

Raymond C. Adamczyk
10315 W. Greenfield, #530
West Allis, Wisc. 53214

June 11, 1995

Dear House Ways and Means Committee,

I wish to go on record in expressing my views on the tax debate. The Flat Tax seems the simplest and fairest tax idea out there. What could be fairer than every American paying the same percentage or rate? But I think it is extremely important to include in the language of any flat tax bill a ceiling percentage, above which taxes could not be raised. Please consider a maximum percentage in the wording of a flat tax proposal, say 20%, or something reasonable in that neighborhood. Otherwise, what is there to stop a future legislator from increasing a flat tax of today to say, 75%?

Thank you for allowing me to express my views on this matter.

Raymond C. Adamczyk
Raymond C. Adamczyk

STATEMENT OF THE AMERICAN ACADEMY OF FAMILY PHYSICIANS

The American Academy of Family Physicians is pleased to present to the Ways and Means Committee this statement for the record of the hearings held June 6-8, 1995, on replacing the federal income tax. The Academy's purpose in presenting this statement is to support two of the Chairman's stated goals for the hearing:

- to encourage greater savings and investment and
- to improve the international competiveness of American workers and business.

The Academy, which represents over 80,000 practicing family physicians, family practice residents, and medical students with an interest in family medicine, has a longstanding interest in the impact of health care costs on the American economy. Health care costs in the U.S. are extraordinarily high and are escalating rapidly. For these reasons, they not only compromise access to necessary health care services and lower the quality of available care, but they also siphon badly needed resources away from other sectors of the economy, particularly those involving international trade.

This statement will address the following issues: (1) U.S. health care costs are the highest in the world and the gap between U.S. health care costs and those of other developed nations is growing wider; (2) high health care costs have a negative impact on savings and investment, the federal budget deficit, and the competitive position of U.S. business in international markets, (3) the major factor explaining the high health care costs in the U.S. relative to its international competitors is the extent of development of its primary care system; (4) reforms of the Medicare and Medicaid programs and in the private sector will have little impact on costs until the primary care infrastructure is substantially enhanced; (5) Congress can facilitate the shift toward primary care without increasing government involvement in the health care market mostly through modifications in existing federal programs: and (6) because of chronic and severe shortages of primary care physicians in rural communities, these enhancements in the primary care infrastructure are of crucial importance to the most internationally competitive sector of the U.S. economy, agriculture.

1. U.S. health care costs are the highest in the world.

As a percentage of gross domestic product, total health care expenditures in the U.S. are two-thirds higher than the average for countries belonging to the Organization for Economic Cooperation and Development (OECD) and more than 30 percent higher than expenditures in Canada, the second-highest country. In terms of per capita health care spending, spending in the U.S. is 2.2 times higher than the OECD average and more than 50 percent higher than spending in Canada.[1]

Not only is U.S. health care spending considerably above average, the rate of spending growth continues to outpace that in the other major OECD countries (Canada, France, Germany, Japan, and the United Kingdom). From 1980 to 1992, the percentage by which the U.S. health care spending-to-GDP ratio exceeded the average for the other five major OECD countries doubled from 30 percent to more than 60 percent. Over this same period, the percentage by which U.S. per capita health care spending exceeded the other five countries grew from 60 percent to more than 90 percent.

Changes in the health care spending-to-GDP ratio over time provide a measure of the a nation's total resources devoted to the health care sector of the economy. By adjusting health care spending by changes in overall prices it is possible to

assess the investment opportunities forgone in other sectors of the economy. Compared to the other major OECD countries, the opportunity costs of U.S. health care expenditure growth are substantially higher. This finding reflects that fact that between 1980 and 1992, health care spending in the U.S. increased 3.5 percentage points faster than per capita GDP, compared to 3 percent points in Canada and 2 percentage points or less in the other major OECD countries.

In summary, the U.S. health care system remains the most expensive in the world, and the gap between the U.S. and the other OECD countries is widening. Compared to the other major OECD countries, the U.S. faces the highest rates of increase in health care spending relative to GDP, the highest health care inflation relative to overall prices, and the highest opportunity costs of forgone consumption and investment in other sectors of the economy.

2. High health care costs hinder the international competitiveness of U.S. business.

Businesses in the tradable goods sector face particularly high health care costs. Fifty-eight percent of America's internationally traded goods and services are manufactured goods. In 1992, employer costs of employee health benefits per hour were 76 percent higher in the manufacturing sector than in the non-manufacturing sector.[2]

Faced with steadily higher health care costs, American businesses respond in a number of ways. They hire fewer workers; provide lower wage increases or less generous benefits for existing workers; forgo investment in more plants and equipment, education and training, and research and development; lower dividends to shareholders; or increase prices, thereby leaving consumers with less income to spend on other goods. Each of these outcomes has a negative effect on the economy and on the competitiveness of American business in international markets.

Increases in health insurance costs are either shifted back onto workers in the form of lower take home wages or shifted forward in the form of higher prices. Backward shifting if often inhibited by minimum wage legislation, existing labor contracts, and informal restrictions against wage reductions. In some industries, compensating for rapidly rising health care costs would require real reductions in wages. Wages are not easily lowered, and fully compensating reductions are not possible. Moreover, workers increasingly value their health insurance benefits and are unwilling to give up coverage or accept reduced benefits. Health insurance benefits have become a major issue in collective bargaining.

Due to increased health care costs, total compensation for workers with health insurance may be higher than the value of the workers' production. Higher labor costs thereby result in lower profits or increased profits. However, companies are able to pass higher health insurance costs forward in the form of higher prices with little loss of sales only when competitors experience parallel increases in costs.

There is a wide disparity in the combinations of fringe benefits and wages offered by different companies. Because companies with and without health insurance benefits compete in the same markets there is great pressure on companies that provide insurance to devise methods to eliminate the cross-subsidies. This is reflected in shifting of production overseas, outsourcing to small companies without health insurance and the increased use of part-time labor.

A country's international trade balance will reflect the equilibrium between domestic savings and domestic investment. Interest rates will be higher in countries with low savings relative to investment than in countries with surplus savings. Higher interest rates will attract foreign capital, raising the exchange rate, and, thereby, reduce exports and increase imports. Furthermore, increases in public outlays for health care translate into larger budget deficits and reductions in national saving.

3. The under-developed primary care system is a major factor in higher U.S. health care costs.

There is a substantial body of evidence indicating that the lack of a well-developed primary care system is a major factor in explaining the higher U.S. health care costs. This evidence stems from a variety of sources including cross-national comparisons, studies of the variation in per beneficiary Medicare expenditures, comparisons of the cost of care provided by primary care physicians and subspecialists, and examinations of the impact of lack of access to primary care services. The following section reviews briefly this evidence.

- The lower health care costs, better health status (i.e., higher quality), and greater satisfaction ratings in other developed nations are, to a large extent, due to their reliance on primary care.

The most extensive work in the area of international comparisons has been done by Barbara Stafield, M.D.[3] She compared ten Western industrialized nations on the basis of three characteristics: the extent of their primary health service, their levels of 12 health indicators (e.g., infant mortality, life expectancy, and age-adjusted death rates), and the satisfaction of their populations in relation to overall costs of the systems. In nine out of ten countries, she found that nations with better developed primary care systems have lower health care costs, better health status indicators, and higher levels of satisfaction with their health care systems. Specifically, when the proportion of primary care physicians is greater, health care costs are lower. This is because primary care physicians have a more cost-effective style of practice and do not substitute unnecessary medical tests for good clinical judgement. Furthermore, nations with greater access to and reliance upon primary care services show lower infant mortality rates, longer life-expectancy, better immunization rates, lower age-adjusted mortality, and greater overall satisfaction with health care services than the U.S. The better developed a nation's primary care system, the better the population's health status and the higher the level of popular satisfaction. Ratings for the United States were low on all three measures.

It is important to note that higher health care costs in the United States are not due to greater use of hospital beds, the aggregate supply of physicians, or a greater number of physician contacts. Inpatient beds, admissions, average length-of stay, and occupancy rates in the U.S. are among the lowest in the OECD countries. Physician contacts per person per year in the U.S. are below the OECD average, and the U.S. physician-to-population ratio is slightly below average. However, the U.S. has a far higher percentage of specialists than in most other OECD countries.

- In the Medicare program, the lack of primary care is directly related to high per capita health care costs.

The most compelling evidence demonstrating the impact of primary care on overall health care costs comes from several studies examining the variation in per beneficiary costs under the Medicare program. For example, Dor and Holahan

examined differences in expenditures between beneficiaries living in urban and rural communities.[4] After adjusting for differences in prevailing fees, there is a 15 percent difference in per-beneficiary volume of physician services between urban and rural areas. This study used multivariate techniques to examine a broad range of factors that might explain the variation in expenditures including beneficiary demographic characteristics, health status, consumer out-of-pocket costs, income, physician availability, hospital utilization, and health market characteristics.

The results of this study indicate that the most important factor in controlling Medicare expenditures for physician services is the mix of physician specialties. Specifically,

- a ten percent increase in the per capita supply of general practitioners and family physicians results in a two percent decrease in expenditures, and

- a ten percent increase in the per capita supply of "specialists" results in a 1.4 percent increase in expenditures.

The supply of general practitioners and family physicians has a relatively large impact on expenditures for inpatient care, surgical care, and consultations. The supply of specialists has a large impact on expenditures for office-based services, medical and consultations.

The results of the Dor-Holahan study can be used to estimate the impact on expenditures of shifting the current specialty mix to one in which 50 percent of physicians are general practitioners and family physicians and 50 percent are specialists. Holding the aggregate physician supply constant,

- shifting to a 50-50 specialty mix would result in a 39 percent decrease in expenditures for physician services.

Specialty mix is the only policy relevant variable that explains the large variation in Medicare expenditures for physician services, and its impact on expenditures is large. The results of the Dor-Holahan study have been replicated in two more recent studies.[5]

- Primary care physicians have a more parsimonious practice style than their subspecialty colleagues.

There has been a large body of research performed over the last several decades that compare the practice patterns of primary care physicians with their subspecialty colleagues.[6] The most comprehensive of these studies is the Medical Outcomes Study, which showed that given an equivalent patient population, primary care physicians provide more cost-effective care than their subspecialty colleagues. For example, cardiologists hospitalize patients with similar levels of illness at more than twice the rate of family physicians and ordered more tests. Even after adjusting for differences in the types of patients seen by different specialties, cardiologists and endocrinologists had utilization rates that were considerably higher than those of primary care physicians for all health care resources.

- The improved availability of primary care services reduces the inappropriate use of expensive health care services.

The increased availability of primary care services for low-income populations reduces the inappropriate and expensive use of emergency departments. In one study, nearly half (45 percent) of patients waiting for emergency department care

cited unavailability of primary care services as their reason for using the emergency department.[7] Only 13 percent of those waiting had conditions clinically appropriate for the emergency room; 38 percent were willing to trade the emergency room visit for assurances of an appointment at a primary care clinic within 3-days.

- Real world examples of the cost-effectiveness of primary care are provided by HMOs and the State of Hawaii.

Policy makers seeking to constrain the growth in health care expenditures are turning increasingly to HMOs and managed care as an important solution. HMOs have been shown to have far lower rates of utilization of hospital and other intensive technological services with no decrement in quality or patient satisfaction. One of the ways HMOs are able to achieve these results is by dramatically altering the mix of specialties within their provider ranks. Fully 70 percent of U.S. physicians are subspecialists, and only 30 percent are in the primary care specialties. However, within HMOs, the ratio is nearly reversed; 60 percent of physicians are in primary care, and 40 percent are in the subspecialties.[8]

Traditionally, Hawaii's doctors have emphasized primary care instead of specialized services.[9] Utilization rates for high cost treatments are well below the national average. The result of this practice is reflected in Hawaii's low infant mortality rate and low rates of premature death due to chronic disease such as heart disease and cancer. Early detection of potentially life threatening conditions results in low mortality and low hospitalization. Contrary to some popularly held beliefs, Hawaiians are healthier not because of unique genetics, healthy climate, or highly technological medicine, but because they have access to primary care. Moreover, Hawaii's readily available primary care makes its system less expensive. Hawaii's health care costs as a share of gross domestic product are closer to those of Canada, Germany, France, and Japan then that of the rest of the United States. Despite Hawaii's high cost of living, health care is less expensive.

4. Medicare and Medicaid reforms will have little impact on costs until the U.S. primary care infrastructure is substantially enhanced.

Congress is considering a wide range of proposals designed to reduce the rate of increase in Medicare expenditures, including higher beneficiary cost sharing, enrolling a higher proportion of Medicare beneficiaries in managed care plans, Medicare vouchers, and medical savings accounts. While each of these reform proposals holds some theoretical possibility of reducing expenditures, there is only one proven factor that consistently holds down per capita Medicare expenditures, the availability of primary care. Congress' success in controlling Medicare outlays will be directly related to its success in improving beneficiary access to primary care services.

As evidenced by the managed care industry and other nations, primary care is the backbone of high-quality, cost-effective health care systems. In addition to the diagnosis and treatment of acute and chronic illness, primary care physicians routinely provide health promotion, disease prevention, counseling, and patient education services. Historically, primary care physicians have been the providers for America's poor, underserved, and uninsured. For example, nearly 30 percent of all visits by uninsured individuals are provided by family physicians.

In general, primary care physicians can manage 85-95 percent of all patient complaints with the same success, and at less cost, than their subspecialist colleagues. For those cases that require more subspecialized care, primary care

physicians maintain a wide variety of specialty and institutional consultative and referral relationships. It is part of the primary care physician's role to guide patients through the specialty care maze and to advocate for those who otherwise have difficulty obtaining access to subspecialty services.

It is the primary care physician's responsibility to coordinate all resources and services of the health care system for the benefit of his or her patients. Because of the depth and breadth of their training, primary care physicians manage those medical conditions that cause most of the morbidity and mortality in this country (heart disease, high blood pressure, etc.).

Unfortunately, the trends in physician supply are running in the opposite direction. The proportion of practicing physicians engaged in primary care has declined from nearly 90 percent of physicians in 1930 to less than 30 percent today. The distribution of physicians in graduate medical education programs indicates that proportion is likely to decrease still further.

Under the current system, there is no connection between the number and type of physicians needed by the public for its health care and the number and type of physicians that are trained. The choices that medical students and medical educators make are heavily influenced by the fact that teaching institutions get paid much more to train subspecialists in hospital settings and physicians get paid much more to provide subspecialty services.

Medicare, which is the major source of graduate medical education (GME) funding, provides a powerful financial incentive for hospitals to train residents in the procedurally-oriented specialties rather than in the generalist specialties. For example, by limiting funding to hospitals, Medicare funding of graduate medical education targets inpatient training -- training that is relevant to an ever-narrower spectrum of medical care. Family physicians are largely trained in ambulatory settings where more and more health care services are delivered. Yet, these sites are ineligible for Medicare training funds.

Leaders of individual academic medical institutions decide how many residencies and fellowship positions they need to serve as inexpensive house staff for their various departments. Upon completion of their training, these physicians are turned loose on the community whether or not there is any need for any more physicians in their particular specialty.

Federal spending on Medicare GME currently totals over $6 billion annually, which averages nearly $70,000 per resident.[10] In some teaching hospitals, the per resident payment is over $100,000 per year (in some rural states the per resident amount is only about $10,000 per year). Congress has placed absolutely no control on the flow of this money in regard to the total number and specialty type of residency positions that are funded. Any hospital that is able to get a residency slot accredited can receive Medicare GME dollars. Given the mismatch between the physician supply and the public's health care needs, this in an irresponsible expenditure of federal funds.

5. Congress can facilitate the shift toward primary care without increasing government involvement in the health care market mostly through modifications in existing federal programs.

Congress can substantially enhance the availability of primary care by modifications in existing federal programs. The changes recommended below will improve payment for primary care services and redirect training dollars toward

programs that produce primary care physicians. None of these recommendations creates new federal bureaucracies.

Given the potential for widespread Medicare savings when primary care services are maximized, the Academy recommends that the following Medicare reforms.

A. Modify Medicare graduate medical education (GME) funding so that it better supports primary care training.

- Limit the number of funded first-year residency positions to 110 percent the number of U.S. medical school graduates.
- Limit the period of funding eligibility to the first three years of residency training.
- Eliminate the penalty that teaching hospitals incur for the time that residents spend training in non-hospital owned ambulatory facilities.
- Extend eligibility for direct GME payments to non-hospital entities that operate approved residency programs.
- Up-weight direct and indirect GME payments for residents in the primary care specialties.

B. Remove disincentives to primary care practice by restoring equity to Medicare payment for visit services, which are the type of service that primary care physicians most commonly provide.

- Implement a single fee schedule conversion factor rather than the three conversion factors currently in use.
- Revise the Medicare Volume Performance Standard (MVPS) formula by replacing the current factor for the growth in the volume and intensity of services with one based on projected growth in gross domestic product plus two percentage points.

C. Reverse the anti-rural bias in Medicare physician payment.

- Eliminate the Geographic Adjustment Factor (GAF).
- Provide 20 percent bonuses to physicians providing services in health professions shortage areas (HPSAs) and eliminating bonuses for specialty services in urban areas.

Although Medicare GME provides some support for primary care physician training, Title VII of the Public Health Service Act is the only federal program that provides targeted funding for primary care training. Many family practice residency programs would not exist today if it were not for the availability of the Title VII funds. Until Medicare GME funding changes occur, primary care training programs will remain highly dependent on grants from Title VII.

The American Academy of Family Physicians strongly supports the reauthorization of Title VII of the Public Health Service Act. In particular, the Academy urges Congress to pass S. 555, the "Health Professions Education Consolidation and Reauthorization Act of 1995," which was introduced by Senator Nancy Kassebaum and adopted by the Senate Labor and Human Resources Committee. S. 555 would achieve the combined goals of supporting primary care physician training, consolidating a number of different federal health professions training programs, and achieving budget savings.

6. <u>Enhancements in the primary care infrastructure are of crucial importance to rural agricultural communities</u>.

Despite the fact that agriculture is the most competitive sector of the U.S. economy, nowhere is the shortage of primary services felt more severely in rural agricultural communities. The supply of physicians in rural communities is only one-third to one-half that in urban areas.[11] Moreover, in counties with fewer than 50,000 residents the ratio of primary care physicians to population has actually decreased since 1990.[12] The impact of the rural physician shortage is reflected in higher rates of chronic disease, higher death rates from occupational trauma, and lower health service utilization rates.

Although generally in short supply, family physicians are three or four times more likely than other specialties to practice in rural areas. They are the *only* physicians among all the specialties who are as likely to settle in nonmetropolitan areas as the general population. Subspecialist physicians tend to locate their practices in urban and affluent communities, not in rural and other underserved areas.

Family physicians are the principle providers in community health centers, rural health clinics, federally qualified health centers, and the emergency rooms of local hospitals. Virtually all of the providers in frontier communities are family physicians.

Rural and agricultural advocates have recognized the need for more primary care in their communities. Specifically, the American Farm Bureau Federation has recommended enhancements in:

- Efforts of medical schools to train additional qualified family physicians to practice in rural areas;

- Incentives at state and local levels to encourage doctors to practice in rural areas.[13]

The American Academy of Family Physicians appreciates this opportunity to address health care issues that affect the international competiveness of American business and the savings and investment rate in the U.S. We look forward to working with the Committee and the Congress in crafting proposals to improving the accessibility and quality of health care services as well as bringing health care costs under control.

Notes

1. The information on comparative health care costs is derived from: Schieber, G.J., Poullier, J. and Greenwald, L.M., Health System Performance in OECD Countries, 1980-1992, Health Affairs, Fall 1994.

2. Data from the Bureau of Labor Statistics cited in the testimony of Edith Rasell, M.D. before the Subcommittee on Health for Families and the Uninsured of the Senate Finance Committee hearings on the impact of health care reform and U.S. business competitiveness, January 12, 1994.

3. Starfield, B., Primary Care and Health: A Cross-national Comparison, Journal of the American Medical Association, 266(16), October 23/30, 1991.

4. Dor, A. and Holahan, J., Urban-Rural Differences in Medicare Physician Expenditures, Inquiry, 27, Winter 1990.

5. see Welch, W.P. et al., Geographic Variation in Expenditures for Physicians' Services in the United States, Journal of the American Medical Association, 328(9), March 4, 1993, and Chetty, V.K. et al., Medicare Reimbursement and Physician Specialty Distribution, publication pending.

6. Greenfield, S. et al., Variations in Resource Utilization Among Medical Specialties and Systems of Care, Journal of the American Medical Association, 267(12), March 25, 1992.

7. Grumbach, K., Keane, D., and Bindman, A., Primary Care and Public Emergency Department Overcrowding, American Journal of Public Health, 83(3), March 1993.

8. Group Health Association of America, HMO Industry Profile, 1993 Edition.

9. Testimony of John C. Lewin, M.D., Director of Health, Hawaii State Department of Health, before the Senate Committee on Labor and Human Resources, October 19,1993.

10. Council on Graduate Medical Education, COGME 1995 Physician Workforce Funding Recommendations for Department of Health and Human Services' Programs, June 1995.

11. Kindig, D. and Movassaghi, H., Physician Supply in Small Rural Counties, Health Affairs, Summer 1989.

12. Council on Graduate Medical Education, COGME 1995 Physician Workforce Funding Recommendations for Department of Health and Human Services' Programs, June 1995.

13. Letter from Dean R. Kleckner, President, American Farm Bureau, to Mrs. Hillary Rodham Clinton, February 11, 1993.

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Statement Of John William Kurowski
Founder Of The
American Constitutional Research Service
Before the
Committee On Ways And Means
United States House Of Representatives

June 1995

Mr. Chairman and Members of this Committee:

The subject of tax reform was extensively debated by the Founders of our country. I do not know if other participants in these Hearings have taken the time to research the accounts of these historical debates when formulating the suggestions they will present to this Committee, but, having researched the Founders' original tax reform package, I am inclined to believe its fundamental principals are as valid today as when they were put into practice over two hundred years ago.

Our nation's first revenue raising Act was "...in a certain sense a second Declaration of Independence; and by a coincidence which could not have been more striking or more significant, it was approved by President Washington on the fourth day of July, 1789." [See, Twenty Years of Congress, James G. Blaine, 1884, Vol. 1, page 185]

James Madison, in discussing this Act before Congress identified a fundamental principal concerning the power delegated to Congress to lay and collect taxes:

> "...a national revenue must be obtained; but the system must be such a one, that, while it secures the object of revenue it shall not be oppressive to our constituents."

The Act went on to imposed taxes, not on Congress' constituents, but on specific "goods, wares, and merchandise, imported into the United States", and not one dime was raised under the Act by internal taxation! Internal taxes were frowned upon by the Founders, especially when a national revenue could be had by requiring foreigners to pay for the privilege of doing business on American soil!

Jefferson, in his Second Annual Message (December 15, 1802) states:

> "In the department of finance it is with pleasure I inform you that the receipts of ***external duties*** for the last twelve months have exceeded those of any former year, and that the ratio of increase has been also greater than usual. This has enabled us to answer all the regular exigencies of government, to pay from the treasury in one year upward of eight millions of dollars, principal and interest, of the public debt, exclusive of upward of one million paid by the sale of bank stock, and making in the whole a reduction of nearly five millions and a half of principal; and to have now in the treasury four millions and a half of dollars, which are in a course of application to a further discharge of debt and current demands." [emphasis added]

Imagine...all this in consequence of "external duties"!

In Jefferson's Second Inaugural Address (March 4, 1805), he points out:

> "At home, fellow citizens, you best know whether we have done well or ill. The suppression of unnecessary offices, of useless establishments and expenses, enabled us to ***discontinue our internal taxes.*** These covering our land with officers, and opening our doors to their intrusions, had already begun that process of domiciliary vexation which, once entered, is scarcely to be restrained from reaching successively every article of produce and property...
>
> "The remaining revenue on the consumption of foreign articles, is paid cheerfully by those who can afford to add foreign luxuries to domestic comforts, being collected on our seaboards and frontiers only, and incorporated with the transactions of our mercantile citizens, it may be the pleasure and pride of an American to ask, what farmer, what mechanic, what laborer, ever sees a tax-gatherer of the United States?"[emphasis added]

Although a national sales tax appears to be somewhat fairer than existing taxation, such a tax would do ill to our nation as the various proposals are all based upon an internal consumption tax plan which ultimately increases the cost of goods manufactured on American soil; burdens the American Citizen in its collection; and, are to be paid by the "farmer, mechanic, laborer", etc., who will continue to see the intrusion of the "tax-gatherer of the United States" if such a system is adopted!

In view of the undesirable effects of an internal national sales tax, perhaps it is wise to follow the Founder's plan and study how imposts and duties (external taxation) were successfully used to fill the national treasury, encourage domestic manufacturing and assist in building a strong industrial base.

In addition to imposing a specific amount of tax on specific articles of consumption imported, the first revenue raising Act also imposed an across-the-board tax on imports which was higher for imports shipped in foreign owned foreign built vessels, and discounted the tax for imports arriving in American owned American built ships:

> "...a discount of ten percent on all duties imposed by this Act shall be allowed on such goods, wares, and merchandise as shall be imported in vessels built in the United States, and wholly the property of a citizen or citizens thereof."

This patriotic and skillful use of external taxation gave American ship builders a hometown advantage and predictably resulted in America's merchant marine becoming the most powerful on the face of the planet. Unfortunately, today when I visit the docks in New York's Hell's Kitchen area, I am saddened that I can no longer read the names on the docked ships as they all seem to now be foreign owned foreign built vessels displaying flags and languages I am unfamiliar with....an irrefutable sign of America's decline brought about by the obvious acceptance of thirty pieces of silver.

Yes, there was a day when our national treasury was gladly filled by foreigners paying for the opportunity to do business on American soil. But this was when members of Congress, and those running for Office, put American interests first and would have considered the NAFTA, GATT and the WTO as acts of sedition, and would have tarred and feathered those participating in the surrender of America's sovereignty.

A national sales tax plan which omits external taxation as a principal source to fill our national treasury, is in fact a surrender of national sovereignty to the advantage of foreign interests!

A Second Source To Fill The Treasury

Having identified imposts and duties (external taxes) as being the Founder's intended primary source to fill our national treasury, I will now turn to their intended internal consumption tax plan.

An across the board national sales tax would unquestionably increase the cost of production on American soil, as previously pointed out. To avoid this, and other unwanted effects of an across the board national sales tax, common sense dictates we must exclude from the list of taxable items, tools of production, supplies necessary to conduct business, services needed to sustain business, and the necessities of life (food, shelter, clothing, medical expenses) i.e. all those items which makes labor possible must be excluded.

In simple language, a consumption tax plan ought to be limited to articles of luxury, and each article must be individually selected by Congress and the appropriate amount of tax must be determined for each specific item chosen, just as was done in the first revenue raising Act of our country!

By limiting the tax to articles of luxury, and requiring each article to be specifically chosen and the appropriate amount of tax determined by Congress, a self regulating check and balance is imposed upon Congress. If Congress does its job properly and the nation as a whole is productive and prosperous, the sale of articles of luxury will undoubtedly increase, and with it, the flow of revenue into the common treasury! But, if Congress' policies become burdensome and its regulatory requirements upon business, industry and our nation's labor force inhibit a hearty economy, or any particular article is excessively taxed, the first sign would be is a decline in the flow of revenue into the national treasury! Thus, the free market place determines the limit of taxation under the Founder's internal consumption tax plan, and it establishes a self regulating gauge beyond the reach of Congress' manipulation!

As Hamilton said, in regard to taxes on consumption, they:

> " . . . may be compared to a fluid, which will in time find its level with the means of paying them. The amount to be contributed by each citizen will in a degree be by his own option, and can be regulated by an attention to his own resources. The rich may be extravagant, the poor can be frugal; ***and private oppression may always be avoided by a judicious selection of objects proper for such impositions*** . . . It is a signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess. ***They prescribe their own limit, which can not be exceeded without defeating the end proposed__that is, an extension of the revenue.***" [No. 21 of the Federalist, emphasis added.]

Balancing The Budget

Still one more question remains to be answered: what is to be done if insufficient revenue is raised from external and internal taxes on consumption?

Once again the Founder's plan shines bright above all contemporary suggestions. Careful research into our Nation's early legislative history reveals the Framers did in fact provide Congress with an emergency power to be used if deficits should arise. And the wisdom of the Framer's method, unlike the proposed balanced budget amendment (S.J. RES.1), contains a brilliant mechanism which would abruptly end Congress' current profligate spending habits!

Under the Framer's plan, whenever the monies arising from Congress' normal taxing powers (imposts duties and excises) are found insufficient to fund federal expenditures during a fiscal year, and a deficit is produced by Congress borrowing to finance expenditures, Congress must then use its direct taxing power at the beginning of the next fiscal year to raise an amount sufficient to retire this deficit.

Congress is required to follow the rules of apportionment when imposing this tax, and bills each state for a share of the deficit. Each State must contribute a share of the total deficit in proportion to its allotted number of Representatives as set forth in Article 1, Section 2, clause 3, of the United States Constitution. The more votes a State exercises in the House, the larger is its share toward extinguishing a deficit . . . ***representation with proportional obligation!***

The chart below is based on a total House membership of 435:

STATE	NO.OF REPRESENTATIVES	SHARE OF DEFICIT
NEW YORK	31	31/435's
MARYLAND	8	8/435's
CALIFORNIA	52	52/435's
IDAHO	2	2/435's
FLORIDA	23	23/435's
etc		

FOUNDING FATHERS' FAIR SHARE FORMULA

The states are left free to raise their share of the tax in their own way, within a time period set by Congress. But if any state shall neglect to pay its share, then Congress must send forth its officers to assess and levy that state's apportioned share, together with interest thereon.

Legislative History

This method of extinguishing deficits appears in seven of the ratification documents which gave life to the United States Constitution. The first emergency *direct tax* was imposed in 1798, to extinguish part of the Revolutionary War debt. It was later used during the War of 1812, and also to extinguish deficits during the Civil War.

The Sixteenth Amendment to the United States Constitution did not repeal or alter Congress' power, or *obligation,* to impose the emergency direct tax should a deficit arise. The power of Congress to impose a direct tax still exists, and direct taxes are still required to be apportioned among the states, as pointed out by the United States Supreme Court [see Stanton v. Baltic Mining Co., 240 U.S. 103, (1916); Eisner v. Macomber, 252 U.S. 189 (1920); and, Bromely v. McCaughn, 280 U.S. 124 (1929). Also see Congressional Research Service Report No. 84-168 A 784/275, which was updated September 26, 1984].

Big Advantages

There is no smoke and mirrors with the `FAIR-SHARE' method of balancing the budget. The emergency direct tax is required to be imposed whenever Congress closes a fiscal year with a deficit. The structural mechanism which would immediately bring fiscal sanity to Congress is the requirement of having Congress send a bill to the governor of each state, notifying him to remit his state's *apportioned share* toward extinguishing the deficit created during the year by Congress; the governors and state legislators being left with the burden of having to raise this money, and to send it off to Washington, D.C.

Picture, for a moment, the expression on the faces of the Governor of New York and the New York State Legislature, if New York should receive a bill for its apportioned share [31/435] of the 1995 federal deficit. This threat would create a compelling incentive for the Governor of each state, and the various state legislatures, to keep a jealous eye on the spending habits of their Congressional Delegation . . . it would require the fiscal accountability which the state governments once *demanded* from their Senate and House Members!

In addition, because each state's share of the tax burden is determined by a fixed rule, similar to that which determines the House membership size of each state, a barrier is erected preventing the kind of mischief which Congress now practices, i.e., discriminatory tax legislation; pork-barrel favoritism; special interest lobbying, etc.

Bottom Line

The Framers of our Constitution provided a specific method to extinguish anticipated deficits through an emergency direct tax. Hamilton, in No. 36 of The Federalist Papers, reminds us:

> "Let it be recollected that the proportion of these taxes ***is not to be left to the discretion of the national legislature, but is to be determined by the numbers of each State, as described in the second section of the first article*** [United States Constitution]. An actual census or enumeration of the people must furnish the rule, a circumstance which effectually shuts the door to partiality or oppression. The abuse of this power of taxation seems to have been provided against with guarded circumspection." (EMPHASIS ADDED)

The rule of apportionment was written into our constitution to remedy a major defect associated with "democracies", which Madison points out in No. 10 of The Federalist Papers:

> ". . . have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security or the rights of property; and have in general been as short in their lives as they have been violent in their deaths."

And so, the Founding Fathers formed a Constitutional Republic to avoid the predictable disastrous consequences of democracy.

The intended use of the emergency direct taxing power to extinguish deficits is not only far superior to any of the proposed balanced budget amendments being offered . . . it is already part of our Constitution. The method in text form is as follows:

The Fair Share Balanced Budget Method

"A R T I C L E__

"SECTION 1. Congress ought not raise money by borrowing, but when the money arising from imposts duties and excise taxes are insufficient to meet the public exigencies, and Congress has raised money by borrowing during the course of a fiscal year, Congress shall then lay a direct tax at the beginning of the next fiscal year for an amount sufficient to extinguish the preceding fiscal year's deficit, and apply the revenue so raised to extinguishing said deficit.

"SECTION 2. When Congress is required to lay a direct tax in accordance with Section 1 of this Article, Congress shall immediately calculate each State's apportioned share of the tax based upon its number of Representatives as allotted by the Constitution, and then notify the Executive of each State of its apportioned share of the total tax being collected and a final date by which said tax shall be paid into the United States Treasury.

"SECTION 3. Each State shall be free to assume and pay its quota of the direct tax into the United States Treasury by the final date set by Congress, but if any State shall refuse or neglect to pay its quota, then Congress shall send forth its officers to assess and levy such State's proportion against the real property within the State with interest thereon at the rate of___ per cent per annum, and against the individual owners of such property. Provision shall be made for a 15% discount for those States paying their share by___ of the fiscal year in which the tax is laid, and a 10% discount for States paying by the final date set by Congress, such discount being to defray the States' cost of collection.

Conclusion

There are participants at this Hearing, and many political pundits appearing on talk shows across our country, who are far more articulate than I in identifying the glaring defects and dishonest nature of income taxation, whether flat or progressive. Likewise, there is also an abundant supply of those presenting well rehearsed arguments against an across the board national sales tax, and have displayed their rhetorical skills quite admirably. But who, I ask, has made a substantial argument against the Founding Father's original tax reform package?

Perhaps our only problem in regard to tax reform is that we, as a nation, have lost touch with the original intent and wisdom of those who framed and ratified our Constitution...such negligence culminating in our current dilemma.

In closing Mr. Chairman, I would like to take this time to thank you and your staff for allowing me this opportunity to present my humble opinion on a subject of such great importance.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE HOUSE WAYS AND MEANS COMMITTEE ON AN ALTERNATIVE FEDERAL TAX SYSTEM

June 6, 1995

Farm Bureau is the nation's largest general farm organization with a membership of 4.4 million member families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Our policy is developed by producer members at the county, state and national levels of our organization. We appreciate the opportunity to comment on tax issues important to our member families.

Farm Bureau applauds the efforts of this committee to hold hearings and move forward with the tax debate in the 104th Congress. Making tax policy more farmer-friendly has been on the top of Farm Bureau's agenda for many years. The current debate contains many good tax reform proposals which are important to farmers and supported by Farm Bureau including; a lower capital gains tax, a higher estate tax exemption, deductibility of health insurance premiums by the self-employed and expanded use of individual retirement accounts (IRAs). We urge the committee to view these proposals as the start of a series of tax changes that will improve the economic well-being of our nation and its farmers and ranchers.

Federal tax policy must give all citizens, including farm and ranch families, more opportunity to keep their own money and create their own personal financial safety net rather than rely on government. For farm families to be financially secure, tax policy must create a business climate where well managed farms can produce profits. Then, tax policy must allow farmers to keep more of their income so they can save for future financial security.

Over time, the U.S. tax code has become more complex and harder to manage. Thus, U.S. tax policy has a tougher time accomplishing its intended agenda of encouraging private initiative, economic growth, equity, simplicity and collecting the needed revenue with a minimum amount of economic distortions. All of this has come at a cost to the private sector in terms of lost output and efficiency in our economy. It is now estimated to cost $192 billion annually to comply with the current tax system and its 480 forms.

Current Farm Bureau Policy

Farm Bureau policy states that tax policy should be designed to encourage private initiative,

economic growth, equity and simplicity. Farm Bureau supports the consideration of a single rate net income tax system. Farm Bureau policy currently opposes a value-added tax and believes that sales tax should be reserved to state and local governments. Farm Bureau also supports the repeal of federal estate taxes as well as cutting the tax rate on capital gains to a maximum of 15 percent and indexing capital gains for inflation. Farm Bureau supports changes in IRAs to expand their use for saving for education, for the purchase and upgrade of primary residences and for medical illness. Tax changes to reinstate IRAs, to allow non-employed spouses to participate, and to expand the uses for saved funds will be good for farm and ranch families of all ages.

Farming and ranching are extremely capital intensive businesses. Even a part-time, beginning farmer who owns little or no land can easily have over $100,000 of capital investments. When land is added to an operation's assets, capital needs can quickly reach a minimum of $200,000 to $300,000. Capital gains tax relief is needed to facilitate the movement of agricultural capital assets to the next generation of America's farmers and ranchers and to improve the economic viability of existing farm operations. It is preferable for this transfer to occur while both generations are alive, rather than be subject to estate taxes at the time of death.

Farmers and ranchers have a vital interest in estate taxes because production agriculture remains a family enterprise-based industry. According to the 1992 Census of Agriculture, 85.9 percent of farms and ranches are individual or family proprietorships and 9.7 percent are partnerships. Of the 3.8 percent of operations that are incorporated, only 0.4 percent are not family held. Without estate law changes, the next generation will find it more difficult to continue farming.

Farm Bureau also supports increasing the annual gift exemption per donee from the current $10,000 to $20,000. This would provide another tool to ease the estate tax burden and help keep farms and ranches in the family.

The 25 percent tax deduction for health insurance premiums of self-employed sole proprietors has been made permanent in recent legislation and will move in the near future to 30 percent. This is a move that Farm Bureau has supported. We commend Congress for passing this legislation. In addition, Farm Bureau supports a permanent 100 percent deduction for health insurance premiums paid by self-employed individuals. Providing self-employed persons the ability to deduct 100 percent of the cost of their health insurance is a matter of fairness. Corporations, including farms that are incorporated, are able to deduct the entire costs of their employees' health insurance. It is only fair that all farmers, regardless of how their businesses are organized, be able to deduct their entire health insurance costs.

Farm and ranch income can vary greatly from year to year. When farmers and ranchers have good income years, the amount of savings they can shield from taxes is limited and their incomes are heavily taxed. During tough financial years, farmers and ranchers may have no money to save. Changes in IRA rules will allow farmers to save more money and allow them to retain more of their income from savings. In addition, increasing the variety of uses for savings will give farmers more control of their financial future.

Farm Bureau supports accelerated depreciation, allowing for annual expensing of preproduction expenses and increasing the amount of capital purchases allowed to be expensed each year. Farm Bureau also supports tax incentives for producers who are forced to make expenditures in order to comply with environmental laws. Farm Bureau supports allowing farmers and ranchers to count income from livestock sales and disaster payments in the year that they would normally have occurred so that taxes paid are fair and a true reflection of normal farm income. Finally, Farm Bureau supports the creation of a per child tax credit, elimination of the marriage penalty and an increase in the personal exemption.

Creating a New Tax System

Current debate is beginning to move beyond tax reform toward a complete overhaul of the entire federal tax system. New tax systems being debated include the flat tax concept, a national sales tax, a value-added tax system and other consumption-based tax systems. Farm Bureau supports consideration of a single rate income tax system, but has not endorsed any specific plan. Farm Bureau believes that the goal is to design a system that is fairer and simpler and will encourage strong economic growth and greater opportunity for all citizens.

The earliest work on a new system was done by Stanford Professor Robert Hall and Alvin Rabushka of the Hoover Institution. Their book, The Flat Tax, was first published 10 years ago, with a second edition this year. According to their analysis, a hypothetical farmer in Iowa would be due a carry-forward against future taxes when gross farm revenues (amount received from crop sales) fall short of the total farm expenses paid (including the purchases of goods, services, materials, wages, salaries, pensions, capital equipment, structures and land). In a profitable year, each farmer would also be able to deduct the costs of doing business (including capital equipment, structures and land) from revenues before calculating and paying taxes owed. The results, based on Hall and Rabushka, could be sent to the government on a 10-line postcard.

This type of flat tax is favorable for farmers and ranchers with families (since personal allowances and dependent exemptions will still be deductible) and farmers and ranchers with business expenses (that can be deducted in the year they were made). Several flat tax plans have recently been proposed in Congress and several more will likely be added in coming months. Under each of these proposals, farmers would still be able to deduct all legal business expenses and transmit the results to the IRS on one simple form. The results should be positive on the macro economy as well.

Earlier this year, House Majority Leader Dick Armey (R-TX) put forth his proposal based on the flat tax idea to simplify the U.S. tax code. This proposal would create one tax rate (20 percent initially and 17 percent after the federal government is downsized) allow Americans to calculate their taxes in just minutes instead of hours. The results could be sent to the IRS on a postcard. The positives that Farm Bureau notes with this type of plan include: eliminating the current double taxation on savings and investment, lowering our already high marginal tax rates, simplifying tax compliance, insuring fairness, producing higher economic growth, and higher taxpayer compliance while restraining the growth in federal spending.

On the Senate side, Sen. Arlen Specter (R-PA) introduced on March 2, 1995 the Flat Tax Act of 1995 (S.488). This bill would also scrap the majority of current deductions and regulations and replace them with a 20 percent flat tax that could be filed on a simple 10-line postcard. While the Armey plan would eliminate all deductions and further cut the size and cost of government, the Specter plan would include limited deductions for home mortgage interest on up to $100,000 in borrowing and charitable contributions up to $2,500. Individuals would not be taxed on any capital gains, interest on savings or dividends. In our opinion, this is a very positive step. Under this plan, farm businesses would be able to expense 100 percent of the cost of capital formation, including purchases of capital equipment, structures and land in the year in which the investment would be made. The major positives about the Specter plan are:; simplicity, less regulations, more economic growth, increased efficiency, lower interest rates, lower costs of compliance and decreased fraud.

On April 25, 1995, Senators Domenici (R-NM) and Nunn (D-GA) added their plan to this mix. Positive features of their include: simplifying the tax code and spurring personal savings and business investment. A new deduction for the 7.65 percent social security/medicare payroll tax would be added as well as a deduction for education/training costs and all personal savings including stock/bond purchases. The marginal tax rate for married couples earning over $24,000 a year would be an effective 32.35 percent (after deducting the social security tax rate). This, in our opinion, is still a relatively high marginal rate. Business would pay a flat rate of 11 percent on income (revenues minus expenses) compared to the current rate of 35 percent, a plan that could be an aid to farm businesses.

House Ways and Means Chairman Bill Archer has recently called for the abolishing of the present income tax system and replacing it with a consumption tax. In his words, the current system is "too broken to be fixed and must be replaced." The Archer replacement tax would be a broad-based tax on individual and business consumption spending with exemptions for medical and housing expenses. Chairman Archer would also repeal the 16th Amendment to the Constitution that authorizes the current income tax. While Farm Bureau policy currently does not support a value-added type tax, we commend the Chairman for his open mind and willingness to help move America closer to a new tax system.

Tax policy and the resulting rules, regulations and systems are critical to our members. Policies and systems that are fair and equitable promote both the economic well-being of farmers and our nation's food supply. Our tax system must provide incentives for citizens to pay their fair share of their respective tax liabilities and encourage all citizens to create personal financial safety nets. We urge the debate to continue as America moves toward such a new system.

STATEMENT OF AMERICAN IRON AND STEEL INSTITUTE (AISI) ON BEHALF OF AISI's U.S. MEMBER COMPANIES

The American Iron and Steel Institute (AISI), on behalf of its U.S. member companies, commends Chairman Archer and the Committee on Ways and Means for holding this hearing to examine the potential benefits of fundamental tax restructuring and alternatives to the current income tax system.

This is a huge undertaking. It is one that holds enormous promise even as it raises major concerns. Our long-held position is that this subject deserves serious national consideration. We therefore applaud all of the tax policy leaders on both sides of the political aisle for having the vision to move this issue into a front-and-center position in the 104th Congress.

Needed: A Careful Look at the Pros and Cons

For the past several years, AISI has been one of the strongest, most public supporters of a careful, in-depth study of the pros and cons of basic tax reform. By letting the Congress know at every opportunity that this is a key issue for U.S. steel producers, AISI has sought to promote a national debate on this matter. We concluded long ago that the study of fundamental tax restructuring is a priority issue for one simple reason -- the existing U.S. business tax system is hurting U.S. investment, productivity, competitiveness, economic growth, jobs creation, and ultimately the standard of living in the United States.

Still, as Chairman Archer has recognized, basic tax reform must be more than just an improvement over the current system. To justify the great effort that such a massive task entails and to ensure that the end result will be a pro-competitive tax system for the 21st century, the Congress must proceed carefully, look at the pros and cons, listen to those in the private sector that will be most affected, and address the significant number of serious concerns, questions and issues related to fundamental tax restructuring.

If the Congress does decide, after an appropriate period of careful study, to take the current income tax system and "tear it out by its roots," the aim on the business side should be to create a simple, revenue-neutral substitute for, not an add-on to, the existing business tax system of the United States (corporate income, including alternative minimum, taxes and payroll taxes). Accordingly, we are pleased that virtually every one of today's major bills or proposals -- from the flat tax to the "USA Tax" -- endorses the concept of a total replacement of the existing business tax system.

The fact that hardly anyone today would suggest enacting a consumption or value-added tax as an add-on to the current income tax system is progress -- it is a first step on the road toward national consensus. What we now need to do is start defining the kind of tax system and tax policy results that we would like to see well into the next century. As Chairman Archer has said, consideration of basic tax reform must be measured against certain well-defined goals. We would urge that the Congress begin by developing a list of guiding principles.

Guiding Principles

If we as a nation are to move toward fundamental tax restructuring, it must be done right. Basic tax reform must conform to key principles. Any new business tax system should:

1. **replace current taxes on U.S. companies and avoid net increases in taxes on U.S. businesses** -- we will not improve U.S. competitiveness, if there are net increases in taxes on U.S. firms;

2. **provide for immediate expensing of new plant and equipment purchases** -- any new system should encourage U.S. investment,

discourage disincentives to investment, and promote rather than hinder the competitiveness of U.S. manufacturing;

3. **be border-adjustable** (exempt exports, apply to imports the same as U.S.-produced goods) -- this is an essential element of leveling the playing field and developing a pro-competitive U.S. tax system for the 21st century;

4. **be simple, less burdensome, and relatively easy to administer** -- steel and other U.S. industries share these goals with the individual taxpayer; and

5. **include appropriate transition rules** -- it is absolutely critical that Congress recognize that issues of fairness and equity affect both businesses and individuals and, if we are to make the new system fair, U.S. firms must be allowed to carry with them into this substitute system the net operating losses (NOLs) or tax credits that they have accumulated under the current system.

Potential Benefits

If properly constructed along the lines discussed above, basic tax reform could yield many benefits. It could lower the U.S. cost of capital, simplify the U.S. business tax code, promote U.S. exports, and provide additional revenue (from imports) for federal deficit reduction and other important national goals. In addition, many economists now believe that this could all be done without raising taxes for U.S. businesses or causing significant price hikes for U.S. consumers.

Accordingly, there are good reasons for the Congress, U.S. industry and U.S. citizens to spend a substantial amount of time over the next year or two trying to craft a new, replacement tax system.

Inadequate Capital Cost Recovery -- The Present System is Broken

There is no doubt that the existing anti-competitive U.S. business tax system is retarding U.S. investment flows and harming U.S. competitiveness. Thus, in January, at Committee hearings on the tax provisions of the "Contract with America," we testified that, as Alternative Minimum Tax (AMT) payers, AISI's U.S. member companies agree totally with Chairman Archer that "the present system is broken...".

On June 6, 1995, the American Council for Capital Formation (ACCF) testified about some of the problems related to the current system. It noted that net business investment in the U.S. has fallen to only half the level of the 1960s and 1970s; that the stock of equipment needed for strong productivity growth has increased all too slowly since 1980; that tax policy does affect capital costs, and that tax rates on investment do affect the level of investment. It also noted in particular that (1) the marginal tax rate on domestic U.S. corporate investment is 37.5 percent -- higher than most other countries -- and (2) U.S. taxes on machinery and equipment investment are especially high (e.g., 18.5 percent on new investment in machinery, versus only 8.8 percent in Japan).

Compared to other countries, the capital cost recovery system in the United States today is grossly inadequate. Based on recent research by Arthur Andersen, the ACCF estimates that, under the AMT, the "present value" of the entire stream of cost allowances for U.S. investments in modern continuous casting equipment is only 59 percent, compared to 81 percent in Japan, 82 percent in Germany, 78 percent in Korea, and 88 percent in Brazil. Viewed another way, after 5 years, a U.S. steelmaker under the AMT recovers only 37 percent on its investment in new plant and equipment, versus 58 percent in Japan, 81 percent in Germany, 90 percent in Korea, and 100 percent in Brazil. It was not always this way. Between 1981 and 1985, when a strongly pro-

investment tax regime was in effect in the United States, the present value for a similar investment made in the U.S. was close to 100 percent.

A Recipe for Capital Formation –
No More AMT and Full Expensing: The Example of Steel

When AISI testified in January, it stressed that "capital costs and capital formation remain critical concerns to our industry....{and that} the last thing we need is an anti-competitive tax that raises the cost of capital and impairs capital formation." Improving the U.S. capital cost recovery system, therefore, would be one of the most important potential benefits of fundamental tax restructuring for the American steel industry. Taking steel as an example, here is why.

U.S. steelmakers must continuously invest in new plant and equipment in good times and bad in order to modernize, remain competitive, and comply with environmental laws and regulations. The AMT treats depreciation as an increase in income. As a result of this adverse treatment of depreciation, many capital-intensive, marginally profitable U.S. steelmakers remain permanently stuck in the AMT – the world's worst capital cost recovery system, with a 150 percent depreciation method and a 15-year cost period for most steelmaking assets (compared to 200 percent and 7 years under the regular tax).

We estimate that the AMT raises our industry's cost of capital by as much as 20 percent. This is why, until basic tax reform is finally in place, steel and other U.S. manufacturing industries will continue to give strong support to the kind of significant "incremental change" contained in H.R. 1215. The House-passed bill and the AMT provision sponsored by the Chairman would remove a major disincentive to U.S. investment by phasing out the AMT by the year 2001.

The bottom line: if the United States were to adopt a truly pro-competitive tax system -- with no AMT to penalize investment and with full and immediate expensing of new plant and equipment purchases in Year One -- it would be a major boon to capital formation in steel and other U.S. manufacturing industries, including our major customers in steel-using industries.

Border-Adjustability -- A Way to Promote U.S. International Competitiveness

A second important reason to consider basic tax reform is the opportunity to include a border-adjustability feature, which could provide significant benefits for U.S. international competitiveness in addition to yielding a substantial amount of revenue from imports.

The United States today is virtually the only major economy in the world that does not use some form of GATT-legal border-adjustable tax (BAT) on business activities in its territory. In Western Europe, Japan and other markets, U.S. exporters and the products that they sell face a BAT upon entry. In the U.S. market, however, we do not require foreign companies to pay a BAT on the goods they sell here – and our foreign competitors also get a rebate of their own government's BAT when their products leave as exports. As a result, the international playing field is not level when it comes to fiscal policy.

Perhaps the best example is the one closest to home. Everyone knows that the North American Free Trade Agreement (NAFTA) will eventually eliminate duties on intra-NAFTA exports of steel and other products. What has not received enough attention is the fact that U.S. exports will continue to be charged a 7 percent goods and services tax upon entry into Canada and a 15 percent VAT upon entry into Mexico -- and that these taxes will continue to be rebated for Canadian and Mexican exports to the United States.

Border-adjustability must be part of any basic tax reform. When combined with full expensing, a substitute BAT could have a powerful pro-competitive effect on manufacturing and the U.S. economy.

Tax Code Simplification

A third main reason to consider fundamental tax restructuring is tax code simplification. As AMT payers, steel companies know all too well the problems associated with tax code complexity. AISI's U.S. members have to keep two sets of books -- one for the AMT and one for the regular tax -- and pay the higher of the two (nearly always the AMT). In addition to this requirement, there are the numerous depreciation and inventory calculations, the all-too-frequent changes in the Code, and the extremely technical language that only an army of accountants and IRS officials can understand.

Looked at from a national perspective, the existing tax system is fraught with excessive administrative costs, and the total annual U.S. compliance cost for the private sector is estimated to be in the $300 million range. Surely, there are better ways for U.S. firms and individuals to spend their time and money.

While any new tax system must include appropriate transition rules, which would involve some complexity, AISI would encourage the Congress to keep the goal of tax code simplification at or near the top of its aims for basic tax reform.

Major Concerns, Questions and Issues

With so much in the way of potential benefits from fundamental tax restructuring, why are we and other U.S. industries holding back somewhat and not rushing to endorse without qualification basic tax reform? The answer is this: perhaps the only thing more complicated than the current U.S. tax code is trying to figure out what a total replacement of the existing system would mean for one's own company, one's industry and the U.S. economy at large. As noted previously, there are a number of critical concerns, questions, and issues that must be addressed before Congress takes the historic step of actually moving to enact fundamental tax restructuring.

Net Tax Burden -- Will It Be Higher?

The potential benefits to U.S. businesses from basic tax reform will be clearly diminished if a new tax regime results in net tax increases. Unfortunately, even assuming that any new tax will be a replacement for, and not an add-on to, existing taxes on U.S. businesses, it is possible that tax burdens on U.S. industry (both in the aggregate and on individual industries and firms) could go up. In this regard, three central questions are:

- What will the tax rate be?
- How broad will the tax base be?
- And will there be net tax increases on U.S. businesses?

U.S. manufacturers have reasons to be concerned. Looking at just one proposal, Price Waterhouse has estimated that, whereas aggregate U.S. corporate tax liability in 1991 -- under the current system -- stood at about $68 billion, it would rise to $78 billion under a 17 percent flat tax, to $88 billion under a 19 percent flat tax, and to $106 billion under a 23 percent flat tax.

Moreover, there are concerns not only about the rate that will be chosen but about the issue of how the tax base will be computed. Our U.S. member companies wonder, for example, if they will be given full credit for social security taxes paid in whatever fundamental tax restructuring proposal is finally adopted. In addition, they are very concerned that some of the proposals add labor

compensation items (e.g., health and pension legacy costs) back into the tax base mix. The effect of this could be to create a "super payroll tax," and that could be especially damaging to some U.S. steel producers.

Effects on Financial Statements -- Both Winners and Losers

Yet another serious concern is the possibility that basic tax reform could eliminate deferred tax assets (e.g., NOLs, minimum tax credits, and health care costs that have value as future tax deductions). This loss of such future deductions and credits could have a devastating effect on some steel companies' financial statements. Accordingly, our U.S. member companies worry about this accounting treatment of fundamental tax restructuring.

The concern is real because the Financial Accounting Standards Board issued "Statement 109, Accounting for Income Taxes," in February 1992, which mandates a liability method for computing deferred income taxes. The adoption of a tax other than on income could have a significant impact on the financial statements of companies. For example, companies with large deferred assets due to NOLs or minimum tax credits could suffer substantial losses from the reversal of such assets, as well as a weakened balance sheet.

The impact of basic tax reform on financial statements is a major concern for some steel companies, because it could possibly wipe the equity of some companies off the books. The main point we would like to make, however, is that there could well be both major windfalls and big losers from the accounting impact of fundamental tax restructuring and, at least so far, this issue has not received the required attention. If the Congress does move forward to enact a new tax system, we urge it to take action to preserve these tax assets.

Accumulated Tax Assets and Credits -- The Paramount Need for Appropriate Transition Rules

AISI has always recognized that basic tax reform could not ensure that every U.S. steel company would pay no more under a new tax system in any given year than they do currently. At the same time, the more we have studied this issue, the more obvious it has become that, even under a well-constructed, revenue-neutral, border-adjustable, substitute tax regime, there must be clear and fair transition rules to ensure that key industries and firms are not unduly disadvantaged, even temporarily.

Many steel companies, for example, have built up significant accumulated tax assets under the existing corporate income tax system -- including NOL carryforwards and AMT credits -- that total hundreds of millions of dollars. Our U.S. member companies naturally want to know: what will happen to these NOLs and other accumulated tax assets under various basic tax reform plans? Unfortunately, appropriate transition rules are a key missing ingredient from many of the proposals for fundamental tax restructuring. This is an issue of basic equity. It remains an absolutely critical issue for AISI's U.S. members.

Some have suggested that, for "GATTability" reasons, the choice is between (1) a tax that is border-adjustable and (2) a transition rule that provides U.S. companies access to their NOLs and accumulated tax credits. If correct, this would obviously make the concept of basic tax reform much less attractive to steel and other industries. We do not agree, however, that this is the choice. First, as one means of solving the problem, the Congress could allow U.S. firms to cash out their NOLs and accumulated tax credits. Second, as Gary Hufbauer (Institute for International Economics) recently noted, "the {GATT-}permitted range of adjustments is not static. Instead, it has gradually expanded over time....{In addition,} the introduction of a new tax has sometimes served as the occasion for enlarging the range of permitted adjustments."

If the Congress does move ultimately to enact fundamental tax restructuring, it should ensure both that the new tax is border-adjustable and that there are appropriate transition rules in place so that U.S. companies and industries are not unfairly disadvantaged. The issue of what may or may not be allowed by the new World Trade Organization will perhaps be a factor in the coming national debate. At this time, it is just one more concern that needs to be addressed.

The Effects on Prices and Consumption – Two Important "Wild Cards"

The American steel industry, like a number of other key manufacturing industries, is inextricably tied to the performance of the U.S. economy as a whole. While AISI and just about everyone else would like basic tax reform to promote U.S. savings and investment, we do not wish to see a new tax system dampen U.S. consumption of steel-intensive products that contribute to the standard of living of our citizens and improve the competitiveness of our businesses. Fundamental tax reform should make the economic pie bigger -- it should grow both U.S. savings and consumption. The question is: will it?

The concern here is whether price increases could result from a new replacement tax system and whether these could possibly push down U.S. consumption of steel-containing manufactures. At the end of our national debate on tax policy, if the Congress does enact basic tax reform, it will inevitably involve some "leap of faith." Two things, however, are obvious right now: we will need to be very clear about our main goals as a national economy, and we will need to improve the way we analyze this issue.

Analytical Constraints

The problem for us and every other U.S. industry is that, while we can all probably agree that, for example, not taxing capital expenditures will have tremendous impacts in all kinds of ways, there is no way to understand these effects fully by using a static analysis.

The fact is that, while a static analysis assumes that certain macro-economic numbers (e.g., consumption levels) will not change, one of the primary aims of fundamental tax restructuring is to effect a society-wide change in tax payer behavior (e.g., to increase savings). At the same time, the "science" of trying to estimate both the micro and macro-economic effects of basic tax reform through use of a more dynamic model has a long way to go.

In sum, there are simply too many moving parts to estimate with any degree of certainty the potential impacts on (1) economic growth, (2) federal revenue, (3) the cost, price and demand of products, (4) the cost of capital, (5) exchange rates, and (6) securities' prices. In addition, some of the dynamic effects from basic tax reform could take decades to work themselves through the economy. Thus, all we can do is try to make an intelligent guess as to how fundamental tax restructuring might affect our particular industry and/or company.

Conclusion

This Committee is embarking on something -- a possible complete overhaul of tax policy in the United States -- that has not been done in this country in over 60 years. AISI applauds you for initiating the process. For our part, we have been looking at the issue of fundamental tax restructuring for a long time, and intend to contribute what we can to the national discussion on basic tax reform that the Committee, Senate Finance, and the "Kemp Commission" will be leading.

In part because of the aforementioned analytical constraints, we have not sought in this testimony to come out for or against any of the major proposals for basic

tax reform. While the economic consequences of each could vary widely, they all have their good points and something to commend them when compared to the existing U.S. business tax system. Our intention here is to suggest guidelines, benchmarks, and principles that we would appreciate the Congress considering as it delves deeper into this important public policy matter.

AISI's U.S. member companies are grateful for this opportunity to provide written comments on fundamental tax restructuring for the record, and look forward to participating actively in the coming debate.

AMERICANS FOR TAX REFORM

Grover G. Norquist
President

May 25, 1995

Hon. Bill Archer, M.C.
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Archer:

We at Americans for Tax Reform salute you for your steadfast efforts in passing the Contract with America tax reductions through the House of Representatives and we urge you to stand firm in your negotiations with the Senate.

We also look forward to your scheduled hearings June 6-8 on proposals to revise or replace the income tax.

Americans for Tax Reform strongly supports reform proposals that will make federal taxes and tax rates fairer, simpler, flatter, and lower. We enthusiastically support the Armey Flat Tax proposal soon to be reintroduced in this Congress.

Americans for Tax Reform strongly opposes any national sales tax or value-added tax. Such taxes have consistently proven in practice to be "add-ons," not replacements for existing levies.

Americans for Tax Reform sponsors the Taxpayer Protection Pledge, which was recently signed by Senator Bob Dole. Other Presidential contenders who have signed the Pledge include Senator Phil Gramm and Pat Buchanan. In the last election cycle, over 400 candidates from both parties were Pledge signers.

Our president, Grover G. Norquist, would welcome an invitation to testify at the June hearings. Norquist is nationally recognized as a leader of the grassroots taxpayers' movement. We would additionally welcome any future opportunity to comment or testify as you find useful.

Sincerely,

James P. Lucier, Jr.
Director of Research

cc: Rep. Phil Crane

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STATEMENT OF
JOHN H. PERRY, JR.
FORMER CHAIRMAN,
AMERICANS FOR THE NATIONAL DIVIDEND ACT,
TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
June 7, 1995

Mr. Chairman and Members of the Committee, my name is John H. Perry, Jr. and it is my pleasure to have the opportunity to address a concept I originated nearly fifty years ago and which is before this Committee as one proposal for reforming our Federal tax system. My idea is the basis for H.R. 430, the National Dividend Act, introduced by Congressman Billy Tauzin in the 104th Congress. I am grateful for the confidence that Congressman Tauzin has invested in the National Dividend Act, and for keeping the legislation, which received support from Members across the political spectrum during the past decade, before the Congress.

Members of the Committee, one month shy of ten years ago, I appeared before this Committee championing the National Dividend Act as the Committee conducted hearings which led to the Tax Reform Act of 1986. At that time the gross Federal debt of the United States was $1,816,974,000,000 and the deficit that year, 1985, was $212,334,000,000. As you consider changes to our tax structure in 1995 our Federal debt approaches $5 trillion, and the Budget of the

United States, submitted by the President a few months ago, projects deficits in the $200 billion range for the rest of the century.

There are two changes to our Federal tax structure which will change those numbers, one is good for the short term -- the tried and true method of ***raising*** taxes to meet the demand for revenue, a method not even remotely appropriate today; the other is a permanent, long-term solution, the National Dividend Plan, the subject of H.R. 430, a concept which changes tax structure in such a way as to address not only tax "supply," but tax "demand."

A full decade before my appearance at the 1985 hearings, and before his election to the Presidency, Ronald Reagan noted that the National Dividend Plan "is not a half-baked utopian dream. It is a well thought out, fully documented program. . ." It is, moreover, a program to which I have devoted not only fifty years of my life, but a considerable portion of my assets. A tax bill with the National Dividend Plan as a central feature would be assured of passage and it would be veto-proof -- no legislator could vote to deny voters a dividend and no President would fail to sign the bill.

In the decade between 1985 and 1995 the Congress has considered, and even passed by majority vote, such ideas as budget control acts, and balanced budget amendments to the Constitution, and, more recently, the line item veto, to provide tools for restraining the demand for Federal spending. These ideas, worthy though they may be, and appealing in the abstract, fail for want of addressing demand where it begins: with the people of the United States. It is the voters and taxpayers who insist they want less government, and lower taxes, yet they remain solicitous of programs from which they have, for years, derived

some benefit or which they see to be addressing perceived needs without regard to the depth of those needs or alternatives to meet them.

Even the flat tax, and alternative tax systems being discussed today do not touch spending. And although different ways of developing revenue may be attractive, no systematic program that I have seen puts a cap on revenue -- down the road even a flat tax could be increased to meet more spending. Of course the revenue from any tax scheme could be ignored in favor of continued deficits. And while spending limits and reductions are a priority today, there is no "built-in" limiting mechanism, nor any assurance that the special interests will not derail even the best-intentioned deficit reducing efforts.

The National Dividend Act sets in motion the National Dividend Plan (NDP), a comprehensive program to eliminate Federal deficits, create a "profit sharing" trust fund for America's voter-taxpayers, and create an incentive to support our national business and industrial enterprise.

If the National Dividend Act had been implemented as a part of the Tax Reform Act of 1986 our budget would be in balance for 1996, and America's voter-taxpayers would be sharing in the distribution of National Dividend Trust Funds amounting to some $140 billion -- the portion of Federal tax receipts represented by corporate taxes.

H.R. 430, the National Dividend Act, contains five basic provisions. The first, and the central innovation of the Plan is the creation of the National Dividend Trust Fund in which all Federal corporate income tax receipts would be placed instead of being spent as part of the government budget. The Fund would be distributed to all registered voters so long as the Federal budet was in balance.

Dividend payments would increase as corporate profit increased -- the incentive to support business and industry paying Federal taxes.

The second provision gives voters a vested self-interest in resisting Federal deficits. Deficits would be discouraged by using the Trust Fund to meet excess spending thus reducing dividends. In other words, voters will insist that their legislators live within our government's means, and since all voters have an equal interest in the result, all Americans, rich and poor, "big" and "small," have an equal voice. All voters have an incentive to weigh each program for its value both to them as individuals and to the national interest.

The third provision is the elimination of the double taxation of dividends. This would end Federal personal income taxes on corporate dividends -- and on the Trust Fund distributions. It would serve to attract investment dollars into the private sector creating new jobs and stimulating business and industrial growth, benefitting the American economic machine. The growth would, as it provided jobs and income, increase regular Federal revenues for necessary government operations as well as increasing corporate tax revenue for the Trust Fund.

The fourth provision is a cap on the Federal corporate tax rate. It would be up to the Congress to determine what the percentage would be -- H.R. 430 uses the current rate -- but it assures business of parameters so that business decisions and future plans can be made.

Finally, the fifth provision is a freeze on Federal expenditures to phase-in the program. Every econometric model that we have seen indicates that Federal revenues would meet Federal spending in as little as three years if spending were frozen. The legislation provides a five-year phase-in period, or balance, after

which percentages of corporate tax beginning with 20 percent and increasing by 20 percent each year, are dedicated to the Trust Fund.

Using the decade of the eighties as an example, the following table illustrates the effect of implementing the National Dividend Plan:

A DECADE UNDER THE NATIONAL DIVIDEND PLAN

(In $ Billions)

	RECEIPTS	OUTLAYS	TRUST FUND	DEFICIT*	DEBT
1982	617.8	745.7	—	127.9	1136.8
1983	600.0	745.7	—	207.8	1371.2
1984	666.5	745.7	—	185.3	1564.1
1985	734.1	745.7	—	212.3	1817.0
1986	769.1	756.5	12.6	+ 23.4	1996.7
1987	854.1	815.5	38.6	+108.4	1996.7
1988	909.0	852.0	57.0	+163.3	1996.7
1989	990.7	907.9	82.8	+245.0	1996.7
1990	1073.3	961.3	112.0	+327.6	1996.7

* *+ figures indicate surplus*

The National Dividend Plan (NDP) gives each voter a stake in making sure that government addresses real needs, and in seeing that his or her legislator responds accordingly. Giving citizens a stake in measuring their demands against true budgetary impacts, and the prospect of a return on the success of American business may be a "radical" concept, but it is one with which we each live in our household every day: we must balance our budget -- especially on our long term commitments, and the better we work, the more successful we are.

But, you say, this would just encourage greater divisions among people -- exacerbate the tension between the haves and the have-nots. Never has America denied its most needy citizens. Indeed, poll after poll shows that America's voters want to address legitimate social needs -- but that they also want to keep more of their own money to spend as they find appropriate. They would rather give their church, or local government, or some charitable entity money to meet perceived needs than to have a massive government program. They would rather use their own resources to pay school or college costs than to have to beg from and qualify for some faceless government program.

But the practice of responding to special interests, "oiling" the hundreds of squeaky wheels that now make up not only our Federal programs but the way that we legislate, will have to pass the "means" test: Is it worth it if it means that my dividend is reduced? Some demands will meet that test: certainly challenges to our national sovereignty or national interests around the world which may demand defense expenditures, unusual events such as the disasters which have occasionally resulted in our people demonstrating that we are the most compassionate nation on earth, and other events which may call on our

enlightened self-interest to meet our national interest. The National Dividend Plan gives America's voters not only the opportunity to continue to generously meet national needs, but the self-interest to demand that those needs meet the test of being measured by the light of day.

America is, even with its inequities and its problems, the greatest nation on earth -- a successful and ever-growing experiment in democracy. For decades politicians and economists have debated the role of government and the use of revenues as a tool of policy. The National Dividend Plan is the logical conclusion of that debate: it uses revenue as a social tool to define and limit the role of government. The NDP can once again give life and meaning to the words of Alexander Hamilton -- incidentally the first U.S. Secretary of the Treasury -- that "Here (in Congress), sir, the people govern."

Mr. Chairman and Members of the Committee, thank you for this opportunity to present the National Dividend Plan as contained in H.R. 430. I truly believe that the NDP not only provides a unique way to give the American voter-taxpayer a new sense of both public and private economics, but that it is the only concept which addresses both the need to limit spending and the requirement that spending decisions involve the American people. The National Dividend Plan encourages voters to make judgements, to weigh alternatives, and it even provides for the opportunity to not only forego a dividend but, in special circumstances, to deficit spend against future dividends -- because America is as good and generous and great as it is.

Instead of bemoaning the task of 535 Members of Congress trying to restrain themselves from doing what 260 million Americans appear to want them

to do. it's time that we create an environment in which the millions of American voter-taxpayers demand that the 535 do what needs to be done -- and give them the tool, the incentive, to make it happen. Rather than damn us all to continuing mediocrity, let us seek to develop our greatness, to make us all rich.

John H. Perry, Jr., former Chairman of the Americans for the National Dividend Act and the originator of the National Dividend Plan concept, was Chairman of two Florida corporations headquartered in West Palm Beach, Florida: Perry Oceanographics, Inc., and Perry Offshore, Inc. The latter was the largest commercial builder of robot and manned submarines in the U.S. Mr. Perry is Chairman Emeritus of the Perry Foundation, Inc., a not-for-profit corporation dedicated to marine science.

From 1966 to 1968 he was a member of the U.S. Commission on Marine Sciences, Engineering and Resources which, after two years of study, submitted its report entitled, "Our Nation and the Sea." He served as Chairman of the Commission's technology panel. Mr. Perry facilitates marine research at the Caribbean Marine Research Center. Through the Perry Energy Systems Division of Perry Oceanographics, he has developed an energy process for making methanol from sea water. His current energy project is to have his Energy Partners Company build fuel cells which will make combustion engines obsolete.

Mr. Perry is the former President and Chairman of Perry Publications, Inc. which until 1969, operated 26 newspapers in Florida; **All Florida Magazine**, a Sunday supplement; **Palm Beach Life** magazine; the statewide All-Florida News Service, and numerous commercial printing plants in Florida. Perry Publications pioneered the development of computerized printing of newspapers in the early 1960s. He is a director of the Nassau Guardian (1844) Limited, Nassau, Bahamas. He is the author of The Ultimate Self Interest: A Strategy for National Solvency (1984, 1987), a detailed explanation of the history and operation of the National Dividend Plan.

Mr. Perry was born in Seattle, Washington, January 2, 1917; graduated from Hotchkiss in 1935, Yale in 1939, and attended Harvard School of Business Administration. He makes his home in West Palm Beach, Florida.

June 9, 1995

Phillip D. Mosely, Chief of Staff
House Ways and Means Committee
1102 Longworth Bldg.
Washington DC 20515

Dear Mr. Mosely:

I understand that the House Ways and Means Committee has scheduled "Open"!! hearings on the oppressive US Tax situation.

Please register my "vote" for a total US tax-system overhaul and strongly in favor of a reasonable "Flat Tax".

Thank You.

Sincerely,

James L. Anderson MD
E330 Gerbing View Drive
Union, WA 98592

Encl: (6)

cc: Norman Dicks, US House of Rep.
Slade Gorton, US Senate
Patty Murray, US Senate
Newt Gingrich, Speaker, US House of Rep.
Richard Armey, Majority Leader, US House of Rep.

ROBERT H. ASHWORTH
16300 198TH avenue NE
Woodinville, WA 98070
(206) 788-7895

RE: Flat Tax

Phillip Mosley
Chief of Staff
U.S. House of Representatives
Longworth Office Building
Washington, DC 20515

Dear Congress person,

The time has come for a flat tax of some kind. It must be one where there is no judgment made on what is a legitimate deduction by the IRS. There should be **no deductions.**

It would not have to exceed 10% as all money that changes hands will be taxed adding additional black market monies that are currently not being taxed.

Also, the economy will have a boom like never before. The problem with our economy now is a lack of jobs caused by too high of taxes and the increasing risk to start businesses.

Do it now!

Sincerely,

Robert H. Ashworth

Auto Source
Auction Sales & Broker
Lic. # D12842

June 16, 1995

Mr. Phillip Mosley, Chief of Staff
Committee on Ways & Means
US House of Representatives
1102 Longworth
Washington DC 20515

Dear Mr. Mosley,

I am in complete support with eradicating our current tax system which as you know penalizes the productive people of this country.

I think the National Sales Tax would be the best system to replace our current system for these reasons:

1. It is the form of taxation our Constitution allows.
2. It would require everyone to pay. Drug dealers, prostitutes, and other illegal money makers would finally contribute to our system.
3. It would not allow the Congress to eliminate the deductions and then raise the tax, like they could if we had a flat tax.

A flat tax would still allow for cheating and wasted time preparing forms for the IRS. We must eliminate the IRS and all the wasteful acts associated with preparing our tax returns.

My wife spends too much time with accounting for this business, in addition to our other joint business and our rental properties.

Lastly, we're sick of paying 15.3% of our income in Social Security taxes in addition to income taxes because we're self employed. If the employees of this country had to come out of their savings like we do, this debate would have taken place many years ago.

Please push towards the National Sales Tax.

Thank You,

Rick Jabour

800 "D" Davis St. • Vacaville, CA 95688 • (707) 447-5757 • (800) 441-5657

848 Jackman St. #317
El Cajon, Ca 92020
June 2, 1995

Dear Mr. Mosely,

It is exciting to have input into the issue of changing the tax laws. We must preface our ideas, however, with the statement that it is not the tax laws per se that are the problem, but the overspending. The overspending, and the apparent attitude of our Congressmen that there is an open checkbook available from the American people is what has caused the taxes to be so onerous.

Therefore the first change we would make would be that spending must always be based on the PREVIOUS year's available money, not the estimated amount. That way, unless there is a major recession or depression, the budget ought to always be balanced.

We would most like to see the income tax eliminated. However we do not trust Congress with a "phase in phase out". When Reagon allowed a tax increase with a "future" spending cut, the spending cut was never realized. Therefore we no longer trust "future" promises. If a national sales tax is started, it should be started simultaneously with the income tax being eliminated, and not gradually.

If we instead go to a income flat tax, there should be no national sales tax, and there should be flat tax of perhaps 10-12% with a mandated ceiling (forever) of under 20%. Without a ceiling, I could see the Congress once again consider taxpayers "rich" and we would be even more heavily taxed than now. If there is a flat tax, there should be no tax for incomes of $10,000 or below for single people and $20,000 or below for married people. Other than that there should be no "earned income" credit, and noone should be exempt from the tax, including welfare recipients or other holders of government handouts. A deduction for children including a deduction for child support for whoever pays it,and for interest paid (not just mortgage interest but any interest), and a deduction for taxes paid (including not just state or city taxes but sales tax as well) should be included so we are not paying tax on tax. Also, there should be a deduction for money received that is simply return of income, such as the portion of pensions that comes out of salary that had alreay had taxes taken out of it. Social security tax and Medicare tax should also be deductible. Once again, whatever the money this raises, that should decide the spending. Just like my budget, the budget should be based on income, not on what the Congress can extort from the people. Except for the items mentioned, the tax code should be eliminated. It is too complicated and too difficult to understand. The IRS should also have to prove any claims so that the taxpayer is assumed innocent. Apparently the IRS not can assume that a taxpayer earned income and force the taxpayer to pay tax on this income without evidence that the taxpayer earned said income. This practise of the IRS is ridiculous and the agency should have to prove that the taxpayer earned any disputed income.

Should the income tax be eliminated completely, and a sales tax be instituted instead (as I would like to see), state and local income taxes should also be eliminated. The sales tax then should be only on actual sales of goods, not sales of services. There should be no tax on capital gains. The sales tax also has to have a ceiling beyond which it cannot go. A sales tax of 10-12% seems reasonble, with perhaps food being exempt. The tax should not be able to be higher than 15%. The name of the game is CUT SPENDING. If this has to be forced on Congress by reducing revenues and saying "Thats all there is", so be it.

Thank you for asking for our input.

Yours sincerely,
Lynn Badler
Ted Warren

MR MICHAEL BALL
200 RAVEN CT
MODESTO CA 95350

Dear Group,

I would like to site 3 reasons opposing the consumption tax.

I. A consumption tax on expensive luxery items or any large ticket item, would increase the cost of those items, considerably. This would in turn create the desire, to purchase these items, from other countries. I would also like to site a "trickle down affect" in our economy, on U.S. businesses, and the desire to compete, when these expensive items are more attractive to purchase abroad, just to avoid a consumption tax.

II I fore-see a likely infringement upon the individual right to sell. Yard sales and garage sells or even the right to sell a used vehicle (privately), could potentially become illegal. The only way to avoid this, would be to create another bureaucratic mess, by making citizens apply for some type of sales permit and to

describe the item or items and the selling amount. This too, would lead to the non-negotiable sells in the private sector, if an individual must site a sales amount, in advance.

III With a consumption tax, even the poor and poverish would have to pay and I believe they should be exempt from paying any federal tax.

I would like to site 2 reasons in favor of the flat tax.

I It's more fair and easy, and would apply to all Americans who create an income anywhere in the world, and that tax would be paid, regardless where they made their ~~[illegible]~~ incomes.

I would hope that the flat tax would exempt the poor and poverish, and would have little or no deductions.

II A flat tax would always encourage more and more productivity as the more you earn, the more you keep. I can think of many times, that employees did not wish to work any over time, because additional hours would place them in a

higher tax bracket and they'd make less take home pay. This produced negitivity toward more production and pay!

Notation: As much as I, personally, would like to see the elimination of the IRS, I do not believe this should be the goal. It is a far better achievement to do what is right and fair and to do what is good for America!

So much time and effort is currently spent on tax preparation, because it's a mess and a hassell, to sift through codes and laws. This time would be better spent producing and creating a larger income, to pay to flat tax. And I believe it would be better spent for federal revenues, as well.

Sincerely,
[illegible]

Phyllis D. Beamon
2401 Determine Court
Louisville, Kentucky 40216
May 30, 1995

House Ways & Means Committee
ATTN: Phillip Mosley
Longworth House
Washington, DC 20515

Dear Representative,

I am writing this letter and requesting that it be presented and read before the House Ways and Means Committee on Tax Reform which is scheduled for June 6,7, & 8. The situations and problems that I see in the forthcoming tax reform programs must be addressed by us, the concerned public. It saddens me to see the freedoms and country that our ancestors fought and died for being allowed to vanish without our speaking out on behalf of its salvation. To begin with, the Revenue Act of 1862 is very antiquated and desperately in need of review and updating to meet today's needs rather than the war time periods in which it was formed. Tax preparation and filing has become so complicated and confusing that it must be simplified. I have worked as an accounting clerk in a large business, still the tax laws and forms are so complicated it makes many things easy to either over look or miss completely.

Taxes were implemented as a temporary method to help this fine country. All law abiding, hard working Americans do not mind helping our country remain strong and vital, however, enough is enough! I have served my country in foreign lands and seen how the socialist programs work - they do not work. Why do you think the Soviet Union fell, the people were tired of the oppression. Our forefathers fought to remove themselves from the oppression of England and the situation of taxes being levied heavily on them. I do not mind paying "my fair share", but the continuing of the government to increase taxes on it's constituency and not allowing enough for personal exemption (which should be approximately $12,000 or more) is becoming increasingly hard to bear by ourselves. We are not only taxed when we buy items, but we are taxed directly off our income. If a flat tax was made of 7-8% to be paid when things are purchased, everyone would be paying their share of taxes and the earlier mentioned tax forms, etc. could be done away with. This would again simplify taxes and no one (whether legal or illegal income was being made) would be exempt from paying into the support of this countries needs, in fact even monies "stashed" into foreign bank account would not be exempt.

The power that has been given to the IRS needs to be more controlled and monitored. As it presently stands, the IRS has the authority and power to take a persons assets even though no wrong doing has been established. There are numerous examples of properties, people had worked hard and long to acquire, being lost permanently due to an error not on the persons part, but on the part of IRS. I personally have had two mistakes made in my taxes. The first they claimed that my calculations were incorrect and

so they threatened and billed me for the difference plus interest. The error was on their part, not mine - the notification of their error in truth being made and corrected so I owed nothing was far from being as aggressive in apologies as the earlier had been in accusations! This brings up another point, they charged me interest on the amount I was suppose to have owed them, but they do not pay interest when they owe us and delay release of our refund. And to think this whole program started as a voluntary program, seems to me that the attitude of correspondence could have some considerations and politeness, being rude does not help solve problems. The second incident, they claimed I owed some monies, rather than research the difference I sent them a check for the full amount, with all papers attached that were to be returned (signed, dated, and mailed with check). Several months later I was notified that some form was not returned (though I had copies) so I was being penalized $5.00 and threats were express if I did not pay this additional $5.00. Note should be made that the form they wanted signed did not accompany the notice and so if I had sent a check for $5.00, in another several months would I have received another penalty? Possibly? Probably!

Being an only child, another area of concern for myself is the discussed changes in the inheritance taxes. My parents worked many years saving, doing without, hoping that their only child could have a better, easier life than they had. If laws are changed then a lot of what they have sacrificed and saved to help me will instead go to the government, to support or "shore-up" programs that the funds have been being misappropriated and wasted in the past . They even stand a chance (if sickness occurs) of loosing their home, because Medicare and Medicaid can take your home if your health bills are high, but yet we had no choice from the beginning as to whether to pay into these "insurance" programs (which is what they are) or not. Had people been allowed to invest those monies into other areas many of these Federal Programs would be unnecessary. Another example of misuse of Federal Taxes would be prisoners given Pell Grants. I can understand trying to help rehabilitate them to release back into the community, but why not loan them money rather than give them a grant. I (a law abiding, tax paying citizen) did not qualify for a Pell Grant - I made to much money! At the time I was attending college full time and working full time - single making my own way. Had I committed a crime I guess I would have qualified for a grant! Does there seem to be something wrong with this premise? There does to me. What is our incentive to work, save, and strive to better ourselves? This again brings up another point, when I get old enough to draw Social Security it will not be there. The government has already told all of it constituency of this fact. Another Federal Program that I have supported will NOT BE THERE FOR ME! I have had to pay into it, but will never see ANY return. At least with a life insurance policy, or a saving account, I would have a small amount of income.

I love this country and would not wish to live anywhere else. I have lived in other countries! This is my home and I am supportive of its original goals and dreams of our forefathers. It is up to people like myself to voice our opinion, otherwise the leaders of this once great country, may loose sight of the importance of each and every American.

Sincerely,

Phyllis E Beamer

P.O. Box 1750
Fairfield Glade, TN 38558
June 1, 1995

Mr. Philip Mosley
Chief of Staff
Ways and Means Committee
Washington, DC 20515

Dear Mr. Mosely:

Please let it be known that I support a flat tax of 17 to 20% with some built in protection for unreasonable increases on a regular basis.

Let the free market forces work and get government out the way.

The role of government is to protect its citizens from aggressive enemies, if it gets out of the health care business, school lunches and other social programs it can learn to balance its budget.

Man should be entitled to the fruits of his labor, women too. It's not for the government to determine what allowance we should be allowed to have.

It's time this government got its fiscal house in order and learn some restraint.

Sincerely,

Joan R. Bean

DONALD A. BELT, Ph.D.

920 Sunnyslope Road • Hollister, CA 95023 • Tel: (408) 637-1911 • Fax: (408) 637-8200

May 29, 1995

From: Donald A. Belt

To: Committee on Income Tax Reform via Philip D. Mosely.

Subject: A Proposal for Replacing the Current U.S. Income Tax System with one that is fair to everyone, painless to no one, and simple to administer. I call this new System 'The One Percent Transfer and Exchange Tax'.

Under this new program, every time a transfer or exchange of money or property from one person (or business entity) to another occurs, a one percent tax would be immediately due and payable to the US Government. There would be no exceptions or exemptions. For example, if Exxon sells (or transfers) five billion worth of goods or services to another, they would pay a one percent tax at the time the transaction occurred. There would be no deductions or offsets. The tax would be based on the gross value of the goods or services transferred. If a bank loaned $300,000. to someone, a one percent tax would be due at the time the transaction occurred. When the Bank received repayments, a one percent tax would also be due. Again, there would be no exemptions. If an Estate willed property to family members, the one percent tax of the value of the property would be due when the property transferred. If the Ford Foundation donated a million dollars to a cause, a one percent tax would be due. Everything purchased retail or wholesale would be taxed at this rate. This principle would apply to all tranactions of monetary value.

Two Key Provisions of this plan would include:

-The One Percent Transfer and Exchange Tax would apply to <u>every</u> transfer or exchange of money or property <u>without exception.</u> No deductions or offsets would be given to any person or business entity for any reason whatever. This provision would also apply to any money or property leaving or entering the United States.

-The One Percent Transfer and Exchange Tax Act would be fixed at the one percent level and this level could not be increased by Congress, ever.

This proposal would eliminate most of the IRS Code, many of their employees and much of their overhead. There are many other benefits too numerous to mention.

Leni S. Berliner
5406 Connecticut Ave., NW, #401
Washington, D.C. 20015
202-362-0264 (p)
202-237-2155 (f)

June 14, 1995

Phil Moseley
Minority Chief of Staff
House Ways and Means Committee
1106 LHOB
Washington, D.C. 20515

Dear Mr. Moseley,

I wish to lend my support to Mr. Archer's call for replacing the income tax with a consumption tax. Doing so will increase personal and national savings and investment, while the result should be at least growth- and revenue-neutral (if not stimulating), if priced properly and administered efficiently.

You may find it useful in preparing specific proposals to contact those who were involved in the Chilean tax reforms of 1975, 1984 and 1989: I attach a paper on the topic written by Jose Yañez of the Universidad de Chile.

Sincerely,

Leni S. Berliner

enc.: as stated

Oscar Muñoz, editor (1992) Economic Reforms in Chile
Occasional Paper #7, Inter-American Development Bank
Washington, D.C.

II. TAX REFORMS

By José Yáñez[1]

This chapter presents the principal features and the results of the major tax reforms introduced in the Chilean tax system in the 1970s and 1980s.

In the early 70s, the Chilean tax system was beset by serious problems, which were reflected in the generation of inappropriate incentives in the area of resource allocation, such as the vertical integration of companies solely for tax reasons and because of the pyramidal structure of the taxes, which encouraged tax evasion. Moreover, the tax system had become extremely complex due to the numerous exceptions, deductions, loopholes and special cases that were added as time went on.

Along with this, public finances deteriorated gradually until 1973, when the State budget deficit reached the unprecedented figure of 24 percent of the gross geographic product (GGP). The volume of tax receipts, both in absolute and in real terms, fell between 1971 and 1973. In 1971, receipts were 17.6 percent of the GGP and in 1973 they fell to 16 percent. This drop occurred despite the efforts of the authorities to increase tax revenues in order to finance their redistribution policy.

It was in these circumstances that the sweeping tax reform of 1974-1975 was introduced, when, with a view to solving the above mentioned problems, nearly all of the taxes were changed.

The most notable reforms were the replacement of the sales tax with the value added tax (VAT), the improvement of the indexing system, the tariff reform (lower uniform tariffs) and the new tax and audit administration.

The primary short-term objective was to increase tax receipts to help reduce the enormous budget deficit existing at that time. Tax receipts as a percentage of GGP rose to 17.1 percent in 1974 and to 21.7 percent in 1975. Later, this percentage stabilized around 19.5 percent and remained there for several years (Table 2.1).

With regard to the long-term objectives, the most important was eliminating the inefficiencies that existed in the old system in terms of resource allocation. To achieve this, the VAT was established and preferential tax treatments such as sectoral and regional exemptions, which discriminated between public and private enterprises, were abolished. The second objective, which was closely related to the first, was to eliminate the myriad differences established with respect to taxable goods, as well as the countless rates, exemptions, exceptions, deductions and rates established in the form of nominal fixed amounts per unit

[1] Professor, Faculty of Economics of the University of Chile.

Table 2.1. Tax receipts as a percentage of GGP

Years	Taxes		Total
	Direct	Indirect	
1971-73	5.1	11.2	16.3
1974-80	5.8	13.8	19.6
1981-83	4.9	17.9	22.8
1984-87	4.2	19.3	23.5
1970	4.8	10.6	15.4
1980	6.2	14.3	20.5
1985	4.2	19.4	23.6
1987	3.7	20.2	23.9

Source: Budget Office, Ministry of Finance. *Report of the State of Public Finance*, various issues.

of product (given the inflationary context of the economy, it was constantly necessary to enact laws or decrees to adjust them).

The objective of equity remained on a plane secondary to the two objectives mentioned above. It was pointed out that the distributive objective was achieved by properly focusing the distribution of social spending on the population and that there was no need to worry about the progressivity of the tax system. Nevertheless, despite this, a series of measures was adopted that tended to promote greater vertical and horizontal equity, as a result of the elimination of discriminatory tax treatment and the simplification of the taxes. Certainly, all the measures aimed at the indexing of incomes, the introduction of the "tax unit" concept, and advance monthly payments made the system more equitable.

In the 1980s a second major tax reform was carried out, this time targeting the income tax. The reform was undertaken in 1984, but full implementation took several years. The primary objective was to minimize the factors in the income tax that discouraged savings and investment. To achieve this, rates and bases were reduced and certain provisions of the income tax law were abolished. In this reform, the objective of efficiency in the allocation of resources took precedence over equity. Moreover, the income tax became far more complicated and there was a drop in tax receipts.

The tax reforms of the 1970s and 1980s had a very specific long-term objective: economic efficiency. This will become clear later when we analyze the reforms in detail from the perspective of the tools used to implement tax policy. Along with this, special attention will be given to analyzing those taxes that made the greatest contribution to the objectives of efficiency, simplicity and increased receipts.

The tax system and inflation

Taxes and inflation influence one another. In the context of an inflationary economy, taxes can be used as a tool to help check or slow this process, particularly those that have a direct impact on the consumption component of

aggregate demand. On the other hand, inflation can also affect the real value of taxpayer contributions as well as the real value of the State's tax receipts.

Some of the tax reforms introduced in Chile in recent years have eliminated the effects of inflation on taxpayer contributions and the Public Treasury's tax receipts.

Among the principal measures adopted to benefit taxpayers, special mention should be made of the indexing of assets and liabilities, the reappraisal of real estate and the tax unit. On the other hand, the principal measures to prevent the devaluation of tax receipts by inflation include the collection of *ad valorem* taxes, regularly adjusting real estate appraisals and establishing advance monthly payments (obligatory or voluntary).

Indexing assets and liabilities

Taxpayers in the first category, i.e., those with capital earnings from commercial, industrial, mining, agricultural, financial and other types of enterprises, must annually adjust their shareholders' equity and the amounts or items comprising their taxable assets and liabilities, provided that the taxpayer declares his real income, as shown in a general balance sheet.

The indexing is applied to the shareholders' equity at the beginning of the fiscal year, increases or decreases in the shareholders' equity, the goods comprising the fixed assets, the goods comprising the liquid assets, the value of credits or rights in foreign or adjustable currency, the value of foreign currency and gold holdings, the value of concession locales, mining holdings and concessions, manufacturing rights, trademark and patent rights, organization and start-up expenses, the value of corporate shares, partnership contributions, debts or obligations in foreign or adjustable currency, etc. The objective of the Chilean tax legislation was for taxpayers to pay taxes on the real profits of the company and not the nominal profits. For the purposes of indexing, the Consumer Price Index (CPI) was used as an indicator of inflation in the relevant periods. Although many details of the indexing system are constantly being fine-tuned, in general terms it has provided an adequate solution to the problem of inflation in determining real profits for tax purposes.

Real estate reappraisal

In Chile there is a tax called the "real estate contribution" or "property tax," which is based on the value of real estate. Since the process of appraising a property is costly, the law stipulates that the interval between one appraisal and another can be no longer than 10 years nor shorter than 5 years. Between appraisals, the value of the property is adjusted semiannually in accordance with the variations in the CPI.

The actual value of real estate changes over time due to obsolescence, wear and tear, the value of the land, construction costs, improvements, disasters, relative scarcity, etc. The actual value may be tied to the market value of the property, which varies over time with the economic conditions in the country. The Internal Tax Service appraisal must be close to the actual value of the

property so that the tax payment reflects the taxpayer's true ability to pay.

The use of this system helped to increase tax receipts, in real terms, by almost four times with respect to previous years, when the appraisal was only adjusted at rates lower than the CPI for the period in question, and a distinction was made between agricultural and other types of real estate.

The Tax unit

The tax unit (TU) is a value selected at a given time, which is then adjusted on a monthly basis in accordance with the CPI. This, then, is a unit of account that has maintained its actual value over time or the nominal value of which has been increasing at the rate of monthly inflation, but one month behind.

This TU has been used in various ways in Chilean legislation. One application is in determining the tax liability of the so-called small taxpayers in different economic areas. Another application is in the field of tax penalties, which are also based on this unit of account. In addition, certain tax deductions and exceptions, especially in the income tax system, are based on the TU. Still, its most important use has been in defining brackets for the uniform employment tax and the global supplemental tax. In an inflationary economy, this prevents taxpayers from falling into brackets with higher marginal rates simply because their income is wholly or partially adjusted. In times of inflation, this tool is essential to avoid constantly changing the direct tax burden on taxpayers.

Ad valorem taxes

Almost all of the taxes in the Chilean system have been established on an *ad valorem* basis, i.e., as percentages of the price or value of a transaction. The main reason for this is that *ad valorem* taxes protect the real value of receipts, given that the treasury collects an equivalent amount of the increase in prices due to inflation. Taxes established in unitary form, i.e., as a certain number of monetary units per product unit, necessitate constant adjustment of the rates to avoid the real erosion of tax receipts. The *ad valorem* system avoids this problem.

Advance monthly payments

Taxpayers who must file annual income statements must make advance monthly payments against the taxes they will be required to pay when filing the annual statement. These payments, duly adjusted, are deducted from the total amount owed and, when applicable, the taxpayer must pay the balance not covered by the advance payments, or, in the opposite case, if the total of the advance payments is greater than the amount of taxes owed, the taxpayer receives a refund.[2]

Although the chief objective of the advance payments is to normalize the flow of revenues to the national treasury, it is also a way of spreading taxpayer payments evenly over time. The advance payment enables the taxpayer to pay

[2] Ministry of Finance, calculation of national general revenues for the year 1990.

a portion of his taxes, thereby reducing the amount owed at the end of the year. The use of these tools has greatly increased the fairness of the Chilean tax system as well as its effects on the allocation of resources. The interests of the State, of workers and of employers have been well protected against the negative effects inflation can have both on payments and on tax receipts.

Value added tax

One of the most significant tax reforms of the 1970s was the introduction of the VAT, which replaced the sales tax.

A sales tax of 8 percent was charged each time a good changed hands and taxes were paid on prices that already included other taxes. These characteristics of the sales tax were detrimental to the efficient allocation of resources. Companies, in order to reduce the direct tax obligation, sold vertically, decreasing the number of transactions and avoiding eight tax points for each transaction eliminated. On the other hand, the so-called pyramidal structure of the tax undermined the equity of the tax system. What the pyramidal structure involved was that the price charged at each stage included the taxes paid in the preceding stages, i.e., taxes were charged on other taxes. The pyramidal structure would not have been a problem if the prices of all goods were affected equally the tax. However, the tax obligation differed, depending on the number of transactions in which each unit of a single product was involved.

The VAT has the advantage of being neutral with respect to the organization of the production and distribution of goods. Since the VAT is charged for each of the transactions involving a given good, but only on that part of the price that is added, from a purely tax-oriented viewpoint, it makes no difference to the taxpayer whether he manufactures his own inputs or purchases them from someone else. Because of this, companies now integrate vertically for reasons of economic efficiency, without this having any effect on their taxes. Under the VAT system, the price of the product is not affected by the number of transactions it was involved in, so that a constant relationship is established between the end price of a good and the tax charged on it. Thus, the VAT eliminates the pyramidal effect, since it is not a cost. The VAT is a tax that is paid at purchase and recovered by the seller, through the tax credit arrangement, and the amount of the VAT must not increase the costs of the taxed product.

The constant relationship between the end price of a good and the VAT enormously facilitated the use of the tax exemption when the product is destined for export—which was arbitrary under the sales tax—and also facilitated taxing the goods imported by the country. Thus, in the Chilean tax system, the VAT on exports is refunded and a general VAT is charged on imports, with the same percentage rate being applied in both cases.

The VAT is viewed in Chile as a consumer tax covering capital goods as well as intermediate products, so that the tax paid at purchase entitles the buyer to a credit against the sales tax. This system is an incentive to investment in capital goods. This ended the discrimination of the sales tax system against investment

in national capital goods, due to the fact that imported goods were exempt.

The VAT declaration in Chile must be made on the basis of what is known as the invoice method, which has helped to discourage evasion. In this case, the percentage of the VAT on the final selling price of the product is applied first, and then the VAT paid on the intermediate goods and capital goods used in production are deducted, provided that these payments are supported by the corresponding invoices. This discourages evasion of the VAT by making it contrary to the taxpayer's interests and because it is a tax that is applied in stages. Evasion, if it is to be made difficult for the authorities to detect, must involve the entire production and distribution process, requiring a number of taxpayers to cooperate for this purpose, which is not easy.

To close any loopholes that taxpayers might use to evade the tax, the VAT base has been steadily expanded over the years. In other words, the objective has been to include all goods and sectors of economic activity in the VAT system. This is why the exemptions originally granted to certain basic consumer goods such as services,[3] commodities, fuels, tobacco, cigars, cigarettes, liquor, construction, etc., were eliminated.

To make the VAT progressive, surtaxes were established for certain luxury items or goods that generate negative externalities, which vary according to the item in question. For example, whiskey has a surtax of 70 percent; jewelry, fine furs, carpets, yachts, canned caviar and fireworks, 50 percent; liquor in general, 30 percent; wine, 15 percent.

The general VAT rate was 20 percent from March 1975 to June 1988, when it was reduced to 16 percent. Later, in June 1990, it was raised temporarily to 18 percent. The VAT base is fairly large, despite the fact that some goods and services are still exempt, such as education, State hospital services, passenger transportation services and bank interest. The VAT applies only to consumer goods and not to capital goods, much as it applies to imports (tariffs are included in the base) and not to exports.

The VAT is intended to be a simplified tax system for small taxpayers: small business owners, craftsmen, and providers of services. A gross monthly amount due is determined, from which the taxpayer is entitled to deduct the taxes charged in the month in question on goods purchased and services utilized. If the difference is negative, no refund may be credited or requested. This simplified procedure has proven to be very useful in reducing the indirect tax burden on small taxpayers.

VAT receipts became the largest source of tax revenues in the Chilean tax system in the second year of its application, doubling the absolute level of receipts between 1975 and 1979. Starting in 1978, the VAT accounted for over 40 percent of the total tax receipts, and reached 50 percent between 1981 and 1982. The introduction of the VAT in the tax system coincided with a surge in

[3] Included were all services for which remuneration was not considered a payment for the services of laborers.

development of the domestic capital market and to eliminate certain inefficiencies and inequities in the tax system.

The combining of the personal and corporate tax systems had various objectives. The first was to eliminate the preferential treatment accorded retained earnings, with a view to promoting the growth of internal investment and channeling these savings toward the financing of investment projects with higher returns, thereby contributing to maximization of the economic growth rate. The second objective was to promote tax equity by taxing shareholders and partners in the same manner, thus eliminating the benefit accorded shareholders to defer the payment of taxes on the undistributed portion of the profits of corporations.

In terms of receipts, the reform increased revenues in national currency from 4.6 percent of the GGP in 1973 and 1974 to 5.9 percent in 1975.

The 1984 reform

The objective of this tax reform was to eliminate discriminatory tax treatment based on the various sources of income, the effect of which had been to increase the negative impact of income tax on private savings. The aim was to encourage private savings and to replace the income tax with another that would conceptually approximate the idea of a tax on personal income. The idea is that income taxes should ultimately be paid by individuals and not corporations.

Taxation of labor income

The tax on labor income is the tax in the second category or the single labor tax, which in the previous reform was completely incorporated into the general supplementary tax. The 1984 reform, as it affected this tax, resulted in a reduction of the direct burden of this tax, which had been increasing in recent years. In 1981 the exemption was increased from three to six tax units and the marginal rates of each bracket were reduced by two percentage points. In 1982 the exemption was increased to 10 tax units and the brackets in the schedule were enlarged.

The 1984 reform lowered the marginal rates of the tax by one percentage point in that year, another in 1985, and a third in 1986. In addition, in 1986, consideration was given to lowering the marginal rate further, from 56 to 50 percent, and enlarging the brackets. In 1985, however, it was considered necessary to postpone the last stage for two years, so that the rate was not actually lowered until 1988.

Until 1983 the income of professionals was taxed with a special 7 percent tax. The reform lowered this rate to 3.5 percent in 1985 and eliminated it in 1986. The rate for advance monthly payments was reduced from 15 to 14 percent in 1984, to 13 percent in 1985 and to 10 percent in 1986.

The supplemental general tax, since it is perfectly integrated with the tax mentioned above, experienced the same variations in rates and brackets as the former. Nevertheless, changes were made in its base: included in the base are only those withdrawals of funds made by shareholders from companies which are not reinvested in other companies, and certain investments held for more than a year can be deducted. Clearly, the aim was to encourage investments with a term longer than one year.

Table 2.3. General supplementary tax and uniform employment tax
(Tax units and percentages)

1983		1988	
Brackets[a]	Marginal rate (%)	Brackets[a]	Marginal rate (%)
0 - 10	0	0 - 10	0
10 - 25	8	10 - 30	5
25 - 40	13	30 - 50	10
40 - 55	18	50 - 70	15
55 - 70	28	70 - 90	25
70 - 85	38	90 - 120	35
85 - 100	48	120 - 150	45
100 and over	58	150 and over	50

Source: Ministry of Finance.
[a] The brackets are determined by monthly tax units for the second tax and in annual tax units for the general supplementary tax.

Taxation of capital gains

The reform retained the tax in the first category on capital earnings. The rate of 10 percent still applied to the profits earned by companies. However, in 1984, authorization was given to deduct this tax as a credit from the supplementary general tax. In other words, as a result of this reform, this was considered a payment on account of the taxes owed by partners or shareholders, and not as a tax that the company owed, as was the case prior to 1983. The credit can only be taken when the profits are distributed or withdrawn from the company and not while profits are being retained. For taxpayers with high marginal rates in the supplementary general tax, this is an incentive to reinvest the company's profits.

The "additional tax" established in the 1974 reform, which applied to corporations and joint stock companies, was lowered to 30 percent in 1984, to 15 percent in 1985 and to zero in 1986. The elimination of this tax ended the discrimination that existed between the various legal forms of a company.

The "additional" tax on the capital earnings of foreign companies operating in Chile was modified, so that the base consists of the amount of earnings retained or remitted abroad. A credit of 10 percent was granted against the additional tax on companies in the first category. The rate of the additional tax was held at 40 percent, but it was later lowered to 35 percent, in an attempt to bring it into line with the equivalent rate in countries that invest in Chile.

The 1984 reform entailed a diminution of the progressivity of the income tax and gave it relevant importance as a source of tax revenues. Receipts in national currency, which were 5.2 percent of the GGP in the early 1980s, fell to 2.9 percent from 1984 on. On the other hand, it is undeniable that it permitted a more efficient allocation of resources, because it eliminated or limited the distinctions made between the various types of income. It also encouraged private savings, but by

reducing the current revenues of the treasury, the reform caused a decline in public savings.

The 1989 reform

In early January 1989, the income tax law was again reformed, this time affecting the tax in the first category, i.e., the capital gains tax. The reform consisted of establishing that the base of this tax would consist solely of profits distributed and withdrawn from companies. Thus, retained earnings were eliminated from the tax base and the supplemental general tax credit of 10 percent of the distributed profits still applied. In this way, it is much clearer that the corporation does not pay income tax. The aim of this reform was to get companies to retain and reinvest some or all of their profits, since they would have 10 percent of all retained earnings as additional funds available for (real and financial) investment projects. The benefit to the taxpayer comes from the fact that he is able to defer payment of the tax and has more funds to invest.

It was also established in the 1989 reform that companies could choose a simplified income tax system, thus avoiding the necessity of filing certain accounting statements.

This reform took effect in June 1990, when there was a temporary return to the provisions of the 1984 reform regarding the tax in the first category. Also, the gap between the brackets for the single labor tax and the supplemental general tax was narrowed, starting at the 30 tax unit level and upwards, and the marginal rates were increased. These changes, which will remain in force until 1994, were an effort to increase receipts in order to finance greater social spending.

The 1990 reform ended the system of making tax declarations on the basis of estimated income for certain taxpayers in the agricultural, mining, and transportation sectors, requiring them to declare their incomes on an actual basis.

Effects on tax receipts

As the above suggests, there was a deliberate intention to reduce the direct burden of income tax, as well as to increase the taxes on consumption. To determine the actual effect on receipts and, therefore, the funds transferred to the private sector, income tax receipts will be examined, but not including receipts in foreign currencies. It will be seen below that the latter consist almost entirely of the revenues generated by copper, which is treated differently from receipts in national currency.

Table 2.4 clearly shows the impact of the 1984 and 1989 reforms on tax receipts, which fell on both occasions. There is no doubt that receipts in 1984, when 1983 incomes were declared, were heavily influenced by the effects of the economic crisis that hit Chile and the world in 1982 and 1983; therefore, it is difficult to say what the cost of this reform was to the treasury in terms of receipts. Nevertheless, not even after the economic recovery did total receipts return to the levels indicated for the years prior to the 1984 reform, i.e., 1980-1982.

The receipts lost to the treasury as a result of the 1989 reform can only be appreciated in terms of the so-called income tax payment system, which involved

Table 2.4. Composition of income tax revenues in national currency
(Percentages)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
First category	4.9	5.2	6.4	4.5	2.9	3.6	4.1	5.9	7.8	9.0
Second category	7.7	6.1	8.7	5.5	3.9	3.2	2.8	2.9	3.4	3.8
Total supplemental	4.0	4.8	6.0	5.3	2.3	1.6	2.8	2.0	2.5	2.8
Additional	1.0	1.3	1.7	1.8	1.9	2.0	1.7	1.9	6.2[a]	3.2
Additional rate	6.3	6.5	7.4	4.1	4.5	4.0	4.6	0.0	0.0	0.0
Article 21	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1
40% rate	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.3	1.1	1.4
Payment system	5.0	1.9	(2.3)	(4.1)	(0.9)	0.1	(3.4)	0.4	0.4	(4.4)
Total income	28.9	25.8	27.9	17.1	14.6	14.6	12.7	14.5	21.3	15.9
Total tax revenues in national currency	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Office of the Controller General of the Republic, *Public Sector Financial Management Statements*, various issues.
[a] Includes income from incorrect declarations equal to 2.7 percentage points, which alter the actual yield of the tax.

Table 2.5. Foreign trade tax receipts
(Millions of 1989 pesos and percentages)

Year	Receipts	Average Tariff (%)	GGP Percentage
1974	83,792	75.1	1.9
1975	103,326	51.6	2.9
1976	87,044	33.9	2.3
1977	94,880	21.7	2.4
1978	89,740	13.7	2.0
1979	76,682	10.6	1.5
1980	75,244	10.1	1.4
1981	90,039	10.1	1.7
1982	50,285	10.1	1.1
1983	89,300	15.9	1.9
1984	133,337	25.0	2.8
1985	156,274	25.0	3.2
1986	130,439	20.0	2.5
1987	159,695	20.0	2.9
1988	176,037	15.0	2.8
1989	153,109	15.0	2.2

Source: Office of the Controller General of the Republic, *Public Sector Financial Statements*, various issues.

heavy outflows that year. The other accounts, except the second category, contain information for the year 1988. The reason for this is that income taxes are generally annual and are declared the year following the one in which the income is earned.

Despite the fact that the reforms were successful in terms of a more efficient use of resources, this was achieved at the cost of complicating the tax and doing less to increase the fairness of distribution.

Tariff reform

In the early 1970s, tariffs were generally high and differentiated, resulting in an extremely complex tariff structure. In 1974 a policy of openness to foreign trade was adopted, thus ending the import substitution process, while at the same time an attempt was made to maximize the country's comparative advantages and open a new path to economic growth based on export sector development. To achieve these objectives, among the economic policy measures adopted was the reduction of tariffs to low, parity levels. This type of policy measure proved to be effective, resulting in substantial growth of the external sector and greater economic efficiency within the country, at a time when the nation was faced with the necessity of competing with other countries.

In 1974 the *ad valorem* rates included in the customs tariff were lowered in

stages until a schedule ranging from 140 to 25 percent was reached. The establishment of duty-free zones and bonded warehouses was also authorized. In 1975 the tariff exemption granted to public services, semi-public institutions, autonomous administrations and State enterprises was eliminated. Permission was granted for capital goods imported prior to a certain date to remain subject to the system of deferred payment of duties, taxes, clearance rates and other levies collected through customs.

In 1977 the rates of the customs tariff were lowered, which continued throughout 1978 and on to June 1979, when the tariffs were at parity at 10 percent. Table 2.5 shows the progress of the average tariff from 1974 to the present. Currently, the customs tariff establishes surtaxes of 5, 8, 10, 12, 15 and 20 percent *ad valorem* and compensatory duties for imports of goods whose prices have been artificially reduced in their respective markets and which could cause serious harm to national production.

Finally, the customs tariff has ceased being a tool whose principal use is to promote the proper allocation of resources between exportable goods, import replacements and importable goods.

With respect to receipts, two situations are discernible. The first, in the early 1970s, occurred when the tariffs were so high that they completely deterred imports of certain goods and services. Reducing the tariffs increased the collection thereof. For example, in 1975, despite the fact that the average tariff fell almost a third and the GGP fell 13 percent, receipts rose 23 percent.

The second situation, in the 1980s, was when the tariff was low and at parity. In these circumstances, raising the tariffs also increased receipts. This is what happened between 1983 and 1985, when the tariff was used as a goal to generate revenues for the treasury. There is no doubt that the introduction of this tariff made a significant contribution to the development of the Chilean export sector and the economy in general, and increased the efficiency, fairness and simplicity of the tax system.

Impact of copper on tax receipts

In Chile, tax receipts can be divided into two parts: receipts in national currency and receipts in foreign currencies. The latter, for convention's sake, are expressed in U.S. dollars and are produced almost entirely by taxes on the profits from the large-scale mining of copper.

The tax from copper is almost the only source of treasury revenues received directly in foreign currency, the other significant channel being foreign borrowing. This shows the enormous importance to the treasury of the international price of copper and the volume of exports, as well as the dependence of the public sector's budget on a single exportable product.

Table 2.6 shows that tax revenues from copper fluctuated substantially in the 1980s, to the point that the largest receipts were 17.2 times greater than the smallest. Copper tax payments are basically the same as income tax. By expressing these payments as a proportion of the receipts of income tax in

Table 2.6. Tax receipts from copper
(Thousands of each year's dollars and percentages)

Years	Taxes		
	CODELCO-Chile	% [a]	% [b]
1980	340,858	97.3	1.3
1981	41,939	88.3	0.1
1982	83,593	95.7	0.4
1983	185,275	43.3	2.2
1984	96,907	96.8	0.5
1985	60,074	97.5	0.4
1986	124,239	93.1	0.8
1987	198,596	98.2	1.1
1988	637,181	98.6	2.9
1989	723,360	98.1	2.9 [c]

Sources: Office of the Controller General of the Republic, *Public Sector Financial Statements*; Ministry of Finance, Calculation of the General Revenues of the Nation, and General Treasury of the Republic, Public Treasury Financial Report.
[a] The percentage of CODELCO-Chile taxes in the total income tax receipts in foreign currency.
[b] The percentage of income tax receipts in the GGP.
[c] Estimated.

foreign currency in column (1) of Table 2.6, it is seen that, on average, the latter was 90 percent higher, and if the figures for 1983 are ignored, the percentage increases to 96 percent. In other words, it is possible to state that income tax receipts in foreign currency are generated almost entirely by copper sales.

The tax resources provided by copper represent a very significant portion of the total tax receipts in foreign currency. On average, in the 1980s, they were 86.7 percent.

Income tax receipts in foreign currency vary greatly when expressed as a proportion of total income tax receipts (both currencies). In 1981 they barely represented 2.8 percent, while in 1989 they had climbed to 52.8 percent. The loss of receipts from the reduction of income tax ordered in 1984 and implemented in stages, as well as the 1989 reform, were offset by greater receipts from copper.

Column (2) shows the income tax receipts in foreign currency as a percentage of the GGP. This share has varied from 0.1 percent in 1981 to 2.9 percent in 1988 and 1989. Undoubtedly, these changes are due primarily to the variations in the international price of copper.

The taxes on copper represent a considerable percentage of total public sector expenditures in foreign currency. On average, in the last four years of the 1980s, they financed a little more than 30 percent of said expenditures. If other revenues in foreign currency generated by copper (profit sharing) are added to the taxes on copper, the percentage of financing expenditures in foreign currency doubles (Table 2.6).

An important conclusion to be drawn from this is that when the State budget relies largely on a single source of financing for expenditures, those expenditures necessarily depend on the variations of that source. Therefore, when things are going well, a stabilization fund should be created with some of the additional resources obtained, so that in the future, if things go wrong, expenditures will not have to be excessively restricted.

Tax administration and prevention of evasion

The tax administration is the State agency whose specific function is to impose taxes and ensure their proper receipt, thus establishing the relationship between the State and the taxpayer.

The tax reform of 1974 established three specific objectives for the tax administration, which have produced good results in terms of preventing tax evasion. The three objectives were to:

a) Implement an information program to increase public awareness of tax reform in all sectors of the country, so that every Chilean would have a complete understanding of the obligations imposed by the tax reform and to ensure fulfillment therewith.

b) Develop a training program for the personnel of the Internal Revenue Service *(Servicio de Impuestos Internos - SII)*, the objectives of which were to respond to the questions, doubts and concerns of taxpayers and thus to adapt the provisions of the reform to the existing conceptual and procedural realities.

c) Establish and maintain information processing systems, whether manual, mechanical or electronic, the general objectives of which were to facilitate and expedite the declaration and collection of taxes and assist the SII in fully exercising the tax controls within its authority.

Numerous programs have been instituted to prevent tax evasion. Following is a discussion of the most important.

Individual Tax Account

The taxpayer's Individual Tax Account *(Cuenta Unica Tributaria - CUT)* is a file containing information about such matters as payments, withholdings, cancellations and credit notes. This individual account has the classic debit and credit structure and contains the information necessary for a tax audit.

The Individual Tax Number *(Rol Unico Tributario - RUT)* is an individual number assigned to each natural or juridical person at birth, which provides access to the taxpayer's Individual Tax Account by the users of the information.

Design of audit programs

Because the value added tax is the principal tax in the tax structure, audit efforts are focused on the VAT, which also has effects on the yield of income taxes. A larger tax debit or a smaller tax credit will have an impact on the taxable base of a company's income tax and will ultimately affect the taxable base of the personal income tax of the owners thereof.

Since the reason for evading taxes is usually to have more disposable income, the additional income resulting from tax evasion will show up sooner or later in the form of increased spending, whether for consumption, investment or savings. When the taxpayer spends the income or saves it, it can be detected and in an audit, he must explain the source of the funds. If the income declared or the wealth accumulated is insufficient to explain the expenditure or the purchase of financial assets, he must then pay the unpaid taxes plus adjustments, fines and interest.

Some examples of audit programs with interesting results in terms of preventing tax evasion are:

a) Detection of failure to declare: this procedure provides for notification of the taxpayer that he has not submitted one or more monthly declarations or the annual income declaration, and forces him to do so.

b) The VAT debit/credit ratio: in the medium and long term, sales must be greater than purchases, otherwise the company would fail. The information is provided by the taxpayer in his monthly VAT declaration. Analysis of this ratio is a very reliable method of detecting tax evasion.

c) Cross-checking of invoices and detection of incomplete declarations: in 1982, the authorities began to obtain information concerning invoices from taxpayer suppliers, i.e., information concerning the latter's purchases. The data obtained from the suppliers' invoices are processed with a view to determining possible irregularities in the vendors' declarations. The cross-checking of invoices also makes it possible to detect falsified invoices.

d) Investment reports: to check income tax declarations, information about the purchase of or investment in certain types of securities by taxpayers is used. In this way it is possible to detect possible irregularities or inconsistencies between the income declared and the investments made.

e) Electronic checking of the consistency of tax declarations: the consistency of the figures entered on various declarations is constantly checked in order to detect errors. If any are detected, the declaration is rejected and the taxpayer is required to submit a corrected declaration and pay any differences owed.

Increase of penalties

In addition to the above mentioned programs to detect tax evasion, changes were also made in the existing penalties, which were increased so that they would constitute a real punishment for evasion. Thus, the cost of evading taxes became very high, thus discouraging this illegal and dishonest behavior. Of course, the principle that the punishment should fit the crime is still respected, but the punishment has been raised to its upper limit.

In summary, the significant rise in tax receipts is due in part to the efforts made to detect and discourage tax evasion. In particular, focusing the efforts of tax auditors on the most profitable tax has paid off handsomely, as has the use of advanced technology (computers, individual taxpayer identification, and trained personnel).

Major lessons of the Chilean tax reforms

Many of the aspects observed following the tax reforms cannot be attributed solely and exclusively to them; instead, they are also due in large measure to other economic policy changes. The opening of the economy and the monetary, exchange rate, fiscal and other policies also explain part of what happened or reinforce the effects looked for in the tax changes.

Another important point was the establishment of specific, prioritized objectives, all aspects of the economic policy being oriented toward the attainment of those objectives which, in the opinion of the authorities, were the most relevant. In this way, all the tools of economic policy were mutually reinforced.

Another lesson is that in inflationary economies, for reasons of both efficiency and fairness, the tax system must be indexed. The goal of the indexing must be to protect both the taxpayer and the State from the effects of inflation. In this area, Chile has achieved an adequate level of success by means of the corrective measures taken. Nevertheless, this does not mean that there are still not other actions that need to be taken to improve the indexing system.

Another interesting conclusion is that each tax is better at achieving a certain objective, so that each should be aimed at that particular goal. For example, tariffs should preferably have a role in resource allocation and should not be used to increase receipts; income taxes discourage savings and investment, while consumption taxes are neutral. In any case, it is the prioritization of objectives that will determine which taxes are used and how they are applied.

A final point worth mentioning is that in developing a tax system, the detection of tax evasion must not be overlooked. A policy which, in relative terms, places emphasis on punishments or penalties for tax evasion in connection with the policy of auditing the taxpayer is a tool that will help curb evasion. Of course, the authorities must ensure that tax evaders pay the penalties imposed on them and avoid forgiving and pardoning these offenses. In other words, the will to implement the policy must be present. The use of the latest technology to audit

tax declarations is another tool that has helped to detect and discourage tax evasion. The use of computers, the creation of the CUT (Individual Tax Account), and programs to ensure the proper documentation of business transactions have been particularly useful in this regard.

Many other conclusions are expressed in each section of this document, which address the various taxes individually; therefore, to avoid being repetitive, they will not be included in these conclusions.

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June 16, 1995

Mr. Phillip Mosley, Chief of Staff
Committee on Ways & Means
US House of Representatives
1102 Longworth
Washington DC 20515

Dear Mr. Mosley,

I am in complete support with eradicating our current tax system which as you know penalizes the productive people of this country.

I think the National Sales Tax would be the best system to replace our current system for these reasons:

1. It is the form of taxation our Constitution allows.
2. It would require everyone to pay. Drug dealers, prostitutes, and other illegal money makers would finally contribute to our system.
3. It would not allow the Congress to eliminate the deductions and then raise the tax, like they could if we had a flat tax.

A flat tax would still allow for cheating and wasted time preparing forms for the IRS. We must eliminate the IRS and all the wasteful acts associated with preparing our tax returns.

I spend too much time with accounting for this business, in addition to our other joint business and our rental properties.

Lastly, we're sick of paying 15.3% of our income in Social Security taxes in addition to income taxes because we're self employed. If the employees of this country had to come out of their savings like we do, this debate would have taken place many years ago.

Please push towards the National Sales Tax.

Thank You,

Kathy Jabbour

499C EDISON COURT • CORDELIA, CALIFORNIA 94585
1-800-585-4044 • (707) 864-4044 • FAX (707) 864-4043

Chief of Staff Mosley
Of Ways and Means Committee
Longworth Building
Washington D.C. 20515

PLEASE, NOW IS THE TIME.

DISSOLVE THE I.R.S. AND

GIVE US A NATIONAL SALES TAX

Other:

From:

John Carl
4325 Zaca Pl
Los Angeles, CA 90065
5/27/95

Mr. Mosely
Committee on Ways and Means
Longworth Office Bldg
Washington, DC 20215

Dear Congressmen,

I want to express my desire that you on the Committee on Ways and Means decide to get rid of the income tax in all aspects, even to the extent of repealing the income tax amendent, ridding us of the scourge that has come of it. I would of course prefer a tax on all imports to the U S. Knowing that is unrealistic I wholeheartedly support a National Sales Tax as proposed by Congressman Archer. Please note that I am also vehemently opposed to a value added tax. I fully believe that a person should know the exact contribution that he makes for the right of self government and that cannot be done with hidden taxes of any sort. This also takes care of all those taxes that are not collected by our Internal Revenue Service. The "underground economy" would then pay their fair share due to the fact that they need goods and services just like the rest of us. I wish you all godspeed with the new and improved society in which we all can be free to earn and build without a lot of interference from our employees in government.

Sincerely,
John Carl

6-18-95

Phil Moseley
Majority Chief of Staff
House Ways & Means Committee
Room 1102
Longworth House Office Bldg.
Independence & New Jersey Aves., SE
Washington, D.C. 20515

Mr. Moseley,

We would support a National Consumption tax (not V.A.T.) and the total elimination of the I.R.S.

Our problem is why the delay? We hear talk of 1996 or 1997 and beyond for implementation. This is baiting the public.

Why not get going NOW and get the job done?

Sincerely,
A. A. Carter

5244 Rosewood Dr.
Mission, K.S. 66205

Att: 6 copies

STATEMENT OF
BRADLEY D. BELT*
DIRECTOR, DOMESTIC POLICY ISSUES PROGRAM
THE CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

CONCERNING REPLACEMENT OF THE FEDERAL INCOME TAX CODE

PRESENTED TO THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

June 6, 1995

Mr. Chairman, Congressman Gibbons, members of the Committee, I am delighted to have the opportunity to testify before the Committee on Ways and Means on a matter that has a direct bearing on the future economic prosperity of all Americans. In addition to balancing the federal budget, no more important action can be taken to spur economic growth than replacing the federal tax code with a new tax system that would facilitate, rather than punish, economically productive behavior. Increasing realization of this fact is due in no small part to your vocal support for tax replacement, this series of hearings being the latest example of your exemplary leadership on this vital issue.

The Center for Strategic and International Studies[1] has been a proponent of comprehensive tax reform since 1992, when the CSIS Strengthening of America Commission recommended replacing the current income tax with a new consumption-based tax designed to promote saving and investment. This proposal has evolved into the USA Tax Act of 1995 (S. 722), which was recently introduced by the chairmen of the Strengthening of America Commission, Senators Pete Domenici and Sam Nunn.

While CSIS is proud of its sponsorship of the Commission and its work, the purpose of my testimony is not to advocate any one tax replacement proposal. Rather, I wish to present the economic rationale for tax replacement by examining the current tax code's fundamental deficiencies, outlining basic principles and a framework for a new system of taxation, and providing a brief analysis of the major tax plans that have been advanced by members of Congress.

The simple truth is that the current tax system is hopelessly flawed and must be replaced. The ad hoc tinkering at the margins of the code that has characterized tax "reform" in recent decades has only exacerbated the problem. What is needed is a new tax system--a tax system that will not penalize entrepreneurial activity, that is transparent, fair, and comprehensible, and that will enable American enterprises to compete effectively in the global marketplace.

The new tax system should fully integrate individual and business taxes, and, most importantly, should encourage, or at least remain neutral with respect to, economically productive activity. In this regard, the new tax system should exclude net new savings from the individual tax base and allow businesses to expense new investments in the year they are made. In contrast to the existing tax system, individuals would have an economically rational reason for saving rather than consuming, and businesses would be able to invest in R&D, new plant and equipment, and human resources--the kind of investment necessary to enhance productivity and provide for future prosperity.

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*The views expressed herein are those of Mr. Belt and do not necessarily reflect the views of CSIS, its staff, or its contributors.

[1]CSIS is a non-partisan public policy research institute based in Washington, D.C. that provides policymakers with a strategic perspective on issues relating to domestic and international economics and finance, politics, and global security matters.

The economic arguments for replacing the current tax system are compelling and, with the advent of the 104th Congress, the political prospects for tax reform have never been better. The challenge will be to resist the temptation to tinker with the familiar and instead completely rethink tax policy. Only if we take the bold step of replacing our tax system with a new system that is efficient, comprehensible, and conducive to savings and investment can we ensure that those who pursue the American Dream have any hope of attaining it.

WHY WE NEED TO REPLACE THE INCOME TAX

During its relatively short lifespan, the federal income tax has evolved into a byzantine maze of nearly incomprehensible and often inconsistent rules and regulations that both engenders distrust among taxpayers and taxes the abilities of expert practitioners. Its questionable and superficial equity is undermined by a variety of exemptions, deductions, and credits, and it clearly distorts the relative prices of goods and services, altering behavior in a manner inconsistent with sound economic principles.

The imperative for comprehensive tax reform becomes apparent when one considers that almost one-fifth of America's annual gross domestic product (GDP) is funneled through a federal tax system that wastes billions of dollars, misallocates resources, and impairs U.S. competitiveness. Fiscal profligacy on this scale jeopardizes America's economic future and hampers its ability to meet severe domestic and international economic challenges.

Although they may disagree on specific alternative approaches, proponents of comprehensive tax reform all condemn the existing income tax. As the debate on tax reform has progressed, the litany of the tax code's woes has become very familiar:

- *The tax code is too complex and costly.* By virtually any measure--including the astonishing number and length of IRS forms and instructions--the current U.S. tax code is extraordinarily complex. Most troubling are the economic costs of compliance that complexity imposes on society. Due to excessive complexity, valuable time and resources--which could otherwise be devoted to economically productive activities--are wasted on compliance with and enforcement of unnecessarily complicated rules and regulations. Estimates of total direct and indirect compliance costs range into the hundreds of billions of dollars.

- *The tax code distorts economic activity.* Because the present tax code does not treat all economic transactions in a neutral manner, it distorts the pricing of goods and services and thereby reduces overall economic efficiency. The tax code, for example, encourages current consumption at the expense of saving by taxing individuals on their earnings and again on their returns from their savings. Among the more serious economic decisions that the U.S. tax code distorts is the choice of how businesses finance investment by taxing corporate equity income once when earned and again when returned to shareholders in the form of distributed dividends. This double taxation of dividends reduces the incentive for entrepreneurial activity.

- *The tax code is anti-competitive.* The U.S. tax system impacts directly on the competitiveness of American businesses that operate in an increasingly globalized economy. Businesses are affected both in terms of the amount of taxes they pay and the types of distortions that the code creates. The U.S. corporate tax code increases the cost of capital for American businesses and thus erodes U.S. competitiveness. Moreover, the corporate income tax is, in many respects, inconsistent with the tax regimes of our principal trading partners, with the result that American exports often are relatively more expensive overseas.

Wholesale tax reform is clearly needed to address these deficiencies. Anything

less than a completely new system of taxation will not be sufficient. To ensure that this new system works, Congress must recognize and adhere to certain fundamental principles of tax reform.

PRINCIPLES FOR COMPREHENSIVE TAX REFORM

America's experience with the income tax offers several important lessons that should inform the process of tax replacement. First, the tax code should not favor those who consume resources over those who save. Second, the tax code should be simple enough for Americans to understand. Third, taxpayers must be convinced that everyone pays his or her fair share. Lastly, the tax code must not hamper U.S. businesses operating in the global marketplace. These lessons can be distilled into the following principles for tax reform:

- *Efficiency.* An efficient tax structure does not discourage economically productive activity. Or, more accurately, it treats transactions in a consistent and neutral manner and does not reward or penalize decisions to buy, save, borrow, invest, or produce. As a result, prices are undistorted and accurately reflect the valuations of consumers and producers, allowing them to make decisions that optimize their economic well-being.

- *Comprehensibility.* A comprehensible tax is one that is not needlessly complex and allows taxpayers to understand and comply with their tax obligations without having to expend undue time, effort, and financial resources. This will reduce taxpayer cynicism and minimize compliance and administrative costs. Similarly, a simplified tax system is less costly for government to enforce because there are fewer tax rules and regulations for taxpayers to evade.

- *Fairness.* Reinstilling the high taxpayer morale that once existed in the United States will require a tax system that treats taxpayers fairly, or more accurately, satisfies societal notions of equity, which can be quite subjective. At the very least, the tax system should promote horizontal equity, so that people who are similarly situated economically bear similar tax burdens.

- *Constructive Empowerment.* Taxpayers should have the ability to lower the amount of their earnings that are subject to taxation by saving and investing more of their income, not by working less. In addition to incentivizing economically productive behavior, this will give taxpayers a greater sense of control over their taxes and thus increase support for the new tax system.

- *Competitiveness.* The tax code should work to the advantage of American businesses competing in the global marketplace. This will require an awareness of how domestic taxes are treated by international tax rules and adjusting our tax rules accordingly.

If Congress can remain faithful to these basic principles, and use them as beacons to navigate through the politically tumultuous waters of tax replacement, it can fashion a new tax system that is consistent with America's economic interests. I now turn to what such a tax system would look like.

FRAMEWORK FOR A NEW TAX SYSTEM: KEY FEATURES

To be consistent with the principles described above, the tax system that replaces the current tax code should include the following features:

- *Lower rates and broader base.* High tax rates, especially at the margins, discourage economically productive activity and encourage economically unproductive

activity. Broadening the base by eliminating deductions, preferences, and credits would allow effective and marginal rates to be lowered, thus stimulating economic growth and productivity-enhancing investment.

- *Fully integrated individual and business taxes.* An integrated tax structure would reduce complexity and ensure that income is taxed only once. Integration of the individual and business taxes would produce a number of economic benefits, such as increasing investment in corporations, reducing corporate dependence on debt finance, and lowering the cost of capital.

- *Exclusion of saving from the tax base.* Ideally, what would be taxed is some measure of consumption, rather than simply income. In an income tax framework, individuals would be allowed to deduct from their tax base all income that is saved or exclude from their income the return from savings. This would eliminate the current code's hostility to this economically vital activity.

- *Immediate expensing of business investment.* Businesses should be able to deduct expenses at the time they are incurred. Not only do depreciation and amortization schedules dramatically increase tax complexity, they discourage business from investing in plant and equipment, research and development, and human capital.

- *Harmonization with foreign tax systems.* To compete on a more equal footing in foreign markets, the United States should adopt a system of taxation that is consonant with the tax regimes of our principal trading partners.

In addition, adoption and implementation of a new tax system requires appropriate transition rules. Most tax proposals contemplate a fully phased-in tax system. Unfortunately, while a tax system may be designed from scratch, it would have to be implemented in an environment in which economic decisions and behavior are made in the context of previously enacted laws and regulations. Without appropriate transition rules, large segments of the economy might suffer severe short-term dislocations that could more than offset the longer-term benefits of the new tax system.

Moreover, accounting, political, and social factors affect tax policy. For better or for worse, no tax code is simply an economic document. It will inevitably reflect the value judgments and priorities of the population to which it is applied. In an ideal policy world, the new tax system outlined above would be based exclusively on the principles I have described, and these principles would be consistently applied.

Many policy choices, however, will be based on practical and political realities that would, if adopted, tend to undermine the theoretical purity of the tax replacement models advocated by economists. Congress will face policy options concerning the tax treatment of certain items--such as housing, education, and health care--that may place it at odds with economists. While I do not have time to delve into specific policy options, it is my hope that, to extent possible, policy choices will be assessed on the basis of sound economic principles, and not political expediency.

KEY ISSUES

The tax reform debate has focused on several issues that arise in replacing the current income tax. Two issues that I will focus on have received considerable attention and have generated much disagreement: the effects of tax reform on national saving and tax fairness.

Saving. The principal difference between a tax system based on the principles I have described and the current income tax is that the new system would not include savings in the individual tax base. In part because of the dynamic effects of tax policy

changes, it is difficult to predict the precise extent to which private savings are likely to increase after the current tax code's bias against saving is eliminated. A number of economists have argued that targeted tax incentives do not necessarily increase savings, but simply result in a shift in savings from non-tax preferred investments to those that are tax preferred.[2]

It is useful, however, to examine the performance of the individual retirement account (IRA), which was introduced in the early 1980s and can be used as a reasonable proxy.[3] By excluding savings from the tax base, the new tax system would effectively operate like an unlimited, unrestricted IRA. Such a system, however, will have a stronger effect on saving than IRAs or 401(k)s. IRAs allow a deduction only for retirement saving (assessing a penalty for early withdrawal) for no more than $2,250 annually. In addition, the 1986 Tax Reform Act reduced the maximum annual contribution to IRAs and eliminated eligibility for high-income earners. But the new tax code would apply the deduction to saving for any purpose for all households, and set no limit on the amount of saving that is tax deductible.

Although there is no assurance that excluding savings from taxation will change behavior and result in more private savings, economists have identified three effects that should, over time, significantly improve the prospects for a greater rate of private saving:

- *The Incentive Effect.* This characteristic is perhaps the most obvious of the three. By excluding savings from the taxable base, households can easily and legally reduce their tax burdens by saving more. This creates an obvious financial incentive to save.

- *The Horizontal Redistribution Effect.* This effect describes the redistribution that takes place among persons in the same income class. Conversion to a neutral tax code would reduce the tax of above-average savers and raise that of below-average savers within each income group. The result would be more total saving from each group.[4]

- *The Postponement Effect.* The new tax would reduce the tax burden during the work-stage of life, postponing some burden until the retirement stage and enabling workers to save more.[5] In an economy with growing real wages and an expanding labor force, the higher saving of workers outweighs the higher dissaving of retirees, increasing aggregate net saving.

It should be noted that consumption is not a vice to be punished by the tax code. We must remember that one person's consumption is another person's income. Tax reform should therefore seek to increase aggregate consumption over the long term by

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[2]William D. Andrews and David F. Bradford, "Savings Incentives in a Hybrid Income Tax," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, D.C.: The Brookings Institution, 1988), p. 292.

[3]Concerns that targeted tax incentives such as IRAs merely result in individuals shifting the locus of savings (rather than creating new savings) led Congress to significantly restrict IRAs in 1986. Empirical studies have concluded, however, that even for those who had been significant savers, IRAs appear to have stimulated an increase in their total saving, not a mere shift among savings vehicles [see Steven F. Venti and David A. Wise, "Have IRAs Increased U.S. Saving?: Evidence From Consumer Expenditure Surveys," *The Quarterly Journal of Economics*, August 1990]. The case is further bolstered by the evidence presented in a more recent study that looked at the experience of participation in another tax-preferred savings vehicle, the 401(k) plan, and found that contributions to these accounts did not simply substitute for other forms of saving and that participation in 401(k) plans among those eligible exceeded 60 percent at all income levels [*Business Week*, September 27, 1993, p. 28].

[4]Stephen B. Maurer and Laurence S. Seidman, "The Consumption Tax, Horizontal Redistribution, and Aggregate Saving," *Mathematical Modelling* (Vol. 5, 1994), p. 216.

[5]Laurence S. Seidman, "Boost Saving with a Personal Consumption Tax," *Challenge* (November-December 1989), pp. 48-49.

contributing to economic growth and prosperity. It will do this by encouraging the saving and investment necessary to improve economic productivity. This, in turn, will produce a permanently higher level of future consumption per household--i.e., a higher standard of living.

Fairness and Rate Structure. Most people equate tax fairness--a very subjective notion in and of itself--with progressivity and a steeply graduated rate structure. High marginal tax rates, however, impose economic costs on society by discouraging economically productive activities such as work and by encouraging tax evasion and tax avoidance, whereby taxpayers seek to limit the amount of their income that is subject to the high marginal tax rate.

Moreover, this definition of tax fairness, which has become ingrained in this country's political psyche, confuses the issue of how tax burdens are distributed along the income spectrum. This is because rate structure alone does not determine the degree to which a tax is progressive. Specifically, it does not tell you the percentage of one's income paid in taxes, or the *effective* rate of tax.

Consider the existing income tax code. Somewhat surprisingly, the effective tax rate paid by high income taxpayers under current law is quite similar to that they would pay under a 17 percent flat tax with family and personal deductions large enough to produce a zero effective rate for about half of all families. Although the top five percent income group currently faces a marginal tax rate of 39.6 percent, data compiled by MIT professor Jonathan Gruber indicate that their effective tax rate is just 17.4 percent (low-income taxpayers have effective rates near, or even below, zero).[6] The variance between marginal and effective tax rates occurs because high-income taxpayers are today able to avail themselves of numerous tax avoidance strategies. Consequently, while the rate structure does affect the distribution of tax burden across income groups, it should not be the sole basis for assessing the relative fairness of proposed tax plans utilizing different rate schedules.

Another tax fairness issue concerns the tax code's role in distributing income among various groups in ways deemed politically or socially appropriate. Aside from expressing concerns that use of the tax code for redistribution purposes creates economic distortions, many have argued that the expansion of numerous federal social and economic programs have obviated the need to redistribute income on the revenue side of the federal budget. Former chairman of the president's council of economic advisors Michael Boskin recently noted that the percentage of the federal budget devoted to transfer payments has increased dramatically since the 1950s. If we can achieve social and economic ends through government spending, then relying on the tax code for redistribution becomes unnecessary and counterproductive.

PROPOSED ALTERNATIVES TO THE INCOME TAX

With the advent of the 104th Congress, the prospects for replacing the current tax system have taken on a new urgency. Most of the attention has focused on three approaches to replacing the federal income tax: the Unlimited Savings Allowance (USA) Tax System promoted by Senators Domenici and Nunn, the "flat tax" advocated by House Majority Leader Dick Armey and Senator Arlen Specter, and Senator Richard Lugar's national sales tax.

The USA Tax System

The USA Tax Act of 1995 (S. 722) was recently introduced by Senators Domenici

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[6]Jonathan Gruber, "Payroll Taxation in the United States: Assessing the Alternatives," in Robert J. Shapiro, ed., *Enterprise Economics and Tax Reform: Promoting U.S. Growth in the Global Economy*, Working Papers, Vol. III (Washington, D.C.: Progressive Foundation, 1994), p. 22.

and Nunn. The USA Tax is based on the recommendation of the CSIS Strengthening of America Commission, which was organized under the auspices of the Center for Strategic and International Studies and chaired by Domenici and Nunn.

The USA Tax is an integrated tax system comprised of an individual tax and a business tax. The individual tax would operate like a "super" IRA, with taxpayers subtracting their net new savings from their gross income--which includes wages, salaries, fringe benefits, and capital income--and paying tax on the difference. The USA Tax employs a graduated rate structure and allows taxpayers to continue to file annual tax returns that will look like the forms they are already familiar with. The USA Tax also maintains the home mortgage interest and charitable deductions, and adds one for post-secondary tuition expenditures.

The business tax would asses a flat 11 percent tax rate on "gross profit," or the difference between the revenue from the sales of goods and services and the amount paid to other businesses for goods and services such as plant, equipment, rent, and supplies. All forms of business enterprises (not just corporations) would pay this tax. Businesses could immediately expense all of their investments and the tax would be border adjustable and territorial.

The USA Tax directly addresses the current tax code's most glaring flaw: the double taxation of savings and investments, and Senators Nunn and Domenici claim that the USA Tax would be much simpler than the income tax, with about 80 percent of the Internal Revenue Code eliminated after enactment. While it is not clear that the USA Tax would lead to increased saving, this would be the most ambitious effort to incentivize saving. In as much as a graduated rate structure may be necessary to satisfy societal notions of fairness, the USA Tax does so to maintain progressivity. Moreover, the USA Tax is the only proposal which has thus far garnered strong bipartisan support.

It has been noted, however, that calculating net new savings could be a new and time-consuming chore for many taxpayers. For those filers who use the relatively simple 1040EZ form, for example, the USA Tax could be far more complicated. Moreover, because businesses are not permitted a deduction for either wages and salaries or dividends and interest, it appears that labor and capital income is taxed twice--at both the business and individual levels. In addition, it has been argued that the USA Tax would relatively benefit capital intensive exporters at the expense of labor intensive service industries.

The Flat Tax

Two versions of the flat tax have been proposed: Senator Specter's Flat Tax Act of 1995 (S. 488) and House Majority Leader Armey's flat tax, which was part of his Freedom and Fairness Restoration Act, a bill that he introduced in the 103rd Congress. Both plans are based on the work of Robert Hall and Alvin Rabushka of Stanford University. Essentially, all wage and business income would be taxed at a single tax rate of 20 percent under the Specter plan and 17 percent under the Armey plan. Except for personal allowances, all deductions would be eliminated (Specter would permit deductions for home mortgage interest on home loans of up to $100,000 and charitable contributions up to $2,500). In addition, while the USA Tax System would tax capital income at the individual level if it is not saved, capital income is taxed at the business level under the flat tax and is not part of the individual tax base. Businesses would be allowed to immediately expense their investments.

The most compelling feature of the flat tax is its simplicity. Individuals and businesses would spend significantly less time and money paying taxes and the IRS's enforcement costs would decline dramatically. The flat tax would tax all income once and only once, thereby eliminating the double taxation of saving and investment. It would also integrate business and individual taxation and continue annual tax returns.

The flat tax suffers principally from the perception that it will reduce vertical and horizontal equity. First, many believe that the rich will benefit disproportionately from a flat tax at the expense of the middle class. For the very rich, this is probably true, although the generous personal and family allowances make the flat tax progressive. Second, because capital income is not taxed at the individual level, one person with exclusively labor income will be taxed at the individual level while someone with an equal income from returns from capital will not be taxed at the individual level. This capital income is taxed at the business level, but this tax burden is shared by consumers and workers in the form of higher prices and lower wages. Another political liability is the elimination of deductions for charitable contributions and home mortgage interest or, as Specter proposes, capping the deductions below current law. The mortgage interest deduction, in particular, will be defended by homeowners and the real estate industry.

The National Sales Tax

Senator Lugar has suggested replacing the federal personal and corporate income tax with a 17 percent national sales tax on goods and services--with an exemption for food and medical services--that would be assessed at the point of retail sale. Low-income taxpayers could be given a tax rebate. Unlike the USA and flat taxes, which tax consumption but function as income taxes, the sales tax is a pure consumption tax.

First, as with the flat and USA taxes, the sales tax would eliminate the current tax code's anti-savings bias and, according to some economists, significantly stimulate economic growth. Second, a sales tax would virtually eliminate the need for a tax code, which would reduce taxpayer paperwork and lower compliance and enforcement costs. In fact, Lugar would eliminate the IRS, a prospect that appeals to many Americans. Lastly, proponents of the sales tax note that it would tax the underground economy, because criminals could not avoid taxation when they purchase goods and services.

The sales tax, however, has serious drawbacks. Being a consumption tax, it is potentially quite regressive: low-income taxpayers would pay a larger portion of their income in taxes than wealthier taxpayers. A sales tax could be made progressive by providing a waiver or refundable tax credit for low-income taxpayers, but doing so would compromise the objective of administrative simplification. Another problem is that, because the sales tax would be obscured in the selling prices of consumption items, the taxpaying public would be less sensitive to its tax burden. The sales tax would also face political opposition from retailers who would have to play the role of tax collector and from state and local governments that wish to retain their own sales taxes. Moreover, unless the 16th Amendment (authorizing the income tax) is repealed, many believe that the sales tax would add to existing levies rather than replace them.

CONCLUSION

While the tax reform plans I have just described differ on specifics, they share common elements that make them all far preferable to the existing tax system; in fact, the similarities are much more important than the differences. In short, they shift the tax base from income to consumption, thereby eliminating the current code's bias against saving and investing; they make taxation less complex; and they better integrate business and individual taxation (the sales tax would do away with both). Most importantly, tax reform proponents are unanimous on the issue of greatest significance--the need to replace the tax code. There is complete agreement that the tax code imperils our ability to achieve real productivity and wage gains and improve our standard of living.

While comprehensive tax reform is economically desirable and should receive the support of a majority of Americans, certain interest groups will inevitably resist any significant change in the tax code. Because the current tax system is distortionary, it changes the relative prices of commodities and thereby creates winners and losers. To the extent that a new tax system eliminates these price distortions, it will make losers out

of the old winners, and vice versa. For example, completely neutral treatment of savings would result in state and local governments losing their present tax-based funding advantage and the housing industry could suffer if the tax benefits accorded homeownership were eliminated. While these may be desirable outcomes on efficiency grounds, the reality is that the new losers will have every incentive to resist change, and many have powerful lobbies that could put considerable pressure on members of Congress. A proposed tax structure which is not sensitive to these potential minefields will fail.

The American people, moreover, tend to view radical change with healthy skepticism. Part of the problem is that the public perceives many tax reform proposals as attempts to increase their aggregate tax burden. Of course, the tax proposals now under consideration could be made revenue neutral, and since any new tax system based on the principles outlined above would be a more efficient way to collect taxes and would enhance future productivity, it would be, over the long run, less burdensome. The federal government would therefore require fewer tax revenues than under the existing income tax.

The fact that taxpayers will be able to lower their tax burden by consuming less and saving more, in a manner of their choosing, is perhaps the best political marketing tool for comprehensive tax reform. Granting individuals greater control over their money and the way in which it is taxed would give them a sense of empowerment and enable proponents of tax reform to garner the grassroots support that it both needs and deserves.

Not since 1954 has the outlook for comprehensive tax reform been so promising. This opportunity must not be wasted on complex and incremental manipulations of the income tax. The United States needs instead to implement a new tax system that reflects today's economic realities and raises public revenues in the most fair and least complex and distortionary manner possible. In doing so, we would take an important step in safeguarding the American Dream.

COMPARISON OF INCOME TAX WITH MAJOR TAX REPLACEMENT PROPOSALS

Proposal	Tax Rates for Married Couples	Individual Tax Base	Major Exemptions, Deductions, and Credits	Business Tax Rates	Key Business Tax Features
Current Income Tax	$0-$39,000 15% $39,001-$94,250 28% $94,251-$143,600 31% $143,601-$256,500 36% Over $256,500 39.6%	▸Wages ▸Salaries ▸Pensions ▸Interest ▸Dividends ▸Annuities	▸Personal and family ▸Charitable contributions ▸Mortgage interest ▸Fringe benefits ▸Municipal bond interest ▸State and local taxes ▸Earned income	▸Corporate income tax rates: $0-$50,000 15% $50,001-$75,000 25% $75,001-$10,000,000 34% Over $10,000,000 35%	▸Immediate expensing: no ▸Wages/salaries/pensions: deducted ▸Fringe benefits: deducted ▸Interest: deducted ▸Dividends: not deducted ▸Alternative minimum tax
Armey Flat Tax	All wage income: 17%	▸Wages ▸Salaries ▸Pensions	▸Personal and family	▸All business income: 17% rate	▸Immediate expensing: yes ▸Wages/salaries/pensions: deducted ▸Fringe benefits: not deducted ▸Dividends/interest: not deducted
Specter Flat Tax - S. 488	All wage income: 20%	▸Wages ▸Salaries ▸Pensions	▸Personal and family ▸Charitable contributions ▸Mortgage interest	▸All business income: 20% rate	▸Immediate expensing: yes ▸Wages/salaries/pensions: deducted ▸Fringe benefits: not deducted ▸Dividends/interest: not deducted
National Sales Tax - Lugar version	All taxable sales: 17%	▸Retail purchases	▸Food ▸Medicine	▸All businesses pay 17% tax on retail purchases	▸Border adjustable
USA Tax - Domenici-Nunn - S. 722	$0-$5,400 8% $5,401-$24,000 19% Over $24,000 40%	▸Wages ▸Salaries ▸Fringe benefits ▸Pensions ▸Interest ▸Dividends ▸Annuities	▸Net new savings ▸Personal and family ▸Charitable contributions ▸Mortgage interest ▸Municipal bond interest ▸7.65% payroll tax credit ▸Post-secondary tuition ▸Earned income	▸Gross profits: 11% rate - defined under USA Tax as revenue from the domestic sale of goods and services (excluding financial receipts) minus the amount paid to other businesses for goods and services	▸Immediate expensing: yes ▸Wages/salaries/pensions: not deducted ▸Fringe benefits: not deducted ▸Dividends/interest: not deducted ▸Border adjustable ▸7.65% payroll tax credit

STEVEN B. CORD, President ALBERT S. HARTHEIMER, Vice President EDWARD H. SCHOYER, Treasurer HANNO T. BECK, Secretary

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Testimony - Dr. Steven Cord

for the FUNDAMENTAL TAX REFORM HEARING

June 1995

PROPOSAL - Tax land ownership, not producer income. This can be done by giving federal grant preferences to those cities which tax land assessments more than building assessments, or more directly by levying a federal tax on income from land ownership. For further details on this, contact us as we have been doing research and actual implementation of this for many years and with many governments.

BENEFITS - If this were done, land sites would have to be used efficiently (it would be uneconomical to hold sites out of full use and yet pay a tax on its rental value), and this by itself would create jobs and promote economic development. Surely, this is better than raising prices via a national sales tax.

Also, taxes on labor and capital could be substantially reduced, thereby once again creating jobs and economic development. Most voters would receive tax reductions (i.e., they would pay more with labor-and-capital taxes than with land taxes).

ENDORSERS - Seven recent American Nobel Prize winners in economics have endorsed this idea (see enclosure) as well as hundreds of prominent urban experts (see enclosure). The proposal has worked well wherever tried.

We are a non-profit research corporation and we offer to put our experience at your disposal for expenses only; please feel free to contact us.

H. L. Chambers
6225 Salt Cedar Road, NE
Rio Rancho, NM 87124

Wed, June 7, 1995 11:15 PM

Mr. Philip Mosley, Chief of Staff
House Ways & Means Committee
1102 Longworth House Office Bldg.
Washington, D C 20515

Dear Sir:

Enclosed please find six (6) copies of a statement regarding revision of the personal income tax for submission to the Ways & Means Committee.

I wish - in this statement - to express my views and address the topic of the personal income tax.

Most of us would agree that our system of taxation is too complex, too expensive to administer, and subject to "attempts to defraud" on the part of both taxpayer and government.. Instead of a cooperative symbiotic relationship, we seem to have an inefficient, antagonistic, contentious and adversarial relationship. This is generally unproductive on all counts.

Some in government, as well as private citizens and lobbying organizations, seem to favor a so called "flat tax" as a replacement for the personal income tax . **I don't favor the flat tax as a replacement for the personal income tax for the following reasons:**

1. It requires individuals to "report" their income. This leads to fraudulent underreporting on the part of the so called "underground" economy and others. The underground economy has been estimated by IRS survey to generate from 3 to 4 billion dollars annually. Individual businessmen (proprietors) have - for generations - been "skimming" their own gross to avoid income taxes. Requiring individuals to "report" income generates unnecessary bureaucracy - in the IRS and elsewhere. In short, it generates extensive costs for both government and taxpayer. It allows much "income" to go "unreported and so untaxed".
2. What criminal mobster, prostitute, drug dealer, marijuana grower, money launderer, etc., will report their income honestly on a "flat tax" postal card form?
3. Do *you* really believe that individual privately practicing professionals honestly report *all* of their *cash* income? I speak of such as doctors, dentists, optometrists, private duty nurses, lawyers, photographers, tailors, etc., etc. I'm sure you 'get' the thrust of my thinking
4. I believe that we need to rid ourselves of much of the IRS - our most **despised** bureaucracy! A flat tax would not effectively achieve this goal.

I don't support a "flat tax", nor do I support a "value added tax" (for many of the reasons cited above, as well as because of the tremendous bureaucracy such a tax would require for administration). **I do strongly support a national sales tax, imposed and collected at the point of final sale, as a replacement for the personal income tax for the following reasons.**

1. Money is relatively worthless until spent to acquire desired goods and services. Even the persons cited above for probable tax evasion spend money to obtain goods and services they need or desire. Conspicuous consumers will pay taxes commensurate with their conspicuous consumption. Nothing but prescription drugs, foodstuffs, and directly paid defined medical expenses would be exempt from sales tax. Restaurant meals would NOT be so excluded. Nor would school-lunch charges. Such would ensure that welfare recipients and the impoverished "poor" thus would have their tax liability reduced, but would still pay some taxes.

2. The sales tax "rate" could be periodically adjusted to meet the real needs of government without altering any other part of the system.

3. Existing 'loopholes' could be eliminated, and no opportunity to create future 'loopholes' would be supported by such a system.

4. The resulting expansion of the tax "base" would reduce rates while promoting fairness.

5. Printing, distributing, and auditing of tax forms and instructions, refunding, and general record keeping on the part of IRS would be very substantially reduced. Such savings could be applied in a fashion deemed proper by The Congress.

6. Individual ordinary taxpayers would no longer be required to retain - at considerable expense - tax preparers to sort out the obfuscating tax laws and IRS regulations, deliberately made so by The Congress and the IRS. This would accrue to the individual's benefit.

7. Cost of collection and forwarding such sales tax should result in a payment by the government of a very small percentage to the collector based upon the amount of tax collected.

8. This collection method could be standardized and inserted in the cash register automatic computer driven system extant at nearly all business outlets.

Other reasons could be cited, but the thrust of my comments should be quite clear to you.

I cannot believe that The Congress - having allowed the initiating of a complex procedure to use the House Post Office for fraudulent purposes and having discovered a means for writing and cashing personal checks for which there were no funds on deposit in the House Bank - would find construction of the general system proposed to be beyond their competence!!!!!

I strongly urge you to seriously consider making changes to our personal income tax structure in keeping with the comments above.

I request that you inform me of House Ways and Means Committee activities in these regards.

Very truly yours,

Harold L. Chambers
copy to computer file

Mr Phillip D Mosley, for the 1 202 225 3121
House Ways & Means Committee
Longsworth Building
Washington, DC 20515

Honorable Sirs:

I am indebted to Mike Reagan, 1 800 468 MIKE, the son of our former President, for calling my attention to your hearings on reforming federal taxation. As 1996 candidate for United States Representative in California Congressional District 12, I take the Oath of Office to heart: I will to the best of my Ability, preserve, protect and defend the Constitution of the United States.

Please forgive my few simple minded questions:

Is our Government Constitutional in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity?

Does Article I Section 2 of our Constitution state that Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers... ?

Did the Supreme Court of the United States find the Civil War Income Tax unconstitutional? When the 16th Amendment was passed in 1913, was the promise made by Congress that the rate would not exceed 7% on incomes over $500,000?

With regard to the Constitution and taxation, have we lost our way, wandering for some years in the wilderness? Did Judge Learned Hand remind us that the power to tax is the power to destroy?

US Treasury and Census statements indicate that since 1913, government spending has increased 824 times faster than our population. Are we really that much better off? Has human nature remained constant enough for 82, 207 or 3400 years, that we can avoid an endless sea of high compliance costs, deficits, debts and poverty under the yoke of tax tyranny?

I pray yes. Therefore I support the Biblical and Constitutional 20% flat tax proposal of Chairman Bill Archer, exempting savings, capital gains, state taxes, churches and poor people from taxation. Experiences in Britain versus Hong Kong confirm the wisdom of Joseph in limiting taxation and government. We love our liberty.

Yours most truly,

Richard Charles 1 415 347 9382 Home Office
POB 322
Burlingame, CAlifornia 94011

Honorable Philip Mosely
Chief of Staff, Ways and Means Committee
Longworth Building
Washington D.C.

June 3.1995

Dear Sir:

I understand you will our letters included into the record our during the Tax hearings. The following is my thoughts on taxes and our burdensome tax system:

As a small business owner I can assure you there is absolutely nothing that can be more disruptive, time consuming, and costly than dealing with the Internal Revenue Service. Every income earning individual must deal with a large, clumsy, indifferent and often inept bureaucracy that makes inconsistent and often arbitrary determinations that can cost you everything you own and more. Although the extreme examples of bureaucratic ineptitude wiping out innocent taxpayers are probably relatively rare, the fact that it happens at all, and that the IRS appears to publicly flaunt these "triumphs", creates a chilling tyranny over every hard working individual in this country. A type of "taxpayer terrorism" engaged in by our own government for the purpose of keeping taxpayers appropriately submissive.

Furthermore, I resent the amount of resources I must devote to research, planning and record keeping , to try and preserve as much of my hard earned income as I can. These are resources I can scarcely afford but that I must expend if I want to merely exist, let alone prosper in this country.

I also resent the social engineering our elected officials are always engaged in. It should *not* be the role of government to punish or reward individuals for earning, investing, or spending their hard earned income the way they want.

Liberty from this entirely unnecessary burden on the individual can only come with elimination of all the complex and often indecipherable tax laws and replace it with a simple flat rate. No exceptions, no deductions-- not even one; lest future law makers use it as a reason to add new and more complex rules later.

Even better would be the total elimination of the income tax altogether. I realize other forms of revenue generation could be socially unpopular and perhaps politically impossible but please consider that when our government is entitled to know anything about our income, true privacy as our Constitution requires can not be achieved. Currently we are required to report where we earn our money, where we invest it, our marital status, the number of children we have, where we get our health insurance, were we go to church, what charities we give to and so forth. (Incidentally, most of these items are things I am barred by law from asking any potential employees! Is the government so much more privileged?) And if you are self employed you even have to report, among other things, how many stamps you buy!

Only you have the power create a United States where law abiding citizens can truly be free from this unnecessary, and unreasonable burden. I implore you to eliminate this intrusion into the most personal and intimate details of our lives. I can only hope and pray that you choose total liberty for your country. Thank you for this opportunity.

Peter Chopelas
15105-317th St. NE
Arlington, WA 98223

CITIZENS FOR SOUND TAX REFORM

OFFICE OF THE PRESIDENT

Thursday, 8 June 1995

Dear Representative Mosely,

Thank you for addressing the issue of tax reform. It is long overdue, and a sound solution should pass your committee and the House without any trouble. Of course, a sound solution involves replacing the current system with the 17 percent flat tax, as proposed by Rep. Dick Armey. I hope you will support the flat rate tax, and will be watching Congress to see what you do. Thank you.

Cordially,

Tim Ruel

1276B Kamahele St
Kailua, HI 96734-3339
Phone/Fax: 808/261-7212

TO: OUR SERVANTS,
All elected/appointed officials
In the State of Washington and in Washington D.C.

FOR THE RECORD:

FROM: WE, THE PEOPLE, THE GOVERNMENT

Many lives have been sacrificed for this Flag, and for the FREEDOMS it stands for. Our State and Nation are on the brink of bankruptcy, because too many of our elected officials have submitted to the control of Our Prime Enemy: THE MONEY POWER. WE, The People, are losing our individual rights to LIFE, LIBERTY, and the PURSUIT OF HAPPINESS, because of the unconstitutional laws and regulations that have been passed, and forced upon us! Under the black and white illustration of Our Flag below, is the Pledge of Allegiance to our Flag and to our Country. Do YOU know this Pledge by heart? Do the words YOU say when you make this Pledge come from YOUR Heart? and bring a 'lump to YOUR throat'? Have YOU read and understand, the Constitution of the United States of America, and the Constitution of the State of Washington? If Your answers to these questions is 'YES', welcome aboard! Join the effort to RESCUE OUR STATE AND OUR NATION FROM BANKRUPTCY AND ANNIHILATION, by supporting THE 1% FLAT-RATE TRANSACTION TAX REFORM PROPOSAL, with NO DEDUCTIONS, NO EXEMPTIONS, and NO LOOPHOLES!

"I pledge allegiance to the flag of the United States of America, and to the Republic for which it stands, one nation, under GOD, indivisible, with liberty and justice for all."

Shortly before his assassination in 1865, ABRAHAM LINCOLN was quoted as saying: "I fear for the safety of my country. Corporations have been enthroned, an era of corruption in HIGH PLACES will follow, and the MONEY POWER, of the Country will endeavor to prolong its reign by working on the prejudices of the people, until the wealth is aggregated in a few hands and the REPUBLIC IS DESTROYED."

Don't let Lincoln's prophesy happen! If everyone who truely loves AMERICA, will JOIN THIS BATTLE TO RETURN OUR GOVERNMENT TO THE PEOPLE; and if the POWER TO CREATE MONEY and ISSUE U.S. TREASURY NOTES were once again IN THE HANDS OF CONGRESS; and if the unjust, complicated, and inadequate FEDERAL INCOME TAX were to be replaced with A LOW FLAT-RATE TRANSACTION TAX, America would be 'OUR AMERICA' again! YOU, who are members of the Committee On Ways And Means, have THE WAYS AND THE MEANS TO RESCUE OUR NATION... We pray that GOD will guide you, and that this mission will be accomplished, before you adjourn.

THE COALITION FOR A 1% TAX
Chairman, Clarence P. Keating, Jr.
2669 36th Avenue S.W.
Seattle, WA 98126; 1 (206) 937-1092

(Over)

THE 1% FLAT RATE TRANSACTION TAX

TWENTY FULL YEARS have been devoted to the research necessary to draft this TAX REFORM ACT: it is Constitutional, simple to administer, provides adequate revenue, and is worthy of YOUR support!

UNDER THIS ACT:

1. ALL STATE and LOCAL TAXES in conflict with our Constitution will be REPEALED! NO sales tax, property tax, B&O taxes, Hotel-Motel tax, excise taxes, tolls, and fees for licenses & permits.
2. Everyone, from the largest corporation to the individual citizen will be taxed at the same low rate (not to exceed the Constitutional limit of 1%).
3. The Tax will be paid by the SELLER OF GOODS OR SERVICES.
4. Checking or Saving Accounts will not be taxed; when you write a check, the person receiving the check will pay the tax.
5. At the present time, approximately 22% of your income is paid out in State and Local Taxes. That's $5500.00 on a salary of $25,000.00 a year. Under the 1% TRANSACTION TAX, YOU WOULD BE PAYING ONLY $250.00, to your State and Local Governments.

HIGHLIGHTS OF THE 1% FLAT RATE TAX:

Our research indicates that there are over 3 TRILLION dollars transacted annually, within the Washington State banking system alone. Taxing these dollars at 1% would produce a revenue of at least 30 BILLION dollars. Our present combined State, County, and Municipal budgets have been around 25 Billion. Under the 1% TRANSACTION TAX, the way would be cleared to wipe out our acquired bonded indebtedness and regain our sovereignty as a free state, since we will no longer suffer the indignities of having to submit to Federal blackmail control.

A DEBT-FREE WASHINGTON COULD BE THE BEACON TO GUIDE ALL THE STATES OUT OF CHAOS!

THIS TAX-REFORM PLAN WILL WORK!

There are literally TRILLIONS OF DOLLARS in electronic money transfers in our Country annually; these are untaxed dollars. Add to these the SPECIAL EXEMPTIONS granted the large Corporations and the LOOPHOLES they all find to use; and, finally, all of the OTHER TRANSACTIONS in the Market place, our verified figures show that a Tax of a fraction of 1% on the total of these transactions, would be sufficient to provide ALL of the revenue needed by every level of government in our Country! The 'Money Power' knows this too, as is evidenced by the 'CONSPIRACY OF SILENCE' on this TAX-REFORM PROPOSAL, by ALL the news-media under their control.

It has been proven over the years, the most recent was during President Kennedy's administration, that when taxes are lowered the revenue is increased because the economy is improved. The 1% TRANSACTION TAX will leave more money in the pockets of the people for them to spend or invest, and the economy will be stimulated again!

May 29, 1995

The Honorable William Archer, Chairman
Committee on Ways and Means
Longworth Office Building
Washington, DC 21565

ATTN: Phillip Mosley, Chief of Staff

Dear Congressman:

Attached are six (6) copies of "Income Tax Conclusions" which I would like entered into the record of the forthcoming hearings on Tax Reform. I understand your hearings are scheduled for June 6, 7, 8, 1995 in the Ways and Means Committee.

Congressman Archer, you are to be commended for the courageous public stand you have taken regarding the current income tax situation and the monstrous consequences perpetrated by the Internal Revenue Service bureaucracy. Millions of us agree with you and hope you prevail over any proposal that supports taxing the fruits of anyone's labor.

The Founding Fathers knew it, you know it and millions of us out here know it. That is, we know that a properly designed government's sole function is to protect the unalienable rights of every individual from foreign and domestic enemies, to ensure that justice is carried out in the courts and to provide an honest money system. THAT'S IT! We can do the rest. A proper government would only have limited powers to raise taxes, and thus, would be restricted to its 'necessary' size. The income tax was deliberately imposed so as to give government an unlimited source of funds to involve itself in an unlimited number of unnecessary activities, restricted only by the endurance of the people.

The attached "Income Tax Conclusions" were taken, with permission, from Lynne Meredith's "Vultures in Eagles Clothing", Prosperity Pubiishers, 17011 Beach Blvd., Suite 900, Huntington Beach, CA 92647. Her book is the culmination of seven years of research into the history of income taxes in America. Congressman Archer, if you are serious about getting all the facts out on the table, I urge you to have Lynne Meredith to testify before your committee.

Bob Corke

Bob Corke
(196) 441-8025
(916) 456-8902

INCOME TAX CONCLUSIONS

"[T]he Constitution recognizes the two great classes of **direct** and **indirect** taxes, and lays down two rules by which their imposition must be governed, namely the rule of **apportionment** as to direct taxes and the rule of **uniformity** as to duties, imposts and excises. "**Pollock v. Farmers' Loan & Trust Co.** 158, U.S. 601 at 637.

"**Direct taxes** bear immediately upon person, upon possessions and enjoyment of rights. **Indirect taxes** are levied upon the happening of an event." **Knowlton v. Moore**, 178 U.S. 41

Constitution Article I, §2, Cl. 3 "...**Direct** taxes shall he **apportioned*** among the several states, according to their respective numbers..." **Article I, §9, Cl. 4** "No capitation** or other **direct** tax shall he laid unless **in proportion to the census** of enumeration... "

***Apportionment** means to equally divide among the population (census) regardless of income. ****Capitation tax:** "a tax imposed upon a person at a fixed rate, regardless of taxpayer's ability to pay, occupation, assets or income."

1895	**Direct, unapportioned taxes on income ruled unconstitutional**	**Pollock v. Farmers Loan & Trust Co.** 157 U.S. 420 "...We are of the opinion that taxes on personal property, being a **direct tax**...the income of personal property, are likewise direct taxes. The tax...so far as it falls on the income of real estate or personal property, being a direct tax within the meaning of the Constitution, and therefore, unconstitutional and void because **not apportioned** according to representation..."
1909	**President Taft proposes Tarriff Amendment**	Congressional Record June 16, 1909, pg 3344: "It is now proposed to make up the deficit by the imposition of a general income tax, in the form, substance and almost the same character as that which, in the case of Pollock v. Farmers' Loan and Trust Co. (157 U.S. 420) was held to be a direct tax, and therefore **NOT** within the power of the federal government to impose unless apportioned among the several states according to population...I, therefore, recommend an amendment...imposing on all corporations...an excise tax measured by 2% on the net income of such corporations. This is an excise on the **privilege** of doing business as an artificial entity...This course is much to be preferred to the one proposal of reenacting a law once judicially declared to be unconstitutional."
1909	**Corporate Tariff Act of 1909**	
1913	**The 16th Amendment is declared to be ratified**	This was an unsuccessful attempt to override the Pollock Case ruling.
1916	**SUPREME COURT RULES: The 16th Amendment did not overturn the Pollock Case.**	"The 16th Amendment contains nothing repudiating or challenging to the rule of the Pollock Case..." **Brushaber v. Union Pacific RR Co.** 240 U.S. 1 at 12

1916	**The 16th Amendment did not give congress the power to collect an unapportioned direct income tax.** **The 16th Amendment is Constitutional because it is only applicable to indirect taxes.** **The income tax is an excise.**	"..[T]he confusion ... arises from the [erroneous] conclusion that the 16th Amendment provides... a power to levy an income tax which, <u>although direct</u>, should not be subject to the regulation of apportionment... [T]he far reaching effect of this erroneous assumption... if acceded to, would cause one provision of the Constitution to destroy another; ... bringing the Amendment into irreconcilable conflict with the **general requirement that all direct taxes be apportioned**... This result would create radical and destructive changes in our constitutional system....The 16th Amendment, as correctly interpreted, is limited to indirect taxes and for that reason is constitutional....The conclusion reached in the Pollock case...recognized the fact that taxation on income was in its nature an excise..." **Brushaber v. Union Pacific RR Co.** 240 U.S. 1 at 10, 11, 12,18,19

"Excises are taxes laid upon the manufacture, sale or consumption of commodities within the country, upon licenses to pursue certain [regulated] occupations and upon corporate privileges; the requirement to pay such taxes involves the exercise of privilege." **Flint vs Stone Tracy Co.** 220 US 107.

"The 16th Amendment does not extend the power of taxation to new or excepted subjects..."
<u>Peck v. Lowe,</u> 247 U.S. 165

1920	**The 16th Amendment did not eliminate the regulation of apportionment for all direct taxes.**	"The 16th Amendment must be construed in connection with the taxing clauses of the original Constitution " <u>Eisner v. Macomber</u>, 252 U.S. 189 at 205

26 CFR (1939) §9.22(b)-l "<u>Exclusions from gross income</u>.–The following items <u>shall not</u> be included in gross income and shall be exempt from taxation under this title:

> (b)-1 **Exemptions; exclusions from gross income.** Certain items of income...are exempt from tax and may be excluded from gross income...<u>those items of income which are, under the Constitution, not taxable by the Federal Government.</u>"

FINAL CONCLUSION: The 16th Amendment is constitutional because it is limited to **only** <u>indirect taxes</u>. **Compensation for Labor** and **the exercise of the Right to Labor are property** and, as such, are <u>items of income, under the Constitution</u> (Art. 1, §2, Cl.3, Art. 1, §9, Cl. 4), <u>not taxable by the Federal Government</u>. Compensation earned, exercising the Right to Labor is excluded from "Gross Income" and <u>**is exempt from taxation under Title 26**</u>, under the authority of Title 26, Code of Federal Regulations (CFR) ('39) §9.22(b)-1.

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303 WEST BROAD
TEXARKANA, TX 75503-2822
JUNE 18, 1995

CHIEF OF STAFF
PHILIP MOGELL
COMMITTEE OF WAYS AND MEANS
LONGWORTH H.O.B.
WASHINGTON, DC 20515

DEAR SIR:

RE HEARINGS FOR ALTERNATE FEDERAL TAXATION.

WE WOULD LIKE TO MAKE THE CASE FOR A 5% NATIONAL SALES TAX, WITH ABOLITION OF THE FEDERAL INCOME TAX AND INTERNAL REVANUE SERVICE, SINCE THE I.R.S. WOULD NO LONGER BE NECESSARY.

IN 1985, A FORMER I.R.S. EMPLOYEE, MIKE LOVE OF WACO, TEXAS, DREW UP A WANG COMPUTER MODEL FOR SUCH A TAX. WITH THE DEFICIT AT THAT TIME, A 5% NATIONAL SALES TAX WITH NO CREDITS, DEDUCTIONS, EXEMPTIONS OR EXCEPTIONS WOULD HAVE BALANCED THE BUDGET IN 2.62 YEARS. IN HIS MODEL, 2% WOULD GO TO THE GENERAL ACCOUNTING OFFICE AND 3% TO SOCIAL SECURITY. IN SUBSEQUENT YEARS, THE REVANUES NOT USED FOR THE CURRENT YEAR'S BUDGET COULD BE USED TO REDUCE THE NATIONAL DEBT. FIVE PER CENT IS PLENTY TO TAKE CARE OF OUR NEEDS AS THE TAX BASE (U.S. POPULATIUON) HAS INCREASED IN THE LAST DECADE.

ABOUT 40 STATES, INCLUDING TEXAS, COLLECT SALES TAXES. TEXAS COLLECTS HERS THROUGH THE STATE COMPTROLLER'S OFFICE. A SIMILAR OFFICE WITH CONSTITUTIONAL SAFEGUARDS COULD BE SET UP AT THE FEDERAL LEVEL TO COLLECT THE TAX FROM BUSINESSES OF ALL KINDS.

ADVANTAGES OF A NATIONAL SALES TAX INCLUDE EASE OF COLLECTION, NO PAYROLL DEDUCTIONS, THE SHRINKING OF THE UNDERGROUND ECONOMY, A BOOMING NATIONAL ECONOMY, WITH BUILT-IN INCENTIVES TO BUY HOMES AND OTHER BIG TICKET ITEMS AND LESS FEDERAL BUREAUCRACY.

OTHER ADVANTAGES: NO CUMBERSOME FEDERAL TAX RETURNS FROM INDIVIDUALS, NO RECORDKEEPING FOR TAX DEDUCTIONS BY INDIVIDUALS AND LESS WORK FOR ACCOUNTANTS.

THE ECONOMY WOULD BOOM AS A RESULT OF AMERICANS' GETTING MORE MONEY TO SPEND, THANKS TO LOWER TAXES. THIS WOULD RESULT IN MORE TAX COLLECTIONS, DUE TO THE INCREASED CONSUMER SPENDING. MORE JOBS WOULD BE CREATED AND PRODUCTIV1TY WOULD INCREASE. THIS IS ILLUSTRATED IN AN ADAM SMITH ECONOMIC MODEL IN BOTH PERFECT COMPETITION AND IMPERFCT COMPETITION.

THIS SIMPLE MODEL IS FOREIGN TO THE CURRENT ADMINISTRATON THAT INSISTS TAXES MUST BE RAISED TO FINANCE THE DEFICIT.

ONE DISADVANTAGE: A NATIONAL SALES TAX WOULD BE REGRESSIVE IN THAT LOW-INCOME PERSONS WOULD PAY PROPORTIONATELY MORE THAN MIDDLE AND HIGH-IMCOME PERSONS. HOWEVER, WE DOM'T SEE THIS AS A BIG PROBLEM, SINCE PEOPLE ARE USED TO PAYING SALES TAXES IN MOST STATES. IN TERMS OF DOLLARS, HIGH-INCOME PERSONS WOULD PAY THE MOST.

ONE LAST ISSUE. THE PROPOSED 17% FLAT TAX PROPOSED BY CONGRESSMAN DICK ARMEY (R-TX) IS, IN OUR OPINION, AN INSULT. FOR SOME PERSONS IN THE 15% TAX BRACKET, ESPECIALLY THOSE JUST STARTING SMALL BUSINESSES, IT COULD MEAN A TAX INCREASE. THIS TAX COULD BE RAISED AT ANY TIME, OR INDEXED. THE CURRENT I.R.S. BUREAUCRACY WOULD STAY IN PLACE. (THE FEDERAL GOVERNMENT IS LOOKING TO CUT JOBS. HERE'S A GREAT PLACE TO START.) UNDER OUR PROPOSAL, IT WOULD TAKE A 2/3RD'S MAJORITY IN THE HOUSE OF REPRESENTATIVES TO RAISE THE SALES TAX, OR, BETTER YET, WHY NOT PUT IT TO A VOTE OF THE PEOPLE? .

WE BELIEVE A NATIONAL SALES TAX WOULD BE ADVANTAGEUS FOR OUR ECONOMY AND FOR TAXPAYERS AND WOULD CUT THE BUREAUCRACY. EVERYONE WE'VE MENTIONED THIS TO LOVES IT; IT WOULD HAVE BROAD-BASED SUPPORT. PLEASE CONSIDER A NATIONAL SALES TAX.

PLEASE REPLY. THANKS.

SINCERELY,

Hazel Cotton

HAZEL COTTON

6/19/95

PHILLIP MOSLEY, Chief of Staff
1102 House Office Building
Washington, DC 20515

Dear Sir:

I am for a 13.5% Consumer Tax which will omit tax on housing, food and medical care.

Get rid of IRS!

Thanks.

B. Denney
3221 Louisville
El Paso, TX 79930

COMMITTEE ON WAYS AND MEANS

HEARING ON TAX REFORM

JUNE 6-8, 1995

STATEMENT OF THE DISTILLED SPIRITS COUNCIL
OF THE UNITED STATES

The following statement is submitted on behalf of the Distilled Spirits Council of the United States, Inc. (DISCUS), for inclusion in the printed record of the joint hearing on fast track issues. DISCUS is the national trade association which represents U.S. producers and marketers of distilled spirits. We welcome the opportunity to contribute to the Committee's investigation into reform of the current Federal tax system.

DISCUS concurs with Chairman Archer that any reform of the federal tax system should be directed towards simplicity, increased savings and investment, economic efficiency and international competitiveness. In addition, DISCUS believes that the various tax reform proposals should be evaluated in terms of the incidence of taxation on each sector of the economy as well as on competing lines of business, the impact on state revenues, and the short-term (first 4-5 years) macroeconomic impact.

Among the several tax reform proposals now before the Ways and Means Committee, four types are particularly noteworthy: (a) flat tax proposals by Rep. Richard Armey (R-TX), Sen. Richard Shelby (R-AL), and Sen. Arlen Specter (R-PA); (b) the national sales tax proposals by Rep. Bill Archer (R-TX) and Sen. Richard Lugar (R-IN); the Unlimited Savings Allowance (USA) Tax proposal by Sens. Pete Domenici (R-NM) and Sam Nunn (D-GA); and the subtraction-method VAT proposal by Rep. Sam Gibbons (D-FL). DISCUS makes the following recommendations to the Committee, and would welcome the opportunity to elaborate upon these points if called upon by Congress:

- **The federal government should reduce its dependence on narrowly-based excise taxes.**

  - High rated taxes on specific products – such as on distilled spirits for which 44% of the price of a typical bottle is taxes – are fiscally inefficient. Further tax increases have little revenue-generating potential, and further distort the allocation of resources in the market.

  - Liquor excise taxes are hidden from consumers who therefore do not realize how much tax they have to pay. The tax is imposed on the supplier who passes it on as a part of the cost of goods to the wholesaler.

  - The government collects much less money from the excise tax than consumers have to pay. Excise taxes cascade into higher prices since – as a cost of goods – it is marked up by the trade just like other costs of goods.

  - Federal tax reform focused on a broad tax base at a uniform marginal rate on all tax payers would be more fair, and cause less price-induced distortion of resource allocation.

- **The federal government should not tax products twice, nor should there be taxes imposed on taxes paid. Presently, distilled spirits is taxed several times.**

  - It pays an excise tax as it leaves the distillery or customs.

  - It pays another excise or "monopoly" tax as it enters state jurisdiction.

  - It pays sales tax(es) as it is sold to the consumer. Not only is the product

taxed, but also taxes are paid on taxes collected earlier by federal and state governments.

- A national sales tax would compound this cascading of taxes because that high-rated tax would constitute another (a) tax on the product, (b) tax on the federal excise tax, and (c) tax on the state excise taxes.

o **Existing specific taxes such as the FET on distilled spirits should be repealed if a new layer of tax, such as a national sales tax, is enacted.**

- Imposing a new tax in addition to, or on top of, the existing FET (Federal Excise Tax) burden would be disastrous for the industry.

- A national sales tax would be particularly heavy on high-priced, premium products. It would move away from the principle that the volume of alcohol (not the value of alcohol) in all alcohol beverages should be taxed.

- Tax fairness demands elimination of double taxation. It would be unfair tax policy to impose a national sales tax or VAT without repealing other indirect taxes on distilled spirits.

- The United States would want to avoid the disastrous experience of Canada, where a "tax revolt" resulted from superimposing a high-rated value-added "Goods & Services Tax" in addition to an existing federal excise tax and provincial sales taxes.

o **The tax burden should be equitably distributed, among both tax payers and products taxed.**

- Regressive federal excise taxes conflict with the principle of tax fairness. Like sales and VAT taxes, excise taxes -- even at lower consumption per capita among lower-income families -- consume a greater portion of income from low- and middle-income families than from the rich.

- Increases in these taxes also cause a greater proportion of jobs lost among the poor than among the wealthy.

- If alcohol content remains the basis on which beverage alcohol will be taxed, government should give serious consideration to a revenue-neutral adjustment of all alcohol taxes in order to apply a uniform tax to all alcohol.

o **Any new broad-based tax should be applied at a uniform rate to all purchases, thereby avoiding the costly complexity of multiple rates.**

- Simplicity and administrative efficiency would be lost in an attempt to make a national sales tax or VAT more equitable by imposing multiple rates.

- The United States would wish to avoid the experience of Belgium, France, Ireland and Italy which have multiple rated taxes.

- There are other, more efficient ways to address equity concerns than by multiple rates.

o **The federal tax system should not undermine state-level taxation systems, or have the unintended effect of diverting revenue from states to the federal government.**

- Following the FET increases in 1985 and 1991, state and local governments

lost more than $140 million in excise tax revenues, and saw unemployment compensation increase by $70 million.

In summary, DISCUS agrees that in the interest of economic efficiency and international competitiveness, federal revenues should be raised through broadly-based income or consumption taxes rather than narrowly-based taxes such as the federal excise tax. The tax system should not waste time and resources of taxpayers and the government. The tax system should encourage businesses and individuals to increase savings and investment. The tax should be far simpler to calculate and administer than the present system. The tax should have a uniform rate with an absolute minimum of exceptions (loopholes, exemptions). Tax reform and all taxes should be fair -- to competing products (e.g., spirits, wine and beer), to those less able to pay, to workers and business, and to the states.

Americans should be as aware of the taxes they have to pay as well as of the benefits they receive so they can evaluate the trade-off when a tax increase is proposed. For this reason, taxes should not be hidden as are federal excise taxes. Most importantly, it also means that a double tax should not be imposed, i.e., the imposition of any type of new consumption tax must include the repeal of already existing and highly regressive excise taxes.

June 22, 1995

DISPELLING THE REVENUE TAX CONFUSION

Dear Chairman Archer:

To avoid the unnecessary confusion regarding the Income Tax, it is imperative that a review of the United States Supreme Court ruling should once and for all settle any questions as to whether the Income Tax is a Direct Tax or an Indirect Tax. In its unanimous ruling, the Supreme Court in Brushaber v. Union Pacific Railroad Company, 240 U.S. 1 (1916) held that the 16th Amendment and the Income Tax enacted thereafter is constitutional because it is restricted to that class of taxes known as Indirect Taxes, which include excises, imposts and duties, all of which are privilege taxes.

The jurisdictional question for purposes of enforcing the Income Tax depends entirely upon the question as to who or which persons are "subject to" the tax, and why and/or how do those persons become subject to an indirect tax. The question is jurisdictional because the term "taxpayer" is strictly a legal term narrowly defined by law as being only such a person who is subject to such a tax. For example, see Title 26, Section 1313(b):

> ". . . the term 'taxpayer' means any person subject to a tax under the applicable revenue law."

This does not include any direct tax. The Supreme Court's rulings in Veazie Bank v. Fenno, 75 U.S. 533, Springer v. United States, 102 U.S. 586 and Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 clearly show that direct taxes are only those laid upon the several States, and that Congress, under Article 1, Section 2, Clause 3, and Article 1, Section 9, Clause 4, may tax the States, provided that such tax shall be apportioned according to the respective populations of the several states, as Congress has done in 1798, 1813, 1815, 1816, and 1861. Such a tax on the States is the only direct tax that Congress may lay and collect.

The Constitution's rule of apportionment as to direct taxes is based upon and controlled by land values strictly in terms of people or population instead of any monetary "market value". Congress must first determine how much money it will raise by such a tax, thus the total amount of the tax is set by Congress and each state pays its share of that amount based upon and according to their respective or individual populations. For example, Congress needs 50 billion dollars and California's population is approximately 10% of the nation's population, and therefore, California's share of that 50 billion dollar tax would be approximately 5 billion dollars. The enforceability of Congress' power of direct taxation is that each state may raise its share from its own real estate tax rolls of each state.

But land speculators, which include banks, insurance companies, individuals and corporate America generally, have historically prevailed through their real estate lobby in preventing Congress from exercising this revenue power, which would tend to discourage and reduce the parasitic enterprise of land speculating. As a result, Congress has not used this power since the Civil War and has been forced by the real estate lobby to eke out the nation's revenue only by its power of indirect taxation.

WRITTEN COMMENTS OF THE EDISON ELECTRIC INSTITUTE

REGARDING REPLACING THE FEDERAL INCOME TAX

BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

JUNE 22, 1995

The Edison Electric Institute (EEI) is the association representing the nation's investor-owned electric utility companies. Its members serve 99 percent of all customers served by the investor-owned segment of the electric utility industry. EEI's members generate approximately 79 percent of all the electricity produced in the United States and serve 76 percent of the nation's customers. EEI and its member companies appreciate the opportunity to present our written comments on this important issue, and look forward to working with the Committee in its search for an alternative tax system to replace the federal income tax.

EEI believes that a broad-based consumption tax is a better way to raise federal revenue than the current corporate income tax. Our current tax system is extremely complicated and burdened with a tangled multitude of exemptions and loopholes. It punishes success and rewards consumption at the expense of savings and investments, and is extremely difficult and expensive to administer. EEI supports the Committee on Ways and Means' efforts to develop an alternative tax system that is fairer and encourages savings. Our testimony will predominately discuss a value-added tax (VAT), which EEI favors as an alternative to our current income tax. If the Committee wishes, EEI will provide additional comments on either the flat tax proposed by Representative Armey or S. 722, the Unlimited Savings Account (USA) tax proposal, at a later date.

BROAD-BASED CONSUMPTION TAX

A VAT is the best alternative to fund the federal government into the 21st century. Although consumption taxes can take many forms, a VAT has become the international consumption tax of choice, and with good reason. A VAT is far superior to our current federal income tax system because it does not rely heavily on income, but promotes a balance between income and consumption. Additionally, it would provide stability and neutrality to our tax system. Since its base is large, encompassing most economic activity, the VAT is nowhere near as vulnerable to economic fluctuations as an income tax, nor dependent on particular industries. Moreover, it taxes all financial factors of production equally, not discriminating between debt and equity, nor penalizing a particular form of business organization. Compared to the income tax, it encourages capital investment and is favorable to international trade. In short, a VAT meets Chairman Archer's goals of administrative simplicity, stimulation of savings and investment, improvement of our international competitiveness, as well as collection of tax revenue from the "underground economy" and from others who currently do not comply with the tax laws. Set forth below is a discussion of how a VAT meets each of these objectives as well as some utility-specific concerns that need to be addressed.

ADMINISTRATION AND COMPLIANCE

The administrative and compliance burdens of a VAT vary greatly, depending on the type adopted. As a rule, the more complicated the tax, the more costly it will be for the government to administer and more difficult for taxpayers to comply. Ideally, a VAT would tax the consumption of all goods and services. A broad-based VAT has two advantages. First, it discriminates less among taxpayers based on their preferences for particular goods and services. Second, a low tax rate on a broad base changes the relative prices of consumer goods and services less than a high tax rate on a narrow base. Excluding goods and services from the VAT base increases the tax rate needed to raise a given

An Indirect Tax is a tax upon the exercise or exploitation of an intangible privilege, which is typically created and granted by a state government permitting certain people to engage in or pursue a certain business, profession, occupation, or trade that is otherwise unlawful. Said privilege so granted is evidenced by a license, which, in and of itself, is a taxable gain. And the use or exploitation thereof is also taxable, with the amount of the tax typically being measured by the income, which is procured under said license. Therefore, an indirect tax could be called a privilege tax. Of course, a God-given, constitutionally protected fundamental human right cannot to be taxed for revenue purposes.

Due to some people's lack of knowledge and understanding of the difference between direct taxes as property taxes and indirect taxes (excises, imposts, and duties) as privilege taxes, their ignorance is often exploited by their employers, who happen to be subject to a privilege tax which includes the income tax and the Social Security tax.

The problem is not only misconduct by the IRS, but even more, it is misconduct by thousands of employers who are unlawfully and fraudulently taking monies from the paychecks of their employees who are not subject to any income tax or any Social Security Tax, or any other revenue tax, and, therefore, no money may lawfully be withheld from their paychecks under the guise of "withholding and collecting" a tax.

Ignoring all of this, the employer, as a condition of employment, unlawfully demands a Social Security number from a prospective employee, who usually submits the number or obtains one in order to "get a job". If the employee is merely exercising a God-given, constitutionally protected, fundamental human right to work, for which no license is needed, then he is not subject to a tax, and, therefore, is not a "taxpayer" within the meaning of the law and cannot lawfully be identified as such, either by number or any other means. Nevertheless, in most instances, his Social Security Number is unlawfully treated by the employer as if it were a "taxpayer" identification number (TIN) so that the employer who is otherwise subject to the full amount of the Social Security Tax, will unlawfully shift half of this Social Security Tax on to the employee.

Not only must Congress overcome the land speculators' real estate lobby and return to using its constitutional power of direct taxation of the states, which is payable from their own real estate tax base, Congress must by appropriate legislation, send a message to all employers to cease and desist from unlawfully attempting to apply the revenue law to employees who are not subject to a tax.

Yours truly,

Sheridan B. Duncan

amount of revenue. A single rate, broad-based VAT would promote economic neutrality and minimize compliance and administrative costs.

If the structure of a VAT includes exemptions and multiple rates, the GAO estimated that the administrative costs could be as much as $700 million higher than a VAT without exemptions. Various factors determine compliance costs; most importantly the design of the consumption tax, the frequency of the reporting period, and the threshold level of taxation. While we understand that the structure of a VAT may need to contain tradeoffs to meet different social, political and economic objectives, such tradeoffs reduce total revenue generated and complicate tax administration.

EFFECT ON SAVINGS AND INVESTMENT

The United States economy suffers from an imbalance between savings and consumption. The national savings rate has declined steadily through most of the 1980s and 1990s, and is now lower than that of most of its trading partners. Between 1983 and 1992, the net national savings rate of the United States averaged 3.6 percent. Over the same period, compared to the United States, Japan's net national savings rate was five times as high, Germany's rate was three times as high, and the European Union countries' savings rates were, on average, twice as high. The U.S. net national savings rate dropped below 2 percent in 1992.

Net domestic investments in those countries noted above during the 10-year period were 1.5 to three times those in the United States. Due in large part to our low savings rate, compensation and real wages have declined in relation to historic trends. The current federal income tax system contributes to this deterioration because it creates biases that distort economic decisions and penalize savings. A low savings rate leads to reduced investment, lower economic growth, fewer jobs, and a lower standard of living. The result of these biases is to make the United States dependent on foreign savings for capital formation and to sustain its trade deficit.

A VAT can stimulate savings if it replaces other taxes that discourage savings. The savings rate measures a society's desire to sacrifice consumption today for increased consumption tomorrow. We need to encourage increased savings in the United States. Without savings, funds are not available for capital formation and financing of the national debt cannot occur without borrowing from abroad.

EFFECT ON INTERNATIONAL COMPETITIVENESS

Since its inception in the 1950s, both developed and developing countries have widely adopted the VAT. According to the International Monetary Fund, about 90 countries have adopted VATs. This includes all fifteen of the countries that make up the European Union and twenty-three of the twenty-five industrial nations that make up the Organization for Economic Cooperation and Development. The United States remains one of two Western industrialized countries without a national consumption tax. As a result, the United States relies more heavily on income and payroll taxes than most of its major trading partners. This puts United States companies and workers at a disadvantage as they attempt to compete in the ever expanding global marketplace.

The competitiveness of the United States would improve if a VAT replaced our corporate income tax. A VAT is "border adjusted," i.e., imposed on foreign imports while exempting United States exports. The principle is to impose the tax in the country where consumption of the goods or services takes place. Border tax adjustments are indirect taxes that are refundable under the General Agreement on Tariffs and Trade (GATT). A destination-based VAT with border tax adjustments provides a trade advantage over an origin-based VAT without a border tax adjustment.

Enacting a VAT in addition to our current income tax system would not create a trade advantage. However, if a VAT replaced the corporate income tax, the price of United States products could fall compared with foreign goods to the extent that the price le\ reflects the corporate income tax. If replacing the corporate income tax with a VAT low

the prices of American goods, then the United States trade balance would improve.

UNDERGROUND ECONOMY

Various estimates indicate that under our income tax system, lost revenue from the "underground economy" is as high as $200 billion annually. This is a significant revenue loss almost equal to the current federal budget deficit. An invoice-method VAT would go a long way toward taxing the underground economy as it would be more difficult to escape taxation. The invoice-method requirements of a VAT are necessary to ensure a high level of compliance, and thereby to address Chairman Archer's concern with the underground economy.

UTILITY ISSUES

The interaction of a VAT with state ratemaking raises issues for the electric utility industry. The "revenue requirement" of an electric utility includes its tax liability and is in principle recovered through the ratemaking process. State gross receipts taxes, state franchise taxes, and federal income taxes are all liabilities included in a utility's revenue requirements. A sales tax is not part of the revenue requirement. Utilities cannot automatically adjust rates to reflect changes in such taxes since these changes require approval of regulatory authorities. By contrast, a sales tax is generally a liability of the consumer with utilities serving solely as collection agents for the government. Consequently, utility bills automatically reflect a sales tax.

Treatment of a VAT for ratemaking purposes should ensure that the ultimate consumer of electricity bears the cost. However, the design of a VAT raises several issues. The design of a VAT could be such that utilities are simply collection agents. This is how the House drafted the proposed BTU tax in its version of the Omnibus Budget Reconciliation Act of 1993. An invoice-method VAT is a liability of the ultimate customer and would be collected and remitted by the utility. It would not be part of the utility's revenue requirements. Instead, the VAT would be a separate calculation outside the ratemaking process.

Alternatively, the design of a VAT could designate the seller as the taxpayer. Such a design would create regulatory problems for the utility. For example, under a subtraction method VAT, such as the USA business tax, utilities likely would be required to obtain regulatory approval in order to include VAT amounts in rates.

TRANSITIONAL RULES

EEI realizes that the implementation of any alternative tax system will require complicated transitional rules. Our current income tax system requires the depreciation of capital expenditures over varying lives and provides for limits on the use of credits and losses. Any alternative tax system should provide corporations with an ability to amortize their remaining tax bases in capital assets, use any tax credits qualified under existing law, and utilize any unused net operating losses.

CONCLUSION

EEI recommends that this Committee adopt a position supporting an invoice-method VAT as a replacement for our current federal income tax system and establish as its number one priority, its implementation. **EEI believes that implementation of a VAT should only be adopted as a replacement for our current income tax system and not as a means to generate additional revenue.** Additionally, EEI believes that a VAT should tax all business consistently. We thank the Committee for the opportunity to present our views, and we look forward to working with you in the future on this proposal and other important matters.

Comments for the Record
In Connection with Hearings on Replacement of the Federal Income Tax
June 6 through June 8, 1995

By R. Randall Capps
Federal Tax Director and Assistant Treasurer
EDS

On behalf of EDS, I would like to compliment Chairman Archer and the Committee on Ways and Means on the committee's effort to find ways to make the federal tax system more simple and to reduce negative effects of the current system on the economy. EDS believes that it is good to review possible alternatives to the current system and would like to be a constructive participant in efforts to improve or replace the current process. I would, however, like to raise a word of caution with regard to some of the proposals under consideration which could, as currently structured, pose serious problems for the information technology industry in particular and for U.S. workers and the economy as a whole.

Several options under consideration would employ a subtraction type VAT structure as the principal vehicle of taxation or as the principal vehicle of taxation applied to business income. The most detailed of these is, perhaps, the USA Tax Act of 1995 (the "USA tax") proposed by Senators Pete Domenici (R-N.M.) and Sam Nunn (D-Ga.).

Under the USA tax, capital expenditures and expenditures for equipment would be fully deductible but deductions for wages and employee benefits would be eliminated. The loss of the deduction for wages and benefits would be partially offset by a reduction in the corporate tax rate and a credit for payroll taxes. However, the resulting tax increase would still be dramatic for companies in labor intensive industries, particularly those high growth, high wage industries such as information technology services which are the engines of economic growth and high wage employment for the future. It is probable that the tax burden of many high technology companies would rise by as much as 50 percent.

In addition, under the USA tax proposal, wages would be taxed twice, once at the corporate level and once at the individual level. In the case of a pure subtraction VAT, the double taxation of wages would be eliminated, but the burden on labor intensive companies would be even greater because the corporate tax rate would have to be much higher under a pure subtraction VAT system. While such systems are typically regarded as "consumption" taxes, it is important to note that a subtraction VAT is in essence a tax on payroll.

There are a number of problems that could arise from these systems. Because wages and benefits are not deductible and the costs of plant and equipment are immediately deductible, the systems dramatically increase the costs of labor in comparison with the costs of equipment. Thus, industries that are heavily dependent on the contributions of individual workers would be disadvantaged, especially those industries that employ highly skilled workers and pay good salaries and provide good benefits. In addition, these systems would encourage companies to replace workers with technology, because the costs of labor would be artificially high in comparison with the cost of machines. Finally, the systems would provide an incentive to locate labor intensive work outside the United States.

As mentioned earlier, the Domenici-Nunn proposal attempts to mitigate the negative effect on labor intensive industries by allowing a payroll tax credit and reducing the corporate tax rate to 11 percent. However, even a 7.65 percent payroll tax credit will not offset the 11 percent coporate tax with respect to low and middle income workers, and it provides no offset whatsoever with respect to benefits or to wages that exceed the Social Security cutoff. Moreover, there is a strong tendency for tax rates to increase over time, and there is little likelihood that the credit would increase proportionately.

We realize that the discussion of alternative systems is in a very early stage, and we would very much like to continue to be a part of that discussion. We hope that any system that is adopted will not have a disproportionate affect on labor intensive industries, particularly those industries where the United States is a world leader. I would be happy to provide additional information on the effects of various proposals on our industry as the discussions progress.

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11 June 1995

Mr. Philip D. Mosely
Chief of Staff
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Mosely:

This past week the House Committee on Ways & Means, chaired by Representative Bill Archer, held hearings about overhauling the collection of taxes by the Federal government.

I am writing to share my preference with the Committee as to what I would like to see replace the current Federal income tax system. ***I favor the imposition of a national sales tax***, collected by the individual states along with their own sales taxes, ***in place of the current system***, for several reasons. Here are five:

- **INCREASE COMPLIANCE RATE:** I understand that there is something like a 98% compliance rate here in Texas for the collection of sales taxes. I understand that the compliance rate for Federal income tax is *much* lower. A national sales tax will be fairer.
- **ENCOURAGE SAVINGS AND INVESTMENT:** Income-tax payers are penalized for saving and investing. Sales-tax payers are rewarded for these activities. A national sales tax should lead to greater financial security for individuals and the country.
- **REVEAL CURRENTLY HIDDEN TAXES:** Our current system prevents consumers from seeing what fraction of what they pay for goods and services goes to the Federal government in the form of taxes. A national sales-tax system would make those taxes obvious. This should make the Federal government more accountable.
- **ELIMINATE MOST COMPLIANCE EXPENSES:** Various groups estimate that we spend billions of dollars annually to comply with the current system. A national sales-tax system should eliminate these expenses and add only fractionally to the sales-tax compliance expenses required to make *state* sales-tax payments. This should save billions annually.
- **INCREASE PEACE OF MIND:** The current system strikes fear in the hearts of taxpayers, most of whom honestly file their returns but fear being audited by the IRS. A national sales-tax system will eliminate fear of audits, which has an immeasurable but definitely negative effect of the nation's productivity.

Recognizing that everyone has basic expenses, some would argue that food and housing be exempt from a national sales tax. After all, even the poorest in this country must buy food and housing. However, I tend to favor ***NO exemptions*** for any product or service, including food or housing, because I believe that exemptions, exceptions, etc., are ***a corrupting influence***.

Instead, I favor vouchers being included in the system. A voucher would be sent to each American each month. This would be financially equivalent to what we have now: an income level below which we do not charge taxes.

Sincerely,

Kirk Mahoney

Kirk Mahoney, Ph.D.
Owner

June 06, 1995

Philip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Richard C. Foreman
8835 Via Diego Lane
Lakeside, California 92040-5045

Hearings held June 6, June 7, and June 8, 1995-
Main Committee Hearing Room
1100 Longworth House Office Building

Distinguished Ladies and Gentlemen,

I would like to commend you on the task upon which you now embark. The income tax as it presently stands is an infringement upon the rights and freedoms of all Americans wether they are rich, poor, or "middle class". The income tax as it presently stands enslaves the rich into a lifestyle of deceit, enslaves the poor in their welfare prison, and enslaves the "middle class" into forced labor with both spouses finding it necessary to leave the home and find employment or live in abject poverty.

To state my views quickly let me just ask that you include the book "The Tax Racket: Government Extortion From A to Z" by Martin Gross, a name you should all be familiar with. I feel that the proposal for the "National Sales Tax " would serve our nation best, but only if the 16th Amendment is repealed, the Internal Revenue Service is abolished, and the IRC, and all regulations promulgated by this agency, be incinerated. Pardon my over-zealousness.

I thank you again.

Richard C. Foreman

Philip Mosley - Chief of Staff
House Committee on Ways and Means
US House of Representatives
1102 Longworth House
Washington D.C. 20515

June 7, 1995

Dear Sirs:

I am in favor of a retail consumption tax **if the sixteenth amendment is repealed**.

If you would eliminate income taxation and all the monitoring and compliance infrastructure necessary to enforce it; you would not only save a great deal of money on these unnecessary functions, but **you would restore hope to the nation**.

You would see the floodgates of productivity and creativity burst open in this nation once again. You would see people anxious to work because **they would keep what they earned**. They wouldn't have to be afraid anymore.

They wouldn't fear that they had inadvertently violated one of the thousands and thousands of petty bureaucratic rules. They wouldn't have to submit to the **unconscionable TCMP anal exams of the IRS**.

When I first heard that there would be open hearings on possible replacement of the income tax my heart rejoiced. I never dreamed the possibility existed that in my lifetime that any elected representatives would ever seriously consider reversing the totalitarian trends of the late twentieth century. Please restore the equal standing of all men before the law; everyone should pay the same thing. The government's proper role is to provide justice for its citizens. Remember, **Fairness is the enemy of justice**.

Steven R. Friedrich
5661-A Gold Hill Road
Placerville, CA 95667-9434
(916) 642-8731

Tax Reform
House Ways and Means Committee
Longworth Building
Washington, D.C. 20515

June 13, 1995

Dear Legislators:

Following are recommendations for Tax Reform:

1. Balanced budget amendment.
2. Repeal the XVI Amendment.
3. Abolish the IRS.
4. Establish a ten percent (10%) tax on commodity purchases, proceeds of which may be used to operate Federal Government within bounds of Constitution, except in case of war declared by Congress.
5. Voluntary tax:
   50% for federal senators, divided equally.
   25% for representative;
   25% as designated by citizen.

With kind regards and best wishes for your success in this endeavor.

Johana Moon Garrison
260 Butte Drive
Baywood Park, CA 93402
(805) 528-8720

5621 Charlotte Way, #31
Livermore, California 94550
June 15, 1995

Phil Mosely
Chief of Staff
Committee on Ways and Means
1102 Longworth Office Building
Washington, D. C. 20515

Dear Mr. Mosely:

A tax on income discourages wealth creation and savings. When applied to business, it encourages debt and discourages the accumulation of equity. Also, the additonal record-keeping required of businesses amounts to a hidden tax in itself.

The present system requires the intrusion of a bureaucracy into the lives of citizens. To make things worse, the IRS is largely exempt from the requirements of due process.

I believe that either a flat tax or a consumption tax would be an improvement on the present system.

Sincerely yours,

Michael E. Goldsby

Sidney J. Gutting, DC
947 Central Avenue
Louisville, Kentucky 40208-1213
May 29, 1995

House Ways & Means Committee
ATTN: Phillip Mosley
Longworth House
Washington, DC 20515

Dear Representative,

This letter is being sent and is to be read before the House Ways and Means Committee on Tax Reform scheduled for June 6,7, & 8. I feel that it is imperative that my view be expressed concerning the following issues or areas of interest.

Personal exemption in respect to taxes should be raised to about $12,000 or more before being taxed. We pay taxes on items as we buy them with the money that is income that we are taxed on before we receive it, whether salary or wages. Sounds like double taxation. Though one of the following examples is more of a state level issue, many similiar situations exist in Federal Government: In my family I pay a tax for schools and have no say in their running because I have no children attending those schools - I have no children in private schools - I have NO CHILDREN, but pay taxes for public education. Federal level might be the Food Program, I pay for food for children and I have nc children, I also pay for many children's programs in welfare, but I have no children. Additionally the Federal Programs do not recognize me as a professional - I am a Chiropractor, a professional in the medical community that is ignored as a recognizable appropriate care within Federal Employee and Care Programs. These examples sound like examples of taxation without representation both at State and Federal levels.

The above and the fact that the Revinue Act of 1862 is antiquated and needs to be not only reviewed but updated to today, rather than war time, are reasons that support a flat tax. If everyone paid taxes - the same reasonable amount (approximately 8%) - on items purchased then it would ensure that no one "got away" from paying their faire share and would dramatically simplify filing of taxes. The process of filing taxes has gotten so involved and complicated that a person almost needs to be a CPA to begin the process of calculating and completing the forms.

Also, one issue that needs to be addressed by all is the fact that taxes began as a temporary, voluntary act that would help the country, therefore we had no true liability to pay. Now do not get me wrong I love my country and the freedoms that exist, I only want to see the original intent of the founding of this great country continue rather than it becoming as the Soviet, Communist communities (which by the way have FAILED!! Socialism does not work). As time has gone by the areas that are being "helped", however, has increased to such an extent that the cooperative volunteers of this country

are being victimized - raped, if you will, by their own government. A government that is increasingly endeavoring to control and overpower it's constituency.

Another example of this power would be, the priveledge that IRS has to seize assets before wrong doing has been established. I personally have been on the other end of IRS erroneously claiming a debt. One year they claimed that I owed about $200.00 more in taxes due to an addition error. Outcome, I did not owe this - there was an addition error, but on their part. The very next year they claimed I owed about $266.00, rather than research it (there did exist a remote possibility I could have made an error and owe some) I sent a check for the full amount. About four to six months later, they were penalizing me $5.00 for not signing?? a form that I had made a copy of and returned to them. They threatened all types of repercutions if I failed to pay this $5.00 over something I had signed, dated, made copies of (why would I do this and not return the form?), and returned; they could not find the original so acused us of not following their directions. The letter they sent us was not very polite or consideration given to the fact that they might have been in error. Then when we called, they wanted us to send a letter, copies of items, etc. and request that this $5.00 be corrected, they claimed that they could not correct this charge without additional paperwork! This amount of money may seem small BUT similiar situations could and have occured with larger sums involved and no reacquition of losses (personal properties) were able to be recognized.

There has also been a discussion of a change in the tax programs to change inheratence taxes. Think for a moment, many parents strive all their lives just to help their children have a better life; now the government is wanting to take more of this away from people. Where is the encentive in this country anylonger to prosper, even slightly - answer is there is none. If we are honest, we know already that by the time I am old enough to draw social security it will probably be non-existent. Example of a tax that was established, misused, and this one no one was ever given the opportunity to not participate. It was mandated that we all pay into this program. Had we, the hard working people of this country trying to make a living for ourselves and families, been given the option to invest these monies rather than loose them, there would be little to no need for social security.

The waste, misuse, opression must stop. I work often six days a week just to make ends meet, my wife works with me and works numerous additional weekends, and you want more of me? This is no longer the country our forefathers faught and died for, it has become what they fled.

Sincerely,

Sidney J. Gutting, DC

Sidney J. Gutting, DC

Sandy Harper
20 Corte Almaden
San Rafael, CA 94903'
June 11, 1995

P.D. Moseley
Ways and Means Committee
U.S. House of Representatives
Longworth Building
Washington, D.C. 20515

Re: Review of U.S. Tax Policies

Dear Mr. Moseley:

I believe that your committee is planning on studying the revision of our tax policy. Hurrah! We have long needed to have our elected officials listen to our voices and make some significant changes in this antiquated tax system. Under the Internal Revenue Service we have watched the system become a monster without a master who has been left to run amuck. There is no need for such a complicated tax system paying for who knows what.

I would like to see a flat tax or a national sales tax type alternative to the system now in place. It is outrageous to have to hire a tax accountant to file taxes. Please look at simplifying our tax laws so this task will evenly distribute the tax burden and at the same time make the yearly reporting to be done on one page without the assistance of an accountant.

I have found the tax laws to be encumbering and discouraging. Our country was founded with the idea that a person could strive to get ahead with hard work and an entrepreneurial spirit. Because of the tax system that we now live under that is rarely possible.

My request to you is to simplify, grow government smaller and distribute the tax burden more evenly.

Sincerely,

Sherry Harper
20 Corte Almaden
San Rafael, CA 94903
June 11, 1995

P.D. Moseley
Ways and Means Committee
U.S. House of Representatives
Longworth Building
Washington D.C. 20515

Re: Review of U.S. Tax Policies

Dear Mr. Moseley:

I understand that your committee is beginning a study to revise the current tax policy. I am thrilled that this has finally reached a place of priority with our elected officials. I am in favor of any kind of revision to our tax laws that will finally bring some relief to the citizens of this country. We have become so controlled and bogged down by the current system of tax laws and have grown to dread anything that has the Internal Revenue Service insignia stamped on it. I would favor a flat tax or some form of national sales tax to simplify our system and balance the taxation to be evenly distributed among our citizenry.

At my birth in the mid 1940's the tax laws asked for less than 15% of a person's income and still provided the basics necessary to run this great country. Since then we have witnessed the growth of "Big Government" to a place where an average middle income person (such as my parents were) being saddled with outrageous taxes. These undue taxes all but bring our free enterprise system to a screeching halt since it discourages the "American Dream" to get ahead and succeed. There is no incentive to grow a business or reach higher if it only creates more taxation and regulation. This, I believe will eventually kill our great country.

Please study the tax laws carefully and simplify. The smaller we can make the regulatory system (especially the I.R.S.) the better. It is absolutely ludicrous that it takes a tax accountant to file our yearly tax reports. Bring this down to a single page and we will all be better off.

I will be anxiously awaiting a new tax program. Thanks for giving this matter your time and energy.

Sincerely,

Sherry Harper

6-7-95

S Haxby
327 E Pearson Ave Apt 1
Anaheim, CA 92802-4334

Phil Moseley
Chief of Staff
Ways and Means Committee
House of Representatives Office 1102
Washington D.C.

Dear Sir,
As a Sr citizen I believe that the new tax structure being considered should be looked at in the form of a consumption tax. I cannot have to pay any tax on things I didn't buy, therefore if I had any money I could save it to help feed me. I do not think clothing, food and medicine should be taxed for these are things one can not exist without. Anything else should be tax at consumption as is GASOLINE! Also as state sales tax at present.
It's about time the I.R.S. which has become the American form of a "GISTAPO" is stopped!!
Sincerely
Susan Haxby.
Add this to my friends letter.

Helming
Consulting Services, Inc.

June 8, 1995

Congressman Bill Archer
House of Representatives
Washington, D.C. 20515

Chairman Archer:

I respectfully request that the attached income tax reform proposal be made part of the record for the hearings on tax reform held June 6, 7, 8, 1995.

The consumption tax proposal I am advancing is the subject of my upcoming book. The proposal calls for the complete elimination of the current income tax system. Eliminated also would be all other taxes on income, such as taxes on capital gains, inheritance, gifts, and profits. Taking the place of all federal taxes would be a 4-level, point of sale, consumption tax. At each point of sale the rate of tax collected would range between 1.5 and 10 percent. The plan, as proposed, would generate approximately 1.3 trillion dollars annually.

This plan is inherently less regressive by its design. The necessities of life such as food, housing and medical needs are either not taxed or are taxed at a low rate. Those who have more money to spend over and above the necessities will be paying more in taxes.

But perhaps the most appealing feature of this plan that contributes toward non-regressivity is that wealthy businesses and wealthier individuals will pay much more in taxes than ever before while they have the ability to make more money than ever before.

The elimination of the tax on capital gains and profits will generate more activity of the buying and selling of companies, real estate, and other assets because there will be the opportunity to make more money on appreciation, expansion and success. On the front side of the transaction, before new profits and appreciation, the tax is collected. This will be a high source of Federal revenue that will greatly broaden the tax base and reduce regressivity.

In my opinion, this plan could be put into effect without a lengthy transition period. In fact, the Social Security and Medicare structure for raising revenues is the only area I see as needing transition time which I have accounted for in my plan.

7917 Bond
Lenexa, KS 66214-9866
Phone: (913) 492-3330
Fax: (913) 492-6229

I also do not believe that there would be a catastrophic affect, as some have stated, to the domestic or international markets. To the contrary. I believe taking this bold and aggressive action will send the long-awaited message to the world that we are taking control of our economic destiny to remain the leading world economic power. Further, I believe that the rest of the world will eventually follow our lead and convert their own beleaguered tax systems to consumption based systems.

In addition, I do not believe that converting to this system will create any long-term inflationary pressures. At this point in our economic cycle, the consumer simply cannot afford higher prices. Therefore business will not be successful in passing on 100% of the tax. Business will absorb part of the cost in order to stay competitive.

It should be noted that I have been researching and developing this plan for well over ten years. And, I have been publicly speaking to thousands of people and writing about this subject since 1987.

I am an economist residing in the Kansas City area. I have owned my own consulting business for 22 years. My economic forecasting expertise includes the world and U.S. general economy and the world and U.S. agriculture and food economy. I have an excellent track record and reputation for identifying long-term economic trends.

Two individuals who have encouraged me to submit my plan to you include: James Powell, Texas rancher and businessman. Telephone: (915) 653-1688 and Bill Holubec, Certified Financial Planner, San Angelo, Texas Telephone: (915) 942-9932.

Congressman Archer, I concur with you completely on your assessment that a complete replacement for the income tax system is necessary. Furthermore, I also agree that while a flat tax may be a short-term improvement over the current system, it is by no means the longer term solution for all of the reasons you have publicly stated. The case for a consumption tax is so compelling for the long-term health of our economy, it must be bolstered and advanced so that the general public can understand the concept and recognize it as being a credible solution.

I firmly believe that, because of where we are in the long-term 50-65 year economic business cycle, an income tax replacement is eminent. Our economy has been disinflating since 1981 and these deflationary forces will continue to force down real wages, for another 10-15 years. Contrary to popular opinion, I believe this deflationary cycle will run its course forcing the U.S. and the rest of the world to lower prices and increase value in order to increase savings and reduce debt. Therefore, regardless of political philosophy and Federal Reserve policy, the economy will force the necessary changes which ultimately will include creating a way for people to keep more of their income in order to maintain an acceptable standard of living, borrow less and save more.

As I have stated, I have talked to thousands of people over the years about the concept of a national consumption tax. Ten years ago, my audience would say "sounds good, but it will never happen". Now the overwhelming reaction is "how can we get it done." My response to these reactions has remained the same over the years. That is, when there is pain there is gain. When the choices where to cut the budget become more painful and when economic reality sets in, then the climate will be conducive for change. Without a doubt, I believe we are approaching that time of economic reality.

I would very much appreciate the opportunity to discuss my plan with you further. I am confident that I could contribute greatly to the development, formulation and presentation of a consumption tax plan that the American people could understand and embrace.

Sincerely,

Bill Helming
Economist and Consultant

Encls.
BH:es

Executive Summary

Of

A Proposed New National Consumption Tax System For The United States

For

Congressman Bill Archer
Chairman

House Ways And Means Committee
U.S. House Of Representatives
Washington, D.C. 20515

Prepared By

Bill Helming
Economist, Consultant, and Financial Advisor

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June 8, 1995

Helming
Consulting Services, Inc.

KEY ELEMENTS OF THE PROPOSED NATIONAL CONSUMPTION TAX SYSTEM

A. **Would Completely Replace the Present Federal Government Tax System** - This national consumption tax system would replace all present federal government taxes, including the complete personal income tax, the taxation of business and corporate profits (including those of self-employed persons), the taxation of interest income and dividends, the taxation of capital gains, and the taxation of estates, gift, and inheritance, plus the present national sales taxes on such items as gasoline, diesel fuel, alcohol, and tobacco products. The only exception is the overall social security system, wherein all employees under this new tax system would pay a **5%** social security tax, all employers would pay a **5%** social security tax, and all self-employed persons would pay a **10%** social security tax. All remaining money required to adequately fund the total social security tax system would come from the tax revenues generated from the proposed national consumption tax system.

B. **The Present Tax System Is Counterproductive and Is Complicated** - The present U.S. federal government tax system penalizes and/or discourages hard work, self-initiative, creativity, innovation, improving productivity, savings, new investment, economic growth, new job creation, and the creation of new wealth. Taxing consumption will have just the opposite affect and will send all the right and desirable signals for America, plus helping the U.S. become more competitive in global trade and will significantly enhance our U.S. level of total exports in the future. The present U.S. tax system and code is far too complicated, costly, and time-consuming for consumers, families, businesses, and for the government.

Finally, the present U.S. tax base is far too narrow, unfair and it is **not** equitable. As a result, tax rates are far higher than they should be and what is necessary. It is very important to no longer tax income and wages.

C. **Specific Categories that Will Not be Taxed** - Following below are the specific items that will **not** be taxed under the proposed national consumption tax system:

1. All wages, personal income of all kinds, and business/corporate profits.

2. All interest income, dividends, and capital gains.

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Phone: (913) 492-3330
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3. All gifts, donations, estates, and inheritance.

4. All debt service payments for interest and principal, including apartment/condominium payments and rent, and all home mortgage payments.

5. All life, health, property damage and liability insurance premiums.

6. All education, job training, and child care expenses incurred by individuals and families.

7. All savings accounts and plans, all investments in stock and bonds, all monies in retirements plans and all cash.

8. All wages, salaries, bonuses, retirement contributions and all deferred income payments and profit sharing by businesses and corporations.

9. All insurance premiums for workers compensation, liability, property damage, and company paid health care premiums.

10. All debt service payments for principal and interest made by business and corporations.

11. All company working capital, cash equity, and retained earnings.

12. All business and corporate employee training, education, and child care expenses.

D. **What Will Be Taxed, How, and By Whom** - Except for the specific items mentioned in Part C above, all products, goods, commodities, raw materials, equipment, machinery, tools, vehicles, trucks, real estate and businesses of all kinds, all exports, and all services will be taxed when there is a sale, purchase and/or trade involving the above items. The consumption tax will always be paid by the buyer and collected by the seller, regardless of whether that involves individuals, families, businesses and corporations, organizations and institutions, churches, government entities, and many other examples.

This proposed and recommended national consumption tax system will have four specific tax levels and tax rates. These four tax levels and rates are summarized below.

Level 1 - The Level 1 tax rate is **1.5%**. This level and tax rate applies to all raw materials,

commodities, mining, fishing, oil and gas drilling and development, forestry, all farming and agricultural production, all manufacturing, all construction of all kinds, and to all wholesale businesses. All services purchased by these businesses and operations in this category will also be taxed at the same **1.5%** rate. These are typically businesses that add value. We have assumed that on the average the added value process is a multiple of 5. Therefore, the accumulative tax for this key sector of the U.S. economy is **7.5%** in total. For integrated companies or businesses, the consumption tax would be **4%**.

Level 2 - The Level 2 tax rate is **3.0%**. This level and tax rate applies to all actual food expenditures for the at-home or away-from-home consumption and services, not including alcohol or tobacco products, plus all prescription medicines, doctors fees, and hospital and medical expenses, supplies, and services of all kinds. These two key categories are taxed at a very low level to allow for the fact that food and medical services expenditures are a necessity for all persons, including those with low or modest income levels.

Level 3 - The Level 3 tax rate is **5.0%**. This level and tax rate applies to all actual purchases of all real estate and private and publicly owned businesses of all kinds, throughout the United States. For example, this includes all purchases of farm and ranch real estate, existing and new home real estate, apartment and condominium real estate, all commercial, industrial, wholesale, and retail real estate properties, and all hotel, motel, resort, golf course, sports complexes, amusement parks, entertainment and all other kinds and types of real estate that are purchased and sold in the United States.

The Level 3 tax category and **5.0%** tax rate also applies to all private and publicly owned businesses and/or fixed assets that are purchased and/or traded in the United States. All company stock purchases that amount to **10%** or more of the total company stock and value of the private and/or publicly owned companies shall be subject to the **5%** tax paid by the buyer and collected by the seller.

Level 4 - The Level 4 tax rate is **10.0%**. This level and tax rate applies to all actual purchases by individuals, businesses, organizations, institutions, and government agencies, of all products, goods, vehicles, equipment, machinery, supplies and services of all kinds by consumers, families, and businesses at the retail and finished consumer-ready level.. There are numerous examples of items that would fall into this category. A few examples would be automobiles, movie tickets, the dry cleaners, utility bills, consumer hardware supplies, soap and toilet paper, legal fees, gasoline, and thousands of other examples.

Chart 1 summarizes the 4 consumption tax levels that range from **a 1.5% to a 10.0%** tax

rate for individuals, families and self-employed wage and income earners. Chart 2 summarizes the 4 consumption tax levels that range from **a 1.5% to a 10.0%** tax rate for all businesses, corporations, institutions, and organizations in the United States.

Chart 3 shows the comparison of the 1994 tax rates on income for individuals, couples, families, and self-employed persons vs. Bill Helming's proposed national consumption tax. The present tax rate is **20 to 38 percent** vs. a consumption tax rate of **1.5 to 10.0 percent**. Chart 4 shows the comparison of the 1994 tax rates on profits for corporations, companies, businesses, organizations, and institutions vs. Bill Helming's proposed national consumption tax. The present tax rate for businesses is **15 to 34 percent** vs. a consumption tax rate of **1.5 to 10.0 percent**.

E. **Total Taxes Collected Under the Proposed National Consumption Tax System** - For the year 1994, the total federal government tax revenues would have been at least **1.3 trillion dollars** as shown in Chart 5. The total taxes collected by the federal government in 1994 (period ending on September 30, 1994) was **1.257 trillion dollars** under the present federal government tax system. The total net consumption expenditures (purchases) for 1994 were at least **14.0 trillion dollars** under my 4 level consumption tax plan. As noted in Chart 5, the total consumption tax revenues for 1994 would have been **1.049 trillion dollars** and the 10% total social security tax would have generated and additional **251 billion dollars**. Therefore, the total taxes generated by the proposed new national consumption tax plan and the 10% social security tax would have generated at least **1.3 trillion dollars** in total federal government tax revenues for 1994.

As the U.S. economy grows, total tax revenues increase. Over the span of any given ten year time period, the realistic average annual rate of growth for the overall U.S. economy and for federal government tax revenues would be **2.4%** per year. Therefore, total tax revenues under this new federal government tax plan and system would be at least **1.333 trillion dollars** for the year 1995 or would increase between about **33 to 40 billion dollars** per year. Obviously, the rate of increase in total annual federal government spending should not exceed more than **2.4%** per year.

F. **The Role of the IRS Would Dramatically Change** - Under this proposed national consumption tax system and plan, there would no longer be any personal, business, and corporate tax returns filed, no deductions, no depreciation schedules no non-profit status organizations and institutions from an IRS standpoint. The time, cost, and people involved relative to complying with the consumption tax system would be reduced by at least **80%** compared to the present federal government tax system. This by itself will be a great benefit for consumers, families, businesses, and will save billions of dollars.

The national consumption tax system will dramatically simplify the present tax system. The future role of the IRS under this proposed national consumption tax system will be to monitor the tax collection system. Under this proposal, all taxes would be collected by the seller of all commodities, products, goods, vehicles, equipment, machinery, tools, businesses, real estate, and services for Levels 1, 2, 3, and 4, and paid for by the buyer at the time and point of purchase. They will then complete a very simple IRS one-page form showing and documenting all purchases and sales, and send such documentation along with a check to the IRS in a timely manner. These will primarily be businesses of all different kinds, public and private, large and small.

G. **Major Benefits of the National Consumption Tax System** - Following below is listing of the major benefits of the federal government national consumption tax system that I am proposing:

1. The most fundamental and greatest benefit of the proposed national consumption tax system is that it would finally give the power of taxation to the American people. Simply stated, when Americans chose to save and/or invest a portion of their money, they wold not be taxed at all. When Americans decided to spend their money and therefore purchase all sorts of products, goods, equipment, vehicles, machinery, services, real estate, businesses, etc., they will then pay a Level 1, 2, 3, or 4 consumption tax, whichever applies.

Bottom line, under this proposed national consumption tax system, Americans will have a choice, as shown in Chart 6. This will go a long way toward many more Americans being able to improve their standard of living and to realistically achieve the "American Dream". Under the present federal government tax system, we have no choice as shown in Chart 7. This represents a huge and very important difference. Many people in government want to foster growth in government bureaucracy and socialism and the present tax system gives them that power. Remember, the power to tax is also the power to destroy and to control the lives of individual people.

2. Will greatly encourage hard work, private initiative, improved productivity, increased savings, and lower interest rates, as shown in Chart 8.

3. Will greatly improve investment, economic growth, and new job creation. For example, it will result in the U.S. economy growing at least 35% more than under the present tax system that taxes wages, incomes, profits, interest income, dividends, estates, capital gains, etc. This is well illustrated in Charts 9 and 10.

4. Will greatly encourage and increase the rate of growth in the creation of new wealth, new business and small business formation, increased wages and incomes, and new job opportunities for employees and for the self-employed people in America.

5. It will very realistically give more Americans the opportunity to actually improve their standard of living. This represents a major benefit and win-win change for all aspects for our economic, social, and political structure in America, as shown in Chart 11.

6. Will greatly encourage people in America to take more responsibility for themselves and thereby become less dependent on government and others for help and survival. It will foster and encourage more compassionate capitalism, free enterprise, and entrepreneurship, and it will discourage socialism, bigger and more expensive government, higher taxes, and government control of the lives of the American people.

7. It will dramatically lower tax rates and will sharply reduce the amount of taxes now being paid by many of those who now pay taxes in the United States. It will greatly broaden the tax base. It will force the underground, drug and other cash transaction portions of our total U.S. economy to finally start paying their fair share of taxes. Today there is at least one trillion dollars per year that never gets taxed because of the nature of the present tax system. The national consumption tax system would be much more fair, equitable, and simple, compared to the present tax system.

8. Regressivity is reduced because wealthy businesses and individuals will be paying more taxes than ever before. This is made possible by increased business investment and activity because there no longer is a tax on profits, capital gains, and inheritance. Therefore, businesses and individuals will also have the ability and opportunity to make more money than ever before.

Regressivity is also greatly reduced by the necessities of life, such as food, housing and medical expenses being either taxed at a very low rate or not taxed at all. This is made possible because of the much broader tax base as a result of the proposed national consumption tax system.

9. Combines the best and different aspects of (a) a national value-added tax (VAT), (b) a national sales tax, and (c) a national consumption tax.

10. Allows time for Social Security and Medicare program reforms. The consumption tax plan as proposed leaves the existing structure for raising revenues partially in place to allow the time necessary to reform the Social Security/Medicare program. Should Social

Security/Medicare become a "means tested" program for future generations, the Social Security/Medicare payroll deduction could be completely eliminated and the program would be entirely funded by the consumption tax.

11. It would dismantle the IRS as we know it. Most Americans would welcome and applaud a substantially reduced IRS involvement in their lives and business activities.

12. It would be bullish for the U.S. financial markets, including the stock and bond markets, and would also help improve the U.S. trade balance and be supportive for the U.S. dollar. This plan, along with Congress following through on significantly reducing federal government spending, will truly be bullish for America and our economy over the next 10 years and beyond. It also establishes an excellent blueprint for all state and local governments adopting a similar tax plan.

Chart 1

National Consumption Tax Rates For Goods and Services Purchased at Levels 1, 2, 3, and 4

For single people, families, couples and self-employed wage and income earners.

Goods and Services Tax Levels	Gross Tax Rates
Level 1	1.5%
Level 2	3.0%
Level 3	5.0%
Level 4	10.0%

Level 1 = All purchases of production, manufacturing, construction, wholesale, value-added process and services prior to the retail sale.
Level 2 = All purchases of food, medical, hospital, doctor and prescribed medicines.
Level 3 = All purchases of all public and private businesses and all types of commercial, industrial, retail and residential real estate.
Level 4 = All other purchases of goods and services at the retail level.

Chart 2

National Consumption Tax Rates For Goods and Services Purchased at Levels 1, 2, 3, and 4

For businesses, companies, corporations, institutions, and organizations.

Goods and Services Tax Levels	Gross Tax Rates
Level 1	1.5%
Level 2	3.0%
Level 3	5.0%
Level 4	10.0%

Level 1 = All purchases of production, manufacturing, construction, wholesale, value-added process and services prior to the retail sale.
Level 2 = All purchases of food, medical, hospital, doctor and prescribed medicines.
Level 3 = All purchases of all public and private businesses and all types of commercial, industrial, retail and residential real estate.
Level 4 = All other purchases of goods and services at the retail level.

Chart 3

The Federal Government Income Tax System vs. Helming's National Consumption Tax

Tax Rates On Income VS. Tax Rates on Consumption For Individuals, Couples, Families and Self-Employed

1994 Income Tax 1/	Helming's Proposed Consumption Tax
20% to 38%	1.5% to 10.0%

1/ Estimated by Meara, King & Co., CPA, Kansas City, MO.

Chart 4

The Federal Government Income Tax System vs. Helming's National Consumption Tax

Tax Rates on Profits VS. Tax Rates on Consumption for Companies, Businesses, Corporations, Organizations and Institutions.

1994 Income Tax 1/	Helming's Proposed Consumption Tax
15% to 34%	1.5% to 10.0%

1/ Estimated by Meara, King & Co., CPA, Kansas City, MO.

Chart 5

Estimated Total Consumption and Tax Revenues using 1994 as an example

Levels 1, 2, 3, and 4 Combined

Total Net Consumption	Total Tax Revenues Generated 1/
$14.0 Trillion	**$1.3 Trillion Dollars**

1/ Includes the $1.049 trillion generated from the Level 1, 2, 3, and 4 **National Consumption Tax**, plus $251 billion generated from the Social Security/Medicare tax, with 5% paid by employees, 5% paid by employers, and 10% paid by the self-employed. The remaining 5.3% Social Security/Medicare tax, or $129 billion, is funded by and is a part of the $1.049 trillion **National Consumption Tax** for 1994. The total Social Security tax in 1994 was about $380 billion.

Chart 6

Under my proposed national consumption tax system, American's will decide how and when to spend, save, or invest their money

Before

"Uncle Sam" receives his tax revenues!

We Will Have A Choice Under The National Consumption Tax System!

Chart 7

Under today's federal Government tax system, Americans decide how and when to spend, save or invest their money

After

"Uncle Sam" takes 20% to 38% off the top!

We Have No Choice Under The Present Tax System!

Chart 8

Taxing Personal Income Is Wrong and Counterproductive For These Reasons:

1. Salaries and bonuses, after taxes, result in less take-home pay.

2. With an annual salary of $70,000 for a two-income family, total federal, state and local taxes account for 40%. The total taxes paid are $28,000. This leaves $42,000 for living expenses.

3. As taxes go up, savings and investments go down.

4. The incentive to work harder, to be more productive, innovative and creative is reduced.

5. Moderates economic growth and consumer spending, reduces the standard of living, and encourages companies to substitute capital for labor.

Chart 9

Taxing Business and Corporation Profits Is Wrong and Counterproductive For These Reasons:

1. Taxing business profits between 15% and 34% contributes to lower wages, high layoffs and reduced job security, less investment by business, slower economic growth, and a reduced standard of living for at least 70% of Americans.

2. Not taxing business profits will typically result in higher wages, more new jobs, more investment by business, stronger economic growth, an improved competitive economic advantage in the global marketplace, and an improved standard of living for many more Americans.

Chart 10

Taxing Capital Gains Is Wrong and Counterproductive For These Reasons:

- Contributes to lower wages, less new business or existing business development and expansion, less business investment in fixed plant, capital and new technology and less business investment in employee education.

Not Taxing Capital Gains Will Result In:

- Higher wages, more business investment in capital and people, improved economic growth, improved economic advantage in the global marketplace and an improved standard of living for many more Americans.

Chart 11

The Single Greatest Challenge and Opportunity for the U.S. Economy

Decrease Socialism
and
Increase Capitalism

"More government and higher taxes is not the answer. The answer is more savings, more investment, improved economic and new job growth, higher wages and improved productivity, smaller government and reduced government spending, and lower taxes."

Bill Helming

2211-13th Ave. E., #103
Seattle, WA 98102
June 12, 1995

Dear Ways + Means Committee Members,

I understand you're in the process of looking at ways to change our existing tax system/structure. I applaud your willingness to examine this problem!

May I encourage you to support the consumption tax, instead of the flat tax? The problem I have with the flat tax is that it fails to eliminate the need for the IRS, which is one of the biggest reasons for revising the tax system in the first place. If the flat tax is based on annual gross income, the IRS will still want to invade people's privacy to make sure all their income is being reported. The invasion of a government agency into the private lives of it's citizens is unconstitutional and is exactly why we must change the tax system. Also, the cost of supporting such a system is tremendous, which is another good reason to eliminate the IRS.

I support a consumption tax, using rebates so there would be no additional tax burden on the poor. Basic necessities of life, such as food + housing, would be exempt. Such a system would be fair, easy to administer and would lead to the economic growth we need. A National Sales Tax would be collected by retailers at the time of sale and

would replace both the individual and corporate income taxes, as well as gift, estate and federal excise taxes. Forty-six states currently collect sales taxes.

Such a tax has many benefits. Here are some of the major advantages:

- Replacing the income tax, the national sales tax creates more than 1½ million new jobs
- Boosts economic growth by over 40% and makes the U.S. far more competitive on the international scene.
- It will help keep inflation down and put an average of $1,500 more money into the pockets of American workers after taxes.
- The US federal deficit would be 45% less than under the current tax system - a net reduction of over $3.5 trillion *

A National Sales Tax is impossible to hide from Americans - we will see it every time we make a purchase and we will feel the impact of the tax. This produces the level of public awareness that is needed to bring this country back to where the government provides the services to the people, visibly exchanging with those who support it in ways they can see and understand.

People will once again be rewarded for being responsible. They will receive the fruits of their labor for hard work and be encouraged to save. The economy will expand and prosper.

* See "The Impact of a National Sales Tax in the United States Economy" by Dr. John H. Quails.

The unfairness of a tax system, which double axes savings, will be replaced by a true reward for hard work and the kinds of activity which bring about economic growth and a higher standard of living for our children and us.

Also, the underground economy, with its drug dealers and organized crime, will finally be taxed when they buy their fancy cars, boats and jewelry. Recent estimates put this underground economy in excess of $900 billion per year. With the current system, we, the honest taxpayers, are now carrying this burden.

With the implementation of a consumption tax, we should repeal the 16th amendment which would no longer be necessary as Article I, section 8, of the constitution already gives Congress the power it needs.

Most Sincerely,

Paula B. Henderson

June 12, 95

Dear Mr. Mosley

We most certainly need to change our present tax system. The IRS has got to go! and never be revived, please!

I think a flat tax would be fair to all citizens, but I know several other plans are being studied and, we the U.S. taxpayers, must have a break.

So please evaluate carefully all the plans being proposed and come up with a tax that's fair to all –

Thank you

Carol Henry
6412 64 th Ave Ct N.W.
Gig Harbor WA 98335

c/o 1400 S. Sunkist St. #213
Anaheim, California PZ=92806
(714) 999-1486
Fax: (714) 999-1486

June 11, 1995

D. Mosley, Chief of Staff
U.S. House of Representatives
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

RE: IRS and Federal Reserve Abolishment

Dear Mr. Mosley:

Enclosed for the record are:

1. An IRS mailing (Contract and Declaration of Citizenship) from a typical non-taxpayer (six sheets).

2. An IRS mailing requested a determination letter (one sheet).

The purpose of these seven sheets is to show that, when answered, the IRS has no option, under law, but to determine "no tax due, no filing required", and if they do not answer, estoppel and acquiescence prevails.

3. A one-sheet synopsis of IRS illegalities, the Federal Reserve System (the real problem), and what I know to be the solution.

Please make these eight sheets part of the Committee's records.

Sincerely,

Robert T. Hibbard

RTH/krh

Enclosures (3)

cc: Representative Chris Cox
Representative Bob Dornan
Orange County Register

CONTRACT AND DECLARATION OF CITIZENSHIP

California Republic)
) KNOW ALL MEN BY THESE PRESENTS
Orange County)

WHEREAS, THE ETERNAL AND UNCHANGING PRINCIPLES OF THE LAWS OF COMMERCE ARE:

1. A matter must be expressed to be resolved.

2. In commerce, TRUTH is sovereign.

3. TRUTH is expressed in the form of an AFFIDAVIT.

4. An unrebutted AFFIDAVIT stands as TRUTH in commerce.

5. An unrebutted AFFIDAVIT becomes the judgement in commerce.

6. An AFFIDAVIT of TRUTH, under commercial law, can only be satisfied:

   (i) through a rebuttal Affidavit of Truth, point for point,

   (ii) by payment,

   (iii) by agreement,

   (iv) by resolution by a jury by the rules of Common Law

7. A workman is worthy of his hire.

8. All are equal under the law..

The foundation of Commercial Law is based upon certain eternally just, valid, and moral precepts and truth, which have remained unchanged for at least six thousand (6,000) years, having its roots in Mosaic Law. Said Commercial law forms the underpinnings of Western Civilization, if not all Nations, Law, and Commerce in this world. Commercial Law is **non-judicial** and is prior and superior to, the basis of, and cannot be set aside or overruled by the statues of any governments, Legislatures, Government or Quasi-Governmental Agencies, Courts, Judges, and law enforcement agencies, which are under an inherent obligation to uphold said Commercial Law.

KNOW ALL MEN, THAT I CERTIFY IN THIS AFFIDAVIT OF TRUTH THAT THE FOLLOWING FACTS ARE TRUE, CORRECT AND COMPLETE.

I, Kathryn R. Hibbard, Sui Juris, the undersigned, a Citizen of the California Republic (state), domiciled in Orange County, c/o 1400 S. Sunkist Street #213, Anaheim, California, do solemnly swear, affirm, declare, attest and depose:

1. That I am of lawful age and am competent to make this Affidavit.

2. That I have personal knowledge of the facts and stated herein.

3. That I am not under the lawful guardianship or disability of another. This sworn affidavit is made as a matter of record of my own right, sui juris, in my own proper status, propria persona.

4. I was naturally born in the continuous Florida Republic (state), and I am domiciled in Orange County, where I have occupied such status since approximately July of 1987, for a period of approximately 7 years and 11 months.

5. I, Kathryn R. Hibbard, as a natural born, sovereign, preamble, de jure Citizen of one of the 50 sovereign Republic, freely associated complete American states.

6. I am a Citizen under the Constitution of 1787, the Bill of Rights, ratified in 1791, and precedent decisions of Article III Justice Courts of Law.

7. I have rights which are inalienable and were endowed by my Creator and secured by the Constitution. I do not waive any of my rights at any time.

8. The government of the United States may assume no power over the People of the 50 sovereign states that were not specifically delegated to it in said Constitution.

9. I do not owe my Citizenship to the 14th Amendment.

10. I am not liable for the Title 26 USC, Internal Revenue Code (IRC), Subtitle A, §1 graduated income taxes for reasons on my alienage to the State of the forum of United States Tax Laws.

11. I was born in a territory over which the United States is sovereign.

12. I am not the citizen subject to its jurisdiction, as such term is defined in 26 CFR 1.1-1(c).

    (c) **"Who is a citizen:** Every person born or naturalized in the United States and subject to its jurisdiction is a citizen."

2A Am Jur 1420, Aliens and Citizens "A Person is born **subject to the jurisdiction of the United States**, for purposes of acquiring citizenship at birth, if this birth occurs **in a territory over which the United States is sovereign...**"

13. I am "nonresident to" and "not a dweller within" the jurisdiction of the "State of the Forum" of **Art. I, §8, Cl. 17 and Art. IV, §3, Cl. 2** of the Constitution for the United States of America, in which Congress "exercises **exclusive Legislation in all Cases whatsoever**, over such District **not exceeding ten Miles square**," beyond the seat of Government, or places legally ceded by the states for the Erection of Forts, Arsenals, and other needed buildings, or any other territories of properties "belonging to" the United States. I am, therefore, not liable for the Title 26 USC, Subtitle A, §1 graduated income tax for reasons of my nonresidence to such State of the Forum.

"It is a well established principle of law that all federal legislation applies only within the territorial jurisdiction of the United States unless a contrary intent appears."

Foley Brothers v. Filardo, 336.U.S. 281

14. I am not a "resident of", "inhabitant of", "franchisee of", "subject of", "ward of", "property of", "chattel of" or "subject to the jurisdiction of", the State of the Forum of any United States, the corporate State, corporate County, or corporate City, Municipal, body politics created under the primary authority **of Art. I, §8, Cl. 17 and Art. IV, §3, Cl. 2** of the Constitution for the united States of America and I am not subject to any legislation created by such authorities and I am not subject to the jurisdiction of any employees, officers or agents deriving their authority thereof. Further, I am not a subject of Administrative and Article I Courts or bound by precedent of such courts.

"Legislation enacted by Congress applicable to the inferior federal courts in the exercise of the power under Article III of the Constitution cannot be affected by legislation enacted by Congress under Art. I, §8, Cl. 17 of the Constitution." *D.C. Code, Title 11 at p. 13.*

15. As a Sovereign Citizen of one of the 50 states, under the Constitution and Law, only Article III Justice Court of Law decisions are applicable to me.

16. TAKE NOTICE that I hereby cancel any presumed election made by the United Sates Government of any agency or department thereof that I am, or ever have been, a citizen or resident of any territory, possession, instrumentality or enclave, under the sovereignty or exclusive jurisdiction of the United States as defined and limited in the Constitution for the united States of America in Article I, §8, Cl. 17 and Article IV, §3, Cl. 2. I further cancel any presumption that I ever voluntarily elected to be treated as such a citizen or resident.

17. TAKE NOTICE that I revoke and cancel all of my signatures on any other forms which may be construed to give the Internal Revenue Service or any other agency or department of the United States Government, created under the authorities of Art. I, §8, Cl. 17 and Art. IV, §3, Cl. 2 of the Constitution for the united States, authority or jurisdiction over me. I revoke, rescind and make void ab initio, all powers of attorney, in fact, in resumption, or otherwise, signed either by me or anyone else, with or without my consent, as such power of attorney pertains to me, by but not limited to, any and all governmental/quasi/colorable, public, Governmental entities or corporations, on the grounds of constructive fraud and non-disclosure.

18. I am not an officer, employee, or elected officer of the United States, the District of Columbia or any agency or instrumentality of the United States or District of Columbia.

19. I am not an officer of a Corporation, under a duty to withhold.

20. **I am not an "employee"** as such "term" is defined in Law and in the Internal Revenue Code. **Federal Register, Tuesday, Sept. 7, 1943, §404.104, pg. 12267: Employee:** "The term 'employee' **specifically includes** officers and employees, **whether elected or appointed**, of the United States, a State, territory, or political subdivision thereof or the District of Columbia or any agency or instrumentality of any more or more of the foregoing."

21. Because I am **not an "employee", I do not earn "wages"** as such terms are defined in the Internal Revenue Code. The term wages is defined in §3401(a) as: (a) Wages -- "...the term 'wages' means all remuneration...for services performed **by an employee** for his employer..."

22. Further pursuant to the Public Salary Act of 1939, Title I, §1, **I do not earn "gross income"** as such term is defined therein.

    Public Salary Act of 1939, TITLE I -- SECTION 1. §22(a) of the Internal Revenue Code relating to the definition of "**gross income**" (is **amended** after the words "**compensation for personal service**") includes [only] personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing."

23. I am not involved in any type of "revenue taxable activities" including, but not limited to, the manufacture, sale or distribution of alcohol, tobacco, or firearms or any other regulated industry, trade of profession. I am not involved in any wagering activities.

24. I do not reside in or obtain income from any source within the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Guam, or any other Territory, Possession, enclave or instrumentality of the United States or of the District of Columbia.

25. I am not a United Sates Person, United States Resident, U.S. Individual, U.S. Corporation or "citizen subject to its jurisdiction", as such "words of art" are defined in the Internal Revenue code and other applicable U.S. Codes.

26. The 16th Amendment did not repeal the Constitutional apportionment restrictions imposed on direct taxes (Art. I, §2, cl. 3, Art. I, §9, Cl. 4). Taxes on Personal property are direct taxes, not taxable by the federal government unless apportioned according to the census of the states.

27. **Compensation for labor** and **exercise of the Right to Labor** are personal **property** and, as such are items of income under the Constitution (Art. I, §2, Cl. 2, Art. I, §9, Cl. 4), and not taxable by the Federal Government as a graduated income tax. Compensation earned and exercising the Right to Labor is **excluded from "Gross Income"** and **is exempt from taxation under Title 26**, under the authority of Title 26, CFR ('39) §9.22(b)-1, as follows:

    26 CFR (1939) §9.22(b)-1 "Exclusions from gross income -- *The following **shall not** be included as gross income and shall be **exempt from taxation** under this title:*

    (b)-1 Exemptions; exclusions from gross income. *Certain items of income...are exempt from tax and my be excluded from gross income...those items of income which are under the Constitution, not taxable by the Federal Government."*

28. The 16th Amendment is limited to **only** indirect taxes.

29. The income tax is an excise tax. My compensation for labor is my personal property and is not taxable by the federal Government except by rule of apportionment.

30. An excise tax CANNOT be imposed upon the [natural] person measured by his/her income, because such a tax would be a direct capitation tax, subject to the rule of apportionment and not an excise tax.

31. The requirement to pay an excise tax involves the exercise of a privilege. I am exercising no taxable privileges.

32. I provide for my existence by working in a nontaxable occupation of common right.

> "The individual, unlike the corporation, cannot be taxed for the mere privilege of existing. The corporation is an artificial entity which owes its existence and charter powers to the state; but the individual's Right to live and own property are natural Rights for the enjoyment of which an excise cannot be imposed... We believe that the conclusion is well justified that a tax laid directly upon the income of property, real or personal, may well be regarded as a tax upon the property which produces the income." Redfield v. Fisher, Oreg. Sup. Ct. 292 at 813, 827, 819. (1930)

33. My compensation constitutes the "fruits of my labor". This is my substance and my personal property and the Government may not deprive me of any portion of my property by appropriating it against my will.

34. The Victory Tax Act of 1942 [56 Stat, Ch 619 Pg. 884 10/21/42] which implemented "withholding" and 1040 Return requirements, stated:

> **§476 "The taxes imposed by this subchapter shall not apply with respect to any taxable year after the date of cession of hostilities in the present War [World War II]."**
>
> On May 29, 1994 (58 Statutes at Large, Cap 210 §6 (a) REPEAL OF VICTORY TAX pg 235) the Victory Tax and its provisions for Withholding was repealed.

IN SUMMARY:

a) I am not an "employee" earning "wages" and have no "gross income" as such "terms" are defined in the Internal Revenue Code, the Public Salary Act of 1939 and in Law.

b) I am exercising NO taxable privileges and I earn no income upon which a direct "excise" tax may be imposed. The Brushaber court and other supreme Courts have ruled the "*taxation on income is in its nature an excise.*" Flint v. Stone Tracy Co. 220 U.S. 10, ruled "*the requirement to pay Excise taxes involves the exercise of a privilege.*" Further the supreme Court case of Peck v. Lowe, 247 U.S. 165, ruled that a tax sustained upon a [natural] person would be a "capitation" tax (subject to apportionment) and not an excise tax.

c) I am not the "citizen subject to its jurisdiction" as defined in 26 CFR §1.1-1(c) upon whom the Subtitle A, §1 Graduated Income Tax is imposed.

d) I did not incur a tax liability last year, pursuant to 26 USC 871(a) or §871(b), and I do not anticipate that I will incur a tax liability from said sections in the future. However, if I do receive income subject to taxation under those sections in the future, I will file the appropriate Form.

e) I am not required to pay the income tax. I am not "liable for" or "made liable for" the income tax. I am not "subject to" the income tax and I am not required by regulation to file a 1040 tax return.

Please respond to this Affidavit within 30 days to:

Kathryn R. Hibbard
c/o 1400 S. Sunkist Street #213
Anaheim, California (Postal Code 92806)

If you do not feel this is a reasonable period of time, please request an extension in writing. Failure to respond will mean that you have acquiesced to this Affidavit and Supporting Documentation it its entirety and from this date forward the doctrine of "estoppel by acquiescence" will prevail.

Any statements or claims in this AFFIDAVIT, properly rebutted by facts of law, or overriding Article III supreme Court rulings, such shall not prejudice the lawful validity of other claims not properly rebutted or invalidated by facts of law.

I declare under penalty of perjury under the laws of the united States of America that the foregoing, to the best of my knowledge, is true and correct.

Executed at Anaheim, California on _____

Kathryn R. Hibbard
Signature

_____
Witness

_____
Witness

Certified Mail #
Assistant Commissioner of Operations
National Office of the Internal Revenue Service
111 Constitution Avenue NW
Washington, D.C. 20224

Certified Mail #
Internal Revenue Service Center
Philadelphia, PA 19255

Certified Mail #
Secretary of the Treasury
Washington, D.C. 20220

Certified Mail #
District Internal Revenue Director
2400 Avila Road
Laguna Niguel, CA 92656

Written Request for Verified Determination of Status for Tax Purposes Letter, Prior to Filing of Tax Returns

Pursuant to Internal Revenue Laws, and based upon the facts contained in the attached Affidavit, this letter constitutes a written request for an attested, verified **Ruling and/or Determination Letter** from the National Office, the Director of International Operations and the District Director, determining my status for tax purposes, prior to my filing of a tax return. As soon as your agency makes this written determination, I shall file the appropriate form, as required by the laws of the United States of America.

Technical **page 1218-125 (10-25-88)**

RULINGS, DETERMINATION LETTERS, AND CLOSING AGREEMENTS...
P.L.-(11)-23, (approved 6/14/87)
"Rulings and Determination Letters in General:
"Ruling and determination letters are issued to Individuals and organizations upon written requests....as to their **status for tax purposes**...prior to their filing of returns or reports **as required by the revenue laws**. Rulings are issued only by the National office. Determination letters are issued only by District Directors and the Director of International Operations..."

MT1218-196 **P-(11)-30**

Sincerely,
Without Prejudice, All Rights Reserved U.C.C. 1-207

Kathryn R. Hibbard
c/o 1400 S. Sunkist St. #213
Anaheim, California (Postal Zone = 92806)

The enclosed Documents which the wife and I have sent (completed) to the IRS shows conclusively that we and 90% of working Americans are not subject to the so called "income tax" unless they are coerced into, get this, "voluntary compliance". The way out for Citizens is that they had to knowingly enter into this agreement with the Fed (through the 1040 fraud) contract. Many of us, 20-30 Million, non-taxpayers have "noticed", legally, the IRS of their Fraudulent Entrapment.

The IRS must be disbanded and their illegal activities, until they are gone, must stop immediately! The real root problem is the Federal Reserve System (the IRS being the collection agency for the phoney Fed Res holdings of debt).

"Permit me to control the currency of a nation and I care not who makes it's laws!"- Baron de Rothchild.

If I could print up money on my very own private press and loan it out to all my friends at staggering high interest, it would not take too long until I would own the whole neighborhood. That's what the feds been doing since the Congress unconstitutionally transferred this authority to a private mostly foreign owned (pvt stock) organization - the Federal Reserve.

This Fed has created a debt based economy. It creates nothing. Every dollar that America spends it borrows from someone else. Every Fed Res note in your/my pocket is nothing more than a debt certificate. America (through a Criminal congress) has given its greatest power, monetary creation, to the Fed Res. If our Nation can issue a dollar bond, it can issue a dollar bill! I want the Fed Res out, gone, sent packing back to Europe and Congress to (for example):

(1) Congress purposes a 300 Billion, 100 Million budget, requiring 100 Million in currency
(2) This budget is voted on and approved by the Congressional Representatives of the people.
(3) The bureau of Printing and Engraving for the United States of America prints and issues 100 Million in "currency for the united States of America" at a cost of two and a half cents per bill!
(4) The **Treasury of the United States of America** puts $300 billion in credit and $100 million in currency into circulation in exactly the same manner as the federal reserve! Our government is merely providing the up-front capital to finance the future productivity of the American People! It is this "Productivity" that would give the currency and credit its value!
(5) The people, who are the basis for the backing of the funding, accept this currency and credit as payment of their labor, products, services, technology, etc.
(6) There is no longer a compounding federal debt and a need for illegally taxing the compensation for labor (misrepresented as "income") of American Citizens, who will then have more expendable (legal) dollars to improve their Quality of life.
(7) The people buy more products, more jobs are created, the economy is stimulated and the **ECONOMY BOOMS! COST TO WE THE PEOPLE: Absolutely 0!**

45th Congress Ch 146
Chapter 276 - An act to forbid the further retirement of United States legal tender notes.
An act of Congress that has never been repealed. Where are those United States Notes that were lawfully to be kept in circulation and not retired? The law was specific, even if such notes were mutilated, they were to be replaced. These United States Legal Tender Notes were and still should be "gold certificates." It is required that they are reissued in "like denomination in their stead as now provided by law."

CALVIN A. HILL
40 Avenue D 13-E
New York, N.Y. 10009
212-353-3353

May 30, 1995

PHILLIP D. MOSELEY
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: FC-7 Hearing dates June 6 through 8, 1995

A. Opening statements

B. Personal disclosure

C. Ignored abuses

D. What is the present system, <u>really</u>?

E. Can we <u>honestly</u> support this system in its basest form?

F. Why the abuses continue

G. An honest, unintrusive solution.

This is my statement to be made available to the committee for review and printing.

Yours truly,

I am greatly encouraged that Chairman Archer feels committed to "tearing the income tax out by its roots". I am troubled, however, by the fact that whenever this particular dialogue takes place among politicians that they tend to show more allegiance to the Treasury Department and special interests than to their oath of office.

If this is to be an honest debate with an honest effort to expose this abusive system, then our elected officials must consign themselves to their oath of office. The only oath that they have sworn before God and country is to protect and defend the Constitution of the United States of America against all enemies foreign and domestic. And this liberty defying system that has sent hither swarms of Officers to harass our people and eat out their substance, under the guise of representative taxation, can only be described as DOMESTIC ENEMY #1.

In the interest of full disclosure I am compelled to say that I have been convicted of tax evasion in a U.S. Federal Court. I reveal this out of a sense of honor as I find no shame in the consequence. It is nothing that I feel I must hide, or be ashamed of, or be bitter about. Having to relinquish a job that I enjoyed, my residence, and the camaraderie of friends and family for the period of my incarceration was a small price to pay for the crisis of conscience that I would have suffered had I not stood by the courage of my convictions.

In the aftermath of the tragedy in Oklahoma City, President Clinton made a speech castigating Americans who, living in the freeset country in the world, said that they live in tyranny. "How dare they", he said. "How dare they" claim to be subjected to tyranny. On the very next THIS WEEK WITH DAVID BRINKLEY, Sam Donaldson echoed President Clinton's statement. I would ask Misters Clinton and Donaldson: when armed IRS agents in Alaska approached a woman in her vehicle, smashed her window, and literally pulled her out to confiscate her car for allegedly owing back taxes, what would they call that? When a band of armed IRS storm a Michigan day care center, herd the children into a room, hold them hostage and refuse to release them until their parents made a payment to the center, because the owners allegedly owed back taxes, what would they call that?

If we are to be totally honest about this present system, we must initially disregard the obvious need to raise revenue and tackle it at its basic and most simplest roots. Imagine that you are at your monthly poker game along with Thomas Jefferson, James Madison, Ben Franklin and your federal district Congressional representative. As the game and the conversation begins the representative reveals the new method that the Congress will adopt for raising revenue and illustrates the high points:

1. The right to work will no longer be inalienable. All citizens will be required to make application to a federal agency for a national identification number. Any employer found to hire any person without that number will be subject to heavy fines.

2. The national identification number will be required to obtain insurance, use private financial institutions, licenses, and any other public or private endeavors as determined by the Treasury Department.

3. Every working person will be required to reveal to the government all monies earned from the fruits of their labor and investments.

4. Every working person will be required to reveal to the government the names and amounts of every church, charity and non-profit organization that they have contributed to.

5. Each year all working persons will be required to reveal to the government the names of every person that they took to breakfast, lunch or dinner on business, where they dined and the amount spent.

6. Every working person will be required to reveal to the government every member of their family who was ill and sought medical treatment, who treated them, where they were treated, what they were treated for, what treatment they received, and how much it cost.

After all of the information is available, the government will levy an amount of money at a value determined by the Congress. Any person who refuses to provide the required information will have their paychecks, homes, bank accounts and other properties confiscated without the benefit of a trial or public hearing before an impartial magistrate and may be subject to criminal penalties.

Would it be very difficult to gauge the reaction of the members of your poker circle? I don't think so. That an administrative agent of the government could take a form from their desk, fill it out, and prevent an American citizen from receiving their hard earned wages, from receiving their savings or from entering their government padlocked home would outrage them. They experienced this. It is why the Constitution was very specific about direct taxation, trials by jury, just compensation, security in our papers, persons and effects, deprivation of property without due process, and suits at common law. Everything about this present "tax" system makes a mockery of those liberties. It is the stuff that citizen militias are made of.

Criminal investigations for possible "tax" crimes seem to follow those representatives who speak out to House Oversight on IRS abuses. It happened to Senator Long in the '60's, Senator Montoya in the 70's, and Idaho Congressman George Hansen in the 80's. This is not taxation. It is tyranny.

I think that Chairman Archer has the correct idea concerning a consumption tax. For those who oppose it on the grounds that it is regressive and hurts the poor, why do they not argue that very point about the present system. After all, it is the employers who pay the tax, not the employee. When a poor person buys a loaf of bread, they are paying the cashiers "income tax". In addition, that poor person is also paying the tax of the trucker that delivered the bread, the bakers and those who sliced and wrapped it, the millers, etc. The employers must forward this "tax" to the government. And as such, they could not afford it without adding it to the cost of their products and services. So we have an income tax that is a consumption tax that, in addition to raising revenues, violates the very basic tenets of constitutional liberty. It is on the basis of those violations that the present system must be eradicated. It cannot stand against the conscience of a Congress that is true to its oath.

P. O. Box 176
Half Moon Bay, California 94019
June 1, 1995

The Honorable Bill Archer
Chairman, Ways and Means Committee
United States House of Representatives
Washington, D. C. 20515

Dear Chairman Archer:

Subject: Comments for The Committee on Ways and Means Concerning a New Tax System- and Abolishing the IRS

1. The new tax plan/system must take away from goverment as much of our hard earned tax money as possible. It is an inviolate principle-**Government will spend all the tax payer's money it can get and then spend more (go into debt).** You will notice that I do not use the term federal funds-tax payer's money is the correct term.

The government must get less of the citizens money, and be put on a starvation diet.

2. Future Congresses must not be able to just amend the new system to reinstitute the IRS, a destructive ad valorem tax, or return to a system such as today's job destructive progressive income tax.

3. I personally favor the flat tax approach proposed by Majority Leader Dick Armey if the 17% level is either lowered or not increased. Again, the government bureaucracy must not be given any more money no matter how badly they and the special interests scream.

The sales tax approach that you have suggested also seems to be a good one if the Congress is somehow prevented from adding other taxes such as the ad valorem tax or from increasing the sales tax rate on the whim of the crying towel liberal elites.

4. Punitive provisions of the old tax codes such as the requirement to buy at least as expensive a home as the one sold or pay tax on the gain must not be carried forward into the new tax law in any way shape or form.

5. The IRS must be abolished as soon as possible in its entirety. Tax functions greatly reduced with either the flat tax or a sales tax should be handled by the Treasury without additional bureaucracy.

6. The punitive and savings destructive aspects of the current system must be abolished with either new approach. Let me give you a personal example that my wife and I are now dealing with. Some years ago when I took an early retirement, we were able to invest several thousand dollars in U. S. Savings Bonds (due to a good rate at the time and the safety involved). Now we are fully retired and must cash some of these bonds to puchase an automobile. Now we must pay taxes on the money we withdraw for the purchase. Such savings disincentives have virtually destroyed the capital base that the U. S. needs so badly to build a productive economy in a hostile and very competitive world.

7. The anguished cries and screams that will come from the bureaucrats, special interest groups, and the other myriads of those feeding at the hog trough of government that surrounds the present system can be answered this way. Accountants would love to give up tax accounting work for real accounting work. Even the myriads of tax attorneys that feed off the present system can be retrained to do productive work in the economy without destroying the mouths that feed them.

The bureaucrats and special interest groups can also obtain productive jobs that contribute to a growing U. S. economy. Big government in all its facets has destroyed much that was good and productive in the nation. The minority in the house and senate are in denial because they have meticulously built their voter base on the backs of hard working. tax paying American citizens.

In closing, I would like to remind all of you of what you are already

well aware of. The present day federal government is actually the enemy of the people, of families, and of national progress and liberty as the founding fathers desired it to be.

As George Washington so clearly stated, "Government (federal, state, and local-my addition) is a dangerous servant and a fearful master."

You and your colleagues in both the House and Senate must be successful in this initiative. I am convinced that the productive forces for national good that will be unleashed by ending the current tax syetem will amaze us all.

May the good Lord Bless your deliberations and give you the success that we so desperately need.

Very truly yours,

Wayne L. Hinthorn

Wayne L. Hinthorn

3 June 1995

Philip Mosely, Chair, House Ways and Means
U.S. House, Longworth Building
Washington, D.C.

Dear Representative Mosely:

I understand that your committee is meeting this week to consider a significant change to the federal tax system. Here is my input (6 copies):

A flat tax merely simplifies the extortion of income taxes. That's how we got "Tax Simplification" --fewer tax brackets and higher taxes.

Consumers already pay all income tax. The corporate income tax and the extra wages required to enable employees to pay their individual income tax are both a cost of doing business that is added to the cost of every American product. A national sales or consumption tax has appeal, because it would eliminate the cost of the IRS bureaucracy and compliance costs. However, neither a flat tax nor a national excise tax are self-limiting. I submit that you don't need new legislation to improve our tax system. You only need to acknowledge a fraud.

Practically every amendment to the constitution perverted its intent and imbalanced its finely tuned balance of powers and interests. Of those amendments, the 16th and 17th were the most destructive.

The 16th amendment eliminated the requirement for the apportionment of taxes among the states according to the census. The dispersed cost to taxpayers and concentrated benefit to beneficiaries divided Americans into warring groups and made increased government spending inevitable. Repealing the 16th would again make non-uniform (progressive) taxation illegal, and eliminate a powerful tool of privilege used by congresspersons to attract support from favored groups and businesses, and extort campaign funds from threatened groups and businesses. That's why there is always at least talk of amending the IRS code (26 USC) every election year.

The 17th amendment converted senators into glorified representatives, who are easily swayed by public sentiment as manipulated by special interests via a gullible and lazy press. Its repeal would again make senators, elected from and by the state legislatures, truly representative of the state governments. Then when someone suggests that the federal government buy or do something, senators will resist because no senator wants to return to their state to tell their governor and fellow legislators they have to raise state taxes in order to pay more federal taxes.

A return to direct taxes upon the states would eliminate our horribly costly and destructive national income tax. The states can raise the money any way they want, which is usually via a state excise tax, which is great, because it's self-limiting. Reaffirming that states can't tax government securities or commercial paper, i.e. Federal Reserve Notes, would eliminate most state income tax. Better yet, encourage states to elect state senators from and by county supervisors, and directly tax the

counties to pay for state functions. Then there would be a natural resistance to state spending as well.

You can simply declare the 16th and 17th null and void, because they were never lawfully ratified by the states, they were merely declared ratified by Philander Knox. "*The Law That Never Was*" describes the hard evidence (certified copies of state archives) accumulated by Red Beckman and Bill Benson, that proves the 16th amendment fraud. Similar evidence supposedly exists for the 17th amendment fraud, but in reality only one "no" vote was needed to kill the 17th because no state can be denied its representation in congress. The courts acknowledge the fraud of the 16th, but say it's now "a political issue," while the congressional Judicial Committee claims it's a judicial issue. Perhaps it's time for you to make it a political issue.

It's no coincidence that the 16th and 17th amendments and the Federal Reserve Act were all enacted into law in 1913 on 2/25, 5/31 and 12/23, respectively. Federal Reserve Notes have to be taxed out of the economy nearly as fast as they are pumped in to maintain their artificial value, so any real resistance to taxation must be eliminated (17th amendment). By controlling the relative input and removal of Federal Reserve Notes, inflation and deflation can be created at will, which some have argued is necessary to counter wage reduction resistance. (People tend to ignore supply and demand when it comes to their wage. Employees will resist a reduction in wage even if prices are falling and the net effect is an increase in buying power.) However, government control of money has repeatedly proven itself to be harmful to all but those in control.

The Federal Reserve, in conjunction with the legal tender laws, enabled the federal government (12 USC 95) to control the value of "money" and effectively steal from savings, which enslaved retirees as welfare (social security) voters. These clearly unconstitutional acts also enabled the federal government to borrow fiat money without limit and steal from future generations, enslaving Americans as taxpayers from birth. Abolish the legal tender laws and good commodity money will drive out bad commercial paper, i.e. Federal Reserve Notes.

The Federalists did not intend the lengthy process of amendment ratification by three-fourths of the states to be supplanted by the simple act of approving a treaty. Clearly, treaties should not have precedence over the federal constitution as currently alleged. Emergency Powers (50 USC 1601-1706 and 50 USC Appendix) are another perversion of constitutional intent. These should no longer be used as excuses to maintain the status quo.

Acknowledge the fraud.

Sincerely,

William T. Holmes
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TESTIMONY OF SARA E. MELÉNDEZ
INDEPENDENT SECTOR

INDEPENDENT SECTOR (IS) is a nonprofit coalition of 800 corporate, foundation and voluntary organization Members with national interest and impact in philanthropy and voluntary action. The organization's mission is to create a national forum capable of encouraging the giving, volunteering, and not-for-profit initiative that help all of us better serve people, communities and causes. Attached is our Membership list.

The organizations of INDEPENDENT SECTOR and its mission derive from its Members' shared commitment to fundamental values relating to the creation and maintenance of a truly free society. Our Membership list is attached.

Some tax policy officials and analysts believe that the complexity of the current tax code causes an undue amount of unfairness and inefficiency in the raising of tax revenues. These concerns have prompted what are known as "flat tax" proposals. Such proposals have been offered over the last several years, and several are currently under consideration by Congress. The basic goal of a "flat tax" proposal is to apply a single, or "flat", tax rate to all income. A key to the single tax rate actually being flat across all taxpayers is for it to apply to all income. Thus, exclusions from income, and deductions not necessary to properly measure income, are generally not allowed in a flat tax proposal. To the extent deductions consistent with social policy are disallowed, the unintentional effect will be a tax code that is inconsistent with social policy. We believe that a flat tax proposal and similar proposals that disallow a deduction for charitable contributions contain such an inconsistency with the social policy of encouraging private support of charitable causes.

Individuals are motivated to make charitable contributions primarily by their altruistic nature. However, as with any decision related to the use of limited resources, the amount a person gives to charitable causes will be influenced by the cost to them of giving. This cost of giving can be significantly changed by the tax treatment of the gift. The current deductibility of charitable gifts reduces the taxes an individual pays, and thus reduces the net cost of giving. If deductibility of charitable giving is eliminated, then the cost of giving will increase. Generally the more an activity costs, the less of the activity an individual will engage in. A large body of research has shown that tax incentives can have a powerful effect on the amount individuals give. Tax laws can also have important effects on the types of gifts and on the types of groups that receive these gifts.

We discuss below the impact that the proposals would have on contributions to charitable organizations. First, we want to explain why charitable organizations are important to America.

THE IMPORTANCE OF CHARITABLE ORGANIZATIONS TO AMERICA

Nearly one million charitable, educational, religious, health, and social welfare organizations create, nurture, and sustain the values that frame American life. They promote altruism, in a society that reinforces self-interest; community, in a society that reward individual achievement; and pluralism, in a society sometimes threatened with divisiveness. They provoke, challenge, and question. They also teach, mediate, and heal.

Collectively, these organizations represent an increasingly important sector of our society: the independent sector. They function on a not-for-profit basis, entrusted with public purposes and barred by law from private gain. They are exempted from tax on their assets and on income from their public-purpose activities. Those who support them with gifts can deduct those gifts from their own taxable income. Volunteers provide their boards with essential leadership, stewardship and accountability, and play vital roles at all levels.

The independent sector has become a major force in the American economy. In 1990 alone, organizations in this sector received an estimated nearly $123 billion in financial contributions, and volunteer time and energy from nearly 100 million people, as well as income from endowments and revenue-generating activities. That same year, they spent an estimated $389 billion in providing vast and varied services.

Independent sector organizations have played important roles in almost all of American society's major advances – in human rights, health, knowledge, ecology, creativity, and other fields. As with other institutions in our society – government, business, the professions – they are under especially critical scrutiny today. Questioned on what they contribute to the public good, they must be prepared to explain their roles to the public, and give full and frequent accounting of their activities.

At the same time, they must maintain a spirit of diversity and openness that gives them their special character. They must be free to express divergent, even unpopular ideas. And they must not be asked to assume tasks properly performed by government with its vastly greater resources. Only thus can the sector they represent meet the challenge of its independence.

As leaders from other countries are recognizing, organizations of the independent sector reflect and express much of what is best in the American character. They embody and sustain fundamental social, cultural, and spiritual values, including:

Altruism. Independent sector organizations affirm that all human beings have basic moral obligations to look beyond themselves, and to undertake activities for the betterment of other people and other species – present and future. They further affirm that regard for others must balance the self-regard of the marketplace in a duality that engenders the dialogue and compromise essential to democracy.

Altruism is the most fundamental unifying principle among the diverse organizations of the independent sector. It is the root of their other values: compassion, humility, respect for others, concern for the community, and justice for all.

Pluralism. America's multitudes, with our countless heritages, cultures, political philosophies, and religious beliefs, reflect an unparalleled pluralism. This diversity cradles our society's creative energies, and represents a core value of its life.

For the organizations of the independent sector, encouraging and sustaining pluralism represents a second unifying principle. They affirm that our nation gains strength from respecting differences among its citizens and fostering the free and creative expression of ideas and opinions. Each organization owes its own creation to individuals who acted upon distinct ideas and values.

Some organizations work in areas barred to government: religion in particular. Some speak out in the forum of public discourse, and resist government intrusion lest it suppress dissent. Some spring up swiftly, responding in crises to special human needs. Others provide alternative responses to constant needs.

Community. The principle of community reaches beyond geographic or demographic entities. Communities are groups of individuals who share common values, interests, purposes, or goals. They are critical to our economic, political, social, intellectual, and cultural life. The independent sector itself is a vast community.

Organizations of the independent sector create, nourish, enlarge, and sustain communities. Education equips individuals with the scholarship, discipline, and creativity to contribute effectively to community life. Arts, culture, and the humanities stimulate community self-discovery, self-awareness, and self-definition. They preserve a community's heritage, challenge its assumptions, and refine its perceptions.

Human service, health, and religious groups bring commitment to the community's welfare. They instill compassion for community members in need, and provide the mechanisms to address particular community problems. Human rights, environmental, and public policy groups teach leadership, consensus-building, and citizen participation skills that ensure community vitality. They empower individuals to lead, and offer them leadership opportunities.

In summary, business and government alone cannot sustain altruism, pluralism, and community - principles fundamental to American society - nor the underlying values of trust, compassion, justice, and moral behavior that bind us together.

The independent sector has become America's linchpin. Business, government, and in fact all Americans have a fundamental stake in preserving and strengthening it.

HOW CHANGES IN THE DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS AFFECT GIVING TO CHARITABLE ORGANIZATIONS

A deductible contribution actually costs the giver the amount of the contribution less the reduction in taxes due to the deduction. Thus, a $1 gift costs $1 less the applicable marginal tax rate (1 - marginal tax rate). Economists define this as the price of giving. For example, the price of making a $1 deductible contribution for a taxpayer with a 25 marginal tax rate would be 0.75 (1 - 0.25).

The effect of a change in the price of giving on the amount a person give depends on how responsive they are to the price of giving. Empirical evidence indicates that, generally, the percentage change in the amount of giving due to a change in the price of giving will be -1.13 time the percentage change in the price of giving. For example, assume that a person with a 25 percent marginal tax rate is giving $1,000 when the contribution is deductible (e.g. the price of giving is 0.75). If the contribution is made non-deductible, the price of giving increases to 1.0, a 33% increase. Thus, this person's giving would fall by 38% (33% x -1.13), or by $380. In this example, eliminating deductibility of the contribution reduces giving from $1,000 to $620.

The foregoing illustration demonstrates that while the federal government gains $250 in revenue by disallowing the charitable deduction, charitable causes lose $380 as a result of the decreased incentive to give.

Stating the foregoing in the positive, it's a good investment by the federal government to allow the charitable tax deduction. The federal government, by "investing" $250 in revenue lost as a result of the charitable tax deduction, gains $380 or 52% in funds expended by the charity on public purposes such as feeding the homeless, comforting the sick, rehabilitating drug abusers, supporting community arts groups, preserving historic houses, protecting wetlands from pollution and neighborhoods from crime, and serving countless other local, regional, national and even international purposes.

THE MAGNITUDE OF THE EFFECT ON CHARITABLE CONTRIBUTIONS OF A FLAT TAX WITH NO DEDUCTION FOR CHARITABLE CONTRIBUTIONS

The effect of a change in tax rules on the amount of charitable contributions will depend on a number of factors, including the responsiveness of the taxpayers, the speed at which taxpayers adjust their behavior, the distribution of the magnitude of the tax change across taxpayers of different characteristics, and the response of charitable organizations with regard to their fund raising activities. While many flat tax proposals are similar in structure, apparently minor differences can have significant implications for the overall effect of the proposal on the level of charitable contributions. However, the following discussion is meant to provide an indication of the effect a flat tax with no deduction for charitable contributions could have on the level of charitable contributions.

Itemizers can currently deduct their charitable contributions, and the amount they give reflects this incentive. Most flat tax proposals would expand the measure of income subject to tax and reduce the tax rate. In expanding the amount of income subject to tax, some of these proposals would provide no deduction for charitable contributions. If [the] deductibility [of charitable contributions] were eliminated, itemizers would reduce the amount they give. In 1992, approximately 32 million itemizers reported approximately $63 billion of charitable contributions. If the deductibility of contributions were eliminated, this level of giving would likely have been more than $20 billion lower. While charitable organizations may be able to offset some of this reduction by more aggressive fund raising techniques, a substantial short-fall is inevitable.

Most flat tax proposals are designed to be neutral with regard to tax revenues - e.g. to raise the same amount of tax revenues that are raised by the current tax rules. While some flat tax proposals would result in lower total individual income taxes, they generally increase corporate income taxes by a like amount. Since all taxes are ultimately paid by individuals, such revenue neutral flat tax proposals will have no effect on the aggregate tax burden, and thus provide no increase in total after-tax income out of which to give to charitable causes. To the extent some individuals do experience a reduction in their tax liability as a result of a flat tax proposal, the additional after-tax income would likely be relatively small, and would be apportioned among a large number of consumption alternatives as well as savings. Thus, any increase in charitable contributions from increases in after-tax income would be expected to be quite small, and not nearly large enough to offset the reductions due to the increased cost of giving.

In addition to affecting the total amount of charitable contributions, the above tax law changes would significantly affect the proportion of gifts going to different types of recipients. For example, the $20 billion reduction in itemizer giving would likely come disproportionately from educational institutions, cultural institutions, and private foundations.

CONCLUSION

Although not the primary reason for individuals making charitable contributions, the tax treatment of charitable contributions can have very significant effects on both the level and composition of individual gifts. Enactment of a flat tax with no deduction for charitable contributions would result in a substantial reduction in the amount of individual charitable contributions relative to what would be given under the current tax rules. This reduction would come on top of a drop of 24% of household giving to charities, from 1989 to 1993, according to latest information available as reported in Giving and Volunteering in the United States - Findings from a National Survey by INDEPENDENT SECTOR, 1994.

INDEPENDENT SECTOR VOTING MEMBERS

AAFRC Trust for Philanthropy
AASK America Adopt a Special Kid
Access Video Fund
ACCESS: Networking in the Public Interest
Accountants for the Public Interest
The Advertising Council
Advocacy Institute
Aetna Foundation
Affiliated Leadership League of and for the Blind of America
Aga Khan Foundation U.S.A.
Agricultural Educational Foundation (AEF)
Aid Association for Lutherans
Aid to Artisans
Alcoa Foundation
Horatio Alger Association of Distinguished Americans
Alliance for International Educational and Cultural Exchange
Allied-Signal Foundation
Alzheimer's Association
America's Charities
America's Development Foundation
American Arts Alliance
American Association for Higher Education
American Association for the Advancement of Science
American Association of Community Colleges
American Association of Fund-Raising Counsel
American Association of Museums
American Association of Retired Persons
American Association of University Women
American Autoimmune Related Diseases Association
American Cancer Society
American Chemical Society
American Committee on Africa
American Council for the Arts
American Council of Learned Societies
American Council on Education
American Craft Council
American Diabetes Association
American Dietetic Association
American Express Company
American Farmland Trust
American Fisheries Society
American Foundation for AIDS Research
American Foundation for the Blind
American Fund for Dental Health
American Heart Association
American Humane Association
American Humanics
American Indian College Fund
American Indian Graduate Center
American Institute for Cancer Research
American Institute of Philanthropy
American Leadership Forum
American Library Association
American Medical Association
American Museum of Natural History
American Red Cross National Headquarters

American Social Health Association
American Solar Energy Society
American Stock Exchange
American Symphony Orchestra League
American Tinnitus Association
American Women Composers
Americans for Indian Opportunity
Americans for Medical Progress Educational Foundation
Amigos de las Americas
Amoco Foundation
Apple Computer
The Arc of the United States
Arca Foundation
ARCO Foundation
Arizona Community Foundation
ARNOVA - Association for Research on Nonprofit Organizations & Voluntary Action
ARROW
Arthritis Foundation
Arts & Business Council
Asian Pacific American Legal Consortium
The Aspen Institute
The ASPIRA Association
Associated Grantmakers of Massachusetts
Association for Healthcare Philanthropy
Association for Volunteer Administration
Association of Advanced Rabbinical & Talmudic Schools (AARTS)
Association of America's Public Television Stations
Association of American Universities
Association of American University Presses
Association of Art Museum Directors
Association of Black Foundation Executives
Association of Catholic Colleges and Universities
Association of Episcopal Colleges
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Association of Junior Leagues International
Association of Lutheran Development Executives
Association of Performing Arts Presenters
Association of Science-Technology Centers
AT&T Foundation
Atlantic Foundation of New York
Mary Reynolds Babcock Foundation
Bainbridge Educational Foundation
Ball Brothers Foundation
Association of Baltimore Area Grantmakers
Battle Creek Community Foundation
The Bauman Foundation
BellSouth Corporation
Benton Foundation
Beverly Foundation
Big Brothers/Big Sisters of America
Bing Fund Corp.
Blandin Foundation
Blanton-Peale/Institutes of Religion and Health
H&R Block Foundation
Borden Foundation

Boston Foundation
Boy Scouts of America
Boys and Girls Clubs of America
Brain Trauma Foundation
Otto Bremer Foundation
Greater Bridgeport Area Foundation
Bristol-Myers Squibb Foundation
Brunswick Foundation
The Burnett-Tandy Foundation
Edyth Bush Charitable Foundation
The Bush Foundation
Patrick and Aimee Butler Foundation
California Association of Nonprofits
California Community Foundation
California Wellness Foundation
Camp Fire Boys and Girls
Cancer Care
CARE
Carnegie Corporation of New York
The Annie E. Casey Foundation
Catalyst
Caterpillar Foundation
Catholic Charities USA
CBS Foundation
Center for Applied Linguistics
Center for Corporate Public Involvement
Center for Creative Leadership
Center for Creative Management
Center for Foreign Journalists
Center for Media Education
Center for Non-Profit Corporations
Center for Nonprofit Management University of St. Thomas
Center for Policy Alternatives
Center for Public Service, Seton Hall University
Center for Research in Ambulatory Health Care Administration
Center for the Study of Philanthropy-City University of NY
Center for the Study of the Presidency
Challenger Center for Space Science Education
Champion International Corporation
Chase Manhattan Bank, N.A.
The Chevron Companies
The Chicago Community Trust
Chicago Tribune Foundation
Child Care Action Campaign
Child Health Foundation
Child Welfare League of America
Children's Aid International
Children's Fund of Connecticut
Chorus America (APVE)
Christian Church Foundation
Christmas in April USA
Chrysler Corporation Fund
Church Women United
Citibank
Citizens' Scholarship Foundation of America
City Cares of America

City Innovation
City of Hope National Medical Center
City Year
Edna McConnell Clark Foundation
Clearinghouse for Midcontinent Foundations
The Cleveland Foundation
Van Cliburn Foundation
The Clorox Company Foundation
Close Up Foundation
The Coca-Cola Company
CODEL - Coordination in Development
College and University Personnel Association
College Board
Colonial Williamsburg Foundation
Colorado Association of Nonprofit Organizations
The Colorado Trust
Columbia Foundation
Columbus Foundation
Combined Health Appeal of America
Comerica Incorporated
Committee for a Responsible Federal Budget
Commonwealth Fund
Communications Consortium
Community Anti-Drug Coalitions of America
Compeer
Compton Foundation
Conference of National Park Cooperating Associations
Conference of Southwest Foundations
Congress of National Black Churches
The Conservation Fund
Consortium of Endowed Episcopal Parishes
Continental Corporation Foundation
Cooperative Development Foundation
Coordinating Council for Foundations
Corning Incorporated Foundation
Coro/Eastern Center
Corporation for Enterprise Development
Council for Advancement and Support of Education
Council for American Private Education
Council of Better Business Bureaus/Philanthropic Advisory Service
Council of Energy Resource Tribes
Council of Independent Colleges
Council of Jewish Federations
Council of Michigan Foundations
Council on Economic Priorities
Council on Foundations
Council on International and Public Affairs
Counterpart Foundation
Cowles Media Company/Cowles Media Foundation
CPC International
Cystic Fibrosis Foundation
Dade Community Foundation
Charles A. Dana Foundation
Dance/USA
Dayton Hudson Foundation
Deafness Research Foundation

Delaware Association of Nonprofit Agencies
Direct Relief International
Geraldine R. Dodge Foundation
Dole Foundation for Employment of People with Disabilities
Gaylord and Dorothy Donnelley Foundation
R.R. Donnelley & Sons Co.
Donors Forum of Chicago
Donors Forum of Ohio
Donors Forum of Wisconsin
The Dow Chemical Company
Joseph Drown Foundation
Peter F. Drucker Foundation for Nonprofit Management
The Drug Policy Foundation
The Duke Endowment
DuPont
The Durfee Foundation
Earth Share
Eastman Kodak Company
Ecolab Foundation
Ecumenical Center for Stewardship Studies
Educational Testing Service
El Pomar Foundation
Elderhostel
Elderworks
Enterprise Foundation
Environmental Defense Fund
Environmental Support Center
Epilepsy Foundation of America
The Equitable Foundation
Eureka Communities
Evangelical Council for Financial Accountability (ECFA)
Evangelical Lutheran Church in America
Exxon Corporation
Fairfield County Community Foundation
Maurice Falk Medical Fund
Families International
Fannie Mae Foundation
Fel-Pro/Mecklenburger
First Interstate Bank of California Foundation
First Nations Development Institute
First Nonprofit Companies
Father Flanagan's Boys' Home
Community Foundation of Greater Flint
Florida Association of Nonprofit Organizations
Food Research and Action Council
The Ford Foundation
Ford Motor Company Fund
Henry Ford Museum and Greenfield Village
Foreign Policy Association
The Foundation Center
Foundation for Advancements in Science and Education
Foundation for Independent Higher Education
Foundation for the Carolinas
Foundation for the National Capital Region
The Freedom Forum
The Fresh Air Fund

Frey Foundation
Friends of the National Library of Medicine
Lloyd A. Fry Foundation
H.B. Fuller Company
The Fund for New Jersey
Fund for Theological Education
GE Fund
General Board of Global Ministries The United Methodist Church
General Conference of Seventh-day Adventists
General Mills Foundation
General Service Foundation
The Wallace Alexander Gerbode Foundation
J. Paul Getty Trust
Gifts in Kind America
Giraffe Project
Girl Scouts of the U.S.A.
Girls Incorporated
Global Fund for Women
Richard & Rhoda Goldman Fund
Morris Goldseker Foundation of Maryland
Goodwill Industries International
Goodyear Tire & Rubber Company
Edwin Gould Foundation for Children
Graco Foundation
The Grand Rapids Foundation
Grantmakers in Health
Grantmakers of Western Pennsylvania
Lucile & Robert H. Gries Charity Fund
Grotto Foundation
GTE Foundation
George Gund Foundation
Alan Guttmacher Institute
Miriam and Peter Haas Fund
Walter and Elise Haas Fund
Evelyn and Walter Haas, Jr. Fund
Habitat for Humanity International
Hallmark Corporate Foundation
Luke B. Hancock Foundation
Mary W. Harriman Foundation
Harris Bank Foundation
Hartford Foundation for Public Giving
Hawaii Community Foundation
Charles Hayden Foundation
Hazelden Foundation
Edward W. Hazen Foundation
Healing Community
William Randolph Hearst Foundations
The William and Flora Hewlett Foundation
High/Scope Educational Research Foundation
Hispanic Association on Corporate Responsibility
Hispanic Policy Development Project
Hispanics in Philanthropy
Hitachi Foundation
Hoblitzelle Foundation
Hoffmann-La Roche Foundation
Hogg Foundation for Mental Health

Honeywell Foundation
The Hospital for Special Surgery
Hostelling International-American Youth Hostels
Housing Assistance Council
Hudson-Webber Foundation
The Huffy Foundation
Human Life International
Humboldt Area Foundation
Huntington's Disease Society of America
IBM Corporation
Illinois Association of Nonprofit Organizations
IMPACT II
Independent Charities of America
Indiana Donors Alliance
The Indiana University Center on Philanthropy
Innovation Network
Institute for Educational Leadership
Institute for Women's Policy Research
Intel Foundation
InterAction-American Council for Voluntary International Action
Interlochen Center for the Arts
International Alliance of Executive and Professional Women
International Center for the Disabled
International Development Conference
International Executive Service Corps
International Primate Protection League
International Service Agencies
International Society for Third Sector Research
The James Irvine Foundation
Ittleson Foundation
Jacksonville Community Foundation
JCC Association of North America
Jerome Foundation
The Jewett Foundation
JM Foundation
Johnson & Johnson
The Johnson Foundation
Walter S. Johnson Foundation
Christian A. Johnson Endeavor Foundation
Robert Wood Johnson Foundation
Joint Action in Community Service (JACS)
Joint Center for Political and Economic Studies
Josephson Institute of Ethics
The Joyce Foundation
JSJ Foundation
Alexander Julian Foundation
Junior Achievement
Henry J. Kaiser Family Foundation
Kaman Corporation
Greater Kanawha Valley Foundation
Ewing Marion Kauffman Foundation
W.K. Kellogg Foundation
James S. Kemper Foundation
Harris and Eliza Kempner Fund
Kerr Foundation
Charles F. Kettering Foundation

Kids Voting USA
Carl B. & Florence E. King Foundation
John S. and James L. Knight Foundation
Kosciuszko Foundation
KPMG Peat Marwick Foundation
The Kresge Foundation
Samuel H. Kress Foundation
Albert Kunstadter Family Foundation
Land Stewardship Project
Land Trust Alliance
Laubach Literacy Action
Laurel Foundation
Lawyers' Committee for Civil Rights Under Law
League of Women Voters of the United States
Sara Lee Foundation
Leukemia Society of America
Lilly Endowment
Eli Lilly and Company
Lincoln Filene Center
Literacy Volunteers of America
Local Initiatives Support Corporation
George Lucas Educational Foundation
Lupus Foundation of America
Lutheran Brotherhood Foundation
John D. and Catherine T. MacArthur Foundation
Mallinckrodt Group
MANA, A National Latina Organization
Mandel Center for Nonprofit Organizations Case Western Reserve University
March for Life Education & Defense Fund
March of Dimes Birth Defects Foundation
Marin Community Foundation
John and Mary R. Markle Foundation
Marsh & McLennan Companies
Maryland Association of Nonprofit Organizations
MATHCOUNTS/NSPE Education Foundation
Matsushita Electric Corporation of America
Mayo Foundation
McConnell Foundation
Robert R. McCormick Tribune Foundation
McGregor Fund
McKesson Foundation
McKnight Foundation
The Meadows Foundation
Medical Education for South African Blacks
Richard King Mellon Foundation
Memorial Sloan-Kettering Cancer Center
Community Foundation of Greater Memphis
The Menninger Foundation
The John Merck Fund
Mercy Medical Airlift
Merrill Lynch & Co. Foundation
Metropolitan Association for Philanthropy
Metropolitan Atlanta Community Foundation
Metropolitan Life Foundation
Metropolitan Museum of Art
Mexican American Legal Defense and Educational Fund

Eugene and Agnes E. Meyer Foundation
Michigan Nonprofit Forum
Midwest Center for Nonprofit Leadership L.P. Cookingham Institute
Miles Inc. Foundation
John Milton Society for the Blind
Milwaukee Foundation
The Minneapolis Foundation
Minnesota Council of Nonprofits
Minnesota Mutual Foundation
Mississippi Center for Nonprofits
Mobil Foundation
Monsanto Fund
Moore Foundation
Stewart R. Mott Charitable Trust
Charles Stewart Mott Foundation
Muscular Dystrophy Association
Museum Trustee Association
Muskegon County Community Foundation
Mutual of New York
NAACP Legal Defense and Educational Fund
National Academy of Public Administration
National Action Council for Minorities in Engineering (NACME)
National AIDS Fund
National Alliance for Choice in Giving
National Alliance for the Mentally Ill
National Alliance of Breast Cancer Organizations
National Alliance of Business
National Assembly of Local Arts Agencies
National Assembly of National Voluntary Health and Social Welfare Organizations
National Assembly of State Arts Agencies (NASAA)
National Assistance League
National Association for Bilingual Education
National Association for Community Leadership
National Association for Visually Handicapped
National Association of Community Action Agencies
National Association of Homes and Services for Children
National Association of Independent Colleges and Universities
National Association of Independent Schools
National Association of Schools of Art and Design
National Association of Schools of Dance
National Association of Schools of Music
National Association of Schools of Public Affairs and Administration
National Association of Schools of Theatre
National Association of Service & Conservation Corps.
National Association of Student Personnel Administrators
National Association of United Methodist Foundations
National Association on Drug Abuse Problems
National Associations in Colorado Springs
National Audubon Society
National Board for Professional Teaching Standards
National Catholic Development Conference
National Catholic Educational Association
National Center for Learning Disabilities
National Center for Nonprofit Boards
National Charities Information Bureau
National Civic League

National College Access Network
National Committee for Responsive Philanthropy
National Committee to Prevent Child Abuse
National Community Reinvestment Coalition
National Concilio of America
National Conference
National Congress for Community Economic Development
National Consumers League
National Council for Adoption
National Council for International Visitors
National Council for Research on Women
National Council of Educational Opportunity Associations
National Council of La Raza
National Council of Nonprofit Associations
National Council of Private Agencies for the Blind
National Council of the Churches of Christ in the USA
National Council on Child Abuse & Family Violence
National Council on Economic Education
National Cultural Alliance
National Down Syndrome Society
National Easter Seal Society
National Executive Service Corps
National FFA Foundation
National Foundation for Cancer Research
National Fund for Medical Education
National Geographic Society Education Foundation
National Headache Foundation
National Health Council
National Health Foundation
National Hispana Leadership Institute
National Hispanic Scholarship Fund
National Home Library Foundation
National Hospice Organization
National Humanities Alliance
National Institute for Dispute Resolution
National Institute for the Conservation of Cultural Property
National Interfaith Hospitality Networks
National Leadership Coalition on AIDS
National Lekotek Center
National Medical Enterprises
National Medical Fellowships
National Military Family Association
National Multiple Sclerosis Society
National Neighborhood Coalition
National Network of Runaway and Youth Services
National Network of Women's Funds
National Park Foundation
National Parkinson Foundation
National Peace Corps Association
National Press Foundation
National Public Radio
National Puerto Rican Coalition
National Retiree Volunteer Coalition
National Society for Experiential Education (NSEE)
National Society of Fund Raising Executives
National Stroke Association

National Trust for Historic Preservation
National Urban Fellows
National Urban League
National Victim Center
National Wildlife Federation
National Youth Employment Coalition
Native American Rights Fund
Natural Resources Defense Council
The Nature Conservancy
Neighborhood Reinvestment Corporation
New Hampshire Charitable Foundation
The Community Foundation for Greater New Haven
The New York Botanical Garden
The New York Community Trust
New York Life Insurance Company
The New York Public Library
New York Regional Association of Grantmakers
New York Times Company Foundation
Nokomis Foundation
Nonprofit Academic Centers Council
Nonprofit Coordinating Committee of New York
Nonprofit Management Association
Nonprofit Management Program, New School for Social Research
Nonprofit Resource Center
The Nord Family Foundation
Nordson Corporation Foundation
North American Association for Environmental Education
North Carolina Center for Nonprofit Organizations
Northern California Grantmakers
Northwest Area Foundation
NOW Legal Defense and Education Fund
NYNEX Foundation
Oakleaf Foundation
OICs of America
Older Women's League (OWL)
OPERA America
Operation Smile International
Outward Bound USA
Pacific Telesis Foundation
David and Lucile Packard Foundation
Paget Foundation
Community Foundation for Palm Beach & Martin Counties
Park Ridge Center for the Study of Health, Faith and Ethics
Partners of the Americas
Pax World Service
Peninsula Community Foundation
William Penn Foundation
J.C. Penney Company
University of Pennsylvania Center for Community Partnerships
People-to-People Health Foundation
Pew Charitable Trusts
The Pfizer Foundation
Philip Morris Companies
The Piton Foundation
The Pittsburgh Foundation
The Planetary Society

Points of Light Foundation
Population Council
Population Resource Center
Premier Industrial Foundation
Presbyterian Health Foundation
Presbyterian Women
Presidential Classroom for Young Americans
Prince Charitable Trusts
Princeton Project 55
Private Agencies Collaborating Together (PACT)
Private Sector Initiatives Foundation
Pro Choice Resource Center
Procter & Gamble Fund
Project SEED
Prudential Foundation
Public Affairs Council
Public Agenda Foundation
Public Allies
Public Education Fund Network
Public Leadership Education Network
Public Radio International
Puerto Rican Legal Defense and Education Fund
Quest International
Radio and Television News Directors Foundation
Rainbow Research
Raychem Corporation
Raytheon Company
Reader's Digest Foundation
Reading is Fundamental
Recording for the Blind
Religion in American Life
Research! America
Resourceful Women
Retirement Research Foundation
Charles H. Revson Foundation
Rhone-Poulenc
Sid W. Richardson Foundation
Fannie E. Rippel Foundation
Rochester Area Foundation
Rockefeller Brothers Fund
Rockefeller Family Fund
Rockefeller Financial Services
Rockefeller Foundation
Rohm and Haas Company
Rosenberg Foundation
Roy A. Hunt Foundation
SAFECO Insurance Companies
The Saint Paul Companies
Saint Paul Foundation
The Salk Institute for Biological Studies
Salvation Army
San Antonio Area Foundation
San Francisco Foundation
University of San Francisco-Institute for Nonprofit Organization Management
Save the Children Federation
Dr. Scholl Foundation

School Food Service Foundation
The School for Field Studies
Sears, Roebuck and Co. Sears/Allstate/Homart
Seattle Foundation
Second Harvest
Shepherd's Centers of America
Sherwin-Williams Company
Sierra Club
Sierra Health Foundation
Harry Singer Foundation
The Sister Fund
The Skillbuilders Fund
Skillman Foundation
Alfred P. Sloan Foundation
Smithsonian Institution
John Ben Snow Foundation
Social Welfare Research Institute Boston College
Society for Values in Higher Education
Southeastern Council of Foundations
Community Foundation for Southeastern Michigan
Southern California Association for Philanthropy
Southern Education Foundation
The Spencer Foundation
Spunk Fund
W. Clement & Jessie V. Stone Foundation
Levi Strauss & Company
Student Conservation Association
Student Pugwash USA
The Studio Museum in Harlem
Subaru of America Foundation
Support Centers of America
Synergos Institute
Taconic Foundation
Taft Institute
Tandy Corporation
Community Foundation of Metropolitan Tarrant County
TechnoServe
Tenneco
Texaco Foundation
Theatre Communications Group
3M
Time Warner
Travelers Aid International
The Trilateral Commission
The Parish of Trinity Church in the City of New York
Trust for Public Land
U.S. Trust Company Foundation
Union Institute-Center for Public Policy
United Cerebral Palsy Associations
United Leukodystrophy Foundation
United Negro College Fund
United Scleroderma Foundation
United States Catholic Conference
United States Committee for UNICEF
United States-China Educational Institute
United Way International

United Way of America
UPS Foundation
US West Foundation
Vellore Christian Medical College Board (USA)
Vesper Society
Visiting Nurse Associations of America
Volunteers of America
Volvo North America Corporation
Izaak Walton League of America
Washington Center
Washington Council of Agencies
Washington Mutual Savings Bank
WAVE
The Wege Foundation
Weingart Foundation
Weyerhaeuser Family Foundation
Whirlpool Foundation
Mrs. Giles Whiting Foundation
Amherst H. Wilder Foundation
Woodrow Wilson National Fellowship Foundation
The Winston-Salem Foundation
Wisconsin Energy Corporation Foundation
Women and Philanthropy
Women in Communications
Women's College Coalition
The Women's Philharmonic
Women's Research & Education Institute
Robert W. Woodruff Foundation
Woods Fund of Chicago
Greater Worcester Community Foundation
World Federation for Mental Health
World Resources Institute
World Vision
Wyman Youth Trust
Xerox Corporation
YMCA of the USA
Young Audiences
Youth Service America
YWCA of the USA
Zellerbach Family Fund

Kathy Jabour, CFP
Certified Financial Planner

June 16, 1995

Mr. Phillip Mosley, Chief of Staff
Committee on Ways & Means
US House of Representatives
1102 Longworth
Washington DC 20515

Dear Mr. Mosley,

I am in complete support with eradicating our current tax system which as you know penalizes the productive people of this country.

I think the National Sales Tax would be the best system to replace our current system for these reasons:

1. It is the form of taxation our Constitution allows.
2. It would require everyone to pay. Drug dealers, prostitutes, and other illegal money makers would finally contribute to our system.
3. It would not allow the Congress to eliminate the deductions and then raise the tax, like they could if we had a flat tax.

A flat tax would still allow for cheating and wasted time preparing forms for the IRS. We must eliminate the IRS and all the wasteful acts associated with preparing our tax returns.

I personally spend too much time with accounting for my business, my husband's business, our joint business and our rental properties. I'm sick and tired of it all!

Lastly, I'm sick of my husband and I paying 15.3% of our income in Social Security taxes in addition to income taxes because we're self employed. I know without a doubt, that I can prepare for my retirement much better than the government, since advising people on this issue is what I do for a living.

If the employees of this country had to come out of their savings like we do, this debate would have taken place many years ago.

Please push towards the National Sales Tax.

Thank You,

Kathy Jabour, CFP

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FINANCIAL PLANNING

ECONOMIC STABILIZATION PROGRAM P.O. Box 1948 Waianae, HI 96792

June 7 1995

Mr Bill Archer
Committee on Ways and Means
Longworth House Office Building
Washington, D.C. 20515-6348

Dear Mr. Archer;

It is most difficult to change antiquated methods . That have been used more than two thousand years. Many American citizens demand that corrective action must be taken. The method of correcting the present tax situation must be properly accomplished. Since America and many other nations are dependent upon world economic stability.

An appropreate award is requested. Due to the magnitude of the situation.

Adoption of the ECONOMIC STABILIZATION PROGRAM By the President and Congress. in session. With members of the supreme court and national media in attendence. Will result in the following;

No reduction in any State or Federal agencies activities, nor reduction in any military branch will be required. All will receive full funding.

A period of time of two to three hours will be required to present the program to the nation.

Negotiations are invited at the earlyest.

Respectfully,

H. Johnson

H. Johnson
Ph. (808) 696 2115

Roger L. Johnson
575 Wisteria Street
Chula Vista, CA 91911

6 June 1995

Honorable Phillip D. Moseley
U. S. House of Representatives
Ways and Means Committee
1102 Longworth Office Building
Washington, D.C. 20515

Re: *Elimination of the Internal Revenue Service*

Dear Representative Moseley:

As I understand it, the two directions we are headed are a FLAT TAX OF 17% or a NATIONAL SALES TAX. As you deliberate, look at these two options from the viewpoints of taxpayers at the bottom, middle and upper end of the income spectrum. I make roughly $50,000 per year and pay about 14% in federal taxes. I would be hurt by a 17% flat tax. Since our last child gets married this weekend, my wife and I can could drastically reduce our monthly purchases, thereby making the sales tax look good. But...

With a national sales tax, the poor person (who spends every dollar every month just to survive) will be impacted much more than the rich person (who only spends a small part of his income each month to achieve that same goal). With a flat tax, the poor person will likewise be impacted more than the rich person because the poor are paying a much smaller percentage of their income (in the present tax system) than the rich. WITHOUT SOME ADJUSTMENT, THE POOR WILL BE HURT BY EITHER SYSTEM, WHEREAS THE RICH WILL BE HELPED.

I give my vote for the national sales tax, but only if the necessities of life upon which the poor spend nearly all their income (food, clothes, shelter, medical, utilities, etc) are exempt from the tax.

Whatever you do, you must get rid of the IRS! May God help you in your deliberations.

Very respectfully,

Roger L. Johnson

Roger L. Johnson

4715 Rittenhouse St
Riverdale, Md 20737
301-277-2242

20 June 1995

Dear Congressman Archer,

I am writing to ask the ways and means committee to consider a "location value tax" for tax reform. It is also known as site value, land, or single tax.

The tax is levied on the location value of the land a land owner is using.

Regarding the four conditions the committee set out:

1. It would be easy to comply with as the land one is using would have a market value (assessed by similar system to present property value assessment) and the tax rate. Only land owners would be taxed. It is a simpler tax on a lower portion of the populace.
2. Since property, income, and sales taxes could be replaced with the location value tax, greater investment and savings can take place. Improvements to property would be made since the present disincentive of property tax would be removed savings could increase because the burdens on production of income and sales taxes would be removed
3. The location tax encourages "best economic use" on any property because to adjacent properties will have the same tax (example a city lot with an office building will be paying the same tax as an empty lot next to it – the owner of the vacant lot will be encouraged to move pop to the best economic use) with the whole of our land use moving to best economic use – american labor and capital will be internationally competitive.
4. The land that is used cannot be hidden from the tax collector and since the location value subsumes all the economic activity, all the economy will be subject to taxes and there will be no underground economy

I am available for more details

sincerely,
Jack R Jones

6791 Jasper Place S.E.
Port Orchard, WA 98366

Representative Phillip Moseley
Chief of Staff, House Ways & Means Committee
U.S. House of Representatives
Washington, D.C. 20510

May 27, 1995

Re: Tax Reform

Dear Representative Moseley:

Please allow me to submit the following input in six copies for consideration and entry into the Congressional record:

I would like to voice my strong support for the Armey flat tax. Every year Americans are tasked with the burdensome duty of filing their income tax. With the large number of tax forms, schedules, and tax laws that are always changing, even the most educated individual finds this chore extremely difficult. I fail to see why a duty of all Americans has to be so difficult that professional assistance is often required and the best results are not guaranteed.

The appeal of the Armey flat tax is that it is fair and equitable to all Americans. Under this plan people would have less of a tax burden and there would still be plenty of revenue generated. Another appealing aspect is the form for filing your taxes would be about the size of a postcard. Truly, the Armey flat tax is a brilliant idea whose time has come.

If I could incorporate any changes into the Armey flat tax, I would allow deductions for charitable contributions to encourage people to continue giving to their favorite charities, and deductions for home mortgages. Many people purchase homes because of the tax advantage and home sales only serve to better the economy.

Thank you for allowing me this opportunity.

Sincerely,

Craig

Craig R. Kenwood
Port Orchard, WA

Law Offices of

RONALD ALAN KUNS

SAUSALITO OFFICE:
3020 Bridgeway
Suite 107
Sausalito CA 94965

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P.O. Box 751088
Petaluma CA 94975-1088
Tel. (707) 765-4890
FAX# (415) 331-2223

SANTA ROSA OFFICE:
2455 Bennett Valley Rd.
Suite 218-C
Santa Rosa CA 95404

June 7, 1995

P.D. MOSELEY
Ways and Means Committee
U.S. House of Representatives
Longworth Building
Washington D.C. 20515

RE: Review of U.S. Tax Policies

Dear Sir or Madam:

It is my understanding that your Committee is planning on studying the revision of our tax policy with a possibility that a "flat tax" or national sales tax (or other alternative) may replace the travesty that we now have under the current Internal Revenue Code. I have recently read Adams book "For Good and Evil, etc." which I heartily recommend if you have not read it. His treatise on the history of taxation in the world is something everyone should read.

Please count my vote for a complete revision of the insanity we now have. I dream of the day when a tax return is a post card, we no longer have to fear the IRS because it has been disbanded, the billions that are spent on tax preparation can be more effectively used in our economy than subsidizing government bureaucreats, accountants and tax attorneys, and, most importantly, more total revenue is raised from the contributions of all taxpayers to meet the obligations of government (which I trust will be declining under the political regimes to follow this current joke in Washington.)

We will be watching closely to see what is done.

Best regards,

RONALD ALAN KUNS
RAK/sd

Jacqueline Laird
16023 Butte Mountain Road
Jackson, California 95642

June 10, 1995

Dear Mr. Mosley,

Concerning your debate in the House on June 22, please consider the following suggestions on tax reform:

1. Strongly suggest that you get rid of the entire current system. Replacing it with either a flat tax or a consumption tax is equally acceptable to me.

2. I suggest that you either eliminate or drastically lower both capital gains tax and estate taxes.

3. I believe that you should eliminate the restrictions on IRA's when we also have a company pension that were set up in the 1986 tax revision act.

4. To encourage savings, the annual amount of monies we can put in IRA's, 401(k)'s, etc. should be increased since company pensions and social security are being reduced.

Thank you for your time,

Jacqueline Laird

Jacqueline Laird

Original and 6 copies of this letter included, as requested.

15 June 1995

Dear Congress,

As a Conservative [redacted] Republican, I'm so glad The GOP has taken over Congress - and hopefully The White House in 1996. We must do what we can to simplify The tax system and lower taxes to stimulate economic growth. I'm giving you some of my ideas on how to lower taxes, I don't know if all of my ideas are realistic, but we must do something about lowering our debt.

Although I don't specialize in tax law, [redacted] I think some of my ideas are valid. Please read them and ~~are~~ tell me what you think. My number is (818) 296-9696.

Thank you and God Bless America.

Sincerely yours,
U. J. LaRouche

Business ~~Company~~ Tax Relief Program

Preamble: To simplify IRS paperwork, red tape, and bureaucracy, companies have the choice to participate in the Company Tax Relief Program. This program will eliminate tax avenues that cripples the economy to a minimum. The company will save money on taxes, keep more of their profits, and have incentives to invest money to help their businesses grow.

How It can work: Let's say a company with 100 regular employees plus managers and executives and 1 CEO ~~have two~~ ~~this~~ makes $10,000,000 a year. Without participating in the program, the income and tax structures may look like this.

Employees	Salary for Each:	Total Income:
100	$25,000/year	$2,500,000
Managers	Salary for Each:	Total Income:
7	$55,000/year	$385,000
Executives	Salary for Each:	Total Income:
2	$85,000/year	$170,000
CEO	Salary:	Income:
1	$200,000/year	$200,000

The total income for all 110 people is $3,255,000. If the company makes $10,000,000, the capital-gains tax will probably be 31%. This leaves the company $6,900,000, of which $3,255,000 will be given to its workers. Now the money left over is

$1,825,000
$ 245,650
$ 110,500
$ 120,000
$2,321,150

$3,645,000 to spend to improve the company and pay for other expenditures. (Benefits, petty cash funds) Now all 110 people must pay their own income taxes. Let's say the employees pay 27%, the managers pay 31%, the executives pay 35%, and the CEO pay 40%. Knowing this, everybody's net pay (take-home pay) would be:

Employees:

Number:	Ave. Salary:	Tax Rate:	Ave. Net Pay:
100	$25,000	27%	$18,250

Managers:

Number:	Ave. Salary:	Tax Rate:	Ave. Net Pay:
7	$55,000	31%	$37,950

Executives:

Number	Ave. Salary:	Tax Rate:	Ave. Net Pay:
2	$85,000	35%	$55,250

CEO:

Salary:	Tax Rate:	Net Pay:
$200,000	40%	$120,000

For all 110 people, the Net Pay is (100 × $18,250) + (7 × $37,950) + (2 × $55,250) + (1 × $120,000) = $2,321,150. This means that $933,850 - or 27.6% - of everybody's combined salary is taxed. Add that to the $3,100,000 taken away from the capital-gains tax, and the total amount that the company and the workers must pay in taxes is $4,033,850. In other words, 40.34% of the company's income goes to taxes be-

fore anybody takes any money home. This is wrong!

Now, out of the $3,645,000 left over, $2,500,000 is spent on other expenses, like benefits, equipment, and other things. This leaves $1,145,000 in profit.

This is not bad, but lowering taxes will make the situation much better. Here's how the Company Tax Relief Program will work.

<u>The Program:</u>

The basic concept behind the 'Business Tax Relief Program' is that only the company - not the workers - will pay taxes. All individual income taxes will be eliminated, while the company pays only a capital-gains tax. If all employees are willing to work as a team, they should pay taxes solely as a team. The employees should be taxed only once - not twice! Here is what would happen.

1) The CEO of the company goes to the IRS and says, "I want my company to partake in the 'Business Tax Relief Program'."

2) The company is now required to hire an accounting firm made up of at least 1 Certified Public Accountant. The company may or may not already have one. In either case, the CPA should represent the company, <u>not</u> <u>the government</u>!

3) Under the program, the capital-gains tax will be automatically reduced from 31% to 30% and can be reduced more in the future. Remember, a capital gains tax affects everybody, from the CEO to the

lowest employee.

4) All individual income taxes will be eliminated. (How about that for a pay increase!!) All paperwork will now be handled by the accounting firm.

5) The company cannot decrease any employee's salary, even if the decrease is less than the original net pay compared to the new tax-free salary. For example, if an employee's net pay is $18,250 from a $25,000 salary, the company cannot lower that employee's salary to - let's say - $20,000 in a tax-free salary.

6) All employees have the option to be paid only once a month - reducing the paperwork and red tape.

The Results:

For the company earning $10,000,000, 30% will go to the IRS due to the capital-gains tax. This leaves $7,000,000. Now this money can be used to pay all employees.

Employees:

Number	Ave. Salary	Total Net Pay
100	$25,000/yr	$2,500,000

Managers:

Number	Ave. Salary	Total Net Pay
7	$55,000	$385,000

Executives:

Number:	Ave. Salary:	Total Net Pay:
2	$85,000	$170,000

Accountant:

Number:	Ave. Salary:	Total Net Pay:
1	$50,000	$50,000

CEO:

Number	Ave. Salary:	Total Net Pay:
1	$200,000	$200,000

The Total Net Pay for all 111 people - with an accountant now included in the equation - is $3,305,000. Now, out of the $7,000,000 left over, the company has $3,695,000. This is only $50,000 more compared to the $3,645,000 left over from our previous example. Now, let us look at everybody's taxes individually.

Surprise! Surprise! Surprise!

Don't look now! There are no individual taxes! This saves the people in the company $933,850, saving the company a total of $983,850. Let's now examine how this will help the individuals.

Economy Psychology:

For the people making $25,000/year, each will save $6,750 per year since their incomes are now tax-exempt. Think of how America's economic behavior will change since ~~they~~ the people now have more money.

1) They will be less likely to demand a raise.
2) They won't go on strike as often.
3) They will work harder for the money and produce more for the company.
4) They will have fewer health problems due to economic stress.
5) They'll invest more money into a saving account, an IRA, and the stock market.
6) They will donate more money to worthy charities.
7) They can put their children through college - and pay in cash.
8) They will patronize booming businesses that would have otherwise gone bankrupt.
9) They will buy the finer things in life.
10) Company CEOs will employ more people.
11) Improvements in technology will grow at a faster pace.
12) Interest payments - for college loans, cars, and credit cards, for example - will dwindle to almost nothing.
13) They will restore their pride in America.
14) Crime will decrease drastically.
15) They will be better educated.
16) They will be much less dependent on the government after retirement, making life better for all.
17) They will work less and accomplish more.
18) They will spend vacation time <u>on vacation.</u>
19) They will work together as a team.
20) Unemployment will go down greatly.
21) They will not complain nearly as often.
22) They will be nicer to each other.
23) Two-parent households will increase.
24) Personal problems will be solved faster.

25) The Democratic Party will no longer exist.
26) They will be their brother's keeper.
27) Homelessness will be almost non-existent.
28) Teen pregnancy will go down.
29) They will live much longer.
30) They will help strangers in times of need.
31) They will be more physically fit.
32) The size of government will go down.
33) They will laugh much more often.
34) Preventable expenses and suffering will go down.
35) They will be more likely to say "no" to drugs.
36) They will watch more sunsets and less television.
37) Children will grow in more stable households.
38) They will be much less tolerant towards immorality.
39) They will take more risks and fewer changes.
40) Drunk driving will go down.
41) They won't take the Lord's name in vain as often.
42) There will be more orphanages and fewer foster homes.
43) They will borrow more sugar and less money.
44) They will celebrate November 8th as Independence Day. (Think of the year 1994!)
45) There will be more (first-time) weddings and fewer divorces.
46) They will no longer think of "God Bless America" as an oxymoron.
47) Companies will be more conscious about customer service.
48) Young people will give more respect to elderly folks.
49) They will honor old-fashioned family values much more.
50) They will build more and destroy less.

CAN YOU THINK OF MORE!

Reducing (Eliminating) Tax Avenues:

In order to reduce taxes, America must reduce tax avenues. We must eliminate the number of ways Americans are taxed to increase tax revenue and to stimulate the economy. Here's my proposal.

1) Capital-Gains Tax:

The Business Tax Relief Program will give all participating companies a flat capital-gains tax of 30%. This will give companies a greater incentive to invest and hire more people.

2) Individual Income Taxes:

The Business Tax Relief Program will immediately eliminate all individual income taxes. This will help people patronize many other business, help them reduce their interest rates, save for retirement, and help them gain independence from government subsidies.

3) State Sales Taxes:

State sales taxes for all 50 states and the District of Columbia will be immediately eliminated. It's bad enough people are taxed through ~~to~~ their companies for earning money. Why should the government penalize people for buying something? Eradicating the sales tax will stimulate the economy by encouraging people to buy things.

4) Luxury Taxes:

Imposing luxury taxes only weakens the economy and ~~forcing~~ forces hard-working, middle-class Americans to be unemployed. All luxury taxes should be immediately

eliminated.

5) Tobacco and Alcohol Taxes:
Although all Americans should avoid Tobacco and alcohol products of all Kinds, the government should never impose Taxes to discourage consumption. Instead, let a grass-roots movement curb Tobacco and alcohol use. The government should eliminate all Tobacco and alcohol taxes.

6) All Other Taxes:
Don't even think about it.

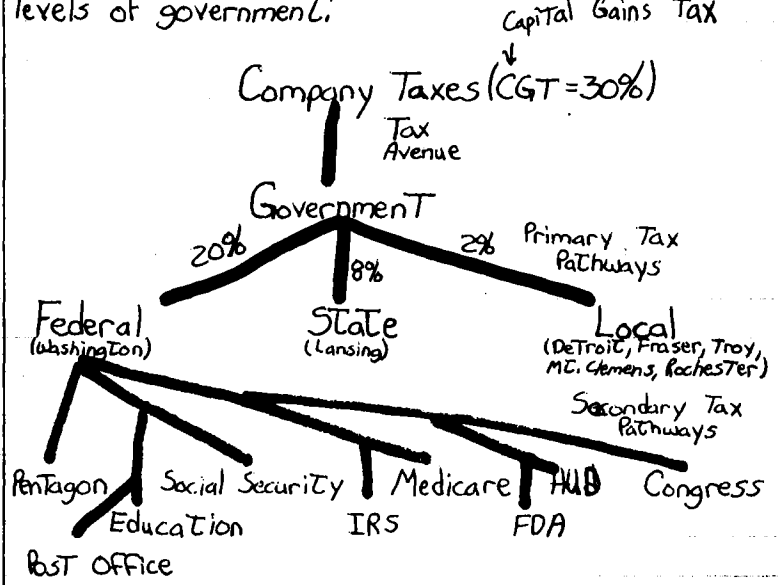
Of course, we should also eliminate all Tax exemptions, Tax deductions, Tax loopholes, Tax returns, and any other Tax avenue That gives money back To Tax payers. By doing This, we will spare Tax payers of needless bureaucracy. If The government wants To cut Taxes, then it should just cut Taxes. Period.
Now let's look at Tax pathways.

7) Property Taxes:
Eliminate property taxes that will go To public schools; lets make all schools private to enhance competition in education.

8) Inheritance Taxes:
Let's give This Tax The booty. Help the older generations give something to generation X so that young people can live The American Dream.

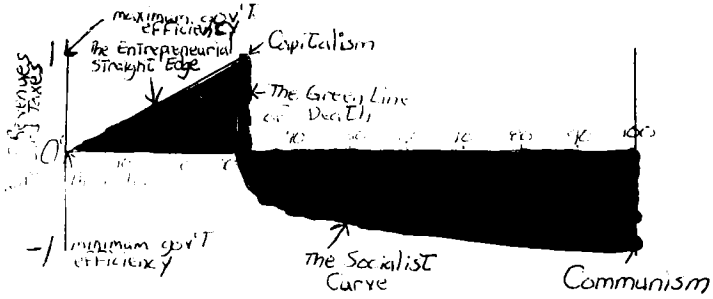
Tax Pathways:

A Tax pathway is a route where tax dollars are distributed. After the capital-gains tax takes 30% of revenues made by a company, these tax dollars will be distributed throughout the various levels of government.



The 30% should be distributed among the Federal, State, and local goverments using a ratio of 20:8:2, respectively. Let these percentages be iron-clad to keep the whole system simple.

The Taxation Curve: What It Is and What It Means



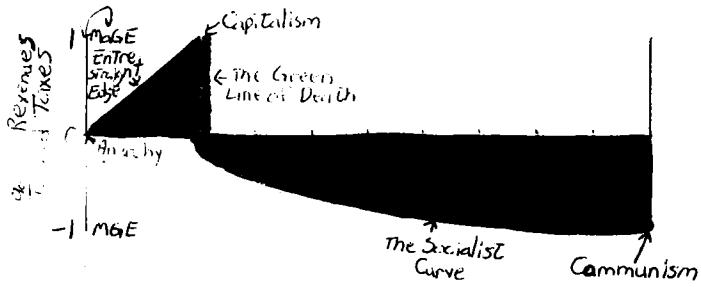
~~2005~~ 1996!

This graph represents what would happen when a certain percentage of ~~Tax~~ revenue goes to taxes. When no money goes into the government, we have anarchy. We have no government, no defense, no law and order.

With a moderate amount of revenues going to the government, it gives us security and morality and useful, sensible controls to make society work. According to the chart above, a 30% tax (from the capital-gains tax) gives a good balance between entrepreneurial freedom and moral government. This is much better than paying 40-50% in taxes ~~of~~ of all kinds today.

Going beyond this point, however, can lead to economic oppression for the people. Companies won't hire people; workers will not save enough for retirement; interest rates ~~are~~ will be higher; people would be pressured to put money into tax-free loopholes instead of investing in their businesses; the economy will weaken; tax revenues will actually decrease.

Lowering taxes - according to the Business Tax Relief Program - will help people save money so they can



2005!

be less dependent on government after retirement. They'll patronize businesses so they can stay in the black. They'll pay for their children's education with cash and almost eliminate their interest payments on loans and credit card payments. Instead of creating a dependency class, America will have an independency class. Unemployment, inflation, and interest rates will remain low.

Despite 30% being relatively lower than what it is today, we can systematically reduce it to 20%. The 30% will be distributed in the following ways: Federal, 20%; State, 8%; Local, 2%. From the year the Business Tax Relief Program becomes law, Congress should implement a 10-year plan to reduce the Capital-Gains Tax from 30% to 20%. To see how this 10-year plan breaks down, please see the chart on the following page.

Year	CG Tax	Federal	State	Local
1996	30%	20.00%	8.00%	2.00%
1997	29%	19.30%	7.75%	1.95%
1998	28%	18.60%	7.50%	1.90%
1999	27%	17.90%	7.25%	1.85%
2000	26%	17.20%	7.00%	1.80%
2001	25%	16.50%	6.75%	1.75%
2002	24%	15.80%	6.50%	1.70%
2003	23%	15.10%	6.25%	1.65%
2004	22%	14.40%	6.00%	1.60%
2005	21%	13.70%	5.75%	1.55%
2006	20%	13.00%	5.50%	1.50%

Having a capital-gains Tax of 20% by The year 2006 will stimulate the economy greatly. Any economic and governmental improvements created from The start of These new Tax laws will become even bigger when Taxes go down.

A 20% capital-gains Tax will help millions of Americans prosper and give Them a chance To donate money To These who need it.

Now let's see how The Business Tax Relief Program will help Americans save money and spare Them of needless bureaucracy.

The Transition

The Business Tax Relief Program will transfer accountants working for the IRS and other governmental agencies to the private sector; they'll be working for companies under the program. These accountants will now handle all IRS paperwork for the companies. They will tabulate all revenue going into their companies and take 30% out for taxes.

The companies will take the other 70% and give it to their workers and buy new equipment. All employees - and employers - will ~~be~~ pay no individual income taxes. They will also pay no other kinds of taxes - sales tax, luxury tax, etc.

On top of that, people will be spared needless paperwork and bureaucracy. Examples of this include:

1) No figuring out income taxes during precious weekends;
2) No hiring accountants to help people figure out their taxes;
3) Much less paperwork going to the IRS.
4) No risk of procrastination (You won't see long lines of cars heading to the postal office on April 15th at 11:58 p.m. so people could drop off their tax forms on time.);

At the end of the year, each participating ~~companies~~ company will receive tax form 1040C. The

~~companies~~ company accountant(s) will collect all of the company's W-2 forms (12 in all; 1 for each month) and claim it on Tax Form 1040C. The accountant sends Tax Form 1040C to the IRS, which sends the company a receipt confirming all the revenues the company claimed - plus all the taxes taken out.

The Concept Behind Having One Tax Avenue:

I think government believes complexity is a Badge of Honor. I do not! It's bad enough the IRS has to handle a phenomenal quantity of paperwork. Why can't the IRS consolidate tax collecting into a single tax avenue?

I'm sure IRS employees are stressed out from the paperwork as much as people and companies are. If a company earns $10,000,000 in a year, everybody - from the CEO down to its lowest employees - contributed to the company's success. If the people in the company were willing to work well as a team, the government should tax the people in the company solely as a team. Why can't the IRS just take 30% of a company's earnings and leave the rest alone? Why can't the government rely entirely on that single tax avenue and then distribute the money among all the agencies on the federal, state, and local levels?

Creating so many kinds of taxes only adds to the bureaucracy and red tape. No more state sales taxes for people buying cars or furniture or diapers. No more luxury taxes for people buying 60-foot yachts or 24-karat gold jewelry. No more individual income taxes! Imagine that!

Of course, all tax loopholes, tax exemptions, tax deductions, and tax returns should also be eliminated. All paperwork involving these transactions are at taxpayer expense, anyway. And since the people of this country will be taxed so much less in the first place, they won't miss these 'benefits' at all.

Businesses now must claim everything. Failure to do so will mean detrimental penalties for the guilty companies. I'm sure all company CEO's would never put ~~his company~~ their companies or ~~his~~ their employees in bad standing with the IRS. (Unless they don't mind the risk of having their workers lynch them.) Remember, all employees of all ~~gen~~ tax evading companies will be penalized as a team. Lowering taxes and forcing all companies to claim everything will simultaneously boost the economy and increase tax revenues.

Let our government's simplicity be its badge of honor!

Special Notes For:

1) Spence Abraham (Republican Senator - Michigan): Congrats on being a newly-elected Senator from the great state of Michigan! Good luck with everything. I'mglad you've been elected in time for the 2nd American Revolution. (I call it that because, just like the 1st Revolution, Americans have spoken against economic and governmental oppression.) I would also like Congress to create a New Crime Bill. In fact, I'd rather call it a Punishment Bill. Let's repeal the present gun bans and include federal laws that will enforce capital punishment on murderers and surgical castration on rapists! In the meantime, urge Mitt Romney to run for the U.S. Senate against Carl Levin in 1996. I think you two would work well together. Don't worry about Ted Kennedy - his terms are numbered!

2) Senator Bob Dole (R-Kansas; Majority Leader): I know you are frustrated for not being elected President. I think the nation would've been in good hands with you in the oval office. However, you've been a great Senator, but I ask a special favor from you the moment the Republicans take over the White House. Please make ~~you~~ sure you boost the defense budget! It's disgusting how the

Clinton Administration has decreased the defense budget and increased the budget of so many needless programs. If anybody can convince a Republican administration to boost the defense budget, it's you. You served in World War II. You were wounded. You know how well the country works when defense is strong, and you know the consequences the country faces when defense is weak. And unlike President Clinton, you do feel the pain war veterans face. Bill Clinton is as un-American as any President in American History. Please boost the federal defense budget and put Bill Clinton in his place.

3) Senator Phil Gramm (R-Texas): From what I have heard, you are going to be a popular choice to be the GOP candidate for President. In that case, you will be the next President. I can't say how effective the Gramm Administration will be but I know it would last eight years. In fact, you can start moving into the White House now. You know, a couch here and a dining set there. I may not be an economist like you, but I hope I gave you a few ideas. Even if lower taxes increase tax revenues, Congress must still decrease spending. First, get rid of the Food and Drug Administration. Deregulate medicine so doctors can give all of us better care and give doctors

more control over their treatment options. Transfer all welfare power to the states and decrease welfare spending by 5% per year until it goes down to a reasonable level. Also transfer all education money to the states and give the states the option to commercialize all schools. Make the tax system simpler to downsize the IRS. There's so much the Republicans can and will do, but please take your time. You can't overturn the New Deal mentality our goverment has adopted over the past 62 years overnight.

4) Rep. Richard Armey (R-Texas, House Majority Leader): I'm so glad somebody has enough common sense to lower taxes and simplify tax bureaucracy. I like your 17% flat tax, and I hope my ideas will give you more insight. I don't, however, like your idea of tax payers writing checks to the IRS. I know you want people to realize how much they're paying in taxes, but the risk of tax evasion would be way too great! But for the most part, I agree with your philosophy - as noted by how hard you were laughing at the opposition on "Meet the Press". Never underestimate the power lower taxes, lower bureaucracy, and a dynamic military will have on America and on Americans. If all goes well for the Republicans, maybe

you and Mr. Newt will receive your Tenure.

5) Rep. Newt Gingrich (R-Georgia, Speaker of the House): First of all, don't listen to any of your critics. It's amazing how a group of freshmen congressmen who are trying to make life better for all Americans can receive such nonsense from the elite media and from liberal democrats. Remember, they will give you and all Americans the impression that the national debt is some uncontrolled act of nature - like a tornado or a hurricane! And now it's up to the Republicans to stop the dam from overflowing. The national debt is now $4.8 trillion, and cutting spending is the only way to lower it. The sad part is that a huge part of the national debt is a result of welfare spending - about $5 trillion worth. The federal government, the nation's most notorious middleman, will take up to 60% in transaction costs. If we completely eliminated programs that the private sector could pay for, the debt would go down drastically. Americans are far and away the most giving people on Earth. Let them take care of the poor. Let them give to charities - like public television. By lowering taxes, bureaucracy, and spending, the people will have more power to help those in need. Now people may ask "What will happen to the poor people?" The

answer: businesses will expand, more jobs will be created, and everybody will have more money. Prosperity will linger and the need for welfare will decrease. Please be patient, Mr. Newt. Everything will be for the best. In the meantime, I'll vote Republican!

Phillip Marsh
378 Golden Gate Ave. #326
San Francisco, Calif. 9410
(415)292-2412

May 27, 1995

Cong. Arnold
Commitee of Ways and Means
Main Commitee Hearing Room
Longwood Bldg.
Washington, D.C.

Dear Sir:

I understand that you are having hearings on the abolition of the Internal Revenue Srevice on the 6th of next month.

I support that idea one thousand percent !!!

The following are a few reasons that I feel that your commitee should look into. I am in a position to verify documentarily, each of the following statements and would further be willing to testify before your commitee if called upon to do so.

1. The I.R.S is NOT a government agency. They claim to be with the Treasury Department, but Title 31 U.S.C. Sec. 301 is the organizational chart for the Treasury Department and it does not list the I.R.S. as one of it's components !

The funds that the I.R.S. steals do NOT go to the United States Government to run the country on. Look at the endorsement stamp that the I.R.S. uses on the back of the checks they are given. It reads: "Pay to the FRB, to the CREDIT of the U.S. Treasury, to reduce U.S. obligations". In other words, all of the so called Tax Dollars that the I.R.S. steals from the American People go only to pay the phony uncollectable INTEREST on the phonier National Debt, which is also as phony as an eight dollar and fifty cent bill !

The abuses of the law by the I.R.S. are too numerous to mention but as for the law that requires an American to file a 1040 Tax return, there is NO SUCH LAW. I know, because last year, I underwent a three long months of trial on tax evasion charges (among other phony trumped up charges) and I offered in front of the Judge as well as the jury, to plead guilty and go to jail, just as soon as the A.U.S.A. could show me the law that required the filing of a Federal Tax Return. My request was met with stony SILENCE !There IS NO SUCH LAW. This scam MUST STOP ! Please do your duty and expose this monster for what it is .

Sincerely,
Phillip Marsh

THE UNIVERSITY OF TEXAS AT EL PASO
UTEP

Department of
Accounting
College of
Business Administration

June 12, 1995

Mr. Philip C. Mosley
Chief of Staff
United States House Ways and Means Committee
1102 Longworth House Office Building
House of Representatives
Washington, DC 20515

Re: Tax Reform Hearings

Dear Mr. Mosley:

I am submitting six copies of each of two items which I wish to be considered by the committee in regard to tax reform:

1. A guest column which I wrote for the El Paso Hearld- Post February 11, 1995, entitled "Flat-tax Proposal Won't Be Simple."

2. An article which I wrote which appeared in March 6, 1995, Tax Notes in summary form, and also in Tax Notes Today in its entirety: "An Analysis of the Armey Flat-tax Proposal."

Please include them in the record. Thank you.

Very truly yours,

Frank A. Mayne, PH. D., CPA

FORGING THE FUTURE

El Paso, Texas
79968-0542
(915) 747-5192

El Paso Herald-Post, February 11, 1995

Flat-tax proposal won't be simple

By Frank A. Mayne

SPEAK YOUR PIECE

The recent editorial "flat tax finds more converts" and news reports on the issue have struck a nerve with me, as I am an accounting professor at UTEP and also prepare some tax returns professionally each spring. My teaching assignments often involve trying to make the tax law more intelligible to aspiring accountants. The editorial asserted that "There is not a taxpayer in the country, we would wager, who would not cheer the demise of the infinitely complicated income tax forms and rules, and their replacement with a post card."

We already do have a form that simple — the 1040 EZ — for single persons with only salary and wages and less than $400 of interest. The form requires only copying W-2 information onto the appropriate blank, a couple of elementary addition and subtraction operations and a look in the tax table. Yet legions of citizens still troop to professional tax preparers, the IRS, IRS-sponsored help centers or helpful friends for assistance with Form 1040 EZ. The problem at the 1040 EZ level is definitely not "infinitely complicated tax forms."

If we go up the next level of tax form, the 1040 and 1040A, I have found that when most rank-and-file taxpayers refer to "complexity" they are referring to the calculation procedures involving personal exemptions, itemized versus standard deductions, and various credits for individuals (i.e., child care). Yet, this is only the tip of the iceberg. In the typical introductory college course that we call "Individual Tax," these basics of calculation will have been covered by the second week of a 16-week semester. Those basics are really the easy part of the course.

The individual tax college course gets more and more complicated as the semester goes, as the rules for proprietorships, investments and the like are covered in connection with such concerns as losses, depreciation and accounting methods. We follow the individual tax course with a second course at the undergraduate level covering partnerships, corporations, estates and trusts. For those who are really gluttons for tax courses, UTEP also offers a master of accountancy with a concentration in taxation, a degree which includes five more taxation courses.

I think the students who have been through any of those courses would say that they were only given a sampling of the many issues involved. Hopefully most of them left the respective course(s) with an appreciation for the complexity that really exists in income taxation of business and investment activity.

> *'The flat tax is being pitched by some as simplification. It should not be. If only the tax rate and the personal exemptions and standard deduction are changed, as in the Armey proposal, all of the real complexity will remain.'*

Mayne

Note that the complexity that I describe is not complexity of mathematically computing the tax. The real complexity is in arriving at taxable income, i.e., the dollar figure to which the tax rate will be applied.

The flat tax is being pitched by some as simplification. It should not be. If only the tax rate and the personal exemptions and standard deduction are changed, as in the Armey proposal, all of the real complexity will remain. As long as the income tax continues to be the principal revenue source for the federal government, all of the current complexity will remain because of the underlying complexity in the determination of taxable income on business and investment.

What the reformers are proposing primarily is a decision involving the economics of the tax burden and the related federal budget deficit, rather than a tax simplification. For comparison, a single person with a $99,999 salary and no other income, deductions, or dependents pays $24,444 under the current tax, but only $17,380 in the 20 percent tax version of Armey's proposal — a whopping $7,064 reduction.

A single person earning $29,000 would pay $3,420 under the current system but $3,180 under the 20 percent Armey proposal, difference of $240. As the editorial pointed out, everybody gets a tax reduction under the Armey 20 percent tax proposal. It is just that the higher-income taxpayers will get a much larger reduction, thus proportionately shifting the burden of the total tax being collected toward lower income taxpayers.

Note that there would definitely be a revenue shortfall in the near term with the Armey 20 percent flat-tax proposal as generous as it now stands. If government spending levels remain constant, and everybody's taxes go down, less revenue will be collected, and we will be increasing the budget deficit by leaps and bounds.

Supply-siders will jump in at this point and point out that the tax reduction will stimulate the economy, which in turn will increase business profits and the number of jobs. The growing economy will eventually increase tax collections. Will the growth be enough to eventually reduce the deficit? Who knows?

Unfortunately, the answer will have to be trial-and-error experimentation, just as it was with the last series of major tax-rate reductions in the 1980s, after which we were left with enormous budget deficits. Those deficits are still being financed as part of the accumulated federal debt.

In fact, interest on the federal debt is the third largest line item in the federal budget. Would we really want to elevate interest on the debt to second or even first place?

In summary, the principal issues being considered here are two-fold: the equity of the tax burden and the size of the near-term budget deficit. To me, those are the real fiscal issues that are being put on the table with the Armey flat tax proposal, not simplification.

Frank A. Mayne is a Ph.D. and CPA who has been an assistant professor at UTEP since 1978.

An Analysis of the Armey Flat-tax Proposal

Frank A. Mayne, Ph. D., CPA

A flat-tax proposal is on the Congressional agenda again. House majority leader Dick Armey has a plan with a 20% rate to start, with eventual reduction to 17% by the third year. The Armey proposal also calls for personal allowances which would be larger than the standard deduction and personal exemption system in current law. However, itemized deductions would be eliminated. The plan calls for personal allowances of $13,100 for a single person, $26,200 for a married couple filing jointly. and $17,200 for an unmarried head of household. Each dependent would increase the allowances by another $5,300.

The Armey plan promises tax reduction for most taxpayers. However, the tax reduction is much more pronounced at upper income levels. Compare the 20% rate to the current top marginal rate of 39.6%, and intuitively there will a revenue shortfall compared to the revenue raised by the current tax law. Conversely, with a revenue shortfall, the federal deficit would be increased by leaps and bounds.

To demonstrate the impact of this proposal, analysis will be presented at both the taxpayer level and the macroeconomic government finance level. Several examples have been prepared, based on typical taxpayers, to demonstrate who will gain and who will lose. Aggregate income statistical data is also used to analyze the impact on the federal treasury.

In the examples which follow, 20% will be assumed throughout for the Armey proposal. Table 1 compares the tax paid by a married couple, with no dependents, at adjusted gross incomes of $40,000, $62,500, and $75,000 respectively. These income levels

were selected in order to be at the midpoint of the statistical reporting brackets used by the IRS in *Statistics of Income* published by the U. S. Treasury. The average itemized deductions reported in the IRS statistics for 1992, the last year which has received complete analysis in *Statistics of Income,* makes a realistic example of an itemizing couple's return. The Armey plan indeed does significantly reduce taxes for all three income levels. The couple with the $87,500 AGI has a reduction of $7,307 and the other couples save $1,631 and $5,307 respectively.

Table 1. Comparison of Three Married Filing Joint Income Levels for 1994 Law and the Armey Plan

1994 Law:				
	Adjusted Gross Income	$40,000	$62,500	$87,500
	Itemized Deductions*	10,736	13,381	17,864
	Personal Exemptions	4,900	4,900	4,704
	Taxable Income	$29,264	$44,219	$64,932
	Tax from Tax Tables	$ 4,391	$12,567	$19,567
Armey Plan:				
	Adjusted Gross Income	$40,000	$62,500	$87,500
	Personal Allowances	26,200	26,200	26,200
	Taxable Income	$13,800	$36,300	$61,300
	Tax using 20% rate	$ 2,760	$ 7,260	$12,260

*Itemized Deductions are assumed. Amounts used reflect *Statistics of Income* (Fall, 1994) averages for income brackets in 1992 data for which assumed income is midpoint of bracket.

The impact of the large personal allowances can be shown in Table 2. The example taxpayers have been selected with one each for the three personal allowance filing statuses. Also, the adjusted gross income has been set so as to be the largest income where the Armey plan would zero out the tax. The table shows the current law does indeed assess significant tax, i.e., $1,031, $2,246, and $1,376 for single, married filing joint, and unmarried head of household, respectively.

Table 2. Comparison of Three Filing Statuses at Income Levels for 1994 Law and the Armey Plan, so as to show maximum adjusted gross income under Armey Plan prior to tax being paid.

Filing Status		Single	Married Filing Jointly	Head of Household
1994 Law:				
	Adjusted Gross Income	$13,100	$26,200	$17,200
	Standard Deduction	3,800	6,350	5,600
	Personal Exemptions	2,450	4,900	2,450
	Taxable Income	$ 6,850	$14,950	$ 9,150
	Tax from Tax Tables	$ 1,031	$ 2,246	$ 1,376
Armey Plan:				
	Adjusted Gross Income	$13,100	$26,200	$17,200
	Personal Allowances	13,100	26,200	17,200
	Taxable Income	$ -0-	$ -0-	$ -0-
	Tax using 20% rate	$ -0-	$ -0-	$ -0-

Since the marginal rate in the Armey proposal is 20%, and 15% is the lowest rate in the current law, the question arises as to whether there might be some income level where the 20% marginal rate actually increases the tax for a person whose marginal rate is now 15%. To answer this question, intuitively, if such a situation exists, it would exist at the breakpoint where the 15% brackets end and the 28% brackets start. Therefore, the adjusted gross incomes selected for Table 3 are the breakpoints at the end of the 15% brackets in the 1994 rate schedule. Note that the Armey plan saves $240 for the single taxpayer at the breakpoint, $1,297 for the married couple, and $312 for the unmarried head of household.

Table 3. Three Filing Statuses at Taxable Income Levels which are maximum taxable incomes at 15% rate for 1994 Law with comparison to Armey Plan.

Filing Status:		Single	Married Filing Jointly	Head of Household
1994 Law:				
	Adjusted Gross Income	$29,000	$49,250	$38,550
	Standard Deduction	3,800	6,350	5,600
	Personal Exemptions	2,450	4,900	2,450
	Taxable Income	$22,750	$38,000	$30,500
	Tax from Tax Tables	$ 3,420	$ 5,707	$ 4,582
Armey Plan:				
	Adjusted Gross Income	$29,000	$49,250	$38,550
	Personal Allowances	13,100	26,200	17,200
	Taxable Income	$15,900	$22,050	$21,350
	Tax using 20% rate	$ 3,180	$ 4,410	$ 4,270

Table 4 presents some situations where the Armey plan would cause tax to go up, due to the elimination of itemized deductions. A single taxpayer, $45,000 AGI, with three different assumptions of itemized deductions, clearly shows that the large itemizer at lower and moderate income levels will be hurt by the Armey plan. In the upper income levels, the pattern would depend on the nature of the itemized deductions involved, as the current law requires reduction of state and local taxes, housing interest, contributions, job-related, and most miscellaneous deductions. Gambling losses, medical expenses, investment interest, and casualty losses are not reduced at high incomes under current law. Therefore, depending on the specific package of itemized deductions involved, there could be high income taxpayers who also lose under the Armey plan.

Table 4. Comparison of Single Returns With Different Itemized Deduction Levels for 1994 Law versus the Armey Plan

1994 Law:				
	Adjusted Gross Income	$45,000	$45,000	$45,000
	Itemized Deductions*	25,000	17,500	10,000
	Personal Exemptions	2,450	2,450	2,450
	Taxable Income	$17,550	$25,050	$32,550
	Tax from Tax Tables	$ 2,636	$ 4,064	$ 6,164
Armey Plan:				
	Adjusted Gross Income	$45,000	$45,000	$45,000
	Personal Allowances	13,100	13,100	13,100
	Taxable Income	$31,900	$31,900	$31,900
	Tax using 20% rate	$ 6,380	$ 6,380	$ 6,380

* Itemized Deductions Arbitrarily Assumed

As the examples in tables have demonstrated, significantly more taxpayers have tax reductions under the Armey proposal. Therefore, using the examples as evidence, it would intuitively seem that the federal tax revenue would fall significantly. The amount of the revenue shortfall can be demonstrated with 1992 tax return data from *Statistics of Income* published by the Treasury.

The analysis which follows estimates the amount of 1992 income which would have been removed from taxation under the Armey plan, and then assumes taxing of the remainder at the 20% flat-tax rate. That amount is then compared to the amount of tax that was collected in 1992.

An adjustment must be made in Armey's personal allowances to make the Armey plan compatible with the available statistics. For single taxpayers the $13,100 allowance is separated into a $7,800 standard deduction and a $5,300 personal exemption. For the married filing joint, the $26,200 becomes a $15,600 standard deduction plus two $5,300 personal exemptions, and for the unmarried head of household, the $17,200 becomes $11,900 standard deduction $5,300 personal exemption. The married filing separate status will have $7,800 standard deduction and $5,300 personal exemption.

The methodology in the income level analysis assumes that the "0- under $15,000" adjusted gross income bracket in *Statistics of Income* data would not produce any tax under the Armey proposal, and that bracket is disregarded in computing the tax which would have been collected under Armey. Only single taxpayers and married filing separate at the upper end of that bracket would have any tax. Under current law this bracket produced only 3% of total tax collected, and collections would obviously be much less

under Armey.

Above $15,000 of adjusted gross there are six income data brackets. In *Statistics of Income* for the five highest of those six income brackets, a significant amount of tax definitely would be collected. To estimate the impact of the Armey personal allowances, weighted-average standard deductions were computed for each bracket using the modified standard deduction amounts discussed above. Weights were applied which represented the approximate proportion of single, married joint, married separate, and head of household returns in 1992 data[1]. The weighted-average standard deduction was then multiplied by the number of 1992 returns for each income bracket to compute the amount of gross income deduction against total federal adjusted gross income.

The "$15,000 - under $30,000" bracket presents a problem. Most married joint filers in this bracket are rendered non-taxable by the Armey proposal, but singles, marrieds filling separate, and heads of household will generally pay some tax. Various adjustments were considered, but it was decided to simply omit this bracket in interim calculations, as was done with the bracket below it. Since the point of the methodology is to measure personal allowance deductions that actually would reduce tax, this is really a conservative assumption in favor of the Armey Plan, and is also an assumption that can be compensated for later. This bracket generated about 10% of total tax collections in 1992, about $48 billion. A portion of that could be added in later with

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[1] For example, if for a given income bracket, 50% of the returns are singles, 30% are married filing joint, 10% are head of household, and 10% are married filing separate, then the weighted-average is:

.5X $7,600 =	3,900
.3 X $15,600=	4,680
.1 X $7,800 =	780
.1 X $11,900=	1,190
	$10,550

no serious distortion to the methodology.

Recall that in the discussion above that the Armey personal allowances were split into standard deduction equivalents and $5,300 personal exemptions. The personal exemptions also will reduce taxable income. Thus, it would seem that the next logical step would be to multiply $5,300 by the total number of personal exemptions taken in 1992 and the result would be an estimate of the amount by which adjusted gross income would be reduced. However, there are some modifications necessary first.

The same problem exists with exemptions as existed with the standard deduction equivalent in the "0 - under $15,000" bracket and the $15,000 under $30,000 bracket. Many taxpayers would list exemptions which get counted in the IRS data, but the exemptions do not really reduce income any more because the income level is already so low in these brackets. In these brackets many of the taxpayers will likewise be reduced to a deficit taxable income by the combined standard deduction equivalent and personal exemption equivalent. Also, it is possible that in the "30,000- under $50,000" bracket that some married filing joint taxpayers with several dependents will also be reduced beyond zero taxable income, such that some of the exemption deduction doesn't actually reduce tax. Therefore, exemptions in the 1992 data taken by taxpayers in the lowest TWO brackets were ignored. It was thought that the small portion of taxpayers in the "$30,000 - under $50,000" bracket who would be zeroed out would probably be smaller than the portion of the "$15,000 - under $30,000" bracket where the exemption would be reducing tax, and this would counterbalance to some extent.

Another required adjustment is the fact that the government

statistics still include the check boxes for "over 65" and "blind" as exemptions to allow comparability to data from years when age and blindness qualified for exemptions. There is no data available on the number of "over 65" and "blind" boxes checked. A possible proxy measure was considered. The data report the number of returns which included pension and annuity income. At an unrealistic extreme, these returns could all be married couples where both spouses were over 65, but the tax return with pension income was being counted as only one return in the data. Therefore, double the number of pension returns in each income bracket was used as a conservative proxy estimate of the over 65 and blind returns. For all returns taken together, that would mean about 35 million "over 65" and "blind" check box entries.

There is another approximation, which confirms that adjustment procedure. Census data in 1990 estimates about 30 million persons over age 65. Since 1992 data is being used, and there will be some blindness entries in the data, the 35 million for total returns with "over 65" or "blind" seems realistic.

Therefore, exemptions taken in 1992, for the five highest income brackets, were multiplied by $5,300 as the estimate of taxable income reduction from exemptions.

Total taxable income reduction of the Armey plan, applied to 1992 data, is $1.101 trillion, and is summarized in Table 5.

Table 5. Summary of Taxable Income Reduction in Armey Plan - Personal Allowance Equivalents applied to 1992 Data.

	Weighted-Average Standard Deduction	Number of Returns	(000,000) Income Reduction
$30,000 under $50,000	$12,992	21,181,531	$275,198
$50,000 under $75,000	14,398	11,885,348	171,200
$75,000 under $100,000	14,928	4,005,642	59,803
$100,000 under $200,000	14,815	2,818,095	41,750
$200,000 or more	14,648	958,163	14,033
Total Income Reduction from Standard Deduction Equivalent			$561,984
Add: Personal Exemptions as adjusted, $5,300 X 116,810,000			539,423
Total Income Reduction From Personal Allowances in Armey Plan - Top Five Brackets			$1,101,407

Recall that the $1.101 trillion came principally from the top 5 income brackets of the 1992 data. Therefore, the income to which the 20% flat-tax rate can be applied must reflect those 5 brackets so as to also be consistently computed. In the 1992 data, total adjusted gross for all returns was $3.623 trillion. Consistent with the above methodology, $.261 trillion AGI from the lowest bracket and $.390 trillion AGI of the next-lowest bracket are removed to leave $2.972 trillion AGI that could remain subject to the 20% tax after the effect of the personal allowances. Now deduct the $1.101 trillion from the $2.972 trillion and the taxable is estimated at $1.871 trillion. Applying 20% estimates tax collection at $374 billion. The tax collection for 1992

actually totaled $476 billion. The financing shortfall is enormous: $102 billion. How much additional revenue would come from the one bracket that was omitted in the above analysis, i.e. the "$15,000 under $30,000" bracket? In 1992 it generated about $48 billion on $325 billion of taxable income. Using the composite weighted-average methodology in Table 5, applied to the "$15,000 under $30,000 data, a weighted-average of $11,361 and $28,485,359 returns, computes about $324 billion, approximately the amount of the taxable income that was in that bracket in 1992. Returns in this bracket were about 36% married joint and 18% head of household. Therefore it would not be unreasonable to expect only one-half to one-third of the 1992 level of income from that bracket. Therefore, $24 billion or so is probably about all that could be hoped for from that bracket, which would reduce the deficit noted above to $78 billion.

Note that every assumption in this analysis has given the benefit of the doubt to the Armey Plan. Two overly generous examples: the 35 million "over 65" and "blind" check boxes, and the assumption of $24 billion from the "$15,000 under $30,000" bracket from 1992 data. Still a large deficit looms. With the balanced budget amendment also a legislative goal, it seems counterproductive to consider a tax reform plan as generous as Armey's.

One alternative way to pursue this plan is to tinker with the flat-tax rate. Note that it will take a 25.4% rate to make this plan revenue neutral when applied to 1992 data. ($476 billion/ $1,871 trillion is 25.4%.) However, a 25.4% rate will decrease the "tax break for nearly all taxpayers" nature of the Armey plan. Note that if a 25.4% rate had been used in Table 3 instead of 20%,

the Armey plan would have been more costly to the the single and head of household taxpayers as compared to current law.

Supply-siders will argue that the tax reduction will stimulate the economy and will in turn bring more people into becoming taxpayers. However, there will obviously be a lag before any such benefit is felt. Experience with the 1981 tax-reduction demonstrated all too vividly that deficits follow tax cuts in the near term. With interest on the federal debt now the third highest item in the federal budget, any course of action which invites accumulation of more deficits should be viewed with extreme caution.

REFERENCE

United States Government. Department of the Treasury, Internal Revenue Service. *Statistics of Income* (SOI Bulletin), Fall, 1994.

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June 15, 1995

MR. PHILLIP D. MOSLEY
CHIEF OF STAFF
HOUSE WAYS & MEANS COMMITTEE
U. S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BLDG.
WASHINGTON, D.C.

Dear Mr. Mosley:

I am writing to you to express my support of either a flat tax or a consumption tax (National sales tax). In each case, if investment income is not taxed, it will have, in our opinion, a very stimulative effect on the economy, which will help everyone. Both of these proposals are widely criticized because of their perceived regressive nature. If in fact they stimulate job creation (which is my opinion) they are not regressive and will help most those at the lower economic levels.

We sincerely hope that these tax proposals receive earnest consideration.

Sincerely,

WILLIAM S. MITCHELL

29 May, 1995
15010-39th Avenue N.E.
Seattle, Wa 98155

Philip D. Bosley, Chief of Staff
Ways & Means Committee
Longworth Building
Washington D. C. 20515

Dear Mr. Bosley,

I believe that the tax code of the United States of America should be totally changed for the following reasons:

1.) Compliance is to complex.

Over 9,000 pages of rules is too many.

2.) Compliance is too expensive.

It costs over 1 Billion dollars to comply and this does not take into account the time it takes individuals to gather their tax information.

3.) The tax system is not fair.

It currently penalizes people who wish to work long and hard by making them pay more of their money than those who do not work as hard.

4.) Too much social engineering is done with the tax system.

It is not fair to give a tax brake (Clinton's New Plan) for sending your child to college to people earning $95,000, but not to parents earning $102,000.

Why should parents sending their children to college get tax breaks, but families whose children become mechanics or electricians do not get tax breaks?

A National Consumption tax would be most fair. Let people decide if they wish to pay the tax. Those that wish to spend money and not save it would be taxed. The second most fair method would be a National Flat Tax.

Rip out by the roots the old tax system that allows special interests to manipulate the system by contributing to the reelection campaigns of Congressman and Senators.

Sincerely,

Scott J. McCorkell

June 19 1995

Dear Committee Members,

Since hearings are being held on our complex tax system I would like to address to you my concern. Rep. Archer has my support in abolishing our present tax system. I am in favor of replacing the present system with a national sales tax in place of all the federal taxes.

I believe the benefits of a national sales tax would generate enough revenue to run the country, also enough to eliminate the national debt within a relatively short time.

I encourage all members to change our tax system to a fair tax system with a national sales tax.

Sincerely,

Adele Medlin
4 Gardenia Drive
Greenville, SC 29611

6-9-95
Meeker
18322 N. Mission Hills
Baton Rouge, La
70810

attention: Phillip Meeks

I strongly urge you to help pass Dick Armey's 17% flat tax.

Thank you - a concerned citizen

Mrs. Clino Meeker

James C. Morris
c/o 8041 Hosbrook Road #200
Cincinnati, Ohio State Republic 45236

June 5, 1995

Mr. Philip B. Mosley
Committee of Ways and Means
Main Committee Hearing Room
Longworth Building
Washington D. C. 20215

Dear Mr. Mosley:

The Genie is out of the bottle! In spite of a Government controlled and filtered education system more and more American Citizens are learning of the deceit, deception, fraud and mendacity that involves the whole "income tax" system. In fact in order to make most American Citizens "taxpayers" the IRS must LIE to their system and create an EXCISE taxable happening. Another words wages are not taxable so in order to make one LIABLE the IRS will code the IMF file identifying the Citizen as one involved in the sale of NARCOTICS! The Citizen doesn't even know they are involved in narcotics. This is just one example. There are more.

The American people are NOT going to continue to put up with the out of control GESTAPO tactics of the BATF/IRS. The biased, ignorant MEDIA cannot continue to mislead the American Citizens. It is time for you folks to step up and assume a leadership position and COMPLETELY SHUT DOWN the BATF/IRS. The IRS is responsible for forfeiture and seizure of assets of over 5000 households per WEEK. They are destroying small businesses and are directly responsible for hundreds of suicides every year. On top of that the BATF/IRS lies to CONGRESS. See attached exhibits.

The concept of a flat tax is unconstitutional and out of the question. Remember that the SUPREME COURT has ruled that you cannot tax ones' labor! Wages are labor and are not commerce and thus not taxable! The only tax that can be CONSTITUTIONAL is an EXCISE tax. Yes, a sales tax would pass that test. If there were a national sales tax there would be no need for a Federal tax collector. The States are already set up to do it. I would bet that a 5% national sales tax on all purchases excluding food, medicine and primary home purchase would raise far more revenue than is now realized. It would be fair because it would apply to all and thus ALL CITIZENS would be contributing their FAIR SHARE. It would be important to make it almost impossible for CONGRESS to raise the per-centage of the tax amount. If this is not done CONGRESS will start raising the rate and it won't be long and the country will be right back in the mess it is in now.

In spite of what the Socialist, self appointed elitists now running the Government think, most Americans are a very fair and caring people. They just can't stand being lied to and ripped off and that is what is happening now. It is time for CONGRESS to become RESPONSIBLE and get rid of the BATF/IRS once and for ALL!!! While you are at it shut down the depts. of HOUSING, EDUCATION, COMMERCE, ENERGY, and the big bad guy of all-the FEDERAL RESERVE! Look at all the money and grief you will save the CITIZENS. That is what you want isn't it?? WOW!! We could all begin to be free at last! Why wait do it now!! Also, keep the money in this country. Stop sending it to the IMF.

Sincerely,

James C. Morris

Tax payments diminish a person's possessions. Welfare payments increase a person's possessions.

In both cases, the result is to change an identity.

Income taxes transfer money from a rich person to a poor person, with a slice for the bureaucrat. The tax system converts the taxpayer from a successful businessman into a borrower headed for bankruptcy.

The same tax system converts a welfare recipient from a poor person without a job into a slave, dependent on perpetual hand - outs. If you doubt these results, look at the statistics!

Taxes on identity are used as tools to change that identity -- it is political/social control in the hands of a modern Machiavelli.

The U. S. Government uses the tax system for this purpose. More specifically, it is the *system* of collecting income taxes which is used to change identities of taxpayers. Income taxes cannot be administered without absolute certainty as to the identity of the taxpayer, and once identified, the Government then sets about to change that identity.

Sales taxes, based on the action of selling, do not require identification of persons. The Government may raise the taxes on certain types of selling, or on certain types of products, and people may then be persuaded to change their purchase habits, but these sales taxes don't facilitate a change in the very identity of the person. The system of income tax collection lends itself to identifying and then changing identities.

Those words may sound strange to you. Perhaps you'll recognize it more easily when I say that politicians designed income taxes to punish the rich and reward the poor. When you make a rich man more humble, you are affecting his identity. When you make a poor person more affluent, you are affecting his identity.

When taxes force a businessman to borrow, and then taxes and interest bankrupt him, his identity has changed as well as his possessions. When an unwed teenage girl can collect $400 welfare each month for every baby she has, what do you think she's going to do? Her identity will change from "unemployed teenager with a chance" into a "terrible mother, pregnant, with no hope for escape from poverty."[6]

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[6] News Item: "Teenage pregnancy cost the federal taxpayers nearly $22 billion in major welfare outlays last year, according to the Center for Population Options. In 1989 the government paid $21.55

Income tax differs from a sales tax because of "adjustments" to the figure being taxed. The "sale" is generally easy to get a figure for. It's the retail price on the invoice. "Income," however, takes thousands of pages of tax law for its definition. Every aspect of "income tax" is complex! There are thousands of rules. Some rules depend on the identity of the taxpayer. Some rules depend on the activity. Some rules describe the various types of "things" which the politicians want to encourage or discourage you from owning. So, the income tax has become a concoction of all the three methods of taxation -- but always aimed at controlling your identity first, then your activity, and finally your possessions.

The so-called capital gains tax has often exceeded 100%! If that sounds crazy, consider the following:

Over a period of many years the inflation rate in our country exceeded 10% per year.

A man purchased stock for $1,000. He watches that stock rise in value by 12% per year, for ten years. He would have an asset worth about $17,200, at a compounded rate.

He has an apparent "profit" of $16,200, and he might pay a capital gain tax of 30% on that profit -- or $4,860. That leaves him with net cash of $11,340 plus his original investment of $1,000. So, he now has cash of $12,340.

If you figure how much of the increase in value was because of inflation you'd find that inflation alone would have made it "worth" $15,900.

In other words, if the asset value just increased to keep pace with inflation, it would be "worth" $15,900 at the end of ten years. Since it was really worth $17,200, his real profit was just $1,300.

He paid tax of $4,860 on a profit of $1,300, for an effective tax rate of 375%.

How many people do you know who would invest in something if the tax rate on their profit was going to be 375% of the profit?

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billion in food stamps, aid to families with dependent children and Medicaid benefits for families in which the first child was born when the mother was a teenager. About 9 million adults and children were in such families." *The Spotlight*, page 2, October 15, 1990.

If you go through these same calculations using a 5% inflation rate, and a very comfortable 10% appreciation rate, you'll come up with a lower effective tax rate, but it would still be well in excess of 100%.

I tell you that the super wealthy don't put their wealth in places where it gets taxed! If you do, then it's because you don't know enough about how legal and safe it is to use the same techniques the super wealthy do.

Now we are into a nest of complexity of definitions of *What is a person? What is income? What is profit? What is an allowable deduction? What is a capital gain?*

There is much less argument about *What is an acre of land?* or *What is a $5.00 retail sale?*

The Most Damaging Basis For Taxation

This complex system of income taxes actually becomes more complicated with the introduction of one more factor. The income tax varies depending, in some cases, on what you are **thinking**!

Taxes often depend on what was the "purpose" of the individual's action! Last I heard, "purpose" was a mental phenomenon -- it was something that went on inside your head. So, tax collectors have to become mind readers, and failing that, they impute motives and purposes to you. They do that based on whatever evidence they can find or manufacture. The result is that they levy the tax on your thinking processes.

Here's a sweeping example of IRS powers, and there are a great many more in the Internal Revenue Code:

> Section 269: "Acquisition made to evade or avoid income tax."
>
> (c) "Power of Secretary [IRS] to allow deductions, etc., in part."
>
> "In any case to which subsection (a) or (b) applies [acquisition of property . . . "the principal **purpose** for which such acquisition was made is evasion or avoidance of Federal income tax . . ."] the Secretary is authorized --

> ." . . to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income tax . . ." [emphasis added]

Tax laws give tax collectors the responsibility to determine what your "purpose" was in doing some act. Judges, in many court cases, have ruled on what someone's "purpose" was. With these precedents, it seems well settled that purpose is not exclusively a private internal, mental phenomenon. Judges now divine your purposes. Usually the judge figures out your internal purpose on the basis of someone's observation of outward actions. Thus, while your true "purposes" may still be very private, tax collectors WILL judge you on the basis of the actions that seem to portray your purposes.

There are even tax penalties which are levied depending on your knowledge! The difference between a tax penalty, or no penalty, is often the judge's decision as to whether or not the taxpayer "knew" that some tax practice was illegal. The difference between "negligence" and "fraud" is based on the knowledge inside the taxpayer's head. I have an entire Chapter in this Book on this subject. See, starting on page 277.

Your thinking processes are the final battleground of suppressive tax systems. Force used to enforce the tax on income is force applied first toward the change of an identity, and only later applied toward your money, and then only later applied toward placing your body behind bars.

Who can say that his identity has not been changed because of the threat of force from the IRS?

A slave who can still think about rebellion is not acceptable. The objective is a robot that produces and makes more little robots -- a true slave is incapable of threatening the master.

Remember, the tax collector intends to change your identity from an affluent person to a poor person, or from a poor person into a slave! He intends to inject such fear into your mind that you wouldn't even think of using the system described in this Book to reduce your taxes -- even though it is legal. Think about it. Do you have any doubt that your thinking is influenced by our tax system?

I suggest to you that the most suppressive, the most complicated taxes are intended to affect **identities** (persons), based on their **actions**, and even based on what they **think** about those actions!!!

These tax laws are suppressive for even more reasons. They include words that are hardly ever defined in simple terms, and in fact are often defined in contradictory terms!

For instance, the U. S. tax laws are apparently the only ones in the world where the identity of U. S. citizenship is sufficient to make a person liable to file a tax return.[7] U. S. tax laws require a U. S. citizen to file a tax return no matter where he lives in the world. He must file no matter how long he has been living outside the U. S. It matters not if all of his income is foreign. The tax laws say "file!."

You would look in vain for a simple statement of this rule in the tax laws. The closest you can come to words that describe this responsibility starts with Internal Revenue Code, Section 6012, which refers to:

"Persons required to make returns of income",

and says that

"every individual having for the taxable year gross income . . ."

must file a return. This part of the Code fails to define "person" or "every individual." We don't know yet whether "citizenship" is a factor in the definition of "person." Subsection 6012 (c) refers to

"For purposes of this section, gross income shall be computed . . . without regard to the exclusion provided for in Section 911 (relating to citizens or residents of the United States living abroad)."

The title of Section 911 of the Code is

"Citizens or residents of the United States living abroad."

This section presents two pages of special rules to explain what type of income would be taxable and under what circumstances for persons who live outside the United States. This is a complex section, but a simple reading of it probably would leave you with the opinion that any person who is a U. S. Citizen must file a tax return regardless of where he lives or how long he may have lived there. You would probably conclude that even a bona fide "foreigner" could be considered a "resident of the United States living abroad," and thus have to file a tax return in the U. S.

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[7] *Cook v. Tait*, 265 U. S. 47 (1924). The Supreme Court ruled in this case that the United States has the power to tax its citizens on their worldwide income solely by reason of their citizenship. "No other major country in the world taxes its nonresident citizens on their foreign-source incomes at all" according to Marshall J. Langer, Professor of Law, Miami University, author of *Practical International Tax Planning*. There is even a tax law that makes it illegal to change your U. S. citizenship for the *purpose* of avoiding taxes!

No other country goes to this extreme to attempt to put a tax on (to control) the identity of a person rather than what he does, where he lives or what he owns. No other set of tax laws that I know about has so much complexity. In no other set of laws has there been such deliberate intention to create slavery.

I'd like to get you to see that the primary target of our suppressive tax systems is a *person*, a person who must be identifiable.

PERSONS WHO ARE IDENTIFIABLE!

PERSONS WHO MUST BE IDENTIFIABLE! That is the key phrase. Systems of **suppressive income tax** start to crumble if you can't be identified. If the government doesn't have your tax numbers, your social security numbers, your licenses to exist (corporate articles, partnership agreements, licenses, etc.), you can escape slavery.[8]

A tax based on "possessions" can hardly crumble, since the tax applies on a "thing." It is physical; has its own obvious discrete existence, and location.

Consumers pay the sales tax (an activity tax). Identification of the consumer does not affect the sales tax. It is hard to hide the activity of selling. But the identity of the buyer is no concern to a sales tax. It is the income tax that most suppressively introduces a tax on identity.

I believe that a national sales tax is the hope and salvation of our taxation system. The sales tax is more broadly based than a tax on property or possessions. The sales tax does not have many of the inherent problems of an "income" tax, and I think it is the idea whose time has come. In the meantime, this trust system can protect you from the ravages of the income tax system.

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[8] Hitler had identification numbers tattooed on the arms of Jews as a means of keeping track of them, and particularly their earnings, and thus the taxes that could be collected. The U. S. Social Security number is not much different in result than the tattoos Hitler put on Jews to help enslave them. You cannot enslave people you cannot count and control. Now, of course, with the passage of the Tax Reform Act (1986) young babies must obtain their identification number, else the parents will be denied tax deductions or other "benefits."

DEMOCRACY OR REPUBLIC

From the Army Training Manual No. 200025 War Department, Washington, Nov. 30, 1928 and ordered removed by Roosevelt.

Prepared under the direction of the Chief of Staff.

Democracy; Authority derived through mass meeting negating property rights. Results in mobocracy. Attitude toward law is that the will of the majority shall regulate, whether it be based upon deliberation or governed by passion, prejudice, and impulse, without restraint or regard to consequences. Results in demagogism, agitation, discontent, anarchy.

Republic; Authority is derived through the election by the people of public officials best fitted to represent them.

Attitude toward property is respect for laws and individual rights, and a sensible economic procedure.

Attitude toward law is the administration of justice in accord with fixed principles and established evidence, with a strict regard to consequences.

A greater number of citizens and extent of territory may be brought within its compass.

Avoids the dangerous extreme of either tyranny or mobocracy.

Results in statesmanship, liberty, reason, justice, contentment, and progress.

Is the "standard form" of government throughout the world.

A republic is a form of government under a constitution which provides for the election of (1) an executive, and (2) a legislative body, who working together in a representative capacity, have all the power of appointment, all power of legislation, all power to raise revenue and appropriate expenditures, and are required to create (3(a judiciary to pass upon the justice and legality of their governmental acts and to recognize (4) certain inherent individual rights.

Take away any one or more of those four elements and you are drifting into autocracy. Add one or more to those four elements and you are drifting into democracy. Harry Atwood.

Autocracy declares the divine right of kings; its authority can not be questioned; its powers are arbitrarily administered.

Democracy is the "direct" rule of the people and has been repeatedly tried without success.

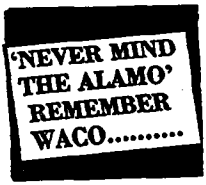
Our Constitutional fathers, familiar with the strength and weakness of both autocracy and democracy, with fixed principles definitely in mind, defined a representative Republican form of government. They "made a very marked distinction between a republic and a democracy, and said they had founded a Republic."

Professor Alexander Fraser Tyler:"A Democracy cannot exist as a permanent form of Government. It can only exist until the voters discover they can vote themselves largess out of the public treasury. From that moment on the majority always votes for the candidate promising the most benefits from the public treasury with the results that Democracy always collapses over a loose fiscal policy, always followed by a Dictatorship."

When the New Deal came into power, it withdrew from Army posts and the Government Printing Office a "Citizenship" training manual which had been in use. This manual, which has never been restored, defined clearly and concisely the difference between a democracy and a republic.. Why has this Citizenship Manual been withdrawn from the Public? Why are our political leaders and newspaper writers so often referring to our government as a democracy? Are they conditioning the minds of the people? Is it because that only under a democracy that they can gain control of the affairs of the people?

The Founders of the United States specifically repudiated "democracy," the "Father of the Constitution," James Madison, stating that it was incompatible with personal security and the right of private property; Since Sec. 4 of Art. 4 of the Constitution. which did not contain the word "democracy", by the simple act of guaranteeing to each state in the Union a REPUBLICAN FORM OF GOVERNMENT, completely bars a democracy form; and, the 1928 U.S. Army Citizenship Training Manual seals the anti-democracy verdict with these words: "The Government of the United States is NOT a Democracy BUT A REPUBLIC."

Democracies have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security; and have in general been as short in their lives as they have been violent in their deaths..On a candid examination of history we shall find democracies characterized by turbulence, violence and abuse of power by the majority trampling on the rights of the minority. (James Madison, father of the Constitution)



RESPONSE LETTER
FROM
RONN JACKSON
11-9-94

In response to Volume 13, Issue 10, November, 1994, I wish to make the following comments:

I am not a "Whistle Blower" from the, BUSH-ERA. I was affiliated with the "Committee and Organization For Universal Peace and Economic Stabilization" (C.O.U.P.E.S.) from September, 1963 to, May, 1985, and off and on, through December, 1990.

The committee controls, and mandates to, the following organizations: "The Committee of 300"; "The Counsel On Foreign Relations"; "The Tri-Latterals"; The Bilderbergers"; "MJ-12"; The Federal Reserve System" and the other fourteen (14) major central banks; "The United States Government"; this is only a partial list and does not contain the "stock" and "commodity" markets and currency exchanges on a global scale.

While documentation exists that the "One World Order" started prior to the "American Revolution", the committee was formed in "1921", concurrent with the formation of the "CFR".

The purchase of 500,000 metric tons of "Gold" by the "Austrian" Government from the Philippines, has nothing to do with the Gold Standard in the United States, but is connected with the twelve (12) families who own, THE CENTRAL BANK.

No signatures or paperwork is necessary for the transfer of Gold from the Far East, South America, or the near East. (The three main repository's for all Gold.) Excluded is daily transactions of "Federal Reserve Of New York" and other "International", like facilities.

As of July, 1994, 5,400.000 tons of Gold had been returned to this country in preparation of, the return to, the Gold Standard. The transformation to the Gold Standard was halted due to an incredible blunder of the United States Government. "Public Law 94-564". The Bretton Woods Agreement. This law had three (3) purposes: 1) Creation of the world bank 2) Creation of the international monetary fund. 3) Creating and granting the President of the United States, the power to issue, extraordinary Presidential Directives, outside the scope and authority of the Constitution. Upon passage of Public Law 94-564, and the mandatory 30 day waiting period. A "PD" was issued and unknown to the American people, giving the "United Nations" the power to tax, the American people, the unknown ramifications and effect of this law is, the agency of our Government, the "Treasury Of The United States" is now controlled and in the hands of others; "The United Nations." If the Gold Standard is re-instituted in this Country, the "Federal Reserve System" must be purchased or nationalized, the blunder that our Government is guilty of is, if "FED" is purchased or nationalized, the treasury reverts to the "United Nations" and then they have control of our currency and of the Gold, in order for a "One World Order" to exist, two conditions must exist. Parity in the worlds currencies, and parity in the wages of the working class of all Countries, Now, do you understand why "President Clinton" didn't fulfill his campaign promise of a tax-cut. This Country must be kept in servitude and bondage without the "Populas" being knowledgeable. Clinton works for the "Committee" also.

While many people have written about the "Federal Reserve System" since its inception in 1913, all accounts are uniformed, and those "Hundreds" of authors, cannot name the ownership and/or control of that private agency.

While "Russbacher" is a part of "Austria's" past, he has not, and will not play a part in that countries future. He has not, nor will he be asked to play a part in any economic decision of that Country.

You people make your own decisions about your journalistic content. I will make no comment on what other papers may say to you, and the, "1st Amendment" to the Constitution Guarantees the Right for individuals to speak their minds. I only suggest you check the validity of anything you print, including this letter, if you decide to print it.

An uninformed "PATRIOT" can be every bit as dangerous as a proponent of the "ONE WORLD ORDER".

In Knowledge, Truth & Freedom,
Ronn Jackson

TO REIN IN BATF

Heavy-handed raids and abuses against law-abiding citizens, harassment of gun dealers, and the illegal computerization of out-of-business FFL dealer records are hallmarks of this rogue federal agency.

BY ILA STAFF

Ask Harry and Theresa Lumplugh. This past summer, 15 to 20 armed men burst into their rural Pennsylvania home. The family cooperates—opening safes, handing over papers—but cooperation doesn't ease the intruders' wrath. One holds a submachine gun in their faces. Another utters a racial slur. One empties vial after vial of cancer medicine and crushes it on the bathroom floor. Another stomps a pet cat to death.

Who are these intruders?

Ask 21-year-old Monique Montgomery. Four masked men break into her bedroom at four in the morning. The glaring lights and the timing of the hit are meant to maximize Monique's disorientation as she wakes from a deep sleep. And wake she does, pulling a gun for self-defense, but the intruders already have their guns drawn and let her have it—four shots, four direct hits.

Who are these intruders?

Ask Louie Katona III of Ohio—successful businessman, civic leader, part-time cop, family man, model American. One intruder pushes wife Kimberly against a wall. Kimberly begins bleeding and later miscarries.

Who are these armed terrorists?

Not a gang of neighborhood toughs. They're agents of the Bureau of Alcohol, Tobacco and Firearms, and the incidents described above are not exceptions, but recent examples of the brute force of unchecked, renegade federal power. Who are the victims? People who've broken no law, in homes where nothing illegal is found.

The terror often comes at the hands of BATF agents clad in ninja black, but the terror doesn't stop there. Even the desk jockeys in the licensing part of the agency get in their licks.

Bend to BATF's politics—or get broken.

BATF visits Randy Engelken, a gun-store owner in Seneca, Kansas, and photocopies any transaction record involving the purchase of military-style semi-automatic firearms. Why just those firearms? The agent comments on Randy's political activism—namely his vocal opposition to U.S. Rep. Jim Slattery (defeated last fall). In a style that would make the old KGB proud, the BATF agent tells Randy: "If you don't lay off Congressman Slattery, you won't have a firearms license."

Surrender your license—or surrender your reputation.

BATF is committed to driving down the number of Federal Firearms License (FFL) holders to drive down lawful gun ownership. And they'll do it any way they can. A typical case: BATF raises the zoning issue by contacting a Pennsylvania township directly, informing officials that a resident with an FFL is conducting retail sales in the township. BATF also speaks directly with a supplier to the dealer, suggesting that the dealer was lying about being a federal agent. The agent also goes to the dealer's supervisor, demeaning his reputation. In fact, no crime was committed by the dealer—who was and remains a special agent with the U.S. Department of Justice Immigration and Naturalization Service (INS)—a law enforcement professional with 25 years experience.

They'll ban what they can—whenever they can.

Ignore the fine print in the '94 Clinton Gun Ban that some firearms are "protected," because BATF ignores it. Forget the fact that the 1860 Henry lever-action was listed as protected, because, for months, BATF banned its importation—considering the cowboy rifle an "assault weapon."

And now they've got your name—and your number!

On February 15, 1995, at a hearing of the House Appropriation Subcommittee on Treasury, Postal Service and General Government, officials of the Treasury Department and BATF admitted that all the records of firearms transactions between U.S. citizens and out-of-business dealers are being entered into a centralized registration system under the control of BATF. Throughout history, registration has always been a precursor to harassment, a stepping stone to gun confiscation. Recognizing this, the U.S. Congress has spoken clearly and distinctly over the last three decades: no money, no people and no administrative expenses can ever be used to register firearms, firearms owners or firearms transactions. Period.

But BATF is not listening. They're copying, collating and computerizing (see "Knox's Notebook," p. 14)—while their agents in the field are harassing, intimidating and hurting honest citizens.

It must stop—and it can! Call your U.S. representative and U.S. senators at (202) 224-3121, and do it now. Tell them it's time to either abolish this rogue agency—or take immediate steps to (1) regain control, (2) expose and prosecute government agents and officials guilty of civil rights abuses and (3) institute strict policies and oversight to ensure that the Bill of Rights is honored, not condemned.

Make the call now . . . before the intruders target your guns, your home and your Bill of Rights.

KNOX'S NOTEBOOK

BY NEAL KNOX

BATF AGAIN REGISTERING GUNS

TREASURY'S Bureau of Alcohol, Tobacco and Firearms is again creating a central registration system of firearms—or at least laying the foundation for one—in clear violation of both criminal law and their funding restriction.

The last time they attempted to ignore congressional rejections of gun registration, by formally proposing regulations to create a registration system in 1978, they lost a chunk of their funding and were forced to change both policies and personnel. That was during Jimmy Carter's Administration; this time, under Bill Clinton, they didn't ask, they just did it.

During February 15 hearings before the House Treasury Appropriations Subcommittee, Treasury Under Secretary Ronald K. Noble denied Rep. Ernest Istook's (R-OK) charge that BATF is violating their funding restriction. For many years, despite BATF's attempts to remove it, their appropriations law has declared: "That no funds appropriated herein shall be available for salaries or administrative expenses in connection with consolidating or centralizing, within the Department of the Treasury, *the records, or any portion thereof, of acquisition and disposition of firearms maintained by Federal firearms licensees.*"

Their round-the-clock program to computerize "semi-truck loads" of out-of-business dealer records didn't violate that prohibition, Noble and BATF Director John Magaw asserted, because it only applied to dealer records; the records they were computerizing were those turned in by *former* dealers.

That's sophistry! The prohibition wasn't intended to protect gun dealers, but the privacy of citizens whose names, addresses and firearms are listed in those records!

Section 926 of the Volkmer-McClure-amended Gun Control Act is even more specific: "No such rule or regulation prescribed after the date of the enactment of the Firearms Owners' Protection Act may require that *records required to be maintained under this chapter or any portion of the contents of such records*, be recorded at or transferred to a facility owned, managed, or controlled by the United States or any State or any political subdivision thereof, nor that any system of registration of firearms, firearms owners, or firearms transactions or dispositions be established."

Then why are BATF compliance inspectors making copies of dealer records, and who paid for their portable copiers? And what happened to all those "Forward Trace" records BATF gathered on selected guns?

The long-rumored illegal computerization of former dealer records was confirmed last May on the ABC *Day 1* television program, while BATF Agent Pat Hynes was showing host Forrest Sawyer thousands of boxes of old dealer records at their new records center. "Right now there's 20 million records here," Hynes said. "*We've already computerized 60 million.*"

In a February 6 letter to Sen. Larry Craig (R-ID), Director Magaw said: "ATF does not have a computer database of gun owners" and that the agent's comments were "misunderstood." Magaw said what Hynes was referring to was "indexing of records of former firearms dealers."

Though that differs from Under Secretary Noble's claim that the prohibition applies only to current dealers, note that even Magaw's "interpretation" is prohibited by both their appropriations restriction and Sec. 926, since a gun's make and serial number are "a portion" of the records that aren't supposed to be computerized, but which Noble says are now being optically scanned.

Noble got into a heated argument with Rep. Istook, claiming that the "legislative history is clear" that the prohibition applied only to current dealers, and that BATF needed to quickly access dealer records to "fight crime."

Rep. Istook snapped: "You're claiming that Congress gave you a loophole that you could drive one of those semis through!"

Congress intended no such loophole. I was NRA-ILA Director in 1978 when BATF attempted to create a registration system that would have tracked guns from manufacturers and importers, through distributors, to dealers—though not (initially) to consumers. (BATF's complete plan, which was approved high in the Carter White House, was to next eliminate private transfers by a "minor" change in the law, and within two years make another regulation change to *include* retail dealer sales, creating a total gun registration system within one generation; the documents proving it still exist, but to protect our sources have never been made public.)

When then-Chairman Tom Steed (D-OK) was shown what was happening, his Treasury Appropriations Subcommittee cut $4.2 million (BATF's "estimate" of the first-year cost) from their budget and added the prohibition against Treasury using any of its funds to create a registration system.

Even after the House of Representatives voted 314-80 to cut their funds and impose the no-registration restriction, BATF belligerently refused to withdraw the regulations for more than a year.

ILA Executive Director Tanya Metaksa, who was then my deputy and spearheaded our study of what BATF's registration scheme would really cost, was part of this history and was outraged by Under Secretary Noble's almost-facetious arguments. She wrote Treasury Secretary Robert Rubin that gun registration "has historically been a precursor to . . . harassment of private citizens, moving on to registration freezes, and ultimately ending with the confiscation of firearms."

Unless immediately stopped, and illegally created records purged, Tanya wrote, "we will exercise all of our options to prevent the establishment of a registration system, including recourse to the courts . . . ."

After 17 years BATF still hasn't gotten the message that they are supposed to follow Congress' orders, not the other way around.

OUR LAW / THE CONSTITUTION

Our founders established this highest law of the land from very ancient Sources. The judicial branch of government is based on the Common Law, (Lex Populi), which is God law, and it is very different from Rulers law (Lex Regii). The founders wanted to avoid "Popish" Roman Civil Law which they saw in Europe, and so they built a Judicial branch of government which relied upon ancient Anglo-Saxon *Common Law*. The Unanimous Declaration of the united States of America (Declaration of Independence) explains *inalienable rights, or God-law*. It declares our intention, as a free and independent nation, to be protected by that law. The founders had expressed these rights many times before in different State Constitutions and Charters. Precedent for these rights came from the Magna Carta of England. Common Law was also fully explained in the book "Commentaries on the Laws of England" by Sir William Blackstone a famous 18th century jurist. There the founders read that the "Makers will" is called the "law of nature" (*God law*) and that "...*no human laws are of any validity if contrary to this*..." Precedent for Blackstone's comments can be found in King Alfreds' code. King Alfred the Great's Book of Dooms "Liber Judicalis" was written less than 900 years after Christ and parallels *Exodus Chapter 21 almost word for word*. Thus the ultimate source of our laws is *Biblical*, and the common law protection of rights is fundamental to our law.

Another very important function that our law serves, besides the protection of our rights, is to establish, *organize, and limit the purposes* of government. In Lacher v. Venus 177 Wis 558. 188 NW 613. 24 ALR 403, it says "The unit of the state is the individual (sovereign citizen), it's foundation is the *family*. To protect the unit in his *constitutionally guaranteed natural right* to form and preserve the family is one of the *basic principles* for which organized government is established."

Since our law is Constitutional and our form of government is a *Republic* (rule by law) then we can call our government a *Constitutional Republic*. Our government is also Federal in nature. Federal means that the sovereign citizens choose representatives, whose job is to swear to uphold and defend the Constitution after they take office. They are not supposed to use their vote to blindly obey the will of the majority, Politicians vote by democratic majority rule, so that they'll be re-elected. But principled leaders uphold their oath of office by voting to sustain the principles of Constitutional law. Thus we can also call our government a *Federal Constitutional Republic*. Since the Constitution is founded on the Common law, which is God-Law, then we can also call our, government a *Christian Constitutional Federal Republic*. There is one thing our government clearly is *NOT, IT IS NOT A DEMOCRACY!* The Founders feared the excesses and tyranny of majoritarian rule democracy as much as they did a monarchy.

In conclusion, law is the Constitution and enactments pursuant thereto, its source is *Biblical Common Law*, and its function is to protect the God given rights of the sovereign citizens by *limiting and regulating the power of government* with a constitution. As Thomas Jefferson so eloquently wrote: "In questions of power, then, let no more be said of confidence, in man, but bind him down from mischief by the chains of the constitution.

FOR MORE INFORMATION:

EXCELLENCE IN PLANNING
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CINCINNATI, OHIO STATE 45236 (513) 793- 7789

THE TRUE ORDER OF AUTHORITY

Our **GOD** Almighty
And Son Jesus Christ
Creator of man. Source of all rights

↓

The **Bible** — Supreme Law Of The Universe
God's covenant with man

↓

We, The People - The Body of Christ
Sovereign Free Men - Creator And Master Party
Of Government By Constitution For The United
States Of America. Source Of All Government Rights.

↓

The **Constitution** — Supreme Law Of The Land
The Peoples Chain (Control) Of Our Government

↓

Peoples Enforcement Controls
Electoral Vote Grand Jury Petit Jury

↓

Government — Servant of We, The People
Sole Purpose is Protection Of Individual Rights.
Power And Authority Enumerated In And Restricted By Constitution.

The Separate And Distinct Function Delegated To Governmental Representatives

↓

Executive	**Legislative**	**Judicial**
Law Enforcement	Law Making	Law Application

"Persons" Subject To Government Law And Rgulation

↓

Corporations (Government Created Persons).
And Sovereigns (Freemen) Who Exchange Their Birth
Rights For Government Privileges And Become Servants
Controlled By Government Rules And Regulations

Instructions:

Study Carefully. Share with your family and friends. Make and distribute at least 100 copies particularly to your Christian leaders who continue to express dismay and inability to understand the U.S. Supreme Court decisions appearing to be contrary to the constitution for the United States of America regarding churches, church schools, banning prayers in school etc.

We can restore **God** to his rightful throne of supremacy and this great country to **One Nation Under GOD!**

AX THE TAX

Abolishing the income tax is no longer a utopian fantasy. Politicians who recognize the huge costs of the current system are seriously considering an alternative.

By Stephen Moore

National Review
150 E 35th Street
New York NY 10016
April 17, 1995

CLOSE your eyes and imagine for a moment an America without an income tax. April 15 is no longer a day of dread. The federal tax on personal income, corporate income, and capital gains is zero. Estate and gift taxes have been abolished. The most intrusive institution in America, the Internal Revenue Service, has been shut down and its 115,000 auditors and enforcement agents have been disbanded. All federal revenues are collected through a national sales tax, and it is no longer the government's business how much money you make and what you do with it once you earn it. H&R Block has gone into Chapter 11; tens of thousands of tax accountants, attorneys, and lobbyists are finding new professions; and now even drug lords pay their taxes.

That giant sucking sound you're hearing is investment, capital from all over the globe pouring into the world's newest tax haven: the United States. Freed from the shackles of an anti-204k, anti-investment, anti-saving tax system, America surges ahead of Japan, Germany, and the rest of Europe in economic growth.

Sound like a utopian fantasy? Until a few months ago it did. But increasingly there are signs that the political foundations of the modern-day income-tax system are beginning to crumble.

On November 9, Representative Bill Archer (R., Tex.), the chairman-in-waiting of the tax-writing Ways and Means Committee, stunned the Washington establishment by announcing that his top priority was the total replacement of the income tax. "On a scale of zero to ten," he said, "the income tax rates a zero." He pledged to "pull up the income-tax system by its very roots."

This month Representatives Dan Schaefer (R., Colo.) and Billy Tauzein (D., La.) will introduce legislation to repeal the income tax and replace it with a national sales tax. They note that since the great income-tax "reform" of 1986 the Internal Revenue Code has been amended some four thousand times. To his GOP colleagues who wish to "fix" the tax code, Schaefer offers this sensible advice: "Give it up. The income tax is beyond repair."

The latest convert appears to be Newt Gingrich. At his recent town-hall meetings in Georgia, the Speaker has confronted ferocious opposition to the income tax. At the February 17 gathering, Gingrich elicited ecstatic applause when he said that he too wants to "get back to an America free from the IRS ... It's time to get the IRS out of your wallet and out of your records."

Even before the turning of the political tide, the income-tax system looked to be about to collapse under its own weight. Earlier this year the General Counting Office reported that the IRS was one of the "most mismanaged agencies" in the Federal Government, incapable of collecting tens of billions of dollars of unpaid income taxes. A recent National Research Council report foresaw a "major breakdown of the tax system" by 2000.

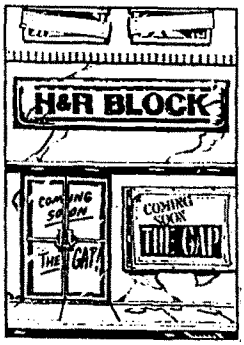
In January, *Parade* magazine ran an article entitled, "What if We Abolished the Income Tax?" *Parade* asked its readers to write in saying whether they were in favor of a consumption tax rather than an income tax. At last count, more than forty thousand responses had been mailed in, running 50 to 1 in favor of replacing the income tax. Even some IRS agents wrote in opposition to the tax code.

GRASS-ROOTS ANGER

REPRESENTATIVES Archer, Schaefer, Tauzin, and now Gingrich have seized upon an issue with potentially massive grass-roots appeal. Vic Krohn, chairman of Citizens for an Alternative Tax System (CATS), a 15,000-member group dedicated to abolishing the income tax, predicts that "the anti-income-tax movement will burst onto the political scene in the last half of the Nineties in much the same way that term limits did in the first half." At a typical CATS meeting, the audience is likely to include construction workers, housewives, school teachers, bus drivers, small-business owners: average Americans with an intense fear and loathing of the IRS. They call themselves "abolitionists," and they're fed up. As a sales assistant at a 1994 CATS event in Cleveland declared, *"The Internal Revenue Code is turning middle-class, working Americans into a criminal class."*

As with term limits, the Washington establishment has greeted this citizen-driven political movement with a yawn of contempt. Opposition on the Left is predictable and easy to explain. Liberal Democrats oppose the sales-tax alternative because the progressive income tax has been the cash cow for a half-century of government spending initiatives. The Left recognizes that any tax system that reminds Americans that they are making payments for welfare, farm programs, shark research, and the Department of Energy every time they visit the cash register threatens to make them even less enthusiastic about funding big government than they already are. The complete replacement of the income tax would require a sales tax of about 16 per cent. Every retail purchase Americans make -- from big-ticket items such as a new $18,000 Ford Bronco, to routine purchases like an 89-cent grape Slurpee at the 7-Eleven -- would include right there on the receipt a reminder of what a bad deal government really is. Eradicate the income tax, and much of the rest of the Washington empire could topple in short order.

More surprising is opposition from the Right. Many conservative leaders have greeted the abolitionist movement with heavy groans of skepticism. Conventional wisdom has it that the income tax is politically ineradicable. This is the complaint of Grover Norquist, presi-



dent of Americans for Tax Reform and conservative strategist extraordinaire. He protests that if Republicans throw their support behind the federal sales tax, America will "end up with the worst of all worlds: both a sales tax and an income tax."

It is for precisely this reason that many conservatives are rallying behind Majority Leader Dick Armey's elegantly crafted 17 per cent flat-tax plan. Modeled on a tax blueprint first developed in the mid 1980s by Stanford University economists Robert Hall and Alvin Rabushka, the Armey proposal would abolish virtually all dedications and loopholes, terminate tax withholding, end the double taxation of savings and investment, shorten the income-tax form to the size of a postcard, and eliminate the capital-gains and estate taxes.

There's very little here not to like. Jack Kemp praises the proposal lavishly calling it "the Kemp-Roth [Reagan tax cut] of the 1990s." And make no mistake about it: the Armey plan is manifestly simpler, fairer, less intrusive, and more pro-growth than our current tax code. Conservatives should support it in a heartbeat over the existing system.

Still, one gets the uneasy feeling that Armey's plan amounts to chiseling out several bricks from America's Berlin Wall at a time when the public is becoming eager to tear it down completely. "The flat tax suffers from one fundamental problem," says abolitionist Billy Tauzin. "It's still an income tax." It does not eliminate the IRS from our lives -- though it would reduce the agency's role. It would still be the business of the government to pry into the most private aspects of Americans' financial affairs each year.

LEAVE US ALONE

THIS may be a critical defect. Unlike the tax revolt during the Reagan era, which was sparked by basic pocketbook issued, the current anti-income-tax uprising is motivated at least partly by concerns about personal liberties and privacy -- the right to be left alone. Abolitionists are the radicals in the rebellion against big, intrusive government. At a CATS event in Los Angeles last year, a truck driver asked me, "Why must American citizens increasingly fear harassment and intimidation by agencies of our own government?" A flat tax won't placate him.

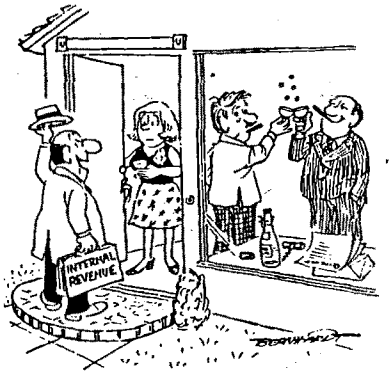
"The IRS has become a symbol of the most intrusive, oppressive, and nondemocratic institution in a democratic society," concedes Fred Goldberg, the commissioner of the agency under George Bush. Every year countless new horror stories are brought to light about people who have been terrorized by the intimidation tactics of the IRS. In one celebrated case, Miami lawyer Dan Heller endured a Kafkaesque ten-year IRS investigation and a four-month prison term. When a federal appeals court eventually overturned the conviction, the IRS was forced to pay Mr. Heller $500,000 in reparations for "gross government misconduct." Even when the IRS ultimately loses, however, such incidents send a potent message to taxpayers: comply, or the Gestapo may soon be pounding on your door.

Members of Congress, including Republicans, have been conspicuously uninterested in curtailing IRS abuses. The agency recently received funding to add five thousand new agents and auditors, even as it was forced to acknowledge that 368 agents were illegally scouring the returns of American citizens. (Only five were eventually fired.) The IRS work force is now up to 115,000, more snoops than are employed by the Environmental Protection Agency, the Occupational Safety and Health Administration, the Food and Drug Administration, and the Drug Enforcement Administration combined. Since 1985 Congress has doubled the IRS budget to $8 billion. The agency is one of Uncle Sam's fastest-growing non-entitlement programs. The latest indignity: the agency has announced, as the *Wall Street Journal* put it, "super tough IRS audits in 1995 and 1996."

The intrusiveness of the tax system is just one of its defects. Its absurd complexity is another, spawning an entire industry of tax attorneys and accountants who earn their livelihoods looking for loopholes. Even the people who write the laws rely on these professionals to prepare their returns. Dan Pilla, author of the new book *Fire the IRS*, reports that "60 per cent of the members of the House Ways and Means and Senate Finance Committees do not prepare their own returns." In 1992 "Loophole" Lloyd Bentsen, then chairman of the Senate Finance Committee and perhaps the single most influential architect of the modern-day tax structure, used a professional tax preparer because, he said, "my return is a complicated one."

What about the rest of us? Pilla discovered that in 1991 "about 70 per cent of the tax returns filed with tax preparers were for citizens making less than $50,000." Americans pay some $30 billion for the services of tax accountants and preparers.

But be warned: using a professional tax preparer by no means guarantees that your taxes will be calculated correct-



"We heard your ship came in. We're here to dock it."

ly. In 1992 *Money* magazine gave 48 accountants a financial profile of the magazine's typical reader and asked them to prepare a hypothetical tax return. Not only did each of them come up with a different answer, but the computed tax liabilities ranged from $16,219 to $46,564 – the higher figure nearly three times the lower. Will Rogers once quipped that "the income tax has made more liars out of people than the game of golf." Indeed, the massive ambiguities in the Internal Revenue Code subject even the most conscientious tax filer to the charge of being a tax cheat.

Furthermore, the Internal Revenue Code is forever getting less user friendly, despite countless good-faith efforts by Congress at tax simplification. The original 1040 form was a model of simplicity: four pages in all, including the instructions. The *New York Times* printed the form in its entirety on a single newspaper page. Today, the *Times* would have to devote several editions to reprinting the four thousand pages of tax forms and instructions. In 1914 there were 14 pages of federal tax law to implement the newly enacted income tax; by 1954 the page count had grown to 984; by 1994 it was 9,400. Shirley Peterson, IRS commissioner in 1992, laments that tax-law changes have become so commonplace that on several occasions Congress has rewritten the law "before the IRS even had time to reprogram its computers from the previous tax reform."

"When men get in the habit of helping themselves to the property of others, they cannot be easily cured of it."

New York Times (1909)

This complexity takes a toll. According to official estimates, in 1990 American individuals and businesses spent more than five billion man-hours computing their taxes. George Mason University economist Walter Williams calculates that this was more mann-hours than were used to build every car, van, and truck in the United States last year. These wasted man-hours alone represent a dead loss to the economy of some $200 billion. (For comparison, the income tax collects about $700 billion in revenue a year.) If converting to a simple sales-tax system merely cut compliance costs in half, it would generate savings in excess of $1,000 per family – more money than is offered in all the tax cuts promised by the Contract with America.

PRODUCTIVITY BOOST

BUT the major economic benefit from the sales-tax alternative (or from a flat tax, for that matter) would come from eliminating the punitive treatment of savings, investment, and capital formation – the essential building blocks of a prosperous economy. In a Cato Institute report, Boston University economist Laurence Kotlikoff estimates the impact of a revenue-neutral replacement of the income tax with a retail sales tax of 16 to 18 per cent. Kotlikoff finds that such a plan would:

1) raise the national savings rate to two and a half times its current level;

2) increase the capital stock by 8 per cent; and

3) raise income and output by almost $500 billion a year, or about $5,000 per family.

To address the fear that Congress might resurrect the income tax after the sales tax was installed, the federal taxing apparatus should be almost entirely dismantled, with responsibility for collecting the sales tax left to the states (a minimal burden, since almost all fifty already collect a state sales tax). A national sales tax can easily be made non-regressive. The first $5,000 of purchases per person could be exempt from the tax; every American would thus get a refund check for $200 each quarter. A family of four with an income of $20,000 would therefore pay no tax. Of course, taxes could be deferred through savings, but since all income is eventually consumed (or else there would be no reason to earn it), it would never fully escape taxation.

Finally, there is the practical problem of evasion under a sales-tax system. However, the IRS admits that roughly $100 billion of income tax is unpaid each year. If retailers were compensated for the cost of collecting the federal sales tax, leakage might not be any worse than under the current system.

Back in 1909, when the Sixteenth Amendment creating the income tax was being debated, the *New York Times* protested: "When men get in the habit of helping themselves to the property of others, they cannot be easily cured of it." Our experience with the income tax since then has fully confirmed that warning. In April Bill Archer will commence an unprecedented set of hearings on the feasibility of abolishing the income tax. This is the first step in the process of liberating America from an eighty-year national mistake.

THE FEDERAL INCOME TAX, THEN & NOW

	1914	1994
Taxes Paid*	$6.7 bil.	$683.4 bil.
Per-Capita Taxes*	$69	$2,622
Individual Filers	360,000	113,829,000
% Population Filing	0.5%	45%
IRS Budget*	$110 mil.	$7.1 bil.
IRS Employees	4,000	110,000
Pages of Tax Law	14	9,400
Pages of IRS Forms	4	4,000
Top Rate	7%	40%
Median Family's Rate	0%	28%

* 1994 dollars

Compiled by the Cato Institute from various sources

770-J Sycamore Ave. #158
Vista, CA 92083
June 15, 1995

Mr. Phillip Moseley, Chairman
Ways & Means Committee
U.S. House of Representatives
Washington, D.C.

Dear Congressman Moseley:

I believe that the income tax which is the fairest for all Americans is the flat income tax.

And I do not believe that it should exclude the poor, unless we agree to exclude police and legal protection for them also. They should understand that taxes are a necessary part of the life of a country. Of course it isn't necessary to actively enforce the law if they don't pay. It takes time for the realization to sink in.

As to the amount, I'm sure that 10% is enough. Why should the government ask more than God? That will be enough to cover the proper duties of our government, namely: to protect American citizens from foreign and domestic enemies (but NOT FROM THEMSELVES), to provide a valid and trustworthy money, based on gold and silver (NOT CREDIT OR FIAT), to regulate interstate commerce and to raise revenue.

The remainder, which will be necessary to eliminate the deficit, should be raised by Congress. This big(?) problem can be quickly reduced by eliminating all programs not mentioned in the original Constitution, especially those having to do with promoting the "general welfare." These words have been corrupted by the no good freeloaders among us who haven't found the strength to turn to God for help. They were never meant by our forefathers to promote socialism. The Congressmen who play their god lead them on to a final disaster. Why should we go along?

Sincerely,

Robert Morrissey

Robert Morrissey

TESTIMONY SUBMITTED BY MICHAEL E. BRUNNER
EXECUTIVE VICE PRESIDENT
NATIONAL TELEPHONE COOPERATIVE ASSOCIATION
REGARDING REPLACING THE CURRENT INCOME TAX CODE
U.S. HOUSE WAYS AND MEANS COMMITTEE
JUNE 22, 1995

Thank you Mr. Chairman for allowing me the opportunity to submit for the record some observations made by National Telephone Cooperative Association (NTCA) with respect to various proposals to replace the current income tax system with a fairer, simpler, and more transparent tax system.

Americans today are frustrated about their individual economic situations and the stress it puts on their wallets. The complexities of filing annual tax forms are overburdensome, tedious and excessively costly for most businesses, full or part-time workers, small business owners, or American consumers. Beyond the border, however, a critical detriment to the economy is a major reason for the abandonment of the current system. The principle detriment is that the current federal tax system discourages savings and investment. The situation is exacerbated for rural workers, businesses, and consumers.

According to several studies, the U.S. ranks last among industrial nations in the percentage of gross domestic product devoted to investment. To address this critical problem, varying proposals for replacing today's complicated tax system have surfaced over the years and have gained in popularity as the 104th Congress has progressed.

The purpose of my testimony is not to suggest that one particular replacement proposal surpasses any other in design or practical application -- that is a decision for you the Congress in conjunction with the Administration, to determine. Rather I would like to point out that each of the proposals NTCA has reviewed thus far, fail to adequately recognize the significance of investment in one critical part of the country, that being rural America. Rural areas, with their lower growth rates, are not natural attractions for investment today and would conceivably be less so under a system that eliminates specific incentives for such investment. As an example, I illustrate the case of the tax treatment under which rural telephone cooperatives currently operate.

S. 722, the "USA Tax Relief Act of 1995", as introduced by Senators Nunn and Domenici, offers the most detailed explanation of how cooperatively organized businesses would be treated under a replacement system. First, the exemption afforded a qualifying telephone cooperative under section 501(c)(12) of the current code would be eliminated. Alternative proposals, while not specific, suggest the same. Of even greater concern however, is the fact that S. 722 would only permit telephone cooperatives to exclude from gross income those patronage dividends that are allocated each year in cash or property. My thesis is that whatever form tax simplification takes, it should preserve the ability of telephone cooperatives to raise capital through their "capital credit" systems in order to continue developing telecommunications infrastructure which in turn results in substantial economic development.

<u>The duty "to serve all" persists</u>

The National Telephone Cooperative Association represents nearly 250 rural cooperative telephone systems who have been active leaders in promoting economic development in their respective rural communities. These telephone cooperatives serve from fewer than 100 consumers to more than 50,000. They employ from 2 to several hundred individuals. They often provide the only local telephone service in areas as large as an entire state.

NTCA member telephone systems, like most of the country's independent local exchange carriers, evolved during the early part of this century to serve low

density, high cost areas that larger commercial companies found unattractive for investment. Congress granted telephone cooperatives an exemption from federal income tax in 1916. Today these systems continue to ensure that every farm and home in rural localities receives the same quality service as that provided to those residing in urban sectors of our country. The challenge is not easily met. In fact, to date, while rural telephone subscribers consist of a mere 4.3 percent of the nation's total number of telephone customers, the areas served by independent telcos account for 40 percent of the nation's geographic area. In a vacuum, this equation equals costly phone service for rural consumers. Fortunately, support programs and additional safeguards have been established over the years to ensure rural telephone service is affordable.

As you are aware, deregulatory telecommunications legislation is currently being considered by Congress. This legislation nevertheless recognizes that rural telcos are charged and will continue to be charged with universal service obligations. Fulfillment of these obligations in a period of rapidly changing technology will require continuous capital formation.

The basis for capital retention by telephone cooperatives

An important principle for the provision of telephone service in these rural, high cost areas, is that capital credits, or the margins of operation that remain after a cooperative has paid its business expenses, constitute, as a legal requirement, a contribution of capital to the cooperative. It is well recognized in law that this method of capital formation is vitally important to the progression of advanced services in rural communities.

The telephone industry is undergoing rapid changes as technology continues to expand and develop. It is paramount that Congress understand the initiatives that are being undertaken by rural utilities and how the retention of capital enables these initiatives to take root. Various community development projects have been initiated under the leadership of the local telcos. These projects create jobs, raise the standard of living and provide security for rural families. These families, like families in all parts of the county, desire to be productive members of society. That is why rural telcos have forged relationships with higher learning institutions for the purpose of delivering course materials not otherwise available in local school curriculum. That is why local telcos have constructed video conferencing sites that enable local leaders to reach out to their counterparts all across the country to share ideas and solve problems. Even more exciting is the rapidly developing state of the art technology used to link teaching hospitals with local clinics where rural patients can receive care without having to travel the distances they were once accustomed to.

In the provision of these services, cost remains the principal hurdle. The investment in infrastructure for these types of services is made possible only through the ability to retain capital. Pursuant to statute and the by-laws of individual telephone cooperatives, the current treatment of capital credits enables local telephone cooperatives to reinvest in the future on a continual basis.

Conclusion

A low rate flat tax on all forms of business entities with an unlimited deduction for capital investment, is in theory a good concept. However, initiatives aiding in rural economic development should be guaranteed special attention. Just as S. 722 retains current law treatment of the home mortgage deduction and charitable giving, and creates a post secondary education deduction all in the name of the long term gains these investment provide the nation, so should investment in rural infrastructure and communities. It is precisely for this reason why cooperatively structured business arrangements operating in rural areas warrant preferenced tax treatment in our tax system. Rural America will be threatened if infrastructure growth is not properly reinforced by safeguards similar to those outlined in the current Internal Revenue Code.

June 8, 1995

Committee on the Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515-6348

Dear Members of the Ways and Means Committee:

I believe that the tax system of our country should be changed by substituting a national sales tax for the income tax system. The IRS, with its dysfunctional bureaucracy and invasive tactics should be entirely abolished and be replaced by a simple collection agency.

A national sales tax would, first, stop penalizing those who are financially successful. Under the present system, those who succeed in business are actually penalized, and hence goods cost more and the job base erodes. Second, a sales tax would distribute the tax burden more evenly among all income groups, in order to prevent the poor from being unfairly disadvantaged, certain basic goods and services, such as rent and food, could be exempted from the sales tax. Third, a national sales tax would be simple, paperless, and record-less. Many records are now kept just to satisfy the IRS.

Thank you for considering my concerns. Please relieve our tax burdens.

Sincerely,

James A. Norfeld

114 Oak Street
Petaluma, CA 94952

ENCL. 6 COPIES

29 May, 1995
1530 N. 115th
Seattle, Wa 98133

Philip D. Bosley, Chief of Staff
Ways & Means Committee
Longworth Building
Washington D. C. 20515

Dear Mr. Bosley,

I believe that the tax code of the United States of America should be totally changed .

The tax system is not fair. It currently penalizes people who wish to work long and hard by making them pay more of their money than those who do not work as hard.Too much social engineering is done with the tax system. It is not fair to give a tax brake (Clinton's New Plan) for sending your child to college to people earning $95,000, but not to parents earning $102,000. Why should parents sending their children to college get tax breaks, but families whose children become mechanics or electricians do not get tax breaks?

Compliance is too expensive. It costs over 1 Billion dollars to comply and this does not take into account the time it takes individuals to gather their tax information.

A National Consumption tax would be most fair, but a National Flat Tax on income would also be preferrable to the current system.

Sincerely,

Nancy L. Niles

Nancy L Niles

June 8, 1995

Phillip D. Mosley
Chief of Staff
Committee of Ways and Means
U. S. House of Representatives
1102 Longworth House Boulevard
Washington, D.C. 20515

The Honorable Phillip Mosley:

Your are right, the current income tax system needs to be revamped. My solution is as follows:

CONSUMER TAX

Every purchase excluding food and medicines have a consumer tax of 7% at time of purchase.

In doing this you would encourage people to save and also to donate to charities.

This would also eliminate the business loop-holes and all would be paying according to their consumption, private, business or government. Yes, this would include all purchases, excluding food and medicines, by the government. When I say every purchase excluding food and medicines I mean EVERY PURCHASE. This would also eliminate a passel of IRS employees saving billions of $$.

I pray this solution or one very similar will be adopted as soon as possible.

Thank you for your time.

Very truly yours,

Patricia A. O'Brien
Rt 4 Box 4495
Prosser, WA 99350

cc: file
Congressman "Doc" Hastings
Senator Slade Gorton

INDIANA UNIVERSITY

SCHOOL OF LAW
BLOOMINGTON

June 20, 1995

Honorable Bill Archer, Chairman
Ways and Means Committee
Room 1102
Longworth Building
Washington DC 20515

Dear Mr. Archer:

I enclose two chapters from my book manuscript. It will be published in a few months. Tne tentative title is, "Why We Should Abolish the Income Tax: A Guide to the Proposals."

Please enter these in the record to accompany the printed record to the hearings on June 6-8, 1995, before your committee.

I enclose a copy of my vitae.

Sincerely,

William W. Oliver
Professor Emeritus of Law

Third Street and
Indiana Avenue
Bloomington, Indiana
47405-1001

Fax: 812-855-0555

Chapter 21

Draft 6/20/95

A National Sales Tax to Replace the Income Tax

1. We need to flee from the complex, controversy-generating income tax to a simple tax, and the sales tax is a simple, broad-based tax. It is computed transaction by transaction; not on a total of many transactions over a period of time. Modern cash registers compute sales tax on each transaction and total the tax over a period of time, such as a day. This means the cost to the retail merchant will be minimal. Everyone pays it and it is progressive since the rich spend more on consumption than the poor.

2. The income tax takes away from business and investors', funds which can be spent by them more productively than by the Government, which, to a large degree, is unproductive and counter-productive.

3. The income tax imposes huge compliance costs on the private sector and abolition will lead to even more improvement in economic performance than that which followed the 1981 Reagan tax cut.

4. The market values of stock are largely based on after-income tax earnings; abolition of the income tax will increase the market value of stocks. Those increases in the value of stocks will increase the net worth of individual stockholders, pension funds holding stock (and thus increase the security of pension recipients both current and future), endowment funds of non-profit organizations, and others. This increase in net worths would be conducive to new ventures in the private sector, the real source of

wealth in our economy.

5. We would replace a tax on investment, with one on consumption.

6. We have a meager savings rate and largely rely on foreign sources to fund our budget deficits and trade deficits. Now the savers face two taxes: one on the income saved, and another on the interest, dividends, or other income received on the savings. Abolishing the income tax will increase savings, and help avoid the disaster which will ultimately come from the combination of budget deficits, trade deficits, and meager savings.

7. The host of people who are cheating on the income tax or winning at playing the audit lottery, would pay the sales tax on their consumption.

A study done by John H. Qualls, Ph.D., at Washington University in St. Louis concluded that a national sales tax at a rate of 17% could replace the revenue presently raised by the income tax. That may sound high, but remember take home incomes go up immediately through elimination of withholding of income tax and payment of estimated income tax.

Here is a summary of the Qualls study:

> The replacement of the current U.S. individual and corporate income taxes by a national sales tax would result in faster economic growth, higher levels of employment, more business investment, higher productivity growth, and an increase in the private savings rate.
>
> These results were obtained from an econometric simulation using a variation of the Washington University Macroeconomic Model (WUMM), available commercially from Laurence H. Meyer and Associates (LHM&A), a St. Louis-based economic consulting and forecasting firm.
>
> A one-for-one replacement of the personal and corporate income taxes with a national sales tax results in a

reallocation of GNP away from consumption and toward investment. The investment share of GNP rises two percentage points (from 17.1% to 19.1%) with the introduction of a national sales tax.

The private savings rate (total of personal and business savings) rises from 15.4% up to 18.1% after the introduction of a national sales tax.

Real business investment is from 19 to 25 percent higher with a national sales tax. In effect, businesses use the extra cash flow resulting from the elimination of the income tax to invest in plant and equipment.

The higher level of capital stock results in more employment. The number of new jobs generated by the national sales tax reaches 900,000 by 2000 and 1,600,000 by the year 2010.

Because of the increase in business investment, real GNP grows at a faster rate after introduction of a national sales tax. Although the annual growth rate differential seems small, at 0.2%, it results in a significantly higher level of real GNP by the year 2010 -- up 4.1%. This amounts to a difference of over $1,500 (in constant 1990 dollars) for every person of working age in the country, or over $3,100 for a family with two working-age adults.

The national sales tax is <u>not</u> inflationary. Although the price of goods (including the tax) would reflect a one-time price increase, the rate of increase in prices after that would actually be lower by 0.2% per year. Thus, sustained inflation would <u>drop</u> after introduction of the sales tax and abolishment of the income tax.

In short, implementation of a national sales tax would go a long way toward rectifying the U.S.'s decline in international competitiveness.

Another study by Laurence J. Kotlikoff, Professor of Economics at Boston University (<u>The Economic Impact of Replacing Federal Income Taxes with a National Sales Tax</u>), corroborates the conclusions of the Qualls study. This study was sponsored by the Cato Institute and released in 1993. It concludes that the abolition of the federal income tax and replacement with a national

sales tax will increase savings and hence available capital, and increase wages in real terms.

For businesses, cash flow will increase from the disappearance of federal income tax payments and the end of the huge unproductive cost of income tax compliance. The added available cash will make funds available for increased investment in plant, equipment and working capital. Since the federal income tax is a cost which must be recovered through sales prices high enough to achieve an adequate profit margin, abolition of the federal income tax should (through the competitive process) decrease prices to consumers, tending to offset the national sales addition to the cost of retail purchases (also offset for the consumer by the end of withholding of income tax and the payment of estimated income tax). Export prices can be decreased to reflect the abolition of the federal income tax and the resultant elimination of the huge costs of compliance. The sales tax will not apply to export sales. The resultant improvement in our international competitive position should decrease our trade deficit, and perhaps even eliminate it.

For individuals, the end of income tax withholding and payment of estimated tax will occur simultaneously with the imposition of the national sales tax. But the motivation for savings is substantially increased; the saver will no longer have the income on the savings reduced by the federal income tax The present situation with savings covering only a small part of our two deficits (trade and budget) and relying on foreign sources to cover the rest of those deficits means that our country is vulnerable to

a loss of confidence in the United States by those outside our borders. Increased savings by our people is a vital goal; substituting a national sales tax for the federal income tax may be our salvation by increasing savings.

To avoid the sales tax being a burden on low-income persons, there will need to be a refund of standard amounts of sales tax to such persons. There will need to be strict safeguards. Don't forget that the I.R.S. has made "refunds" to prison inmates based upon phony withholding forms; as well as the fraud involving the earned income credit (for example, reporting non-existent earnings to get the refund). The working poor on their own mostly do not understand this refundable credit and don't claim it; sharpies claim it for them, and probably get much of the refunds, which they don't report as income.

Excise taxes can be used to satisfy the widespread desire to do something to people who "have too much money." For instance, an excise tax on advertising on the broadcast or telecast of professional sports can reduce the excessive salaries there. While the top rates under the estate and gift tax should be reduced, and relief should be given for family businesses which stay in the family, the estate and gift tax will remain. Excise taxes can be used to inhibit the officers of publicly owned corporations from getting excessive compensation, thereby breaching their fiduciary duty to the stockholders.

Chapter 18

SUMMARY: WHY THE INCOME TAX SHOULD BE ABOLISHED

Draft 6/21/95

1. Payne's Costly Returns alone is sufficient reason to abolish the income tax. That tax, which costs the society and economy 65% of the revenue raised, is intolerable.

2. Congress' pre-1995 record shows that an income tax can be a dangerous instrument in its hands: Marriage Penalty, Percentage Depletion, 1993 Clinton Tax Act, rules on Charitable Deferred Giving, etc.

3. An income tax is unfair in a country with chronic inflation.

4. Complexity and other factors make fair treatment of all taxpayers under the income tax unachievable.

5. There are signs the income tax is breaking down: extensive cheating, the audit lottery, massive non-filing, protesters, an increasing backlog of uncollected assessments, etc.

6. Discriminations exist under the income tax which cannot all be eliminated short of abolition of the income tax.

The Process

Achieving abolition of the income tax will require dedication. Those who understand the problems of the income tax, must show an intensity of effort. Absent some strong mitigating circumstance, vote against every Congressional incumbent who will not support abolition of the income tax, and write and tell them so. Join organizations such as Citizens for an Alternative Tax System and the National Taxpayers Union.

Opposition will be encountered. There is an income tax industry with many persons engaged. These 65% direct and indirect costs resulting from our present federal tax system is putting lots of money in the pockets of many people.

Tax attorneys and tax accountants may mostly oppose abolition of the income tax. They shouldn't, for they know how awful the income tax is, and in a country short on intelligent, well-educated people there will be many other opportunities for them. Tax accountants, freed of the burden of coping with an ever changing, complicated income tax, can do more adequate work on coventional accounting. This will permit them to better assist managers of businesses in making decisions.

Some arguments in opposition have some apparent merit. For instance, the income tax can be said to favor charitable giving, but with the Reagan income tax cuts, charitable giving increased substantially. I.R.A.s combined with the income tax can be used to encourage saving; but abolition of the income tax and replacement with a national sales tax will increase savings much more.

Those in the municipal bond industry and some in local and state government will oppose the abolition of the income tax (under which interest on municipal bonds is free from income tax). Abolition will end the ability of those governments to borrow at interest rates below market. Also such bonds outstanding will tend to drop in market value. But we must look to the overall good of the country. The loss to slaveowners didn't stop us from enacting the 13th Amendment and freeing the slaves.

Abolition of the income tax will make the United States a tax have for foreign capital. At present, in lieu of the income tax, there is a thirty (30) percent withholding tax on nonresident aliens on investment income, such as interest and dividends, from U.S. sources. This has been modified by a treaty with some countries. That withholding will cease with the abolition of the income tax.

If Clinton is no longer president after January 20, 1997, the erosion of confidence abroad in our country should start reversing. With no income tax, capital from abroad will flow into the United States. Combined with increased domestic savings, increased available capital will cause interest rates to drop. Indeed, the price of municipal bonds may increase because the interest rates on those bonds will be above the interest rates on newly issued federal and corporate bonds.

Some in the life insurance industry will want to cling on to the income tax, because the tax-free build-up of cash surrender value can be used to sell life insurance as a tax shelter. But they will be misguided. The unique nature of life insurance will cause that industry to get its share of increased savings after the abolition of the income tax.

The arguments of those who want to hold onto the income tax for some advantage they have under it, are in effect asking to continue a discrimination in their favor.

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CERTIFIED FLOOR INSPECTIONS
CARPET & RESILIENT

June 9, 1995

Mr. Phillip Mosely
U.S. House Ways & Means Committee
1102 Longworth Building
Washington DC 20515

Dear Sir:

I am writing because Mike Reagan said that if I sent you six copies of this letter it would be duly submitted for committee consideration.

Pertaining to new tax legislation I believe the I.R.S. should be mightily diminished by (1) either adopting Dick Armey's Flat Tax Proposal or (2) adopting a National Sales Tax,either of which will eliminate our present Income Tax.

Machinery to collect a National Sales Tax is in place now in all or almost all states. I want no part of any value added tax.

Eliminate double taxation - this taxes both corporations and the dividends they pay. Eliminate the Capital Gains Tax.

Add up the grand total of goods and services purchased or the total of income received to determine what tax income is needed and set the flat tax rate or the sales tax rate accordingly.

Let's establish an honest tax system free from lobbyists. We can call it the "Bill of Rights II".

Sincerely

George A. Palm
P.O. Box 545
Ludington, MI 49431-0545

Copy: Congressman Pete Hoekstra
Senator Spence Abraham
Senator Carl Levin

STATEMENT FOR THE RECORD CONCERNING CONGRESSMAN ARCHER'S HEARING ON JUNE 6, 1995 ON REPLACING THE FEDERAL INCOME TAX

Dear Congressman Archer:

Please consider the following in your deliberations:

1. The two primary motivating factors behind the increase in the number and complexity of the provisions in the Internal Revenue Code are:

(A) Transactions are far more complicated than they used to be and the Code has to be periodically changed to reflect same.

(B) Since approximately 1974, many of the changes in the Revenue Code and, over the past decade increasingly so, have been revenue driven. In other words, the real problem is that Congress is spending far too much money and has to invent ever more complicated ways to raise more money. For instance, take a look at the S.S.I. program. Note the provision which allows an immigrant, after being here for only five (5) years (it used to be three years) and who has never made a contribution to the system to receive S.S.I. payments. This is clearly abusive. Another issue to look at concerning Social Security is the fact that when the program was enacted, life expectancy in this country was age 62. Social Security payments did not kick in until age 65. The current program makes no sense from any equitable point of view and the only thing that is standing in the way of change is Congress' fear of the elderly vote. Congress is underestimating the elderly of this country. If properly explained, they would agree to financial responsibility and equity in the Social Security system. The Food Stamp program should also be scrutinized. The federal government is spending $26 billion a year on food stamps. It does not take a rocket scientist to realize that this is $2,600 a year for each of 10 million families of four individuals. This is 40 million people. This number clearly suggests massive fraud -- perhaps as much as fifty percent of the amount expended.

As a tax attorney who has specialized in civil and criminal tax litigation, I can assure you that the biggest burden on American individuals and American business is EMPLOYMENT TAXES. Employment taxes do not come out of your pocket after you determine whether or not you have a profit. Employment taxes come out of your pocket on an on-going basis regardless of whether your business is profitable. Rate increases over the last decade have made employment taxes even more burdensome. In addition, I have seen many businesses go out of business due to a re-characterization of independent contractors as employees. Part of the problem here is that federal law concerning the independent contractors/employee issue does not take into consideration that when an independent contractor is recast as an employee, there are severe, collateral economic consequences. They include, but are not limited to, a minimum wage and overtime investigation by the Wage & Hour Division of the Labor Department; an audit by the Workers' Compensation insurance carrier; and, an audit by the State Unemployment Compensation bureau. Hundreds, if not thousands, of businesses are being put out of business every year and Congress has done absolutely nothing to solve the problem. (Section 530 of the Revenue Act of 1978 has not solved the problem. The Internal Revenue Service still examines the business; and, the burden of proof and resources required to invoke Section 530 of the Revenue Act of 1978 are both excessive.)

2. Before you throw the baby out with the bath water with respect to the Internal Revenue Code. Please also consider the following points:

(A) If there is no tax on any interest or dividend; and, state and local political entities have to borrow money on par with

businesses, the cost of their borrowing will increase dramatically. The focus, thus far, on, in essence, eliminating the municipal bond market by not taxing all interest and dividends, has been on investors. While this is very important, since most of those investors are elderly people who have worked very hard to acquire the wealth to buy municipal bonds, everyone seems to be ignoring the fact that the cost of borrowing money to state and local political entities will increase dramatically. This will, undoubtedly, result in increased taxes at the state and local level.

(B) When most people buy a house, they examine their cash flow, taking into consideration any tax benefit, and make a decision on what house they can afford in accordance with same. If the mortgage interest deduction is eliminated, many people will find themselves in the position of not having sufficient cash flow, after taxes, to pay their mortgage. This could result in tens of thousands of foreclosures all over the country and the resulting personal bankruptcies. (As the passing of the 1986 Internal Revenue Code showed, when changes occur too rapidly in the tax system, it can result in a financial catastrophe. It has been well established that the changes in the Internal Revenue Code with respect to real estate significantly contributed to the collapse of values in real estate and the resulting savings and loan crisis.)

(C) If you eliminate the charitable deduction under Section 170 of the Internal Revenue Code, charities will be severely impacted.

(D) Individuals and companies have established retirement plans -- whether pension plans, IRA's, or other varieties. If all interest and dividends are not going to be taxed, does this mean that all of the accumulated income inside all retirement plans would not be taxed under a proposed change? While it is standard "Congress speak" to talk about transition rules, it is suggested that the complexities of the transition rules necessary to have any sort of equity in this area would be beyond human comprehension.

(E) For individuals subject to the 39.6% marginal tax rate, the tax is already a "flat tax." This is due to the limitations on itemized deductions contained in Section 68 of the Code and the phasement of deductions for personal exemptions set forth in Section 151 of the Code.

(F) Some businesses operate on a very slim profit margin. For instance, assume a business which has gross revenues of $100 million. Also assume that the cost of goods sold for the business is $99 million. This leaves income, without considering other expenses, of $1 million. If there was a "flat tax" of 14%, the business would be hit with a $14 million tax bill when it only had a profit of $1 million.

(G) Assume an independent contractor sales person receives gross income (gross revenues) of $150,000 per year. Out of this amount, the sales person pays all of his or her expenses in connection with all of his or her business activity. After paying all ordinary and necessary expenses, the sales person is left with $65,000 per year. A gross receipts tax of 14% on gross income of $150,000 would create a tax of $21,000. $21,000 subtracted from $65,000 leaves $44,000.

3. There are a number of things wrong with the laws of taxation in this country. The main things wrong, however, are not being addressed. From my point of view as someone who has been involved with civil and criminal tax controversy work since 1977 and has taught tax litigation and procedure since 1981; and is, therefore, someone who has seen most of the glitches in the system, they are as follows:

(A) Congress does not make technical corrections on a timely basis.

(B) Congress changes the tax law too frequently without sufficient thought and planning. This results in insufficient time for anyone, whether taxpayer or the Internal Revenue Service, to absorb the changes and properly plan and/or administer them. This also results in more glitches that need more technical corrections which Congress does not address.

Robert E. Panoff, (Current Chair of the Tax Section of the Florida Bar [this statement is not in my official capacity]; and, Adjunct Professor of Tax Litigation and Procedure University of Miami School of Law Masters in Tax Program.)
Suite 106
9400 South Dadeland Boulevard
Miami, FL 33156
Telephone: (305) 670-6547
May 18, 1995

June 7, 1995

Honorable Rep. Bill Archer
U. S. House of Representatives
Washington, D. C. 20510

Honorable Rep. Archer:

I picked up Pittsburgh Post Gazette dated today (June 7th, 1995), and read the headline "House opens debate on end to income tax". The side box had a quotation "Our challenge is no less than pull the current income tax code out by its roots and throw it away so it can never grow back". Based on my analyses of behaviors of many individuals over more than two decades and a lot of other analyses and writings, it struck me that this is a statement by an individual who has a lot of Ego (my idea is better) and lives on Jealousy or Hatred of the current tax system. However, I later on found out that it was a statement made by you opening the hearings on the current income tax system - I was just shocked to read it!

The current income tax system could have been simple if we had considered that there is a need to tax all income at the same rate after some basic deductions and avoided changes to it over the past thirty years in form of various kind of "credits and deductions". For example, Pennsylvania has a relatively simple income tax system. I had outlined a simplified system to Senator Harris Wofford in a letter dated April 3, 1992 (more than three years ago) - a copy is attached herewith - it is similar to the one proposed by Hon. Richard Armey.

The concept of taxing income is fundamentally more sound than the National Sales Tax or the Value Added Tax or any other concept. NST or VAT are MORE difficult to administer. In countries where the Sales Tax is the major source of revenue, over a period of time people learn to avoid paying taxes and slowly create a parallel economy - which leads to a creation of an underground economy. Similar thing can happen with the value added tax - where the businesses can keep books in a way where they minimize the taxes they pay and the government will need more agents to monitor the accounting practices of the "businesses".

A national sales tax (especially any thing more than 1%) is a VERY bad idea, because it will force people to pay taxes whenever they buy some thing even if they are not employed. For example, the elderly living on social security will have to pay a tax when they buy something for their grandchildren. Further, the "sales tax" will figure in every buying decision leading to a refrain in purchasing decisions every time - and thus leading to "recession" or a constant burden on the free economy. There are MANY other drawbacks with the concept of National Sales Tax as well as Value Added Taxes. Further, there is no guarantee that the system will NOT grow given the politics that is played in State Capitals or in Washington.

Therefore, the income tax concept is the best among many and there is need for the government to collect some taxes to maintain the minimum operations necessary in today's World - we just cannot avoid some taxes.

Bal Patil

Bal Patil

cc: United We Stand, USA Today, NBC News.
AARP

April 03, 1992 (follows up July 17, 1992)

Honorable Senator Wofford:

Here is an idea which can help a lot of families and large sections of our population. There may be extraordinary benefits to productivity of our economy and and the people at large. The thinking has been developed long ago, separate letters have been written and there is no reason for Republicans to play politics with it (As far as I can tell). The thinking looks at all the people in this nation as ONE HOMOGENOUS GROUP to be served.

The people who invest money for capital gains do not invest it for TAX attractiveness but to make a lot of money (get higher return than the banks or CDs etc. etc.) so they should be more than willing to pay AT LEAST 20% in taxes (to pay for the Government Services such as protection, defense, free enterprise system, administration etc. etc. etc. etc.). All we need is following items for deductions (Home Building and AUTOMOTIVE being primemovers of American Economy)

Total Income : Includes Wages, Tips, Salaries, Dividends, Interest, Capital Gains etc. etc. etc. etc. etc.

Deductions :

1. First 20,000 dollars tax exempt ... needed to pay for food, clothing, shelter, utilities, shoes, rent car to look for job, brush teeth, buy cough medicine etc. etc.

2.	HOME MORTGAGE INTEREST	Maximum Limit of	$ 20,000
3.	REAL ESTATE TAXES	Maximum Limit of	$ 10,000
4.	IRA FOR INDIVIDUALS	$2,000 per adult	
5.	AUTO INTEREST OR LEASE	Maximum Limit of	$ 6,000

All the limits to be indexed for Inflation. THE TAXABLE INCOME will be reduced by actual amounts of items (1+2+3+4+5). The ADJUSTED INCOME TO BE TAXED at a rate of 20% (based on Federal Income data available to me) and (my calculations) do not show any increase in deficits.

CHARITABLE DEDUCTIONS are not included...the ability to deduct it on a TAX FORM should not be the motivator ... the American people are really good at heart and we should encourage GIVING, SHARING etc. as a normal moral activity of all people including the HIGH INCOME people. I think such a bill, with absolutely no other complications, will simplify the life for many people.

DO THE THINGS which are good for PEOPLE AT LARGE and all of you in Congress and Senate can look forward to getting re-elected (to serve people).

Bal Patil

Balaji V. Patil
117 Crestwood Drive
Sarver, Pa. 16055

Additional Info Available
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Statement of Fortescue W. Hopkins, Director, The Patrick Henry PAC(VA)

AMENDMENT XXIX
THE TAX AND SPEND MAGNA CARTA

Section 1. The sixteenth article of amendment to the Constitution is hereby repealed.

Section 2. The fourth clause of Section 9 of Article I of the Constitution is hereby repealed and the third clause of Section 2 of Article 1 of the Constitution is hereby amended by eliminating the language "***and direct taxes***" contained therein.

Section 3. Except for the words "***The Congress shall have Power***", the first clause of Section 8 of Article I of the Constitution, including all legislation enacted pursuant thereto, is, hereby repealed effective as of the beginning of the calendar year following the adoption of this amendment and is replaced with the following language:

"Section 8. *The Congress shall have Power* To Lay an annual non-discriminatory, geographically and intrinsically uniform, flat rate income tax on the annual net income of all individuals in each of the several States, the District of Columbia and all Territories of the United States, only for the purpose of providing the revenue necessary to pay all debts heretofore incurred, to pay the costs of the Legislative, Executive and Judicial Branches of Government, as set forth in Articles I,II, and III of the Constitution and to carry out the powers specifically enumerated in this amendment and now expressly granted to Congress in Article 1, Section 8, Clauses 2 to 18, inclusive, of the Constitution, subject, however, to the following conditions:

A. "individuals" are defined to include all citizens of the United States and all non-citizens who have been residents of the United States for at least six months.

B. The "annual net income" of an individual is defined to include the receipt of anything of value, within one calendar year, from any and all sources, whatsoever, without exception, including interest received on obligations of any State or municipality therein, less cost(adjusted for annual inflation) or expenses related to any value received, less a carryover of any net loss from a prior tax year and shall be deemed to include the proportionate share of annual loss or the undistributed annual net income of any equity type entity(Corporation, Partnership,etc.,) in which an individual has an equity interest. For purposes of this amendment, any non-equity entity shall be deemed an "individual" but, for purposes of computing annual net income shall be allowed a deduction for any income distributed in the calendar year.

C. The term "receipt of anything of value", shall be interpreted as broadly, as possible, and shall include, for example, the cost of any benefit to or expenditure made for the benefit of any individual, except between husband and wife, regardless of the source of such benefit or expenditure; provided, however, that the cost of reasonable educational, medical and living expenses provided to an individual who is physically disabled or under the age of 22, by a parent or grandparent shall not be deemed a "receipt of anything of value to that individual.

D. The "flat rate income tax", except as above provided, shall not, in the slightest degree, be discriminatory or intended to achieve a non-revenue related objective, whether or not such objective is otherwise permitted under this Constitution and no other exemptions, exclusions, tax credits or non-expense related deductions shall be permitted in computing "annual net income" and tax due thereon.

E. Each individual and/or parent or person with custody of a child under the age of 18 shall prepare and file on or before April 15 of each calendar year with the State , District or Territory of residence a one page income tax return disclosing "annual net income" for the preceding calendar year and report and pay such income tax as may be due to the Local Commissioner of Revenue or to such bank or agency as the State, District or Territory of residence may designate.

F. The local Commissioner of Revenue of each jurisdiction shall collect, determine and, if necessary, litigate any dispute concerning the correct amount of income tax due in the local civil and common-law court in the vicinity of the residence of the individual; provided, however, that no presumption of correctness will attach to the State's, District or Territories' determination of additional tax due and that the question of what constitutes a correct "annual net income" and/or "tax" will be determined as a "matter of fact" and not subject to any law or precedent and such individual will be entitled to a jury trial[1] with respect to any such dispute where the amount in controversy is at least $200.00.

G. Interest at a rate double the Federal discount rate will be payable on any late payment of income tax. The penalty for negligent failure to pay tax and/or negligent incorrect tax will be an additional 10% of the tax determined to be due. The penalty for willful failure and/or willfully false tax return shall be 100% of the tax ultimately determined to be due. On or before June 30th of each calendar year, each State, District or Territory shall remit to the United States Treasury all interest and income taxes collected ; but shall retain all penalties for its own use.

. I. On or before April 1 of each calendar year , the US Supreme Court shall establish the "***flat rate***" of this tax on individual annual net income in accordance with the following formula:

R = (X+Y) x 100/Z = _____%

WHERE:

X = Prior Calendar year's total Federal Expenditures.

Y = Ten Percent (10%) of the Total Federal Debt as of 12/31/ of the prior calendar year.

Z = Prior Calendar year's total Federal Income Tax (Which for the first year, after the adoption of this amendment , will be an estimated amount)."

J. The Federal Government may maintain an agency to monitor the performance of the various States in the collection and the determination of this tax and if not satisfied with the performance of a certain State, it may file suit in the Federal courts to mandate a more reasonable compliance with this amendment and ask for an appropriate sanction[2] for the failure of any State to reasonably comply with its responsibilities under this amendment."

CONCLUSION

As a separate amendment, it would also be appropriate to propose an additional amendment, as follows:

"No State shall have the power to impose any form of Tax, Impost, Duty or Excise, except for a local non-discriminatory property tax and except for a flat rate individual income tax on "individual net income" as provided for the United States of America."

As you can see it is proposed to eliminate all Excise taxes(Federal & State), the reason being: (1) Indirect Excise Taxes do not promote ***Individual Political Responsibility*** and amount to a blank check which the politician uses to buy votes with and (2) Unfairly exacts from lower income persons a higher percentage of tax relative to income than from persons with higher incomes..

Also, all Federal duties and imposts are eliminated for the reason that an import duty to protect a farm or manufactured product, etc. is, in effect, an indirect tax on citizens that might otherwise pay less for a certain product.

Also, all Trade should be ***"FREE TRADE OR NO TRADE".*** There is no valid reason why we should not inform the rest of the world of this condition for trade with the largest and richest free trading area in the world, America. Again import duties do not promote ***"INDIVIDUAL POLITICAL RESPONSIBILITY"*** which is the indispensable ***"KEY"*** to ***"INDIVIDUAL ECONOMIC OPPORTUNITY".***

As you will have noticed, this proposed amendment to Section 8, eliminates completely the General welfare clause which, of course, has been improperly construed by the Supreme Court to give Congress an unlimited power to spend, mandate and control.

This amendment prohibits Social Security Taxes, which, if not, in fact, an unconstitutional discriminatory income tax, forces a person to contribute to an insurance program, where he may receive nothing if he dies early, clearly in violation of the "taking" clause of the 5th Amendment.

Also, this amendment eliminates corporate income taxes, but, instead, taxes the individual equity holder. Corporations do not pay taxes and do not vote. Only individuals do, so why tax corporations?

A completely non-discriminatory flat tax , without exclusions or exemptions is certainly equal and, most certainly, is what the framers of our Constitution intended when they used the word "*"UNIFORM"*. Our greatest Supreme Court Justice was ***Stephen Field***, who, with reference to a "$4000.00 exclusion from income tax said in ***Pollock v. Farmers Loan and Trust Co.(1895):***

> "Here I close my opinion. I could not say less in view of questions of such gravity that go down to the very foundation of the Government. If the provisions of the constitution can be set aside by an act of congress, where is the course of usurpation to end? ***The present assault upon capital is but the beginning. It will be but the stepping -stone to others, larger and more sweeping, till our political contests will become a war of the poor against the rich,-a war constantly growing in intensity and bitterness. "If the court sanctions the power of discriminating taxation and nullifies the uniformity mandate of the constitution," as said by one who has been a student all his life of our institutions, "it will surely mark the hour when the sure decadence of our present government will commence". If the purely arbitrary limitation of four thousand dollars in the present law can be sustained, none having less than that amount of income being assessed or taxed for support of the government, the limitation of future congresses, may be fixed at a much larger sum, at five or twenty thousand dollars, [3] parties possessing an income of that amount alone being bound to bear the burdens of government;"***

The last few sentences of Walter K. Tuller's great book: "***THE TAXING POWER/STATE INCOME TAXES***(Callaghan & Co. 1937) bears repeating:

> ***"IF THE COURTS PERMIT THOSE IN CONTROL OF THE EXECUTIVE AND LEGISLATIVE BRANCHES OF GOVERNMENT TO TAX WITHOUT DUE REGARD TO CONSTITUTIONAL LIMITATIONS, PARTICULARLY TO IMPOSE DISCRIMINATORY TAXES, CONSTITUTIONAL LIBERTY IS DEAD, WHATEVER FORMS MAY SURVIVE. THE GOVERNMENT WILL BE, IN FACT, ABSOLUTE. HERE LIES OUR GREATEST AND MOST IMMEDIATE DANGER. THE TIDE TODAY IS SETTING TOWARD THAT SHORE. THE ONLY HOPE LIES IN REVITALIZING THE OATH, SOLEMNLY TAKEN BY EVERY JUDGE OF EVERY COURT, TO MAINTAIN AND DEFEND THE CONSTITUTION OF THE UNITED STATES."***

It is obvious to the undersigned that, as of 1995, the ***"tide has set"*** and that the most important question remains: WILL ***DICK ARMEY, BILL ARCHER*** OR ANYONE ELSE BE ABLE TO EXPLAIN TO THE AMERICAN PEOPLE THE PROBLEM WITH AND THE SOLUTION TO "***DISCRIMINATORY TAXATION***" ?

When you read Henry Mayer's biography of Patrick Henry, "***A SON OF THUNDER***"(University Press of Virginia), it becomes quite clear that it was mostly the common people who backed the resistance to the Crown, and not the landed "***aristocrats***" who preferred the "***status quo***".

The "***COLLECTIVIZATION***" of America will continue unabated unless all "***AMERICANS***" are informed of and understand the dangers of the ever increasing power of the centralized government and are willing to act to compel State Legislators to curtail this power by the only possible means: "***CONSTITUTIONAL AMENDMENTS", proposed and passed by the States.*** The recent "***Williamsburg Resolves***" suggests that many State Governors are willing to take such action and to advise the American people. Lets support them.

The foregoing proposed amendment will be resisted as to complex and that "***REDISTRIBUTION AND THE WELFARE STATE***" should not be so hastily and completely eliminated. As a beginning, at least, the American people should act now to compel the following amendment:

THE TAX MAGNA CARTA

"THE CONGRESS SHALL ENACT NO TAX, DUTY, IMPOST, EXCISE, OR OTHER REQUIRED PAYMENT THAT IS, IN THE SLIGHTEST DEGREE, DISCRIMINATORY OR INTENDED TO ACHIEVE A NON-REVENUE RELATED OBJECTIVE, WHETHER OF NOT SUCH OBJECTIVE IS, OTHERWISE, PERMITTED UNDER THIS CONSTITUTION."[4]

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1 It is noted that the elimination of the Jury trial with respect to **"Stamp Taxes"** prompted the VA House of Burgesses **to approve of Patrick Henry's "Stamp Tax Resolutions" which led to increasing resistance to the Crown and, ultimately, to the Revolutionary War.**

2 The appropriate sanction suggested by Patrick Henry for the non-performance of a State in collecting such taxes would be for the Federal Government to then take over the collection duties.

3 It is noted that without repealing social security taxes and federal excise taxes, Dick Armeys ""\FREEDOM AND FAIRNESS RESTORATION ACT would exclude $5300.00 for dependents and $26,200.00 for married filing jointly for Wages, Salary and Pensions. Is there any doubt whether the " **sure decadence**" of our present government has arrived?

4 To the same effect, see Statements of Fortescue W. Hopkins, Hearings on "TAX REFORM AND DEFICIT REDUCTION, Sept. 1984, Serial 98-97, Pages 575-579 and Hearings on "COMPREHENSIVE TAX REFORM", July 31, 1985, RECORD SUBMISSIONS, Part 9 of 9, Serial 99-49, at pages 8613-8620. There was no response to these Statements. However, this time may be different if THE PATRICK HENRY PAC persuades all State Legislators to read the "TAX AND SPEND MAGNA CARTA" and propose a Constitutional Amendment to that effect.

Karolyn A. Phanauf
5802 Sutters Lane
Bloomfield Hills, MI 48301

Congressman Ways & Means

✓ Why do we need children to get a tax break ??? ($500?)

✓ Why can't kids eat a P.B.J. like my 6 kids did when they were in school? (Parents are lazy) They want to let government feed them!

✓ Cut the welfare to under 18 girls

✓ Feed the babies – that's all

✓ Abortion is not a government decision – it's private – Government out of Abortion – Now

✓ Term limits don't upset me

✓ Don't cut Social Security til you cut Congressional BIG Pensions

✓ government pensions to High!

✓ $123,804 Annually - Thomas Foley

✓ $110,538 Annually - Robert Michel

✓ $96,426 Annually - Rostenkowski

✓ Then you tax my little Social Security pension

It isn't fair!!! Disgusting

✓ I was behind a lady buying a stack of 8 T-Bone steaks, pop + potato chips —

With food stamps!

✓ I'm a pensioner & haven't bought a T-Bone in years

✓ She was driving a nice car too - ($20,000 plus)

✓ A man bought 1 lemon @ 15¢ with food stamp coupon - pocketed the cash

he was in front of me @ the market

Probably went for drugs or booze!

✓ Tax Cut please ! for everyone
(I don't have kids anymore)
H. R. 8 – yes!

✓ The Republicans got it right !
Keep on going

✓ Bonier is a mitcase –
embarrassing to Michigan

✓ Gephart lies, just like
Clinton !

✓ The children are not going to
starve –

✓ Who feeds them on week-ends

✓ Who feeds them on Summer
Vacations

✓ The Democrats are scare
mongering –

Really riled in Michigan

Karolyn A. Phanaul
5802 Sutters Lane
Bloomfield Hills, MI 48301

NO!

Do not change

VJ-DAY

Don't insult our fighting forces

Japan started that war not us — Clinton You weren't here then — V-J Day was a wonderful celebration!

You make me angry in Michigan

Mr. Chairman and members of the Committee:

My name is Daniel J. Pilla. I am a tax litigation consultant from St. Paul, Minnesota. I have been in the business of defending taxpayers against IRS actions for some 20 years. My work focuses on the areas of IRS abuse prevention and cure, taxpayers' rights issues and problems resolution. I have written a total of eight (8) IRS defense self-help books and hundreds of articles and special reports on the issue. Additionally, I edit two nationally circulated newsletters. My writings have been featured in Money Magazine, Tribute Magazine, Reason Magazine, Family Circle Magazine, The Freeman Magazine, and dozens of other financial newsletters and publications.

I am co-founder and executive director of the Tax Freedom Institute (TFI). TFI is a national association of tax professionals who defend citizens against IRS abuse. The organization consists of prominent attorneys, accountants and enrolled agents.

This statement is submitted on behalf of myself in my individual capacity, on behalf of the Tax Freedom Institute, and on behalf of every American business and individual taxpayer.

In the span of my career, I have seen every kind of tax case you can imagine, and many cases you could not imagine. My experience with the IRS has brought me to the conclusion that our current income tax system, which is dependent upon the IRS for enforcement, is the worst possible way to administer a tax system.

My experiences with the IRS reveal that the agency regularly uses tactics of bluff and intimidation, misinformation and disinformation, and in many cases, outright lies to citizens concerning taxpayers' rights and the limitations of the agency. Through my work, I see a continuing parade of glaring examples where IRS revenue agents and revenue officers boldly lie to citizens, refuse to explain taxpayers' rights, and twist the tax law and regulations solely for the purpose of collecting more money.

Unfortunately, many citizens are ignorant of their rights, and of the agency's limitations. As a result, they end up faced with tremendous assessments of tax, interest and penalties against them which too often, are simply wrong.

Through the years, we have seen an explosion of penalty assessments and computer generated notices. At the same time, we have seen a decline in the quality of IRS performance, both in the areas of taxpayers assistance and audit results.

These claims, and others, are fully documented in a report I wrote for the Cato Institute, entitled, *Why You Can't Trust the IRS*. Policy Analysis No. 222, April 15, 1995 (Cato Institute - 202-842-0200). The report examines several areas of tax law administration with a view toward answering the question whether or not the IRS performs its various tasks properly.

The findings may be summarized as follows:

1. The quality of IRS' taxpayer assistance toll-free help service has been steadily declining. While it is true the accuracy of its answers has increased over the years, taxpayers have a steadily declining capacity to get assistance. Whereas, in the 1993 filing season, taxpayers had a 1 in 3 chance of getting their questions answered by the IRS, in 1994, their chances fell to 1 in 4. In February of 1995, the GAO reported that the accessibility of the

system fell to the deplorable level of just 13 percent. See, *IRS' Fiscal Year 1996 Budget Request and the 1995 Filing Season*, GAO/T-GGD-95-97, page 4.

2. Evidence reveals the IRS has increased computer generated notices by 1300 percent over the period from 1988 to 1991. Computer notices account for billions of dollars annually in adjustments to taxpayers' accounts. For example, in 1993, the IRS mailed a total of 60 million notices to taxpayers, making adjustments totaling some $192 billion. However, the fact is that numerous GAO studies show that IRS notices are wrong about half the time. In 1988, the GAO first released a report showing an error rate of 48 percent. Subsequent examinations have been conducted nearly every year since. While the IRS is plainly aware of this fact, it has done virtually nothing to correct the problem. Thus, the agency continues to make unwarranted demands for billions in revenue from millions of citizens every year.

At the same time, the notices themselves are woefully inadequate to communicate what it is the IRS is seeking. In a December, 1994 report, the GAO examined IRS notices, not from an accuracy standpoint, but merely from an understandibility standpoint. GAO found that 31 of the most common 47 notices used by IRS -- 66 percent -- used language that was unclear, used inconsistent terminology, contained an illogical presentation of ideas, and provided insufficient information and guidance to the taxpayer. See, *IRS Notices Can be Improved*, GAO/GGD-95-6, page 8.

3. The IRS consistently makes improper penalty assessments on a wholesale level, amounting to billions in assessments which are not legitimately due. In 1980, the IRS assessed a total of 19.6 million penalties against individuals and businesses. After a decade-long process of tax simplification, one would think penalty assessments would have declined. However, by 1987, the year following massive tax reform, assessments rose to 27 million penalties, and by 1993, 32.97 million penalties were assessed against individuals and businesses.

The evidence indicates that such penalties are simply wrong anywhere between 40 and 50 percent of the time. The IRS' data on penalty cancellation reveals this truth. Yet, because the IRS disseminates incorrect and incomplete information on the penalty cancellation process, many citizens do not attempt to undertake the cancellation process. They wind up paying penalties and interest which they simply do not owe.

4. The IRS is consistently incorrect with the results of the face-to-face audits it performs. About one to two percent of all tax returns filed undergo face-to-face examination. The average audit results in an additional tax and penalty assessment of about $5,000. This number doubles after IRS adds penalties. However, the data shows these audits are incorrect about 50 percent of the time. In fact, a GAO report on the tax burden, released on December 9, 1994, showed that one of the major problems businesses face in dealing with the IRS is the fact that IRS tax auditors lack sufficient knowledge of the tax code to do an accurate or effective job in tax law administration. See, *Tax Compliance Burden Faced by Business Taxpayers*, GAO/T-GGD-95-42, page 3.

5. The IRS' periodic Customer Satisfaction Survey shows that the public's perception of IRS performance is steadily dropping. The survey shows declining confidence in the agency's ability to administer the tax law correctly, answer taxpayer questions accurately, maintain high standards of integrity, keep taxpayer information confidential, and be courteous to taxpayers. The public's composite assessment of IRS' conduct dropped from 6.42

in 1992, to just 5.88 in 1993. This is to say, 41.2 percent of the time, the public feels it was wronged, cheated or otherwise inadequately served by the IRS.

6. The IRS has announced plans laying the ground work for a highly invasive, broad based information gathering program which smacks of Big Brotherism like nothing else. On December 20, 1994, the agency announced plans to introduce a system of recordkeeping that would give it access to every public and private data base in the nation.

In addition, an incredibly invasive audit program has just recently been announced. The program is the District Office Research and Analysis Program (DORA). IRS has termed this the "life-style audit." Under this audit, IRS will not be interested in the entries on your tax return. Rather, it will examine your life-style in hopes of ascertaining whether your life-style is consistent with the income claimed in your return. Included on the list of items to be reviewed are: your home, furniture, fixtures, clothing, jewelry, toys, recreational vehicles, trips and vacations, weddings of your children, business licenses you hold, all real estate holdings, use of credit, and on and on.

Amazingly, these life-style audits are to be conducted by the same tax auditors who have little understanding of the tax code and are mistaken in their audit results half the time.

7. The data shows the IRS regularly and systematically submits incorrect information to Congress concerning the effectiveness of its enforcement programs. While the IRS continues to request of Congress more money, equipment and manpower, it simultaneously fails or refuses to provide accurate reports to Congress on the impact these enforcement programs have on revenue collection.

At the heart of this problem is the $23 billion Tax Systems Modernization program (TSM) which IRS has been engaged in for the last five years. IRS' financial reports to Congress have been so deficient with regard to this program, the GAO recently placed TSM on its list of "high risk" government programs. See, *IRS' Fiscal Year 1996 Budget Request and the 1995 Filing Season*, GAO/T-GGD-95-97, pages 8 and 9.

8. As if all this is not sufficient cause for one to question the continued existence of the IRS and the income system, the GAO's two audits of the IRS' own financial statements show the agency itself cannot do what it asks every taxpayer to do. The evidence shows that the IRS is unable to account for 64 percent of its operating budget, significantly overstated its accounts receivables ledger, and falsified significant records of its accounting activities. While the IRS has made repeated promises and assurances that it will correct the problem, the GAO recently noted it continues to have no confidence in IRS' financial statements, because they still are not "accurate, reliable or consistent." See, *Tax Compliance Initiatives and Delinquent Taxes*, GAO/T-GGD-95-74, February 1, 1995.

In Conclusion, I submit that a tax system consisting of 17,000 pages of law and regulation nobody understands is not suitable for a free society. Similarly, a federal agency which cannot adequately maintain its own accounting ledgers is poorly suited to police individual and business taxpayers.

The tax system of a free society must necessarily release the American people from the burdens of compliance and the hassle of dealing with an error-prone enforcement agency. Tax law enforcement is too important for anything less. The potential for enforcement abuse is too great to allow a government agency to

continue to wield the power of the IRS, given its lack of accountability and incapacity to manage its own affairs.

I therefore submit that we must eliminate the income tax system and the agency which administers it. I submit the only reasonable replacement to the system we now have is a national retail sales tax. *By no means* should such a tax be enacted in addition to any of the taxes we now have. Rather, it should *replace* all current income and payroll tax levies. I support a national retail sales tax because in my opinion, it serves both the government's need to raise revenue to support its legitimate functions, while at the same time, presents the least amount of personal invasion and economic distortion of any other form of taxation.

Most importantly, the national sales tax could eliminate the IRS, and with that, we could eliminate the hassle, anxiety, cost and in some cases, outright tragedy of dealing with an error-prone government agency which literally wields the power of financial life and death over every citizen.

San Clemente, California
June 3, 1995

House of Representatives
Ways and Means Committee
Washington, D.C. 20515

To: Members of the Committee

Your committee will be holding hearings on tax matters in the very near future. I wish to offer this letter as my contribution to your deliberations.

The Federal income tax should be abolished because it is both unfair and incomprehensible. There is no way to "fine tune" this tax to make it equitable and a flat rate tax has many of the same objections in that it would continue to allow the Internal Revenue Service to oversee its administration and collection. The present income tax is unacceptable because:

1. Both payroll and estimated taxes paid quarterly deprive the taxpayer of his right to use his money as he sees fit during the year before taxes are actually due.

2. After income has been taxed the remainder continues to be taxed. Some of these taxes are; Property, sales, gas, utility, etc. etc.

A National Sales Tax would probably be the fairest method of taxation if consideration is first given to the fact that in almost all states a sales tax is already imposed. In California we pay over seven per cent sales tax and are facing an election this month to raise the sales tax an additional one-half per cent in Orange County.

A National Sales Tax should be low and taxpayers should have assurance that once imposed it would not be raised arbitrarily except in cases that are clearly spelled out and cannot be "interpreted" to mean something not originally intended.

May success crown your efforts in a total revision of the onerous tax situation.

Sincerely,

Gloria M. Portner

Gloria M. Portner

129 Avenida San Dimas
San Clemente, CA. 92672

5/31/95

Michael Post
6091 Barbados Ave.
Cypress, Ca. 90630
(714)897-0018

Honorable Bill Archer
Chairman, House Ways & Means Committee
House Of Representatives
Washington D.C.

Dear Sir:

I am writing to urge you to adopt a Flat Tax. I believe a Consumption Tax will too easily lend itself to being hiked in the future (not unlike the sales taxes in many staes, or the gasoline tax), and may have other unintended and undesirable negative effects on our economy. I believe a Flat Tax, paid monthly, or quarterly, by citizens will be the most effective instrument for ensuring an efficient and fiscally responsible government. By overhauling the current horrendous tax system, including eliminating the tax on interest derived from one's savings and investments, and having all of us pay the same tax rate, you would spark a boom in the savings rate, the economy, and the spirit of this nation.

I greatly appreciate your taking my views into consideration as you commence with your desperately needed reform of our current tax system. I also want you to know how much I admire your articulation, leadership and courage in undertaking this Great Work of dismantling the IRS, and enacting a tax that is simple and fair to all, and which encourages the prosperity of the citizens of this country, rather than one which robs us of any hope of prosperity. May God Bless You in this Work!

Sincerely,

Michael Post

P.S.: I would appreciate your circulating a copy of this letter to each of the members of your Tax Sub-Committee. (6 Copies attached.)

Peter W. Powell
3315 Grand Prix Dr.
Sebring, FL 33872

May 25, 1995

Dear Sir,

I am happy to hear that someone in the government wants to hear and will actually listen to want the governed have to say. In reference to taxes, I think like most people who I come into contact with. Taxes give government an excuse to take 60% of my hard earned money and blow it on something anyone with an I.Q. of 75 wouldn't even consider worthwhile.

I am really not interested in any flat tax, I would still be paying more than I should have to pay. With no deductions I would end up paying as much or more than I pay now. The wealthy would still be getting all the break, so would the leisurely poor.

I would like to see a tax that everyone pays the same. It is my belief that the 1% tax that I have heard and read about would be the way to go. If I have to be taxed, why not tax what I spend, not what I make. Everybody would pay the same, there will be no exemptions or exceptions, that is what makes this fair tax system.

It would also raise far more money than the present system does. It has been estimated that at least 400 trillion dollars changes hands in the course of one year. 1% of this amount is almost double or present budget. Under the old system the consumer paid the bulk of all sales tax, but under 1% tax everytime a transaction is made 1% tax is paid. This is the only tax that is not only fair to all, but would raise the money for all those pork projects that Washington is so fond of.

Lastly, it would rid the American people of the I.R.S. Maybe with the I.R.S. out of the way congress would undertake the job they were sent there to do. Like protecting the CONSTITUTION.

Sincerely,

Peter W. Powell

Peter W. Powell

703 Sutter Street
Folsom, CA 95630
June 8, 1995

Chief of Staff
House Ways and Means Committee
1102 Longworth House office Building
Washington DC 20515

Mr. Moseley

Am writing concerning the discussion on the income tax reform hearings conducted by Congressman Archer, and am following instructions given by Mike Reagan from the Mike Reagan talk-show in order to have my views registered before June 22. This includes 6 copies.

Fist I start with the premise that we shouldn't have a federal income tax at all. There are Constitutional questions about that and from what I understand, Congressman Archer would like to repeal the 16th Amendment. I can go for that.

But, since we're going to have an income tax whether we want one or not, I wish to state my views on which one we should have. I like Congressman Armey's plan-a flat tax of around 17% with no federal tax below an income level of 36,000 dollars or something like that. I would make only one revision to that, lower the income limit to 30,000 dollars and the income tax rate to a flat 13%. I haven't run the numbers of course, but I think the government could get plenty of revenue with a 13% flat tax. This due to the multiplication effect once one gets past 10%. The multiplication effect is faster after the first multiple of 10. That's why banks never give interest rates past that number, and charge interest as high as they can on their loans...more money! Simple!

Don't get involved in that consumption tax. I know a lot of people around here like it. Most I've heard on the talk-show-circuit who like it are liberals. I often wondered why. I think I've figured it out. They think a lot of underground money will get taxed that way. And it's the liberal way to want to screw everybody. But it's a plan frought with danger, and it will generate more paperwork than anyone ever thought about, Because they keep argueing that it will have to be fine-tuned. Any time you talk about fine-tuning, something akin to a paper-work

jungle emerges.

Secondly, a lot of people think that will do away with the IRS. Well, the IRS will be with us always, no matter which plan is adopted. But if we can defang the gestapo like tactics of the IRS and put it back into its proper role-that is, simply to be numbers crunchers, then we'll have accomplished sometiing. The flat tax accomplishes that just as well.

Thirdly, I've always maintained that you want to keep the tax system away from the consumption side of the economy and place it on the money made, not on production. You get into a consumption tax and it would very easily fall over into a value-added tax. That's what they have in Europe. That's why it's so expensive to live in Europe. It burdens business by making them tax-collectors for the government more so than they already are, and that would be adrag on the economy. In addition, such a tax would be a small disaster for us on foreign markets. If you think we can't compete globally now, just wait until the consumption tax takes effect.

Lastly, the consumption tax is less equitable on a state-to-state basis. For instance, we out here in California have the highest rated tax system in the country, with a sales tax of 7.5%. Counties add on their %'s and we have an overall average rate of 7.75% sales tax. Add a 16% national sales tax to that and you have 23.5% sales tax plus 11% state income tax, et-al, you get the point. While just to the north, Oregon has no sales tax. There would be massive dislocations in buying patters, probably driving many businesses into bankruptcy.

Addendum: No matter what plan is devised, the federal insurance system must be reformed along with it. I'm including a pay stub from my last check. If you'll notice, I had no federal tax witheld. But over 65 dollars taken out in federal and state insurance programs premiums. That's on one partime check. 77? dollars total. Something's got to be done about that.

Thanks for including my letter

Sincerely

James A Rhodes

James a Rhodes

PAYROLL

EMPLOYEE'S NAME: RHODES, JAMES M/2

SOCIAL SECURITY #: [redacted]

PAY PERIOD ENDING: 5-31-95

OTHER: 94.25 HRS X 5.00

GROSS EARNINGS: $472.50

LESS FED. TAX: 0

SOC. SEC. TAX: 29.30

STATE TAX: 0

DIS INSUR: 4.72

F.I.C.A. 35.91 MEDICARE 6.85

ADVANCE: 0

TOTAL DEDUCTIONS 76.78

NET EARNINGS: 395.72

REMARKS:

EMPLOYEE S SIGNATURE: _____ DATE PAID: _____

Gary and Janette Roulston

June 16, 1995

Honorable Bill Archer, Chairman
Ways & Means Commitee
U.S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D.C. 20515

Dear Representative Archer:

I am writing in regards to the debate to change the tax system of the United States of America.

My name is Gary L. Roulston and my wife and I reside at 7803-B Jefferson Place Blvd., Baton Rouge, LA 70809. I am a 48 year old decorated Vietnam veteran who loves his country and understands the duties and responsibilities of an American citizen.

I acknowledge the need to financially support the operation of my Government, according to Article XVI *"to collect taxes on my income"* so it may carry out its functions according to the Constitution of the United States. We must protect our shores and provide necessary infrastructure for daily functions. But the time has come to say to my government *" STOP! You have exceeded the amounts due you and your actions have now become abusive and oppressive!"*. On April 17, 1995, the Federal Government, by the authority of the present tax laws, demanded 1/3 of my income. Combined with my state and local taxes, our government obligation was 50% of our yearly income. If Thomas Jefferson were alive today, he would swear that King George was again on his throne. Jefferson complained that the King had *"erected a multitude of new offices and sent hither swarms of officers to harass our people and to eat out our substance"*. Similar harassment exists today through the current tax system, a system so complicated that even tax professionals don't understand it.

The amount of taxes that Americans are compelled to pay is outrageous and must be changed! The Bible tells me that I owe God 10% of what we earn to support his bidding. Why does my government demand more of me than Almighty God? I will tell you why. To perpetuate the *"fairness doctrine of the liberal agenda,"* i.e., to support the existance and expansion of the welfare state and to continue its *"liberal blitzkrieg"* of war on the classes. This is a contemptuous attempt to level the playing field as it sees it. It is wrong.

I want to applaud you and the many representatives and senators, regardless of party, that have brought this matter to the forefront. It is long overdue. I feel that for the first time in my life, real fairness in taxation of the citizenry is being seriously discussed. I welcome an opportunity to comment on the consideration of a new tax system and particularly the flat tax.

Of the two types of tax presently being discussed, I feel a flat tax would be preferable to the consumption tax. I especially like the flat tax plan of Representative Armey. My choice is predicated on two things. First, the flat tax is fair and simple. The very poor who make nothing would owe nothing. Working Americans would pay only 17% on what they make over the basic exempt amount. The playing field would *really* be level. Second, the flat tax would not necessitate the repealing of the XVI amendment. If a consumption tax were enacted, I feel a repealment would be necessary to avoid the possibility of a double taxation set in motion by future politicians. I know they would try to find a way to do it. I also believe a consumption tax could require intensive record keeping.

Thank you for your attention to my letter. You may enter this correspondence into the Congressional Record as a letter of support for your action on behalf of me and my family. May God grant our representatives and senators the wisdom of Solomon in addressing this and all matters of the people. God bless America and God bless you.

Sincerely,

Gary Roulston

Gary L. Roulston

7803-B Jefferson Place Blvd. • Baton Rouge, LA 70809 • (504) 925-5366

DAVID SACHS
1155 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10036

May 26,1995

Mr. Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Moseley:

In connection with the hearings on tax reform scheduled for June 6 to 8, 1995, I am submitting for the record of the hearings a copy of my article on that subject recently published in Tax Notes (vol. 66, no. 6, Feb. 6, 1995). Brief summaries of my qualifications and my proposals are set forth in the box at the beginning of the article.

I should point out that my proposals would vastly simplify the collection of income taxes from both individuals and businesses, while relying on concepts most of which are not novel. Most individuals would be freed from having to deal with the IRS at all, and would pay substantially reduced tax rates, the bulk of which, however, could be graduated if desired. Based on data published by the Bureau of Economic Analysis, personal income tax revenues could be maintained at current law levels, even without taking into account the major savings in tax compliance costs for both government and taxpayers. (See example at end of page 867.)

This is the kind of non-gimmicky tax reform that individuals and businesses have been waiting for and voting for, and that they deserve to get.

Sincerely yours,

David Sachs

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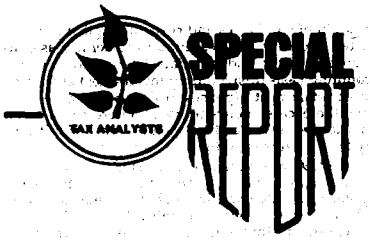

VARIATIONS ON A THEME BY DICK ARMEY — A FRAMEWORK FOR REAL TAX SIMPLIFICATION

by David Sachs

I. Introduction

Pleas for simplification of the federal income tax laws have been prevalent for many years, even during times when tax laws were considerably less complex than they are now.[1] The annual massive "reforms" and revisions of the Internal Revenue Code over the past 20 years, interspersed with comparably intricate technical corrections, have resulted in a broad-based recognition, by government officials as well as tax practitioners and educators, of the need for simplification.[2] Nevertheless, tax legislation continues to generate greater complexity almost on an annual basis. Until 1994, serious suggestions for simplification of the income tax focused merely on identifying and improving the most acute problem areas, such as penalties[3] and pensions.[4] Simultaneously, much attention has been addressed to issues such as revision of Subchapter C (governing corporate reorganizations) and integration of corporate and personal income taxation. In both areas, current law, while far from perfect, is relatively well-known and adequate. There is little doubt that any revision of Subchapter C or integration will introduce

[1] *E.g.*, Paul, "Simplification of Federal Tax Laws," 29 *Cornell L. Q.* 285 (1944); Surrey, "Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail," 34 *Law & Contemp. Probs.* 673 (1969); Bittker, "Tax Reform and Tax Simplification," 29 *U. Miami L. Rev.* 1 (1974).

[2] For example, an invitational conference on "Reduction of Income Tax Complexity" ("simplification" was apparently viewed as an oxymoron), sponsored by the Section of Taxation of the ABA and the Tax Division of the AICPA on January 11 and 12, 1990, included as speakers a stellar roster of 38 current and former government officials, economists, tax practitioners, and tax educators and a participating audience of approximately 185 "conferees." *See* AICPA/ABA, *Proceedings of the Invitational Conference on Reduction of Income Tax Complexity* (hereinafter "Proceedings"), II-B-1 through II-B-3, II-C-1 through II-C-12 (1990). No tax law changes resulted from this conference.

[3] Title VII, Subtitle G (sections 7701-7743) of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. No. 101-239) revamped the complex and sometimes conflicting civil penalty provisions.

[4] N.Y. State Bar Ass'n, Special Comm. on Pension Simplification, "A Process Awry: A Call for Simplification and Rationalization of the Federal Pension Laws," 8 *Am. J. Tax Pol'y* 75 (1989).

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greater complexity, at least in the sense of requiring application of many new concepts.

At the risk of oversimplifying the causes of the seemingly inexorable trend toward complexity, it is suggested that this trend is attributable to a convenient synthesis of the pragmatic need for constantly increasing federal revenues with the theoretical doctrine that the purpose of the income tax is to tax "correct" economic income and the corollary notion that "correct" economic income is susceptible of statutory definition if one tries hard enough.[5] As long as these two factors continue to control the structure of the income tax law, complexity will continue to be unavoidable, all good intentions to the contrary notwithstanding. And since there is no realistic possibility that the need for increasing revenue will dissipate, it is the concept that "correct" economic income must be taxed that must be modified to achieve real simplification. It is submitted that the purpose of the income tax today should not be to tax "correct" income, but rather to allocate in a relatively simple and reasonably fair manner part of the costs of government among the persons and entities that the government benefits. If one can accept this proposition, it follows that it should not matter whether all items of income are precisely determined and taxed, provided that the overall tax allocation is reasonable and as simple as practicable, though perhaps not perfect.

II. The Armey Flat Tax Proposal

On June 16, 1994, Rep. Richard Armey, R-Texas, introduced H.R. 4585,[6] the "Freedom and Fairness Restoration Act of 1994." The bill provides for both income tax simplification and severe spending restraints on the federal government.

The tax portion of the bill is indeed simple.[7] For individuals, it provides for taxation *only* of earned income (retaining the current exclusion of foreign earned income) at the rate of 20 percent for the first two years and 17 percent thereafter. There are standard deductions ranging from $12,350 for separate filers to $24,700 for joint returns. Dependents qualify for $5,000 deductions. These deductions are indexed for inflation. Withholding taxes on wages are repealed. Armey visualizes a postcard-sized individual income tax return.

For businesses (regardless of form of organization), there is imposed a tax on the business at the same 20-percent rate, reducing to 17 percent after two years. The tax base is gross income, excluding investment income, less three deductions: business inputs, compensation of employees and costs of tangible personal and real property. Business inputs are defined as costs of goods, services, and materials determined on a cash accounting basis (disregarding inventories) and travel and entertainment expenses. If deductions exceed income, the excess, increased by an interest rate factor equal to the year-end three-month Treasury Bill rate, may be carried over to the succeeding year.

Since 1994 was a major congressional election year, the Armey proposal, put forth by the chair of the House Republican Conference, inevitably became caught up in the intense pre-election political battles. Conservative commentators lauded the flat-tax proposal;[8] Democrats condemned it, referring only to the individual income tax portion. The business tax proposal was virtually ignored, presumably because it was not of relevance to the average voter.

Supporters of the Armey bill contended that it would promote saving, capital investment, and employment. The principal substantive criticisms of the individual income tax portion of the bill were that it would produce too great a reduction in revenue and too much benefit for higher-income individuals, especially the "coupon clippers." Putting partisan considerations aside, there is still some merit in these objections. They are addressed and remedied in the proposals presented below.

The principal vice of the Armey business tax proposal is that it retains, though in a changed format, the current requirement that businesses compute taxable income under a different regime from what they use for normal accounting purposes. It exacerbates this problem by establishing a new set of taxable-income-determining definitions that, no doubt, will lead to years of litigation over their application to the myriad types of business enterprises. These difficulties are also addressed and remedied in the following proposals.

III. Variations on the Armey Theme — Summary

In keeping with the foregoing precepts, it is proposed that the federal income tax be revised (1) to tax corporations and other business interests on their book income, preferably without adjustment, and (2) to tax individuals mainly by a withholding system imposed on the principal classes of income.

These proposals will be discussed in greater detail below. However, it is not the intention of this commentary to provide an all-inclusive plan for complete implementation of the suggested tax structure. Obviously, considerable further study will be necessary, particularly with respect to categories of persons that are now subject to special tax regimes, such as insurance companies, cooperatives, and tax-exempt entities. Procedural provisions will have to be carefully examined

[5]For brief discussions of the impact on tax legislation of the so-called Haig-Simons economists' definition of income, see Hickman, Comment on "The Role of the Treasury Department in Reducing Tax Complexity," Proceedings, I-E-1, I-E-3; McLure, "The Budget Process and Tax Simplification/Complication," *id.* I-A-1, I-A-12 through I-A-13.

[6]103d Cong., 2d Sess. (1994).

[7]The tax portion of the bill occupies only about 6 of its 50 pages; the remaining 44 pages deal with the spending restraints. The latter provisions are outside the scope of this commentary.

[8]In New Jersey the Republican candidate for the Senate, Garabed Haytaian, running against incumbent Frank Lautenberg, included a slightly modified version of the Armey proposal as a major plank in his platform. Haytaian lost the election.

to determine whether there should be additions, deletions, or modifications.

IV. Corporations

A. Significance of Book Income

The book income of corporations (as disclosed by their financial statements) is relied on by government regulators, shareholders, prospective investors, lenders, and other interested persons for virtually all purposes except taxation. Certified financial statements are generally considered adequate to meet the rigorous disclosure requirements of the securities laws. While not all financial statements are certified, they are accepted as valid bases for evaluating corporate performance, although they may not state economic income "correctly." They should also be acceptable as a means of allocating corporate income tax liabilities. For this purpose, book income does not need to be absolutely correct, but only reasonably comparable on a relative basis. In other words, is it not reasonable for a corporation with book income of $10,000,000 to pay five times the tax of one with book income of $2,000,000?

Is it not reasonable for a corporation with book income of $10,000,000 to pay five times the tax of one with book income of $2,000,000?

There is no inherent reason why this format would not be as fair as the current taxing system. For a short while (1987-89), book income (50 percent thereof) was utilized as one of the measures of corporate alternative minimum tax.[9] Criticism of that element of the AMT centered on the additional complexity resulting from the addition of a third alternative basis for taxation[10] and transitional problems.[11] My proposal, of course, does not involve any alternative bases but rather adopts the basic, existing financial records as the corporate tax base. Transitional issues are unlikely to arise because the new system, in not seeking to define "correct" income, can accommodate some short-run duplications or omissions.

B. Evaluation of the Proposal

It is unclear whether the aggregate tax base under the proposed corporate tax system would differ substantially from the current tax base. In 1994, the Internal Revenue Service reported aggregate corporate taxable income of $366.4 billion in 1990, and $350 billion in 1991.[12] For the same two years, the Bureau of Economic Analysis of the Department of Commerce (the BEA) currently reported respective aggregate corporate profits before tax of $304.7 billion[13] and $334.7 billion,[14] before any adjustments could have been made by reference to tax return data. Thus, assuming that the BEA statistics more closely approximate aggregate book income than do the IRS data, deviation of book income from IRS taxable income (-17 percent in 1990 and -4 percent in 1991) does not appear to be sufficient to justify the retention of a separately defined, exceedingly complex system for calculating income only for tax purposes. Probably all that would be needed is a slight adjustment in the tax rate to compensate for any difference in the tax bases and the identical tax revenues could be produced. Since the major corporations report their book income quarterly, the government would have a more accurate and up-to-date basis for projecting corporate tax revenues than it now has.

It might be argued that financial accounting is biased in favor of balance sheet conservatism (that is, minimizing net assets). Even conceding that, it should not have a significant adverse effect on the relative amounts of reported income. More troublesome is the possibility that corporations will intentionally bias their accounting practices to minimize taxable book income. This problem now exists in the computation of taxable income under the Internal Revenue Code, and it will have to be met with similar deterrents, including IRS audits and penalties. To the extent that certified accounting statements are involved, there would be the added element (not now existing) of the independent review by the certifying accountants.[15] Certification could be encouraged by giving certified financial statements the benefit of favorable presumptions, possibly together with penalties (like the current substantial authority and preparer penalties) for taxpayers and accountants who intentionally deviate from generally accepted accounting principles for the purpose of tax avoidance.

It is recognized that there are varying accounting principles that are viewed as generally acceptable, although the range of acceptable principles is being narrowed.[16] This problem of selective use of favorable accounting principles could be largely ameliorated by imposing, from the outset, a mandatory conformity requirement that would preclude any change in prior accounting for any item without IRS approval. The IRS maintains that it currently has this authority,[17] although there is some judicial precedent to the con-

[9] IRC section 56(f) (1986).

[10] Anthony & Dilley, "The Tax Pressure on Financial Reporting," 66 *Taxes* 466, 472 (1988).

[11] Brown, "Corporate Alternative Minimum Tax," 45 *NYU Ann. Inst. on Fed. Tax'n* 7-1, 7-29 (1987).

[12] IRS, Pub. 1136, *SOI Bulletin*, Summer 1994, Fig. 1 at 22 (1994).

[13] U.S. Dep't of Commerce, Bureau of Economic Analysis, *Surv. of Current Bus.*, V. 71, No. 7, Table 1.14 at 7 (July 1991).

[14] U.S. Dep't of Commerce, Bureau of Economic Analysis, *Surv. of Current Bus.*, V. 72, No. 7, Table 1.14 at 54 (July 1992).

[15] IRS data indicate that $347.2 billion (94.8 percent) of the $366.4 billion in taxable income reported in 1990 was earned by corporations with assets of $1,000,000 or more. IRS, Pub. 16, *Statistics of Income*, 1990 Corporation Income Tax Returns, Table 4 at 37 (1993). Such corporations should be able to bear the cost of certified financials.

[16] P. Delaney, J. Adler, B. Epstein and M. Foran, *GAAP, Interpretation and Application* 550 (1989).

[17] *See* Treas. reg. section 1.446-1(e)(2).

trary.[18] In addition, in the case of public corporations, there would be the countervailing incentive favoring the reporting of increased book income (to say nothing of securities law restraints) to offset any tendency to overutilize accounting principles that reduce income.[19]

IRS audit attention would have to be focused on nonpublicly owned corporations, particularly those that have no certified financial statements.

IRS audit attention would have to be focused on nonpublicly owned corporations, particularly those that have no certified financial statements, to confirm that book income is being fairly reported.

C. Application of the Proposal

Under my proposal, corporations that are subject to tax at corporate rates[20] (i.e., C corporations) would be taxable based upon their income as determined for financial accounting purposes. This would simply be their "bottom-line" net income, adjusted only to eliminate the provision for federal income taxes. The financial statement fiscal year would be used as the taxable year.

A number of consequences, mostly self-evident, would follow from this proposal. The income of all consolidated corporations, including foreign subsidiaries, would be taxable. Foreign income taxes would become deductions rather than credits. No other credits would be available. No income would be exempt from tax or subject to special treatment. In other words, dividends from unconsolidated corporations, municipal bond interest[21] and capital gains would be fully taxable. Conversely, deductions would be available for accruable expenses and liabilities, and the much-debated *General Utilities* doctrine that no gain is taxable to a corporation upon distribution of appreciated property to shareholders would be reinstated. There would be no loss (or other) carryovers or carrybacks, though cumulative corrections of current book income, when appropriate under generally accepted accounting principles, would be taken into account. Consideration would have to be given to the treatment of items that are normally dealt with in footnotes to financial statements, though the presumption would favor disregarding them.

Corporate structural changes would be nontaxable when book income is not affected (e.g., where pooling is permitted). Amortization of goodwill and negative goodwill would be taken into account. Dividends would continue not to be deductible, thus preserving the distinction between debt and equity. However, recent financial developments suggest that the tendency toward overleveraging may no longer be a serious threat to the tax base. In any event, the book-income proposal would merely perpetuate and not exacerbate this problem.

Foreign corporations engaged in business in the United States would be taxable on the book income of their United States branch or facility, subject, of course, to any treaty restrictions. The treatment of S corporations would continue as at present, except that book income would be allocated to the individual shareholders.

No doubt the exceedingly varied nature of business corporations would in some instances result in what some would consider improper taxation. However, some aberrations of this sort should be deemed an acceptable price to pay for the substantial simplification involved. It would, of course, be possible to "adjust" book income (such as by the exclusion of municipal bond interest) to take care of perceived improprieties either in favor of or against the taxpayer, and the pressure to do so would be great if the system were adopted. But, once started, such adjustments would quickly become the rule, rather than the exception, and the benefit of utilizing book income would be lost. For this reason adjustments would have to be kept to a minimum, and preferably avoided entirely. The new system should be given a test period of at least three years with no or minimum adjustments.

V. Individuals and Passthrough Entities

A. Application of the Proposal

Individuals who are not engaged in business (other than the performance of personal services)[22] would be subject to withholding taxes at fixed rates (which in some cases could be graduated) on the following categories of income:

(1) Compensation, including pensions and compensatory annuities;

(2) Interest, including original issue discount and the interest element of financial annuities but excluding municipal bond interest;

(3) Dividends;

(4) Rents and royalties;

(5) Alimony; and

(6) Casino and lottery winnings.

Pass-through entities (partnerships, trusts, and estates) *that are not engaged in business* would pass through the net balances of such classes of income after

[18] *E.g., Gimbel Bros. v. United States*, 535 F.2d 14 (Ct. Cl. 1976); *Beacon Publishing Co. v. Commissioner*, 218 F.2d 697 (10th Cir. 1955).

[19] Corporations having assets of $50 million or more, which are likely to be public corporations, reported 84.3 percent of aggregate corporate taxable income in 1990. *See IRS*, Pub. 16, *Statistics of Income, supra* note 15.

[20] IRC section 11 (1986).

[21] The United States Supreme Court has made clear that there is no constitutional impediment to inclusion of municipal bond interest in the tax base. *See South Carolina v. Baker*, 485 U.S. 505, *reh'g denied* 486 U.S. 1062 (1988).

[22] Such individuals constituted approximately 80 percent of individual return filers in 1990 and 1991. *IRS*, Pub. 1304, *Statistics of Income*, 1991 Individual Income Tax Returns, Table A at 2 (1994).

withholding, either by the payer of the income to the pass-through entity or by the entity if, for some reason, the payer has not withheld. The basic concept would be that such pass-through entities would be subject to one level of withholding on the designated classes of income, so it would make no difference whether or not they distributed their income.

As mentioned, withholding on certain categories of income, such as compensation, could be at graduated tax rates. Governmental payments, such as unemployment compensation and Social Security benefits, could be exempted or taxed, as deemed appropriate. Withholding on original issue discount and financial annuities would be applicable to the amounts accruable by the payers as annual deductions for book purposes, whether or not distributed. This would require the payers to make advance payments of the withholding tax in cases where payment of the discount or annuity is deferred, but such advance payment requirement could be taken into account by the payer in establishing the interest rate and other terms of the obligation. Alimony withholding should be designed to pass through proportionately to the recipient the effect of taxes paid on the income of the payer. This could be accomplished by allowing credits on the withholding tax return to be filed by the payer for taxes paid with respect to the portion of the payer's income paid as alimony.

Foreign persons (including corporations) not engaged in business in the United States would likewise be subject to withholding tax on the same categories of income, much as they are under current law and taking treaties into account.

B. Business Income

Individuals, trusts, and estates engaged in business would, in addition to the withholding tax on the designated classes of income, be taxable on a tax return basis and at rates not exceeding corporate rates upon the net book income of the business, including their shares of business income earned through pass-through entities (e.g., partnerships, S corporations). The pass-through entities themselves would continue to be exempt from taxation on business income, but would be required to file information returns reflecting their book income and its allocation among owners, and to withhold on the categories of nonbusiness income subject to withholding if such withholding has not previously occurred. To avoid distortions of normal pass-through-entity business and investment activities, the classes of income subject to withholding (and related expenses) would be excluded from business income of pass-through entities.

Similar treatment would be applicable to foreign individuals and foreign pass-through entities engaged in business in the United States, subject to treaties.

C. General Effect of the Proposal

The effect of these proposals with respect to individuals and pass-through entities would be to eliminate all credits and all deductions not allowable in determining business book income. Capital gain included in business book income would be taxable. Nonbusiness capital gains would not be taxed. Except for possible withholding tax returns, no tax returns would have to be filed by individuals and pass-through entities that have no business income.

Tax rates could, and probably would, differ with respect to the different classes of income, taking into account fairness and revenue requirements.[23] To the extent rates are graduated on a particular category of income, such as compensation, the effect of joint return or head-of-household rates could be provided.

D. Evaluation of the Proposal

The BEA recently published a reconciliation of its estimates of adjusted gross income compared with adjusted gross income reported by the IRS for the years 1990 and 1991.[24] Two significant facts may be gleaned from the BEA study. First, the initial five categories of income designated above for withholding taxation plus business income constituted at least the following percentages of aggregate adjusted gross personal income reported in the study:

	BEA Adj. Gross Income	IRS Adj. Gross Income
1990	95.6%	94.3%
1991	95.8%	94.5%

This indicates that very little income (about 5 percent) would be untaxed under my proposal. Second, the study indicated that there was a noncompliance gap of about 11.6 percent in both 1990 and 1991 between the adjusted gross income reported by the IRS and the reconciled adjusted gross income determined by the BEA. (This gap does not include unreported capital gains or illegal income.) If the gap could be closed by operation of the withholding and book income system, the already small diminution of the personal tax base by my proposal would be more than fully offset.

The following example shows how the proposal might apply to aggregate adjusted gross income, as determined by the BEA for 1991:

Category of Income	Amount of AGI (bill.)	Assumed Tax Rate	Tax (bill.)
Compensation	$2,793.7	12%[25]	$335.2
Bus. income	343.9	15%	51.6
Dividends	128.3	10%	12.8
Rent	28.2	5%	1.4
Interest	229.8	10%	23.0
Pensions and Annuities	241.4	10%	24.1
Total Tax			$448.1

[23]See example, in part V.D., *infra*.

[24]U.S. Dep't of Commerce, Bureau of Economic Analysis, Relationship Between Personal Income and Adjusted Gross Income, 1990-91, *Surv. of Current Bus.*, V. 73, No. 11 at 68-71 (Nov. 1993).

[25]The 12-percent assumed tax rate on compensation is an average rate; lower-income individuals would be taxed at a lesser rate and higher-income individuals at a greater rate.

For purposes of comparison, the reported federal receipts from individual income taxes in 1991 was $448.4 billion.[26] If higher or graduated rates were imposed on business income, other rates could be reduced or tax revenues increased, or both. The foregoing comparison, of course, ignores the very substantial reduction in costs to both taxpayers and the government from the proposed simplification.

E. Withholding From Dividends and Interest

It is recognized that there was an unsuccessful attempt in 1982 to impose a 10-percent withholding tax on dividends and interest.[27] This tax was repealed in 1983 before it came into effect,[28] as a result of an intensive lobbying campaign sponsored by financial institutions that did not wish to undertake the substantial bookkeeping burden (nor, perhaps, to discourage business from customers who may not have been reporting their interest or dividends). However, the publicly stated objection to withholding was the adverse effect withholding would have on the small investors (the "widows and orphans") who would have no ultimate tax liability. Ironically, the repeal was accompanied by elaborate information reporting requirements that were virtually as cumbersome to the financial community and almost as damaging to noncompliance as withholding would have been. Now that the reporting procedure is in place and fully operational, the additional requirement of withholding should not be a significant additional burden to the financial community.

In any event, current data processing systems of both the IRS and private business should be able to cope with the withholding, and should be able to provide an efficiently functioning system for not withholding on persons entitled to exemption by reason of having low income or otherwise. For example, the IRS could adapt its backup withholding procedures[29] to certify exemption claims by taxpayers. As a fail-safe, the IRS could also provide a "quickie" refund procedure for improperly withheld funds.

F. Possible Additional Variations

It would be possible to permit or require the filing of returns to provide for certain objectives deemed to be meritorious, such as the allowance of foreign tax credits (or other credits), the application of graduated tax rates to income other than compensation, or the taxation of classes of income not readily susceptible of withholding. The obvious problem with departures such as these from the basic withholding concept is that, like modifications to business book income, they are likely to proliferate to the point where they would defeat the simplification objective. If such proliferation could be avoided, one or two special exceptions (such as the graduated taxation of interest and dividends) could be accommodated.

[26] IRS, Pub. 1304, *Statistics of Income*, *supra* note 22.

[27] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, sections 301-308 (repealed 1983).

[28] Interest and Dividend Tax Compliance Act of 1983, Pub. L. No. 98-67, section 102 (1983).

[29] *See* IRC section 3406 (1986).

VI. Conclusions

Some may have the instinctive reaction that the proposals presented above represent too fundamental a change in the system for taxing income. But this is not really the case. The proposals merely expand the application of concepts that, as previously noted, have been adopted by Congress in the past. More importantly, they utilize data and procedures (book income and withholding) that are well-established and readily available with relatively little modification. And most importantly, a change in the system is vital to assure continued effective functioning of the voluntary compliance concept.

Another possible approach for evaluating the proposals, commonly used in connection with proposed tax legislation, would be to calculate whether the evaluator is advantaged or disadvantaged by the contemplated change and to support or oppose it accordingly. It is hoped that this testing procedure will not be applied (though it may result in a majority of approvals). Rather, it is suggested that one should consider whether the business community and the general public would view the new system as a significant improvement over the old and at least as fair, if not more fair.

It is submitted that most people would view with approval the allocation of the business tax burden in the manner proposed.

It is submitted that most people would view with approval the allocation of the business tax burden in the manner proposed. Business people are accustomed to relying on financial statements and should be most pleased to have to produce only one income statement and to analyze only one set of financial data in making management decisions. And the general public would probably view book income as less artificial a measure than taxable income (as currently determined).

As for the exclusive reliance on withholding for nonbusiness taxation, this would make it less feasible to graduate the rates of taxation. But if, as seems likely, an acceptable range of rates could be applied to compensation and other rates could be made low enough, the overall arrangement should meet with public endorsement, particularly since for most taxpayers the very costly (both in time and money) annual April 15 ritual would be eliminated. The de facto exemption of unconventional categories of income should not result in any serious distortions since all the principal types of income would be taxed.

The focus of this discussion has been on the simplification benefits to taxpayers. There would also be considerable benefits to the legislative and executive branches of government, in the elimination of periodic (sometimes annual) marathon sessions for tax "reforms" and the resulting need for ever increasing regulation projects, form changes and taxpayer education. Withholding would also reduce collection costs and collection failures. The audit function would have

to continue in the business return and withholding compliance areas. The judicial branch of the government might also benefit from a reduced number of tax controversies.

The adoption of these proposals would, of course, also require a revision of the functions of the tax practitioner. Those who are not accountants would have to familiarize themselves with accounting principles (as tax accountants have been required to familiarize themselves with legal concepts). However, the inherent complexity and variety of taxpayer activities would, no doubt, continue to generate issues requiring expert assistance. Experience has demonstrated that even seemingly elementary forms of taxation, such as stamp taxes and transfer taxes, raise challenging questions.

The principal benefit to be expected from the instant proposals would be the elimination of many (or most) unnecessary complexities that provide merely a marginal benefit or no benefit at all to the ultimate governmental objective of collecting revenue.

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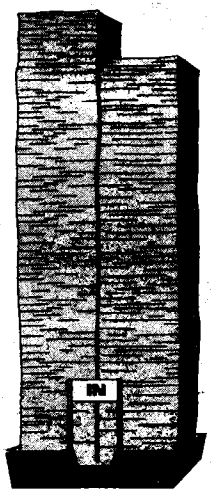

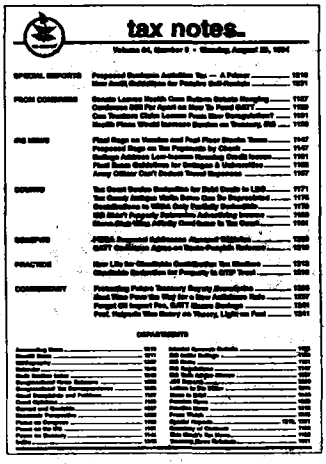

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May 19, 1995

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Chief of Staff
Committee on Ways and Means
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DATES OF HEARINGS: June 6, 7 and 8, 1995
RE: Federal Income Tax - Congressman Bill Archer

STATEMENT FOR A CONSUMPTION TAX

Conclusion: Why ignore the Truth and attempt to placate the American people with a different version of the same illegal tax - as a flat tax would be? Enact a lawful, Constitutional Excise tax (consumption tax) and respect the limitations of the Constitution, which forbids a tax on labor at Article I Section 10. Otherwise, you will still have an underground rebellion and a climate of discontent and non production. Any tax which taxes labor WILL NOT result in a productive economy - as is proven by socialist economies worldwide. Just because "they" do it doesn't mean we should abandon America's way as provided by the Constitution.

It is a fact that the provisions of the Internal Revenue Code are not working. Nothing has been so effective as the "Code" in alienating the American people from their government, tearing down morale and pride in the "American way" and creating hatred for government agencies because of the brutal way the IRS has collected taxes, most often outside the laws that govern collection.

The reason for this does not lay entirely on the fact that the tax imposed began at about 3% in 1913 and crept up to a back breaking 33% as time went on. The main reason that voluntary cooperation has diminished over the years is because many Americans began researching the tax laws, to find out how to deal with taxation that had become so oppressive - and discovered some disturbing facts. While Americans had been led to believe that Congress had 'sold out' the American people with the 16th Amendment, in spite of the fact that the organic Constitution protected against a "capitation" tax, at Article I Section 10 - the opposite was true. The 16th Amendment did not "amend" the organic Constitution by imposing a "capitation" tax on labor - it only amended the taxing provisions granted by the Constitution to the extent that no apportionment was required when taxing "income" which has been defined as "profit and gain" by the Supreme Court. No where did the 16th Amendment impose a tax on labor. This fact is supported by Supreme Court decisions including,

Lucas v Earl, 281 US 111 which states,

> "The claim that salaries, wages and compensation for personal services are to be taxed as an entirety and therefore must be returned by the individual who has performed the services which produced the

> gain is without support either in the language of the Act or in the decisions of the courts construing it.
> ...It is to be noted that by the language of the Act it is not salaries, wages or compensation for personal service that are to be included in gross income. That which is to be included is gains, profits and income DERIVED from salaries, wages or compensation for personal service."

In Connor v US, 303 F. Supp 1187, the court held,

> "[under 61A of the Code] ...If there is not gain there is not income, Congress has taxed income and not compensation...There must be gain before there is "income" within the 16th Amendment."

And finally, that it has been held that the 16th Amendment did not violate the guarantee of Article 1 Section 10, [no capitation taxes] is clearly stated in several Supreme Court decisions,

Stanton v Baltic Mining, 240 US 103, "...the 16th Amendment conferred no new power of taxation...."

Peck & CO. v Lowe, 247 US 165, "[the 16th Amendment]...does not extend the taxing power to new or excepted subjects...".

Brushaber v Union Pacific RR, 240 US 1, "...the Amendment contains nothing repudiating or challenging the ruling in the Pollack case...".

Lastly, the 16th Amendment has no enabling clause, as do the other amendments, because it doesn't need enforcing - it grants no new powers or authority that already didn't exist in the organic Constitution.

Too many Americans, in their indignation that the quality of life in America was rapidly deteriorating by excessive taxation of labor, began studying the law. For many, it became a spiritual quest - for which there is no better motivation for steadfast adherence to a principle.

No power of government, through legislation or brute force, can force a spiritually motivated entity to "comply".

Investigation into Supreme Court decisions - along with investigation into the actual Code and Regulations - revealed that there is no tax on labor for those who prefer to remain outside the jurisdiction of the federal government - which jurisdiction cannot be conferred absent a waiver of the protections of the Constitution - which Americans are refusing to waive. This is proven by the fact that the term "United States" is conspicuously defined in the Tax Code (and the Social Security Act) several different ways - sometimes it includes the "several states" or "the 50 states" and sometimes it doesn't.

FACT 1: Too many Americans have discovered that the Income Tax Code does not extend into the 50 Republics - it could not without violating the Constitution.
While the tax code has been written in such a way that it is confusing, ambiguous and and grammatically obscene - some researchers have finally - after 70 years, deciphered it. This has been accomplished by resorting to the original Acts of Congress published in the Statutes at Large - whereby the mysterious, "anyone liable" is identified.

The IRS has been telling suspicious Americans that they are liable under the code pursuant to Sections 6001, 6011 and 6012. However these sections refer to "every person liable", "any person made liable" and "every individual having gross income....", later restricted to "effectively connected with the "United States". Sections 6001 and 6011 can be dispensed with as not identifying the "one liable" - and therefore having no effect upon anyone, but Section 6012 makes something/someone liable if they have gross income. Gross income is identified in 61 A of the code as being "derived from" everything - including the tooth fairy. Since "income" has been identified as "profit and gain severed from capital" then it does not mean the actual capital. 61A describes many types of sources of capital. As soon as the capital is used to make profit - say on the stock market - the profit is now taxable gross income. This is perfectly fair and Constitutional.
However, the Americans have been pillaged and plundered by the IRS who conveniently ignore the term "derived from" when placing THEIR OWN interpretation on the law. Unfortunately, the courts, which many Americans no longer have respect for, have turned a blind eye to this "custom and practice" to misapply the law as enacted - in complete violation of the organic Constitution, because Americans have waived the protections of the Constitution - unknowingly - by voluntarily signing into the "custom and practice" of tax on labor with W2 Forms and expectation of Social Security benefits.

Americans see their error, perpetrated upon them by ignorance, fraud and temporary crisis, and no longer will participate. [Incidently, the crisis to which I refer could not have occurred if the Federal Reserve board had not been given control over "money" unbacked by gold - but this is an issue that is separate from the issue herein].

FACT 2: Because United States is a "Republic" as guaranteed by the Constitution at Article 4 Section 4, the federal government is limited in their jurisdiction. Indeed, the federal government has very limited powers, pursuant to the Constitution at Article I Section 8. The purpose of a "federal" government was just to provide for foreign relations, self defense, international relations and commerce. Indeed, it's legislative powers were limited to "10 miles square". Somehow, however, this power slowly increased and crept into the 50 Republics - destroying the type of government guaranteed by the Constitution. While there is some confusion over just HOW the government did this - during the Roosevelt era - much suspicion is raised by the fact that the jurisdiction revealed by the type of flag displayed in the courtrooms and in federal buildings is that of admiralty/military/commerce. A simple look into Title 4, Sections 1 and 2 confirms that the national flag of the Republic does NOT provide for the military gold fringe. So why is such flag displayed? [To suggest that the gold fringe is used "indoors" is inconsistent with the fact that many schools and federal agencies use unfringed flags indoors. It is also inconsistent with the fact that Army Regulations 840-10 state that to use a fringed flag in <u>other</u> than a military jurisdiction is disrespectful and a violation of such regulations.]

For this reason, there has been an outcry from the people to their Representatives to reclaim their state's sovereign independent status as a Republic with "10th Amendment" movements. In Colorado, this outcry was met by the passing of HJR 94-1035 - known as the "10th Amendment Bill".

SUMMARY

<u>THE PEOPLE WANT THE "REPUBLIC" BACK AND UNTIL THEY GET IT -THEIR ONLY MEANS OF EXPRESSING DISSATISFACTION IS BY GOING UNDERGROUND" AND INTO THEIR OWN "JURISDICTION" SEPARATE FROM THE FEDERAL GOVERNMENT. TAXES WILL NOT BE PAID VOLUNTARILY WITHOUT THE FEDERAL GOVERNMENT'S ADHERENCE TO THE CONSTITUTION. IT IS A UNIVERSAL LAW THAT THE POWER ALWAYS, ULTIMATELY, REMAINS WITH THE PEOPLE.</u>

The scam is up. And the only way to bring all Americans back into the fold is to return this country to a Republic of 50 sovereign countries, (as the several states are referred to in 28 USC 297) with adherence to the Constitution. It is the Constitution which sets this land apart - from all other lands with their socialist taxes - and Americans will not sit by and watch America become just another unproductive, socialist, welfare state.

A lawful, constitutional consumption tax - rather than a flat tax on labor which will take no time to increase again to impossible burdens - would inspire people to once again, be productive - rather than encourage welfare - and the spending power would increase - fueling a booming economy because the take home pay of every American would increase dramatically. More important, loyalty and respect for the American government would be reborn - which is the foundation to this country's power.

Respectfully, all of the undersigned Americans,

Linda Sanders Littleton, Colorado
Charles M. Meyers Littleton Colorado
Richard Comer, Colo Sp, Colorado Republic
[illegible] Hartley Evans, Colorado Republic
William Campbell Littleton, Colorado
Barry Smith Ft. Collins, Colorado
Bradley Carlson Arvada Colorado
Robert Gibson Englewood Colorado
Steven W. Young Littleton, Colorado
Douglas Sanders Denver
James M Davis Lakewood, Colorado
Barbara Robinson, Arvada, Colorado
Jeffrey Bridges Lakewood, Co.
Kevin Williams, Thornton, Co
Randy Cummins Denver, Co.
Kirk McKuen Colorado Springs Co
Mary Arlington Parker Colorado

Alvin K. Sanford
Mt. Clemens, Mich.
June 12, 1995

Phillip E. Mosely
Chief of Staff, Ways & Means Comm.
1102 Longworth House Off. Bldg.
Washington, D.C. 20515

Dear Mr. Mosely:

I want to be heard on the tax code.

$4½ Trillion debt. Let's not pass it on to our children. 260 million U.S. citizens each share a government debt of $17,837. If we would each pay our share, we will each save $1,386 per year for ever and ever in interest on our national debt alone. In 13 years and 4 months each of us will have saved an equivalent return of all our money. Let's pay it now. We can't wait 7 years to make our first payment on our national debt. In 7 years (2002) our national debt will increase exponentially to $8.4 trillion. Then each U.S. citizen will share $32,300 debt ($64,600 per couple) costing each citizen $2,423.00 per year just for interest on the National Debt. I want to hear all congressional members make our National Debt a political issue and inform all their constituents of a plan beginning immediately to set aside funds in a lock box for this purpose.

Let's all agree to eliminate the debt by these articles:
Article 1. Reduce succeeding appropriations by 10% of current spending, and please no exceptions. Command strict compliance from all administrative departments and agencies.
Article 2. Cut out waste and pork barrel spending. Only spend our money on things we need the government to do for us, like protecting us and our homes and build safe roads for us.
Article 3. No more grants or loans to foreign countries until the budget is balanced and we have a surplus.
Article 4. Each U.S. citizen to be assessed to pay an equitable share of the National Debt.

When all citizens become fully aware of perils facing our economy, I'm sure they will support congressional members who vote for these articles.

I admit my letter may be considered political incorrect, but is factually correct within a 5% margin for error.

I want to hear that Congress is working on a plan to immediately start collecting funds and place in a lock box paying off the National Debt.

Sincerely,
Alvin K. Sanford
Alvin K. Sanford
37255 Charter Oaks Blvd.
Clinton Twp. MI. 48036-2412
Phone (810) 468-9769

6 cys enc.
cy to Michael Reagan

P.S. Republicans balance the budget in 7 years
Democrates say 10 years.
I say do it now (this year)

NASARIO SANTOS
2780 N. PLACITA MIA
TUCSON, AZ 85749

June 13, 1995

Honorable Bill Archer
Chairman: House Ways and Means Committee & Members
1102 Longworth House Office Building
Washington, DC 20515

RE: Federal Income Tax

Honorable Bill Archer:

Concerning Federal Income Tax, I would like to contribute the following opinions and requests to help you in your decisions in this debate. I will strive to make it as concise as possible. First of all, I believe that the primary purpose of the 16th Amendment was to clarify to everyone, once and for all, that Congress always had the power to levy a federal income tax on those employees, as presently defined in Section 3401(C) of the IRS Code, which are:

A - A Corporation.

B - A person who lives in a US Territory.

C - An elected government official.

But, not to include the common US citizen. The fact that the US citizen is exempt from such a tax, is perhaps, why the Supreme Court ruled it un-constitutional. That ruling was back during the US Civil War. The Committees' debate needs to delve into why the common citizen is being forced to pay this Federal Income Tax now.

The crux of the matter is that the common citizen has the sovereign right to the fruit of his labor and the Government nor anyone else has any business inquiring what or how his honest wages were earned, for purposes of taxation. My personal experience with the Internal Revenue Service conflicts with our Constitution and its own regulations. Approximately, about 1984 - 1989, I had my employer: The Kroger Company, 701 Gellhorn, Houston, TX 77001 stop withholding Federal Income Taxes from my wages. I accomplished this legally by submitting a different W-4 with my employer. The W-4 form used was filled out with all the required information. However, the exempt box was checked and my signature was omitted. It is my understanding, that according to the Internal Revenue Service, when I sign a W-4 form, I am voluntarily submitted myself to the Federal Income Tax by becoming an "Employee" as defined in Section 3401(C) - IRS Code. Furthermore, my signature also authorizes my employer to withhold Federal Income Tax from my wages, voluntarily on my part.

My Employer, The Kroger Company, honored by W-4 the way I legally filled it out. Consequently, during those years mentioned, (1984-1989) no Federal Income Tax was withheld from my wages.

It was during that time, I wrote a letter to Representative (Republican) Jack Fields concerning this matter. I questioned him on the legality of my stance. He, in turn, wrote to you, Mr. Chairman, to get your opinion. The response I received was positive. Mr. Fields also wrote a letter to my employer explaining to The Kroger Company that, "The only responsibility they had towards my Federal Income Tax was to honor my W-4 the way I filled it out." The Kroger Company honored my newly filled W-4. Consequently, about 1984-1989, no income tax was withheld from my wages. I needed to do this to be able to support my family financially. Mr. Fields further explained that his office would be available fir I had difficulties with the IRS. For the record, I sincerely thank him for such a generous offer of support.

My "Sweet Taste of Freedom" was short-lived. I, among many others, was laid off from work. When I went with a different employer, my financial state was better, so I volunteered to have Federal Income Taxes withheld, again in 1989. It was not until 1991 that the Internal Revenue Service contacted me. They wanted to collect taxes for those past years of 1984-1989. The tax was $22,000 with interest compounded daily. Now, I am paying monthly a total of $279.00; and the IRS debt is $110,000 with no end in sight!!

Like many other citizens, the IRS has a lien on my property and wages and like so many others, bankruptcy is our only solution. We, and our private debtors, have been greatly wronged by this tax system. I, therefore, request that a National Sales Tax on consumption be considered. This is the only fair Federal Tax that I can see for all. I request that the present income tax system be abolished and amnesty for debts to that system should also be given.

In closing, I request that my letter be included on record in this Historical debate on Federal Income Tax.

Thank you for your time and cooperation. I would like to say that I admire the Constitutional spirit given this Committee and 104th Congress. It rivals the spirit of our Founding Fathers. I pray for God speed and that you give a good fight in this debate.

Constitutionally Yours,

Nasario Santos

NASARIO SANTOS

NS:ph

To: Mr. Phillip Mosely
House Ways and Means

From: Gordon Shearer

Dear Mr. Mosely,

I heard on the radio that I should write to you regarding income taxes and the IRS. After doing quite a bit of research including going through the United States Code, I am in favor of abolishing the IRS, its heavy-handed extortion of good Americans, and the fear that goes with it

For one thing, nowhere do I find in the code (USC) that we are liable to pay income taxes as individuals (non-corporations), although we do pay anyway because we're afraid if we didnt. Also, I think a national sales tax is the way to go - at least it would be lawful and it would certainly be more fair! Even a flat tax would be unlawful and unfair. Please institute the national sales tax!!

Gordon R Shearer
6402 S. Xenon Ct
Littleton CO 80127

STATEMENT OF HAROLD I. APOLINSKY ON BEHALF OF
THE SMALL BUSINESS COUNCIL OF AMERICA

BEFORE THE COMMITTEE ON WAYS AND MEANS

ON ESTATE, GIFT AND GENERATION-SKIPPING TAX REFORM

June 8, 1995

Mr. Chairman and Members of the Committee, I am Harold I. Apolinsky, Past Chair of the Small Business Council of America (SBCA) and currently Vice President - Legislation. I am also a practicing tax attorney (over 30 years) who specializes in estate planning and probate. For over 18 years, I have taught estate planning and estate, gift and generation-skipping taxation as my avocation to law school seniors at both the University of Alabama School of Law in Tuscaloosa, Alabama and the Cumberland School of Law in Birmingham, Alabama. I am here to present our views on estate, gift and generation-skipping taxes.

SBCA is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, which enterprises represent or sponsor over two hundred thousand qualified retirement and welfare plans, and employ over 1,500,000 employees.

The time has come for Congress to repeal the estate, gift and generation-skipping taxes.

An estate tax due nine months after death is imposed on the transfer to children or other heirs of the taxable estate of every decedent who is a citizen or resident of the United States ($600,000 of assets are exempt). The graduated estate tax rates begin effectively at 37% and increase to a maximum rate of 55% (see Exhibit "A" for how the tax is calculated). Taxes on bequests to spouses may be deferred until the last-to-die of husband and wife.

A gift tax is levied on taxable gifts (excluding $10,000 per donee per year) as a back-stop to the estate taxes. The graduate rates are the same. (The $600,000 exempt amount may be used during life for gifts or at death.)

An extra, flat 55% generation-skipping tax is imposed on gifts or bequests to grandchildren ($1,000,000 is exempt).

The 1995 White House Conference on Small Business recommended as its 4th priority eliminating estate and gift taxes. Legislation has been introduced in prior years to accomplish this (Exhibit "B" attached).

With a new entrepreneurial voter wave shifting control of both the House and Senate to Republicans, it is time to repeal these transfer taxes. President Clinton has expressed the desire to retain and increase jobs. Repeal would do this!

- Only 30% of family business make it through the second generation. Seventy percent (70%) do not. Only 13% make it through the third generation. Eighty-Seven (87%) do not. The primary cause of the demise of family businesses, after the death of the founder and the founder's spouse, is the 55% estate tax. It is hard for the successful business to afford enough life insurance. (Premiums are not deductible and deplete working capital.)

- A recent study by Prince and Associates (research company) for National Life of Vermont reviewed the history of 749 family businesses which failed within three years after the death of the founder. The Prince study reinforced and supported the conclusion

of the deadly effect of estate taxes. The businesses could not continue as a result of the tax drain on working capital needed to effectively compete and cover errors in judgment made by new and younger management. Jobs were lost in the communities.

- The estate and gift tax took its present form primarily in the early 30's. The express purpose was to "break-up wealth". Is this consistent with a free enterprise economic system and a very competitive world economy? In 1992, the estate, gift and generation-skipping taxes accounted for only 1.1% of revenue. For 1995, the figure is closer to 0.8%. The expenses of administering this system and loss of jobs probably offset 75% or more of the revenue when you factor in IRS, Treasury and costs of litigation.

- Independent analyses reveal that, were these transfer taxes repealed, the Nation's GDP level of employment and capital formations would increase substantially. According to one study, repealing these taxes would increase GDP from 1993 to the year 2000 by over $79 billion, create 228,000 new jobs and increase capital by $639 billion. (Fiscal Associates, Inc. -- Federal Transfer Taxation: A Study in Social Cost).

- The transfer tax provisions represent 82 pages of the Internal Revenue Code and 289 pages of Regulations issued by the Internal Revenue. The transfer tax system forces many estates, the Internal Revenue Service, and the Department of Justice to expend funds in court. The number of transfer tax cases now total 10,247 representing some 13,050 pages of the Commerce Clearing House Tax Publication.

- Australia repealed their estate and gift tax laws in 1977. It was felt that these transfer taxes were an inhibitor on the growth of family businesses. The legislative body of Australia sought more jobs which they believed would come if family businesses grew larger and were not caused to sell, downsize, or liquidate at the death of the founder to pay estate taxes.

- The President has expressed concern about children inheriting appreciated assets from deceased parents and selling them without paying income taxes on the profits. This is the result of the step-up in basis to the value as shown in the estate tax return. If the transfer tax laws were repealed, there would be no step-up in basis. At the time assets were sold, gain would be taxed and funds available to pay the tax. The fair market value of assets sold would be fixed.

- If you factor the significant expense in collecting these taxes, the income tax when assets were sold, and income taxes from jobs saved and provided, the repeal may be revenue neutral or revenue positive.

- Combined income and estate taxes frequently consume 75% or better of retirement plan accounts at death (see chart attached as Exhibit "C").

A very few of our most wealthy citizens have elected to give up their citizenship, become citizens of foreign countries, and avoid the 55% transfer taxes. The cover story of Forbes, November 21, 1994 (attached as Exhibit "D"), was devoted to "Expatriation -- As the Ultimate Estate Planning Technique." What a loss of available capital! These are the people who may give the most to charity and have the resources to seed new businesses.

This should be a wake-up call that this tax is no longer appropriate. We have the highest transfer taxes in the world. Instead of reacting to this by an "exit tax" -- Congress should step back, study the issue, and then repeal these taxes to promote jobs and the growth of family capital.

It is contrary to the best interest of my tax practice, my teaching, and my firm (we have 8 lawyers out of 94 doing estate planning, administration and probate) to urge repeal of these transfer taxes. It is the right thing to do to help grow family businesses and farms. provide jobs and capital and encourage the entrepreneurial spirit needed for small businesses to become large businesses and family businesses of all sizes to survive death.

EXHIBIT "A"

CALCULATION OF ESTATE TAXES

A. Gross Estate (fair market value at death of all assets, including real estate, stock, cash, life insurance, retirement accounts, etc.).

B. Deductions:

1. Debts and expenses.
2. Marital (assets left to spouse if citizen).
3. Charitable.

C. Taxable Estate.

D. Add Prior Taxable Gifts.

E. Total transfer to heirs (life and death).

F. Apply Rates: 18% to 55%.

G. Less credit ($192,800*)

H. Net tax (effective 37% to 55% [plus 5% for larger estates] due 9 months after death.

I. Extra 55% tax for bequests to grandchildren in excess of $1 million.

* This is tax on $600,000 taxable estate.

EXHIBIT "B"

PERTINENT LEGISLATION

A. Legislation was introduced in July 1993 (H.R. 2717) to repeal estate, gift and generation-skipping taxes.

B. Legislation was also introduced but not enacted in the 102nd Congress would have allowed heirs of small business owners to defer the estate tax owed on a farm or business until it was sold outside the family. In order to take advantage of this deferral, the following requirements would have to be met:

(1) The business must be worth less than $50 million.

(2) The business must comprise at least 40 percent of the decedent's estate.

(3) The person inheriting the business must have actively participated in the running of the business prior to the owner's death.

C. A provision in separate legislation also introduced in the 102nd Congress would have reduced the amount exempt from estate and gift taxes from $600,000 to $200,000. This provision of the bill was subsequently withdrawn.

D. Legislation introduced in the 103rd Congress included bills that would increase the estate and gift tax exemption to $770,000 plus cost-of-living adjustments (H.R. 567), $850,000 plus cost-of-living adjustments (H.R. 1475), $1 million (S. 531) and $1.2 million (H.R. 1110).

E. H.R. 784 was introduced on February 1, 1995 to repeal estate, gift and generation-skipping taxes. H.R. 1039 was introduced on February 27, 1995.

F. S. 628 was introduced on March 27, 1995 to repeal estate, gift and generation-skipping taxes.

EXHIBIT "C"

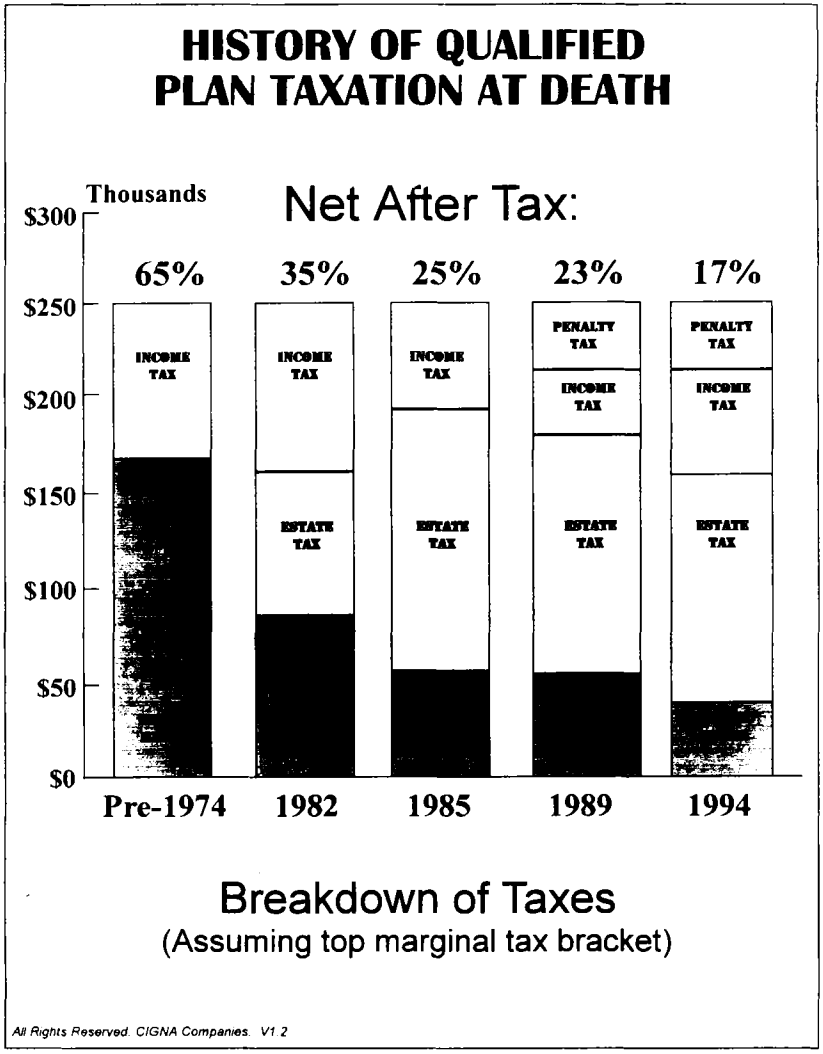

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EXHIBIT "D"

Many Americans are giving up their citizenship. Before condemning them, we might well ask ourselves whether the U.S. tax system isn't killing the goose that lays our golden eggs.

The new refugees

By Robert Lenzner and Philippe Mao

Michael Dingman may easily be able to pay for his new 15,000-square-foot home with the tax money he saved by giving up his American citizenship.

"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

–Judge Learned Hand

"I TALK TO A new client interested in expatriating every week. Many people can't pay the federal tax rate and live in the style they want." So said Francis Mirabello, the head of the personal law department at the Philadelphia office of Morgan, Lewis & Bockius, speaking at a Bermuda conference on offshore money early this fall.

Expatriating? Give up U.S. citizenship? Who in his right mind would give up his U.S. citizenship? Lots of people. You could practically fill a Boeing 747 with well-heeled U.S. citizens who have taken on foreign citizenship rather than submit to what Learned Hand called "enforced exactions" at a level that amounts to virtual confiscation. The exodus may speed up under an Administration that campaigned for office on a tax-the-rich platform.

In 1981 Ronald Reagan lowered taxes. The following year not a single American gave up his citizenship. In 1993 the expatriate community grew by 306 names.

The expatriates of recent years have included:

Michael Dingman, chairman of Abex, and a Ford Motor director. Dingman is now a citizen of the Bahamas and lives there.

Billionaire John (Ippy) Dorrance III, an heir to the Campbell Soup fortune. Dorrance is now a citizen of Ireland and lives there as well as in the Bahamas and Devil's Tower, Wyo.

J. Mark Mobius, one of the most successful emerging market investment managers. Born a U.S. citizen, Mobius has the German citizenship of his ancestors and lives in Hong Kong and Singapore.

Mr. John Spenst
300 Plaza Alicante No. 4180
Garden Grove, CA 92640

300 Plaza Alicante #4180
Garden Grove, CA 92640

June 8, 1995

Mr. Philip Mosely
Chief of Staff, Ways and Means Committee
House of Representatives Office Building #1102
Washington, D.C. 20545

Revising the Tax System

Dear Mr. Mosely:

Please count this as a vote for the Consumption Tax - that is a national Sales Tax.

Of course nobody likes taxes, but some are worse than others. I think it is our objective to enact the tax that has the best hope of bringing in sufficient revenue with the least amount of damage.

Best of all would probably be if we learned to get along on import tariffs as we did from 1778 to 1913 - a short span of 125 years during which we grew from a clutch of freedom-seeking rebels to become a world-class nation. This tremendous spurt of growth was possible because profits were not taxed away, but were re-invested in the economy. However I don't expect to see it happen again, so I will have to vote for the Sales Tax as being the least obnoxious of what is available.

I want to thank you for your radio message. It is nice to know whom to write to. I understood you to say that you wanted responses in six copies, and I am obliging.

Also, I am enclosing an original letter and five copies from a friend, Mrs. Suzan Haxby, who also favors the Consumption Tax.

Please understand that this is not a sudden impulse with me. I have given the matter some serious thought. I am enclosing a photocopy of my letter of March 17 to my Representative, Congressman Robert K. Dornan, where I discuss different forms of taxation at some length. Please feel free to refer to the said letter, or to use in in any way that will help.

Again, thank you for giving me the opportunity to be heard.

Yours very truly,

John Spenst

John Spenst

JS/j

Howard P. Spracklen, P.E.

Electrical Engineering Consultant
21172 Aspen Ave.
Castro Valley, CA 94546
(510) 537-3250

June 8, 1995

Phillip Mosley, Chief of Staff
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Income tax reforms.

The flat tax proposal would be a great improvement over the present system, however it would do nothing to reduce the huge cost of the IRS bureaucracy and its burden on businesses. (Estimated to be of the order of 500 billion dollars per year)

We feel that complete abolishment of the IRS replaced by a sales (consumption) tax would be a much better solution for the following reasons:

1. It would encourage savings, creating a large domestic capital pool.
2. Most states now have a sales tax system in place. Collection of the federal tax would have a minimal impact on the state systems.
3. It would bring in much more of the underground economy to the system.
4. People would be more aware of government costs and less likely to ask for more government services.
5. It would remove the unconstitutional provisions of the IRS wherein people are now found to be guilty until they can prove innocence.
6. An attempt to reconstruct the IRS would be like pruning a destructive weed. It will only grow back more-destructive than ever.

The argument that the tax would amount to double taxation on savings that have been taxed is valid, however in just a few years the savings in taxes on the interest on these accounts would make up for this loss.

Proposals for a value added tax would add to the complexities of the market place, and would hide the tax from the consumers. It has not worked well in the countries that have tried it.

Thank you for your consideration,

Myrtle T. Spracklen

Howard P. Spracklen

Howard & Myrtle Spracklen

STATEMENT OF CONGRESSMAN PETE STARK BEFORE THE WAYS AND MEANS COMMITTEE
June 8, 1995

A TAX CODE FOR THE FUTURE

Mr. Chairman, Members of the Committee.

This week we are examining major changes in our tax code aimed at replacing the income tax with a consumption tax. The main argument for making such a major change in how we tax is that it will improve the performance of the economy and raise our standard of living. I have my doubts about whether some current proposals will do that. But I do agree that we can improve future living standards with appropriate changes in the tax code. In particular, I urge the Committee to consider ways that we can collect more revenue from taxes on pollution and energy and less from taxes on labor and capital.

I am working on a bill, which I will present later this summer, that would gradually reduce corporate and individual income taxes and gradually increase taxes on pollution, excessive depletion of valuable natural resources, and inefficient production and consumption of energy. Over the longer term, these changes in the tax code would produce a healthier society and a more sustainable economy. In the near term they will shift taxes onto foreign oil producers and help reduce the $50 billion per year we spend on oil imports. In short, they would discourage harmful and wasteful economic activities and encourage beneficial and productive activities.

The goal of my plan is not to increase taxes. Every dollar of increased pollution and energy taxes we collect would be used to reduce income taxes. I would begin by cleaning up the existing tax code and removing current incentives that encourage excessive production and consumption of non-renewable natural resources or that encourage activities that pollute. We certainly should not be using our tax code to encourage such economically inefficient activities. By broadening the tax base we would be able to lower existing tax rates without sacrificing revenue. But my plan would go further and gradually phase in economically efficient pollution and energy taxes. Each dollar raised through these taxes would be used to reduce income taxes.

My plan is fully in the spirit of this week's hearings and it builds on the growing body of evidence that economic incentives can be used to achieve desirable social and economic goals. Many member of the Committee want to reduce or eliminate taxes on capital investment and savings and increase them on consumption. My proposal goes further and asks that we tax consumption of products that are non-renewable and that pollute the environment. We know that using taxes to change the economics of a product can work to achieve desired goals. The tax on CFC almost immediately brought new, non-ozone-layer-destroying chemicals to the marketplace. CFC production is way down, and there are reports that the ozone layer destruction may be moderating. The marketplace economics brought about by the tax increase is solving the problem without the need for a complicated administrative licensing process.

You may say, we've tried this before--and lost! Our experience with the BTU tax in 1993 is one that none of us wants to repeat. But the BTU proposal was a tax increase without offsetting tax reductions. My proposal would be simpler and revenue neutral. For every dollar of pain in higher pollution taxes, there would be a dollar gain in lower income and corporate profits taxes. The proposal would also be

a very gradual transition to avoid shock to any particular sector or region of the country--I am envisioning a twenty year transition. A long transition will give industry and labor plenty of time to move toward energy and anti-pollution efficiency, creating jobs in new products and processes before jobs are lost in energy production sectors.

Realistically, this transition to a more economically efficient and environmentally appropriate tax code would not result in the complete replacement of the income tax. After all, if the energy and pollution taxes work as intended to discourage inefficient and harmful activities the tax base should shrink! Nevertheless, we would have an income tax with a broader base and lower rates--the time honored goal of tax reform. We would also have a cleaner environment, a more sustainable economy, and a higher standard of living.

Although my proposal is revenue neutral and will raise average living standards, there will still be winners and losers and we will need to assist the transition. I would expand the earned income tax credit to offset any adverse impact on low-income families. Also, there will be regions of the country or particular industries--West Virginia comes to mind--that are so dependent on a particular product like coal that a gradually rising tax on it would depress the local economy. I believe that can be addressed by the inclusion of a Local Impact Trust Fund, in which revenues could be returned to localities that bear a heavier than average burden under this system, so that those local governments could also lower their taxes and attract new businesses. The Fund could also be targeted to particular industries to help them finance the move to cleaner, less-polluting production methods.

The Congressional majority is obviously very opposed to regulatory approaches to environmental improvement. The EPA and its command and control approach to improving the environment are under constant criticism. This bill is the answer: use economics--the price of products--to encourage recycling, the use of more efficient production processes, and conservation. When fully implemented, the economics of the tax changes will make the EPA and its regulatory bureaucracy virtually unnecessary. Those who pollute won't be able to compete with those who don't. Efficient, non-polluting cars will rule the marketplace. No one will build a house without the best of insulation. It won't take bureaucrats to make these changes--the economics and the marketplace will do it for us.

Mr. Chairman, the world needs to reduce the emission of pollutants and the destruction of non-renewable natural resources. America is by far the world's disproportionate consumer of energy and natural resources and should lead in this effort. As the century ends, we see how America's population has practically quadrupled from less than 70 million to over 260 million in the past 100 years. The world's population has soared from 1.6 billion to nearly 6 billion in this century. One can cite endless studies arguing whether there is over-population, whether there is a greenhouse effect, whether pollution is really a serious threat, whether we are really running out of various valuable minerals. But simple common sense tells us that we are burdening the environment and that future growth of the human race requires that we think of better ways to prevent pollution and ensure the recycling of precious and increasingly scare natural resources.

There are lots of worthy goals for a tax system. The first is to raise the money to run whatever size government the people want. Another is to ensure fairness in a society. Whether we need a tax code revolution to encourage more exports or to increase investment and productivity are interesting questions, which economists can argue about forever. But if you look at the pressures on the environment in the decades to come, I think the most useful and important change we can make would be to help steer, gradually, our economy to one which can survive in an increasingly fragile environment.

I think this is a change which, if people thought about it, would be widely supported and less controversial than almost any other approach. To repeat, I am currently drafting a model bill to achieve these goals. I would appreciate ideas, comments and concerns from you, the Committee, and the public in the weeks ahead.

Thank you.

JAY STARKMAN, P.C.
CERTIFIED PUBLIC ACCOUNTANT
2531 BRIARCLIFF ROAD
ATLANTA, GEORGIA 30329
404-636-1400 / FAX 636-1130

May 23, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

Please add the enclosed article and my following comments on flat tax to the record for the hearing on fundamental tax reform.

A truly "flat" tax would raise inadequate revenues. Using exemptions, deductions and credits would accomplish through complexity that which is easier to accomplish through graduated rates. Originally, the income tax was supposed to be flat. It was the arguments of Rep. John Nance Garner which convinced the House to pass a graduated tax in 1913, and it wasn't until World War II that it applied to the masses.

Consider a three-prong approach to flat tax to raise adequate revenues through very low rates, free the vast majority from the annual drudgery and expense of reporting, and minimize disincentive economic effects.

First, institute a VAT at a low rate, as close to 10% as possible. At a low rate, taxation of savings under VAT which were previously subject to income tax would be minimized, and the transition to VAT would be simpler. Joel Slemrod has suggested that VAT could displace the income tax completely because of the structure of the U.S. economy. (See Joel B. Slemrod, "The Simplification Potential of Alternatives to the Income Tax", *Tax Notes*, February 27, 1995, pg. 1331.)

Second, institute a flat income tax with a high income threshold. Say, only those earning over $75,000 gross would be subject to income tax, at a 20% rate. Revenue from an income tax would allow a low VAT rate. The threshold should aim to exempt some 80% of the population from income tax.

Third, repeal the estate and gift tax, or reduce it to a very low 10% - 20% rate. Without an estate tax, repeal of step-up basis becomes viable, without endangering small business. A recent study by The Tax Foundation concluded that income tax rates would have to be nearly doubled to achieve the disincentive effects of the estate and gift tax. (See Patrick Fleenor and J.D. Foster, "An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship", Tax Foundation Background Paper

#9, The Tax Foundation, June 1, 1994.) I'd prefer repeal because it's a very inefficient tax, comparing the disincentives and cost of estate tax planning and compliance to the revenues raised.

These changes would significantly reduce compliance costs. IRS could be down sized. Most people would no longer have to keep records and file annual income tax returns. Estate planning would become much simpler. Though consumption taxes are regressive, polls consistently rate sales tax as one of the fairest. Retention of an income tax would retain progressivity.

In all forums on simplifying taxes, the issue of wasteful government spending always arises. A simplified tax is possible, but note that Michigan's VAT is very complex. I have little faith that Congress would keeping it simple for long, or resist the temptation to raise rates or expand the tax base for some spending project.

Sincerely,

Jay Starkman

JS:abm:x
Enclosure

The Atlanta Journal / The Atlanta Constitution ▲▲ Wednesday, April 26, 1995 A15

IS A CONSUMPTION TAX THE ANSWER?

The idea of a flat tax may be simple, but its implementation is more difficult

By Jay Starkman

The Bible tells of taxation in the wilderness. God loved his people and wanted them counted. It was unseemly to count heads. So, Moses collected

a half-shekel from every man and counted the coins. Indeed, God loved his people so much, He had Moses count them three times during the first year after they left Egypt, collecting shekels each time.

This was a head tax. It is the simplest flat tax, unpopular in modern societies because it doesn't consider the ability to pay and raises insufficient revenue.

Every tax has two components: a tax rate and what is taxable. A flat tax means any tax system with only one tax rate and broad base. Most people are upset with the current income tax because rates are too high, the law is too complex and government spending is wasteful.

Progressive tax rates have always been intensely controversial. Proponents say more revenue can be raised when high earners pay tax at steeper rates. Recognizing ability to pay through other means requires deductions and credits which are more complex than progressive rates. If these mechanisms are not used, rates must be set low enough for the poorest taxpayers to afford, which may result in insufficient revenue.

Yet, federal tax revenues have remained constant — 18 percent to 19 percent of the gross domestic product for the past 40 years — whether the top rate was 92 percent or 28 percent. So, the net effect of tax law changes has been to redistribute income, add economic and social incentives or carve out an exception for a particular constituency. Not surprisingly, members of congressional tax-writing committees are among the top recipients of campaign contributions from special interests.

Out of 107 million individual income tax returns filed, only 31 million claim a deduction for home mortgage interest or for charitable contributions. Another 15 million claim an earned income tax credit. Emphasizing family values means tax breaks for having dependents and being married. How many of these should we keep in a "flat" tax?

There are harder questions: when, whether or not and how to tax capital gains, municipal bond interest, life insurance proceeds and gains on home sales. Some business expenses must be deductible, like the cost of goods purchased for resale. How about salaries, factory equipment, interest on business debt and employee health insurance?

In 1986, Congress "flattened" the tax to two rates — 15 percent and 28 percent — down from a top 50 percent rate. Nine years and 4,000 tax code changes later, we have five rates, with a top rate approaching 50 percent again.

It would be easier to create a flat "consumption tax," such as a national sales tax or value added tax, than a flat income tax. The biggest hurdle is avoiding double taxation. Those who paid income tax on their savings may again pay consumption tax when they spend their wealth.

Until this century, high tariffs were the major source of federal taxes. Because we imported most manufactured goods, tariffs worked like some of today's consumption tax proposals. The burden fell disproportionately on the poor because they spent a far higher percentage of their income on the affected goods than did the rich. Income tax was introduced to replace high tariffs and ease tax burdens on the poor.

The annual collection cost of the present income tax is estimated as high as $75 billion. Several less costly alternatives promising lower, simpler taxes have been proposed.

Finding one that is flat, fair and simple is difficult.

Jay Starkman, an Atlanta certified public accountant, is a member of the Tax Executive Committee of the American Institute of Certified Public Accountants. The views expressed are his own.

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June 8, 1995

PHILIP D. MOSELY, CHIEF OF STAFF
HOUSE WAYS & MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
HOUSE OFFICE BUILDING
1102 LONGWORTH
WASHINGTON, D.C. 20515

SUBJECT: TAX REFORM

DEAR MR MOSELY,

AS A CITIZEN AND AS A SMALL BUSINESS MAN, I CAN SUM UP MY FEELINGS REGARDING THE TAX SYSTEM IN 1 WORD, ENOUGH. IF I RAN MY HOME & BUSINESS WITH THE CRIMINAL INEFFICIENCIES OF THIS GOVERNMENT, I WOULD BE OUT OF BUSINESS AND/OR IN JAIL. SO MUCH FOR EMOTIONALISM.

THE ONLY SYSTEM OF REASONABLE FAIRNESS IS A SYSTEM BASED ON A NATIONAL TAX ON ALL SALES EXCLUDING, HOUSING, FOOD AND MEDICAL. THIS SYSTEM CAN BE STRUCTURED WITH LIMITED DEDUCTIONS FOR QUALIFIED LOW INCOME FAMILIES. THIS REVISION WOULD REQUIRE THE PASSAGE OF ADDITIONAL LEGISLATION, THE PURPOSE OF WHICH IS TO PROTECT TAXPAYERS FROM THE ARBITRARY WHIMS OF SELF INDULGENT POLITICIANS, WHO ASPIRE TO BUILD BUREAUCRACIES & PERSONAL FORTUNES FROM THE HARD WORK AND OTHERS. THE AMOUNT OF THE TAX SHOULD FALL BETWEEN 12% & 14% OF SALES. BASED ON THE AMOUNT OF FAT IN THE CURRENT QUESTIONABLE BUREAUCRACY, THERE WOULD BE SUFFICIENT MONEY TO FUND THE SYSTEM AND DURING DOWN TURNS, SUFFICIENT INCENTATIVE FOR THE FED TO JOIN THE REAL WORLD AND TIGHTEN GOVERNMENTS BLOATED BELT.

CORDIALLY,

CARL RATKUS

SHAWN McGUIRE, Agent
Auto-Life-Health-Home and Business
12623 E SPRAGUE/ SUITE #2
SPOKANE, WA 99216 PHONE (509) 891-2772 / FAX (509) 891-2775

June 8, 1995

THE HONORABLE PHILIP D MOSLEY
CHIEF OF STAFF
HOUSE WAYS AND MEANS COMMITTEE
US HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, DC 20515

Dear Mr Mosley,

I am writing to you in support of a change in our current Federal tax code practice.

As a small business owner and employer in Spokane, WA., I find the current taxation system difficult to understand, too intrusive, and much too high in the percentages of tax a self employed individual must pay.

An overhaul of the monster that we have created over the last 40-50 years is long overdue and I support a move to the various flat tax proposals that your committee is preparing to review.

President Clinton surely shot himself in the foot for a re-election bid in 1996 by levying the largest taxation increase in U.S. history. Please don't make the same mistake and turn a deaf ear to the American public. We spoke as one voice back in November of 94 and now we look to you to see that the right choices are made.

Small businesses are at the core of the American success story. Isn't it about time that we begin to reward those individuals who embody the entrepenurial spirit that made this country the leader in the economic arena? Or, are we going to continue penalizing those individuals and their families with an archaic and inherently unfair system of taxation?

I hope that you accomplish what you set out to do in this committee session and that the common man is heard both loud and clear.

Sincerely,

Shawn McGuire
Agent - State Farm Insurance

PSYCHOLOGY OFFICES

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June 13, 1995

Honorable William Archer, Chairman
House Ways and Means Committee
United States House of Representatives
Washington, D.C. 20515

RE: Written Testimony

Dear Chairman Archer:

Attached please find a document which I am submitting as written testimony on the subject of the repeal of the current income tax and its replacement with another tax. I am not sure of the correct procedure for submitting testimony to a Congressional committee so am following the procedure for the Nebraska Legislature, which is to direct the correspondence to the Committee Chairman for distribution to the Members.

I cannot indicate too strongly my support for your efforts and that of the ranking minority member to end the income tax as presently structured and replace it, although I disagree with the specific proposals thus far discussed for replacements. I agree completely with the testimony given by Congressman Cox to the effect that Congress has demonstrated an inability to resist the temptation to abuse the Sixteenth Amendment. The Congress should send to the States, concurrently with the passage of replacement tax legislation, a Constitutional amendment significantly modifying or repealing the Sixteenth Amendment.

Congressman Cox is correct in asserting that the People will not trust the Congress at this point absent a commitment of at least this magnitude by Congress.

There are two ideas which I believe are novel in my views (in addition, of course, to my personal experiences). These are indicated with a ▸ on pages three and four. Much else is probably a modernization of the Federalist Papers, #21, Hamilton, at least in some respects.

Thank you for your consideration of my testimony.

Sincerely,

William R. Stone, Jr., Ph.D.
Clinical Psychologist

cc: Doug Bereuter, Bill Barrett, Jon Christensen

Testimony on Taxation to the House Ways and Means Committee

In 1993, fifty years after my own birth, my grandson was born. While he was born with air conditioning and a mother with a master's degree and other "advantages" of technological and societal progression, and I lived most of my childhood in poverty (we had an outhouse until I was in my teens), I felt sorry for him. I did not, as I had expected I might, envy him but was, instead reminded of the story of The Wolf and the Dog I learned as a child.

There was a hungry wolf who, in the early winter, chanced upon a ranch house with a dog. The hungry wolf was allowed by the dog to share his dinner. The wolf enquired how the dog came by food and was told the people supplied it. The dog further described his life and asked the wolf if he wanted to stay. The wolf initially agreed, but then noted the collar around the dog's neck and enquired about it. The dog assured him it was no problem, that he (the wolf) would have one, too, that it was merely where the chain was fastened. The wolf secured some further clarification and, at that point, decided some prices are too high to pay for security and departed.

The income tax is several links in the chain forged by Congress that binds my grandson. The end purpose of this testimony is to petition you to devise a means to remove these links from this chain.

The initial portion of my testimony indicates my position on the need to reform the tax structure. Second, my analysis of specific types of reform is outlined. Third, I provide a chronology of personal and business experiences with the Internal Revenue Service which provide a significant portion of the basis for my views. Fourth, I provide data on my own taxes for 1972 and 1992 for comparative purposes. My experiences demonstrate clearly why the substantial alteration or repeal of the Sixteenth amendment and a change to another tax structure is desirable.

Need For Reform

At one point the income tax was low and voluntary. As recently as 1967 the Commissioner of the Internal Revenue Service was able to truthfully write, "Ours is essentially a self assessment tax system where the citizen fills out the tax forms and sends in his proper tax. This is what distinguishes the American tax system and makes it a model for the rest of the world." Congruently, as a child the ordinary people around me talked about the need to pay their fair share. This was certainly my own attitude and approach through most of the years that I have been paying taxes. While I still wish to pay my fair share, since about the mid-1980's, however, my attitude towards the income tax has shifted. I no longer view the tax burden as a fair share; my motivation in paying taxes now is primarily my fear of imprisonment. While my own apparently outmoded code of honor is such that I do not cheat on my taxes, I do not find moral fault with the people who do cheat and I would certainly not report them for cheating. There are people who may be enemies of mine whom I suspect of cheating on their income taxes, but no one that I hate badly enough to expose to the IRS.

Taxes are necessary to support the government and each of us should voluntarily pay a fair share. One should not be left feeling, as I from time to time do, that in the difference between armed robbery and taxes is more nominal than actual. In both cases one surrenders money that one has

worked for against one's will upon the threat of force. It has only taken a few years for the Internal Revenue Service to get entirely out of hand and even if it were now returned to something like its original state it would only take a few more years to inevitably end up at this point. Congressman Cox is correct that this is not an acceptable solution.

There was a striking lack of reality contact by the Clinton Administration Treasury Secretary that appeared before your committee. The Clinton Administration as a whole seems to be operating in a world of kindly government where the phrase, "I'm from the Government and I'm here to help you", a phrase that elsewhere in America strikes fear in every heart, is taken as positive. Those of us subject to the Secretary's kindly ministrations are appalled by the entirely un-American way in which the Internal Revenue Service operates. The Secretary talks of tinkering around the fringes of the Code, leaving the income tax basically unaltered. Those subject to it have a uniformly different view.

The income tax is probably a major cause of the bloated and disproportionate size of the Federal government. Part of the reason for the bloating is that the withheld income tax makes paying taxes appear painless at the time of payment, which has enabled Congress to make a seemingly endless number of tax increases without inflicting the level of pain that would lead to a tax revolt. The budget had to get entirely out of hand, as at present, before the revolt came. We must not only eliminate this tax as currently structured but must eliminate the opportunity for this problem to re-occur. To this end, the replacement tax must necessarily be painful on an ongoing basis, providing a stimulus to the citizenry to track the expenditures and expansions of the Government. Clearly any tax reform will work much better if the Senate eventually manages to send the long overdue balanced budget amendment to the States.

Reform Proposals

My thoughts on taxation at all levels always began with the rather common sense view that ordinary individuals, who pay almost all of the taxes, must necessarily pay their taxes from their income; they have no other source. Practically speaking, therefore, all tax is in some sense an income tax and the Federal Tax Code needs to be structured with this fact in view. The notion of "property" tax is functionally absurd; property is not a negotiable instrument and cannot, therefore, be used as a form of payment. Neither is there an invariable relationship between property and income or wealth. Similarly, purchases provide no money to the buyer who pays the tax, but must necessarily come from the profits and/or income of individuals. But for the problem of the inability of Congress to comport itself appropriately, it would be my view that the ideal tax would be a flat tax on the income of individuals (not on corporations). Tax on corporations is nothing more than an indirect tax on the individuals who own stocks and receive dividends from the corporation. Corporate income tax is a double taxation removing a part of the income from shareholders before dividends are paid and taxing the remaining profit when paid as dividends to shareholders.

Income Taxes

The optimal income tax would have a large individual exemption adequate to cover actual

individual living expenses. Individuals should not have to pay taxes out of the money that they need for food, shelter, and medical care for themselves and their families. An individual exemption of at least $7,000 per person would be appropriate at this point in history. Beyond the base level, I would think that all genuine income, from whatever source derived, should be subjected to a flat tax rate.

While fairness dictates that income (above the base) of all individuals be taxed, it violates the basic concept of fairness to somehow argue that individuals with higher income should pay a higher rate. Clearly those with more income should pay higher taxes but this does not imply that the rate should be higher. No other exemptions should be allowed, although clearly there would need to be an adjustment for the inflationary portion of capital gains. After all, it seems clear that the primary source of inflation is a government whose expenditures routinely exceed its income, a government which has made a practice of monetizing debt through inflation.

Again, but for the inability of the Congress to comport itself appropriately, the flat tax of Mr. Armey, with one change, would perhaps be the optimal tax. The one revision would be the elimination of payroll withholding and the requirement of direct payment to the government of taxes by each individual taxpayer. Unfortunately, the proposal made by Congressman Armey leaves intact and unaltered the Internal Revenue Service with its un-American and intrusive characteristics.

▸ Perhaps the Sixteenth Amendment could be amended in a way which require simplicity of the tax code and makes payment of taxes painful. Perhaps the specification that a uniform rate be required and withheld tax eliminated could be written into an Amendment of the Sixteenth Amendment. If such language could be devised then the income tax would probably be preferable to a consumption tax.

Value Added Taxes

The value added taxes being discussed as most desirable because they are relatively painless and provide a broad, hard to evade base are unacceptable precisely because they are relatively painless and hard to evade. One of the things that has to be true in order to keep the taxes under control is that the tax must present an ongoing pain to the people paying it so that the taxpayers do not lose track of what they are paying. It is important that taxes be truly voluntary which is, of course, the case (as Hamilton points out) with a tax that is relatively easy to evade.

While a value added tax would, of course, at present, be much simpler than the current tax, it still provides a high level of paperwork for businesses. The other problem with the value added taxes, as discussed thus far in your hearings, is that they are scarcely likely to provide any improvement, within a few years, over the current morass of Federal laws, rules, and regulations. It might likely be initially a simpler structure, but I expect that the administration representative (while generally an individual out of contact with reality) is probably right that one would end up with just as much bureaucracy using a value added tax. The VAT is subject to the same abuses as the present income tax. Right away one gets into the problem of keeping track of the purchase and sale prices of products at multiple points during their development and execution.

Sales Taxes

Absent a Constitutional Amendment to the Sixteenth Amendment, but with its repeal, I am in favor of a sale's tax, to be collected by the States and forwarded to the Federal government. A Sales Tax would be painful and the fact that a sales tax inflicts ongoing pain is one of the benefits of a sales tax. Further, a Sales Tax would be difficult or impossible to apply to private transactions, making the Sales Tax fairly easily evaded. Easy evasion is also as an asset since this trait again limit the power of the Congress to levy rates of taxes that are incongruent with the rates of taxes that people are willing or can afford to pay. The case for a sales tax is made better than I can make it in the Federalist Papers, #21, Hamilton. The sales tax would allow the repeal of the Sixteenth Amendment and elimination of the IRS, making it immensely attractive to all who value Freedom.

The one drawback of sales taxes is the inherently regressive nature of the sales tax. While flat rates should not offend anyone's sense of fairness, it is wrong to require that people be compelled to pay tax with their grocery money or the money that they need to buy shelter or clothing for their children.

▸ While no solution to the regressive nature of the sales tax is perfect, perhaps a good solution would be for the Federal government to rebate to each citizen the tax on a certain base amount of income, probably at least $7,000 per year at present. This rebate could be given without concern as to whether the person actually had that much income. While one could require that an initial application be made for the rebate, one could perhaps simply generate rebates through the Social Security System. Rebate payments to each holder of a Social Security number could occur on a monthly basis and end at death. This would eliminate much of the regressive character and remove the hardship from individuals who are living month to month. After the first month they would have the money available at the beginning of the month.

The problem of providing rebates to individuals who are employed by the Federal government or are receiving Federal welfare benefits or are otherwise non productive could easily be dealt with by adjusting the rate of payment of such Federal benefits to a lower level to compensate for the rebate.

Personal Experiences

My personal experiences with the Internal Revenue Service (apart from the annual filing of returns based on hundreds of annual hours of record keeping), in their entirety, follow. The entire source of all of my business suffering is based on my professional occupation as a clinical psychologist. I have a small private practice and employ a single secretary and someone part-time to vacuum and clean the office. My expenses are those inherent in operating an office. In addition to my contacts with the Internal Revenue Service I must also, of course, interface with local property taxes, State income tax, State sales taxes, State unemployment taxes, Federal unemployment taxes, and various forms and filings in conjunction with these. Even at the State level the absurdity runs to the depth of having to have a "safety committee" to satisfy recent changes in Workman's Compensation laws. The aggregate of these governmental encounters

which makes the minimization of the government in my life a primary objective. The narrative which follows outlines contacts only with the Internal Revenue Service which has the distinction of being the most egregious entity involved but certainly not the only one.

First Substantive Encounter

Shortly after I went into practice full-time, I hired an employee and it was necessary for me to begin withholding tax. I contacted the Internal Revenue Service as to how this is done and was advised that I needed to use the tax tables and make deposits of the withheld amounts and employer contributions in an approved Federal Reserve bank. Skipping what now looks to me to be an appalling level of ignorance, I scouted around and found an approved Federal Reserve bank and opened an escrow account in it wherein I deposited the money withheld. At the end of the quarter, which was about when I found out what deposited with a Federal Reserve bank means, I filed the required 941 and sent the money in.

At that point the IRS contacted me to advise me of my error and to advise me further that I was going to be subject to a penalty and interest charge. I did not object to this, understanding that I had acted incorrectly, if innocently rather than malignantly as they seem to think. At any rate, I inquired what the penalty would be and was advised that they would be sending me a bill.

The bill did not arrive for a number of years. When it did arrive, it was approximately $125.00, $30.00 or so of it interest. I contacted the Internal Revenue Service by telephone since, in the intervening years, I had forgotten I was expecting something from them. They clarified for me what the bill was for and after reviewing my records I indicated to them what had happened and that I had at the time of the error agreed to pay the penalty but had never received a bill. They checked and verified that I had, in fact, never received a bill. The agent on the telephone gave me a figure (absent the subsequent interest), and indicated I need not pay the subsequent interest, and I sent the money to them. The reason that I had not sooner received a bill, I was told, was that they had forgotten to print a special bill and the computer program did not print automatic bills unless the amount was over $100.00.

A year or two later I again received a bill referencing this tax period for the unpaid interest along with a threatening letter. The amount was now down to about $25.00. I tried to contact the person I had dealt with before who was, of course, gone. I talked to his supervisor who advised me that he had not had the authority to make the agreement that he had made.

By this time, I had, of course, received a final warning notice from the Internal Revenue Service advising me that because of my severely delinquent behavior they were, with that letter, placing the agency in a position to seize (without further warning) all of my assets and freeze all of my accounts to secure the money that I was trying to cheat them out of and/or was allegedly refusing to pay.

At that point I, of course, paid the $25.00 and sent a letter telling them that I would like a receipt and that I thought it was too bad they could not keep their agreements.

I, of course, never received a receipt (the IRS does not do receipts). I did, however, over the next

two years receive (at random intervals) small checks referencing this tax period, which checks eventually exceeded the total amount that I had paid in. There was never any sensible explanation as to why I was getting these little checks.

Second Class of Substantive Encounters

Over the years that I have been in business, I have several times a year received notices from the IRS advising me that I have either overpaid or underpaid something or other by some small amount. I am typically unable to locate where they think the source of error is. At this point I, with terror in my heart, of course, pay any amount that they bill me that is not astronomical without even checking to see what it is.

When they send me a notice that I have overpaid and inquire whether I want a refund or not, I always indicate that I want the refund. This is then followed by a notice from them that the requested refund has been applied to my delinquent taxes and that no check will be forthcoming. I have yet to receive any indication of what the delinquent taxes are that these unexpected windfalls are being applied to. I will note the rate of these mystery notices has declined over the years.

Related Non-Encounter

In the early 1980's I incorporated my practice. The sole reason for this incorporation was to create a better situation tax-wise for managing my profits.

Third Substantive Encounter

A few years ago I received notice from the IRS that I had cheated on my taxes by selecting a lower of two rates as applying to my corporation. There is a lower rate for corporations where less than 95 percent of the activity is professional service, as is the case with my corporation. I contacted the Internal Revenue Service and advised them that I was qualified for the lower rate, that the corporation was engaged in property rental, office management, and other investments as well as providing professional services and that these far exceeded the 5 percent cutoff, and were, rather, more around 50 percent.

They promptly basically accused me of lying, of course, and demanded, in effect, documentation to prove I was not lying. They refused to specify what documentation would be acceptable with reference to the tax code. The tax code and regulations referenced by the IRS revealed, of course, no description of required documentation. I prepared documentation that demonstrated that the corporation took in half of its income from other than professional service sources. They, of course, determined that this was not adequate proof that the five percent of employee <u>time</u> requirement had been breached.

At some point in the discussion, I inquired of them how they had determined that I had deliberately cheated on this matter and/or what reason they had to think I was lying. I grew up, by the way, when a man's honor had some meaning and if I don't watch myself I'm prone to think you shouldn't accuse a man of lying without some pretty good reason, a concept alien to the IRS.

Their whole explanation was that it would be possible for me to lie so therefore they had concluded that I was.

At some point in the dispute I became aware that the regulation I was accused of cheating on had not actually been fully adopted by the Internal Revenue Service but was only a proposed regulation. I contacted my attorney, ignorantly thinking this fact might matter, and was advised that this did not make any difference. I was advised that the Federal courts allow the IRS to enforce draft regulations.

At some later point in the dispute I found out that the regulation I was accused of deliberately evading, violating, and cheating on had in fact not even been drafted at the time that I was filing the income tax return wherein I presumably deliberately lied and cheated. I, of course, contacted my attorney again, foolishly, only to find out that the fact that the regulation had not been drafted was no defense against a charge of deliberately cheating on it.

I secured a Federal Court date, eventually, and shortly before the matter was to go to court, the United States Attorney's office was in contact with my attorney indicating that my documentation was adequate legally and that the case should not have been carried forward and offering to settle. By that time I was out some significant amount in legal fees, of course, and had my attorney inquire as to whether they would pay her legal fees.

The informal feedback she got was that they would never, ever pay legal fees unless ordered to do so in court and, furthermore, if I pursued the matter in court to that end rather than settle then they had a number of other areas about my taxes that they were going to start looking into.

My mother did not raise a total idiot so I, of course, accepted their offer for a settlement with no taxes, penalty, or interest due, and a decree was issued by the court. I was only out the cost of defending myself in this case and a year or so of harassment by the Internal Revenue Service.

Fourth Substantive Encounter

Some years ago I filed my personal State and Federal income tax returns and, as luck would have it, that year received a small refund. The refund I received from the Federal government (not significant in size) I cashed and spent.

A couple of years later, I received a threatening letter from the Internal Revenue Service (any letter from IRS is a threat) advising me that I had not filed an income tax return for the year in question and insisting that it be filed. I, in fact, had filed and promptly sent them a copy of the return with an accompanying letter advising them that I had timely filed the return and had, in fact, received the refund and spent it. I suggested to them that perhaps they had lost some of their computer files and that if they had they might verify that I had filed by looking up the refund check.

I received back a letter with no acknowledgement of the content of my letter but rather advising me that my return (the recently sent copy) was incomplete in that it was not signed and that I could not get a refund unless I signed the return, and demanding that I submit a signed return.

I then made another photocopy of my file copy of the return and signed it and forwarded it to them with yet another letter indicating that while I had signed the copy of the return, I did not wish to receive another refund, that I had already received the refund.

I then received yet another hostile correspondence from them indicating that my return was still incorrect in that the return was not also signed by my wife and again demanding that I submit a return signed by both of us or we would not get the refund. There was again no acknowledgement of the fact that I had indicated having a refund and did not want another one.

At this point in the sequence I contacted Senator Exon, if my memory serves, with the matter indicating that I wanted to know if there was a limit to the number of times the law required the submission of the same return to the Internal Revenue Service and indicating that I could not seem to direct the attention of the IRS to the fact that I did not want a second refund. The feedback that I got from the Senator, as I recall, was to the effect that I had to comply with their demands and he really could not help me avoid receiving a refund unless I could show proof that I had received the refund. There did not seem to be a paper trail, so I submitted yet another return, this one signed by both my wife and I, and in due course received a second refund check.

Related Non-Encounter

At the present time I am, on the advise of my accountant for income tax purposes, now operating a second corporation. Although the matter of percentage of time spent in professional activities was adjudicated in a Federal court decision, my accountants are advising that the IRS practice is to wait a few years after losing such a case and then renewing the original complaint and repeating the inquisition. My accountants are advising me that I should operate the two activities under two separate corporations. This of course causes no small inconvenience for someone who cannot afford a full-time accountant but must, with the help of their secretary, do all of their own tax record keeping. Running books for two corporations is fairly entertaining when you do not have background in business administration but wasted your time studying psychology in graduate school.

Summary of Facts Learned

While these four encounters are the only unusual contacts I have had over quite a number of years, they, in total, occupied my time over a span of many years since a year or more of correspondence with the IRS on any matter is about typical.

During my encounters with the IRS, I have learned the following facts:

A. When challenged by the IRS, for whatever reason or for no reason at all, one is guilty until proven innocent.

B. Unless you pay money to go to court, it is functionally impossible to prove yourself innocent since the people you have to prove yourself innocent to are the same people who have tried and convicted you in some administrative process you did not attend.

C. The IRS, like other agencies, apparently, will admit no mistakes. A refund cannot be refused, for example.

D. One can be guilty of cheating on a rule that is not actually a rule and one can deliberately cheat on a regulation that has not yet been drafted. The no ex post facto law notation in the Constitution does not apply.

E. The IRS can seize all of your assets on a whim or in a non-dispute over $25.00.

F. In general, the Bill of Rights does not apply to IRS.

Stone Income - 1972 vs. 1992

Nineteen seventy-two and nineteen ninety-two were selected for comparison on my subjective feeling of similar effective income. The difference is that in nineteen seventy-two my income supported four people at this subjective level while only two were so supported by the nineteen ninety-two amount. The numbers are my personal (non-business) returns and demonstrate the bloating of Federal income tax, the bloating of State income tax secondary to it, and the need to also reform FICA.

	1972	% Increase	1992	Constant Dollars
Adjusted Gross	17,157	426	73,148	17,157
FIT	2,019	594	11,985	2,813
%	11.8		16.4	
FICA Base	9,000		N/A	
FICA (EMP)	468	1208	5,655	1,327
%	5.2		7.7	
SIT	303	1076	3,259	765
%	1.8		4.5	
Total Tax	2,790	749	20,899	4,905
%	16.3		28.6	
1992 Tax @ 1972 rate			11,123	
Difference			8,976	
Take Home	14,367	364	52,249	12,265

June 7, 1995

To Congress:

Get back to basic Republican form of government — PLEASE!

DON'T TAX LABOR OF AN INDIVIDUAL.

DON'T IMPOSE FLAT TAX ON THE LABOR OF AN INDIVIDUAL!

Go back to excises — collect revenue at the SOURCE!!

Impose a national sales tax if necessary.

Don't raise revenue then determine how to spend it. — RATHER, make a budget, then determine how to raise the revenue.

Richard L. Summer
4052 Chalfe Dr.
Garland, Texas 75043
(214) 278-1916

DALLAS COUNTY PRECINCT 2274

INCOME FROM WAGES

1. I INCUR A LOSS IF I DO NOT GET PAID FOR MY LABOR.

2. I AM COMPENSATED FOR MY LOSS WHEN I AM PAID FOR MY LABOR.

3. MY LABOR IS MY PROPERTY.
   a. "The property which every man has is his own labor, as it is the original foundation of all other property, so it is the most sacred and inviolable. Adam Smith's Wealth of Nations, BK.I, ch.10." Butchers Union Co. v. Cresent City Co., 111 US 746, 757 (1884) (Mr. Justice Fuller concurring).
   b. "Included in the right of personal liberty and the right of private property - partaking of the nature of each - is the right to make contracts for the acquisition of property. Chief among such contracts is that of personal employment, by which labor and other services are exchanged for money or other other forms of property. If this right be struck down or arbitrarily interfered with, there is a substantial impairment of liberty in the long-established constitutional sense. The right is as essential to the laborer as to the capitalist, to the poor as to the rich; for the vast majority of persons have no other honest way to begin to acquire property, save by working for money." Coppage v. Kansas, 35 S.Ct 240, 243 (1915)

4. "EXESS COMPENSATION" FOR LABOR IS INCOME.
   a. "Reasonable compensation for labor or services rendered is not profit." Laureldale v. Matthew, 345 Pa. 239, 47 A 2d 277 (1946)

5. I CANNOT RECEIVE "EXCESS INCOME" FOR MY OWN LABOR.
   a. "'Income' within the meaning of the 16th amendment and the revenue act, means 'gain' ... and in such connection 'gain' means 'profit' ... proceeding from property, severed from capital, however invested or employed, and coming in, received, or drawn by the taxpayer for this separate use, benefit or disposal. 'Income' is not a wage or compensation for any type of labor." Stapler v. United States, 12 F.Supp 737, 739
   b. "Compensation for labor is not income." Oliver v. Halstead, 86 SE 2d 858 (1955).

6. I CAN ONLY RECEIVE "EXCESS INCOME" FOR ANOTHER PERSONS LABOR.

   a. I CAN HIRE ANOTHER PERSON AND EMPLOY HIS LABOR.
   b. THE AMOUNT I AM PAID FOR ANOTHER PERSON'S LABOR THAT EXCEEDS THE AMOUNT THAT I PAY THE OTHER PERSON FOR HIS LABOR IS "EXCESS COMPENSATION."
   c. "Congress has taxed income, not compensation." Conner v. U.S., 303 F.Supp 1187.

Another attachment is being retained in the Committee files.

June 7, 1995

Committee on the Ways and Means
1102 Longworth House Office Building
Washington, DC 20515-6348

Dear Sirs:

It came to my attention recently that you are considering changes to our current methods of taxation. I would like to voice my support of a national sales tax as an alternative to our current use of the Internal Revenue Service.

It is my feeling that our current method of taxation is crippling. If you measure the strides I have made throughout my career by salary increases, I have been penalized rather than promoted thanks to higher taxation. As I strive to provide for myself and my family, my dollars are disappearing before my eyes.

I would much rather see a national sales tax based on the premise that the more you spend the more tax you put back into the system. This method would do away with the Internal Revenue Service and utilize the sales tax collection and payment procedures already in place.

By exempting basic living items from taxation this plan would also be more than fair to lower income families. Food, housing and medical related expenses would not be subject to taxation. Luxury items would be taxed accordingly.

I believe this opportunity to spend the full amount of money earned will encourage spending as well as allowing individuals to relieve mortgage, credit card and other debts. Once debts have been relieved the luxury of putting money into savings will increase, giving banks more money at their disposal for lending purposes. More money to lend would translate into more building and growth.

Sirs, I hope you find a way to make this happen.

Sincerely,

Joan Taramasso

Joan Taramasso

4104 Old Sonoma Road
Napa, CA 94559
707-257-7666

Copy 2 of 6

June 22, 1995

Mr. Phillip Moseley, Chief of Staff
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Dear Sir:

On the Michael Reagan Radio Talk Show (June 8, 1995) I heard that your Committee is inviting citizens to send comments and suggestions on the various tax reform plans. I understood Mike to say that they should be sent in by June 27. However, when I called your office on June 20 to find out more about the procedure Walter (who was very helpful) told me that the target date was June 22!

So I worked night and day June 20-22 to finish this paper: "Qualities of Tax Plans". Hope it gets to you in time. Walter said hand-written copies are OK, so I hope you can read my left-handed, arthritic hand-scrit! If you will give me some extra time, I'll be glad to hire a typist (or word processor specialist, or whatever you call them these days) to get a printed copy.

Enclosed are the six copies that were requested by Walter. He said my report will be reproduced along with suggestions from other citizens. The record of the June 6-8 hearings will also be included. (They were excellent! I heard most on replays by C-SPAN 2.) He said the copies will be available in the late summer and will sell for about $10. Please send me one when ready.

Congratulations to you, your staff, Chairman Bill Archer and other members of the Committee for the excellent job you are doing on comprehensive tax reform. (Just wish you all had been in charge in 1986!) Thanks also for letting us plain but interested citizens participate.

Sincerely yours,

Sam Thompson III
UTEP P.O. Box 68306
El Paso, TX 79968-999

P.S. One of my hobbies is writing political lyrics. Enclosed is my creation of April 28, 1995: "The Ultimate Tax Reform" (to be sung to the tune of "America The Beautiful"). Thought you and the others might enjoy it.

THE ULTIMATE TAX REFORM
(Tune: "America The Beautiful")

1) We're hopeful now the income tax may be repealed at last
For many years the Supreme Court said it should not be passed
Repeal the Sixteenth Amendment, admit that it was wrong
And substitute the retail tax, to make our country strong.

2) An evil tool of socialists to redistribute wealth
The income tax is hazardous to economic health
It punishes successful work, incentives it devours
Discouraging the savings and investments that are ours.

3) When we abolish income tax, we won't need IRS
We'll dump their complex maze of rules and bureaucratic mess
No more invade our privacy, no guilt will be presumed
And end their mean Gestapo raids, such policies are doomed

4) The ultimate of tax reform -- a tax on retail sales
So all you earn you now can keep, no April 15th wails
You're only taxed on what you spend, at one low rate renown
Consumer votes scare Congressmen, that rate they will hold down.

5) Some liberals claim the retail tax will mostly hurt the poor
Until they're told a cash advance will ease the pain for sure.
The underground economy at last will pay their share
By buying goods and services, taxation will be fair.

6) Each local business will retain a portion of the haul
With such incentive to report, they won't hide sales at all
To local and state governments the revenues will flow
Then trickle up to federal -- they'll carefully spend our dough.

7) At last our great economy will back in freedom's glow
The saving and investment boom will help good business grow
We'll waste no time on long tax forms, productive work will rise
We'll have more jobs and higher pay -- the retail tax surprise.

Sam Thompson VII
April 28, 1995

QUALITIES OF TAX PLANS

A preliminary analysis of the current income tax system and seven proposed tax-reform plans based on twelve qualities defined for an ideal plan.

by
Sam Thompson III
UTEP P.O. Box 68306
El Paso, TX 79968-9991

June 22, 1995

Qualities of Tax Plans

Table 1 summarizes the twelve qualities of the ideal tax plan. They are based on my studies as an interested citizen of publications, television (C-SPAN, etc), and radio programs. Table 2 contains my preliminary ratings of qualities of the present income tax and the most prominent of the proposed reform plans. Many of the plans are in their formative stages and I have studied some of them more thoroughly than others. Nevertheless, my preliminary analysis may help to reject the inferior plans, and select and improve the better ones.

1.) Sufficient - An ideal tax plan will raise sufficient revenue to pay for legitimate government expenditures. Much of the current spending by the federal government is wasteful, counterproductive, and in some cases unconstitutional. Thus the level of sufficient revenue (and that part to be raised by taxation) will be significantly lower and cannot be determined accurately until the current budget reform process is completed. (If the ill-conceived "entitlement" programs such as Social Security, Medicare, and Medicaid can be privatized or phased out and replaced by targeted subsidies for the truly needy, the budget total may be brought down to a modest level.)

In the IRS booklet for 1994, the total Federal revenue for fiscal year 1993 was $1,154 billion and the total expenditures were $1,408 billion (deficit of $255 billion). Most reasonable people consider these figures to be astronomically high. About 51% of the revenue was raised by personal and corporate income taxes, excise taxes etc, or about $589 billion. To replace the current tax plan, a reform plan needs to raise revenue on this order of magnitude, or somewhat less if budget reform is successful. However, the static concept that a tax-reform plan must be "revenue neutral", that is raise the same amount as the current system, should be discarded.

Table 1 : Desirable Dozen Qualities of the Ideal Tax Plan

1.) Sufficient - Will raise sufficient revenue to pay for legitimate government expenditures.
2.) Undamaging - Will do minimum damage to the economy.
3.) Encouraging - Will encourage saving and investment
4.) Enforceable - Can be enforced without oppressive government intervention
5.) Simple - Can be paid simply and easily; avoidance is not worth the trouble
6.) Inexpensive - Can be enforced and paid at low cost.
7.) Understandable - Can be understood easily and is so obvious that all tax payers can be aware of the tax base, tax rate, and amount paid.
8.) Fair - Will be perceived as fair by most reasonable people; no escalating ("progressive") tax rates, no loopholes (no exemptions or deductions), no privileges (no credits). (Will help needy with subsidies.)
9.) Quick - Will be passed into law so rapidly, will be implemented so easily, and will be accepted so readily, that the transition time to change from the current system is minimal.
10.) Rigid - Will be so rigidly constructed that there is no room for political manipulation (vote buying, pork barreling, log rolling, etc); no longer use tax code for social engineering, only to raise revenue.
11.) Stable - Will be so well prepared that no other tax reform plan will pass for at least 30 years. (May have minor adjustments of tax rates.) With such long-term stability, individuals and businesses can do more accurate financial planning. (Still have unknown rate of inflation.)
12.) Liberating - Will result in abolition of the Internal Revenue Service and repeal of the 16th Amendment to the U.S. Constitution (which brought us the income tax in 1913).

Note: A unified (Federal, State, and Local) retail sales tax is the most ideal plan.

STIII
95.6.20

Table 2: Preliminary Ratings of Qualities of Current Income Tax and Proposed Reform Plans
5 = Excellent, 4 = Good, 3 = Fair, 2 = Poor, 1 = Lousy, 0 = Awful

	(1) Sufficient	(2) Undamaging	(3) Encouraging	(4) Enforceable	(5) Simple	(6) Inexpensive	(7) Understandable	(8) Fair	(9) Quick	(10) Rigid	(11) Stable	(12) Wheeling	NON-WEIGHTED TOTAL
1.) Current income tax (IRS)	4	2	1	1	0	0	0	0	5	0	0	0	13
2.) Progressive income tax (Kaptenoff)	3	3	1	2	1	1	1	0	2	0	0	0	14
3.) Consumed income tax (Nunn and Domenici)	3	3	3	2	1	1	1	2	4	0	0	0	20
4.) Flat rate tax on wage income (Armey)	3	4	4	3	3	3	3	3	4	3	3	2	38
5.) Flat income tax + VAT (Bradley)	4	2	2	2	2	2	1	1	2	1	1	0	20
6.) Value Added Tax (VAT) on wholesale and Retail Sales (Gibbons, others)	3	4	5	3	4	2	2	3	3	3	3	2	37
7.) National Retail Sales Tax (Nugent, others)	3	4	5	4	5	3	5	4	3	4	4	3	47
8.) Unified Retail Sales Tax (collected locally) (ST III)	3	4	5	5	5	5	5	5	2	5	5	5	54
													(max 60)

Notes: See Table 1 for explanation of qualities
See text for discussion of current income tax and proposed reform plans.
Non weighted total of ratings may not be an accurate appraisal because some qualities are more important than others. However, the relative ranking of ① No 8 - 54, ② No 7 - 47, ③ No. 4 - 38, ④ No. 6 - 37, ⑤ and ⑥ tie between No 3 and No 5 at 20, ⑦ No 2 - 14, and ⑧ No. 1 - 13, appears reasonable.

ST III
95.6.20

The current tax plan and all of the proposed reforms are capable of raising sufficient revenue if their rates are high enough. The current plan is rated as a 4 - Good (out of 5) because it does not raise enough revenue to eliminate the deficit. The reform plans that would continue to tax income (Nos 1-4) are rated 3 - Fair because they propose lower rates. However, as dynamic scoring becomes available they may indeed raise more revenue than the current system.

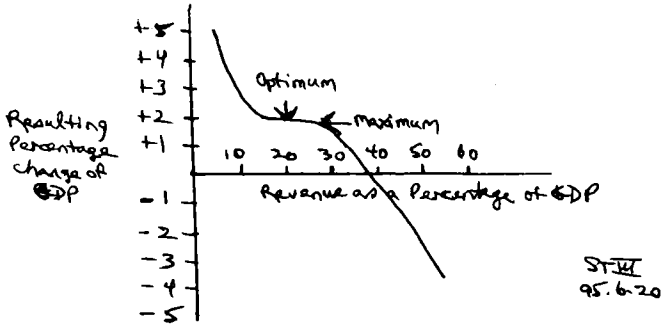
The reform plans that would change the tax base from income to consumption (Nos 6-8) are also tentatively rated 3 because they too aim for low rates. Total retail sales in the U.S. during 1993 are reported to have been 2.1 trillion. A consumption tax rate of 20% would have raised about 420 billion in 1993. To get to the 589 billion of the present system, the rate would have to have been 28%. Although these calculations are only crude approximations, they show that a consumption-based tax is in the ballpark when it comes to raising sufficient revenue. The plan suggested by ex-Governor Jerry Brown (D-CA) to combine a flat income tax and a VAT is rated as a 4 because it may raise as much or more revenue as the present system, but it should be rejected on other grounds.

2.) <u>Undamaging</u>. An ideal tax plan will do minimum damage to the economy. Any amount of revenue taken out of the economy by government will do proportional damage to it.

Combining 1.) and 2.), I submit that the most important goal of tax reform is to choose a plan that will raise sufficient revenue to pay for legitimate government expenditures but also will not do serious damage to the economy. If the economy is seriously damaged, most if not all of the people in the country will suffer.

Figure 1 is offered as a first step in the assessment of economic impacts. It is a preliminary chart showing a plot of total revenue (Federal, State, and Local) as a percentage of real Gross Domestic Product and the resulting change of GDP. A statistical analysis should be made to see what part of a change in GDP is the result of the change in total revenue. Also, the proper time lag should be determined.

Figure 1. Preliminary chart of total revenue (Federal, State, and Local) as a percentage of real Gross Domestic Product and the resulting percentage change of GDP. The maximum is the revenue percentage above which serious damage will be done to the economy. The optimum is the percentage at which the most revenue will be raised while doing the least damage to the economy (inflection point on curve).



The maximum is defined as the revenue percentage above which serious damage is done to the economy. The optimum is defined as the percentage at which the most revenue will be raised while doing the least damage to the economy. Intuitively, I believe that the maximum is around 30% (certainly 50% or above) and the optimum is around 20% (between 10 and 30%).

A select panel of experts, including professionals from both inside and outside of government, should plot such a general curve with appropriate documentation. They may also plot general curves to see if there are significant differences as to whether total revenue is collected from an income or consumption base, or is collected only by the Federal government or by State or Local governments.

Finally, they should plot specific curves for each of the tax reform proposals to see what rates will will result in maximum and optimum revenue percentages and comparison to those of the present system. (The revenue raised by the tax plan may be combined with revenue from other sources to determine the total.) Those proposals which have reasonable tax rates that will raise sufficient revenue at an optimum percentage of GDP may be selected; those which do not may be rejected.

In my preliminary ratings, I show the Flat Tax system as a 2-Poor regarding the quality of underwriting. The tax increase of 1993 is starting to have its effect after the normal two-year time lag. I judge that the Brown plan (No. 5) would not be much better. Those plans that will continue to tax income at escalating ("progressive") rates, No. 2 being proposed by House Minority Leader Richard Gephardt (D-MO) and No. 3 proposed by Senators Sam Nunn (D-GA) and Pete Domenici (R-NM), are rated as 3-Fair because they at least are proposing lower rates. The No. 4 plan submitted by House Majority Leader Richard Armey (R-TX), to tax only wage and pension income at a low flat rate of 17% (and exemptions of $13,100 for a single person, $36,800 for a married couple with two children), is given the best rating of 4-Good. The consumption tax plans, Nos. 6, 7, and 8 would have been rated as 5-excellent except for the fact that they will raise the cost of living for everyone, and even the elimination of income taxes and the integration of subsidiaries

for the ready may not affect the economic impact, so they are optimistically rated as 4-Good.

3.) Encouraging - An ideal tax plan will encourage saving and investment. Investment is the life blood of a growing economy, providing jobs and increasing the standard of living. Thus any improvement in this quality will help to offset any damage done by taxation (Quality No. 2).

In the current system, savings are taxed at a marginal rate up to 39.6% (some "%?"), and capital gains on investments held longer than one year are taxed at 28%. Because the USA has an abysmal savings and investment rate compared to other developed (and some developing) nations, I believe a rating of 1-Lousy is justified. It would be 0-Awful except for the fact that some reduction is given on capital gains taxes.

However, consider my personal situation. As I became a serious investor in mutual funds in the early 1980's, I got used to paying a capital gains tax on investments (outside of IRA's, 403b's, etc) of 14%. After the Tax Reform Act of 1986, my rate doubled to 28%. I consider that rate to be very high. Since then, I have been reluctant to invest in stock funds and have kept most of my nest egg in money market funds. I would guess there are millions of others like me. Thus the elimination of taxes on savings and investments should unleash a torrent of activity, including a significant input from foreigners, that an economic boom probably will result.

Because Gephardt is so committed to escalating ("progressive") rates and redistribution of wealth (and he says he is "not a socialist"!?), I doubt that his plan (No. 2) will give much encouragement to savings and investment, so I have given it also a rating of 1-Lousy. Because Brown has a similar political philosophy, I give his plan a slightly better 2-Poor because he implies a flat rate tax on savings and investments (however, he has spoken of a possible surtax additional rate on the "rich").

The consumed-income tax plan of Nunn and Domenici (No. 3) would subtract the amount put into savings and investment from total income and tax the remainder as a consumption equivalent. Because they keep savings and investment in the tax equation, and thus subject to federal abuse, I give that plan only a rating of 3-Fair. The much better Armey plan (No. 4) takes savings and investments

completely off the table, but the fact that he taxes any income at all allows for a return to taxes on savings and investments in the future, so I rate it as only a 4- Good.

All of the consumption tax plans (Nos. 6, 7, 8) are rated as 5- Excellent because they eliminate taxes on all income and thus greatly encourage savings and investments into the foreseeable future and maybe beyond. Hooray!

4.) Enforceable - An ideal tax plan can be enforced without oppressive government intervention. In fact, an ideal plan should be self-regulating with only a minimum of governmental spot-checking.

For many decades, there have been horror stories of abusive intervention, some armed and violent, by the Internal Revenue Service into businesses and personal lives. Even the initials, IRS, send shudders through all taxpayers. That is why the Chairman of the House Ways and Means Committee, Bill Archer (R-TX), is so determined in his drive to abolish the IRS. If anyone has any hope that the IRS can or will improve, they should read the recent report by Daniel J. Pilla, "Why You Can't Trust The IRS" (Cato Institute, Policy Analysis No. 222), with the timely date of April 15, 1995. Because I have been generally well treated by the IRS, I believe I am entitled to give the current tax system a generous rating of 1- Lousy in this category.

The Gephardt (No. 2) and Nunn-Domenici (No. 3) plans remain so dependent upon the IRS for enforcement I give them a rating of 2- Poor. The same is given to the Brown Plan (No. 5) because he depends on the IRS to collect both the income tax and the VAT. The Armey Plan (No. 4) is relatively simple, so enforcement by the IRS should be less involved; but the work remaining so it is given a 3- Fair. The Value-Added Tax (VAT) on wholesale and retail sales proposed by the Ranking Member of the House Ways and Means Committee, Sam Gibbons (D-FL), (No 6) is also given a 3 because at least two collections on each item of consumer goods or services must go to the IRS.

The National Retail Sales Tax (No.7) proposed by Senator Richard Lugar (R-IN) and others does what it says, but incredibly the payments are sent to the IRS, so I rate it only a 4-Good. For this and other reasons, I am compelled to introduce (hasn't anyone else?) the idea of a Unified Retail Sales Tax (No.8) in which all Federal, State, and Local sales taxes are combined into one rate, are collected by the local business and sent to the Local tax office (City, County, etc.). In my plan, the business would keep a portion of the collection, say 1 or 2%, to cover administrative costs plus a small profit, and may even be given the "float" while earning interest in a bank account before making quarterly payments to the tax office. Thus, each business would have a good incentive to report all sales and collect taxes on them, the system would be practically self regulating, and only rare spot checks would be needed by inspectors from the Local tax office (and they would be the friends and neighbors of the business people). At the Local Tax Office their share of the revenue would be retained and the remainder sent to the State Tax Office, which in turn would retain their share, and the remainder sent to the Federal Tax Office. In this age of computers and wire transfers, the time for the tax money to go from the business to the Federal Tax Office may be measured in nanoseconds. The Federal Tax inspectors may check on the State Offices, and the State Tax inspectors may check on the Local Tax Offices, but the latter would buffer the business people from both of the former. What could be more easily and pleasantly enforceable? So I give my plan a 5-Excellent!

5.) Simple - An ideal tax plan is so simple that the taxes can be paid simply and easily; avoidance is not worth the trouble. Because enforceability and simplicity of complicance are so closely related I give my plan (No 8) a 5 in this category also. I may be too generous in giving a 5 to the National Retail Sales Tax Plan (No.7); a business man who misses a quarterly tax payment to the IRS, has a helicopter land on his roof, and from it come jack-booted thugs who shoot up his storefront with AK-47's, may not think that plan is so simple!

Similarly, the VAT plan (No. 6) cannot be considered so simple if at least two business people, the wholesaler and the retailer, must send payments to the IRS, so it is rated 4. The addition of an income earner sending payments to the IRS further complicates the Brown Plan (No. 5), so it is rated only a 2.

At first glance, the post-card sized reporting form proposed in the Armey Plan (No. 4) appears to be the epitome of simplicity. But the worst feature of it is the that payments must be sent once per month with an annual return to make any adjustments. Sending over 13 postcards to the IRS per year cannot be considered simple and easy, and will drastically increase the potential for problems. The 3 rating could be raised to a 4 with only 1 report per year.

A spin-off from the Armey Plan, called "MC-Flat" by the Congressman (R-IA) who introduced it, is similar except it retains the deductions for mortgages (M) and charitable contributions (C). Such a move is politically popular, but it could wreck the tax-reform process. Restoring such goodies to the tax code would increase the complexity exponentially.

Several of the plans have proposed designating home ownership and other real estate as capital investments. Thus purchases and sales would not be taxed in those plans (at least Nos. 3, 4, 6, 7, and 8). As for charities, won't they be happy to know the contributions they receive are straight from the heart and are not the result of some tax-dodger playing games with the IRS?

The Nunn-Domenici Plan (3) involves so many complexities that it can hardly be called simple, so I rate it a 1-Lousy. The Gephardt Plan, which also will have several tax brackets, is also rated a 1. With over 17,000 pages of laws and regulations (Pilla, 1995, p. 2) the current IRS tax code is generously rated a 0-Awful! That is one reason why Chairman Bill Archer wants to "... tear up the present income tax system by its roots".

6) Inexpensive - An ideal tax plan can be enforced and paid at low cost. Inside the beltway of Washington, D.C., the operating budget of the IRS in 1993 at 7.07 billion doesn't sound like much, but it is an increase of 84% over 1986 (3.84 billion), and is expected to increase to 21 billion by 2002 (Pilla, 1995, p. 23). Incredibly,

the IRS could not account for $4.3 billion, or 64% of its operating budget when the Government Accounting Office tried to audit that agency's budget for 1992 (Pilla, 1995, p. 25). (If any of us taxpayers kept records like that, the IRS would throw us in the Federal Prison at Fort Leavenworth!) Even worse, the cost to all taxpayers, individuals and businesses to comply with the complex IRS code is $600 billion to $1 trillion annually, plus 6 billion hours in work time (Mr. Kurt Hauser, Wall Street Journal, May 14, 1993). All that to collect $800 billion in revenue (William Greer, Wall Street Journal, Feb. 11, 1993). Now is that expensive or what? How about another generous 0-Awful rating in this category for the current tax system.

With that deep attachment to the IRS, I doubt that the Gephardt (No. 2) and Nunn-Domenici (No. 3) plans are much better, so I rate both as a 1-Lousy. The Brown (No. 5) and Gibbons-VAT (No. 6) plans may be slightly better, so they are rated 2. The Armey (No. 3) and Luger (No. 7) plans have less to do with the IRS and the cost of compliance should be reduced, so they are rated as 3 (may be 4). In the Unified Retail Sales Tax Plan (No. 8), the cost of compliance for the consumer is practically zero, the cost to businesses to collect the tax is offset or better with the 1 to 2% fee, and only the expenses of the Local, State and Federal Tax Offices count toward the cost of enforcement. I believe another 5 rating is justified.

7.) Understandable - An ideal tax plan can be understood easily and is so obvious that all taxpayers can be aware of the tax base, tax rate, and amount paid.

The present tax code gets another generous 0-Awful rating, this time because it is not understandable. Each year from 198- to 1991, Money magazine proposed a hypothetical set of data about a typical family and sent it to 50 professionals, asking them to prepare a tax return. They received 50 different answers, none of them correct. Money also discovered that about 60% of the members of House Ways and Means and Senate Finance, the tax-writing committees do not prepare their own tax returns, but have their expert lawyers employed by the committees prepare their returns at taxpayer expense. (Our hero, Bill Archer, is a notable exception.) The IRS answers only about 63% of taxpayer questions correctly (Pilla, 1995, p. 5-7).

Anyone who has ever struggled with an IRS form and booklet more complicated than 1040 EZ should not expect the Gephardt (No. 2), Nunn-Domenici (No. 3), or Brown (No 5) plans to be much more understandable, so I rate them a 1- Lousy.

If a Value-Added Tax (No. 6) is passed, it may be poorly understood when first introduced. Although the tax is levied only on consumption goods and services, it is applied at both the wholesale and retail levels. For some manufactured goods, there may be several levels of taxation. For each level of taxation there would be some administrative cost, so the total price including the VAT may be higher to the consumer than if a single tax were levied at the retail level. In some countries, especially in Europe, the wholesale parts of the VAT are not shown so that much of the tax is hidden from the consumer. To avoid that problem, an American VAT could require that all levels of taxation be printed on the retail receipt, but at a higher cost. The Europeans also exempt some items from their VAT, such as food and medicine; such practice has produced a cumbersome nightmare of misunderstanding. Tax-reform insiders, especially those who favor the VAT, use the new buzz-word "border adjustable" to indicate that the tax may be imposed on imports and rebated on exports with the hope that the balance of international trade may be improved. (They like to point out gleefully that corporate taxes in the Armey plan are not border adjustable.) The VATs adopted by European countries have failed to improve their trade balances (Bruce Bartlett, Wall Street Journal, April 16, 1993). Because all this may not be as understandable, I rate No. 6 as a 2.

The worst thing about the VAT (or any other Federal consumption tax) is that it may be imposed in addition to the income tax, as in Europe. Thank goodness the "Hillary VAT" to finance her radical health-care reform plan never materialized. One of the real dangers of the Brown Plan (No. 5) is that it would introduce double-based Federal taxation on both income and consumption, perhaps starting at low rates but soon mushrooming as the politicians began trading with one then the other. The unwary citizen would have a doubly hard time understanding what is being taxed, what the rates are, and what the total amount of taxes is per year.

The Armey Plan (No. 4) with its relative simplicity should be generally understandable, especially the flat rate and the total tax. However, the tax base may not be so well understood. The plan is to tax individuals and families only on the income from wages, salaries, and pensions (not Social Security). Some may have to be taught carefully that income from savings and investments are not to be included on the postcard to the IRS (who may not give it back!). On the other hand, the more astute may understand the Armey Plan too well and begin taking their active salary in stock and changing their pensions into IRA's etc. That would help economic growth but could play hell with expected Federal revenues. I rate this plan a 3 in this category.

The National Retail Sales Tax by Lugar and others (No. 7) is more understandable and is top rated as a 5. On each receipt of a retail sale the rate and the amount of the Federal tax should be shown. The customer should clearly understand that the tax base is consumption. He or she may not understand the problems the store owner may have with reporting directly to the IRS.

The Unified Retail Sales Tax (No. 8) is equally understandable and is also rated as a 5. As with the National one, I expect the Federal tax rate to be shown on the receipt and to be the same across the nation. However I would hope and expect that each State and/or Locality would try to set a lower tax rate than its neighbor, which would help keep those rates down by competition. The different rates and amounts should be shown on the receipt. In many States, a combined State and Local sales tax is already in effect, thus the addition of the Federal would only add one more line to the receipt. The same is true with the National Plan. Thus the main difference in the two is that in the Unified Plan, the tax is sent to the Local Tax Office instead of the IRS. The customer may be very pleased when he or she understands that the tax money first goes to the tax office in the community.

Dick Armey's objection to a Federal sales tax is that he doesn't like the idea of forcing business people to be tax collectors for the Federal government. In those areas where there is no sales tax at the present time, the sudden introduction of a

Federal sales tax would be quite a shock. However, my proposal for a 1 or 2% portion of the total tax collection to be given to the business people, as well as the possibility of getting the "float" on the interest, should ease the pain considerably. For the many who are already used to a State and or local sales tax, there should be no problem.

8) Fair - An ideal tax plan will be perceived as fair by most reasonable people. There should be no escalating ("progressive") tax rates, no loopholes (no exemptions or deductions), and no privileges (no credits). The needy may be helped with subsidies on the spending side, but should not be used as an excuse to complicate and politicize the tax code on the revenue side.

For many decades, the liberal concept of fairness has gone practically unchallenged. It asserts that the "rich" (rarely defined) should pay escalating, "progressive" (toward what? - socialism?) rates on their taxes because they can afford it, because they don't need the money, because they didn't really earn it, because they are greedy (politics of envy), because they are too successful and need to be punished (zero sum fallacy), and probably some other "reasons" we haven't heard yet.

Many liberals are also extreme egalitarians. So why don't they insist that everyone pay the same amount in a per-capita tax? Don't they believe that everyone's life and liberty are worth the same and should be protected by government for an equal charge? Won't they at least compromise and agree that everyone pay the same rate in a flat tax (on income only)? Gephardt, Brown and others have said they are proposing a "flat tax" at one low rate for most people and then a higher rate or surcharge for the "rich"! Isn't that deceitful, trying to capitalize on the buzz word "flat tax" and then sneak in a "progressive" one?

After "soaking the rich", the liberal's next step in the "fairness" process is to take the tax dollar

and spread them among their bureaucratic buddies in the Federal government. Finally, they distribute the remainder to the "poor" (also rarely defined), which include welfare addicts (several generations on the dole), substance abusers (alcoholics and drug addicts), homeless (many are wandering schizophrenics turned out of mental hospitals), fatherless families (teenage mothers with several illegitimate children), etc., and some truly needy people. For many years, estimates indicate that out of each tax dollar designated for welfare, about 80 cents goes to the Federal bureaucratic overhead and only about 20 cents reaches the "poor" (so this "trickle down" economics?) And yet liberals scream the loudest when conservatives propose that Federal welfare programs be devolved back to the State governments where they can do a better job at less cost.

In regard to the tax code, the liberal concept of fairness demands that the "poor" be exempted from paying any taxes and that low income workers be given a tax credit. In recent years, they have promised (but not yet delivered) tax cuts for the "middle class" (whoever they are).

Even the social conservatives get into the act. They request tax deductions for families with children, home mortgage interest payments, charitable contributions, etc. Even a firm economic conservative like Jack Kemp proposes "enterprise zones" to encourage development within the devastated inner-city areas by giving tax breaks to businesses who locate there.

If we are ever to arrive at the ultimate tax reform -- abolition of the current income tax code, repeal of the 16th Amendment, dismantling of the IRS, and establishment of a simple Federal retail sales tax, we need to convince at least a majority of reasonable people that the strict economic conservative view

of fairness is correct. In most basic terms, to be fair to everyone in the country, the only purpose of the Federal tax code should be to raise revenue for legitimate government expenditures. Thus the code should be strictly an economic document, not a political or social one. Because a growing economy benefits everyone, only the minimum amount of necessary revenue should be extracted, because any amount of revenue taken from the economy will do damage to it. Also, to be completely fair, everyone should pay the same tax rate and no consumption items should be exempted (such as food or medicine.) A logical definition of fairness does not allow punishment of good, hard working, productive people to give benefits to anyone, much less to lazy parasites. Those who truly need and deserve financial assistance may be given subsidies from the Federal spending budget, but the strict economic conservative view is that such help is best provided through State or Local government agencies or private charities.

The current tax code, even after the valiant reform effort of 1986, is so unfair to so many people that we at last have a majority of reasonable people who are convinced it should be thrown out and replaced with something much better. It is so broken it cannot be fixed. Some stop-gap measures may be needed if we have a severe economic downturn, but complete replacement should be delayed until we have thought through the tax-reform process. Does anyone disagree with my rating of 0 - Awful fairness for the current code?

If we can convince an intelligent liberal like Dick Gephardt that his plan (No. 2) with its escalating, "progressive" tax rates is inherently unfair, we will make a great leap forward in the tax-reform process. One of the best arguments on this point I have heard was given by Representative John Ensign (R-NV) during the hearings on "Alternatives to the Federal Income Tax" held by the House Ways and Means Committee (June 8, 1995,

rebroadcast on C-SPAN 2). In a one-on-one debate with Gephardt about his plan, Kemp asked if it is fair to tax Farmer A at a higher rate if he worked hard 7 days a week to make $100,000 in a year, and to tax Farmer B at a lower rate if he goofed off and worked only one day a week to make $10,000 in a year. Gephardt had no direct answer to that excellent question. Yet he and other liberals could become real statesmen if they would admit that their long-held advocacy of escalating tax rates is wrong and unfair, and that for the good of the country they now favor one low flat tax rate. In the meantime I must give the Gephardt plan a 0 rating in fairness.

Senators Nunn and Domenici also continue the unfair practice of escalating rates in their plan (No 3). However, they make a giant step forward in their attempt to eliminate taxation on savings and investment. I do not approve of their method because it keeps income from savings and investment in the tax formula. Nevertheless the fact that these prominent moderate conservatives have reached this milestone is an indication that we only have to convince the liberals that taxing what they term as "unearned" income on savings and investments is wrong and unfair. Hopefully they will soon realize that capital investment is needed to keep an economy growing, which in turn creates new jobs and increased standards of living, and that taxing capital or the gains from investment will slow or reverse this process. Regretably I must give the Nunn-Domenici plan a 2 rating.

If the Armey Plan (No 4) were to pass in its present form, it would be a major achievement in tax reform from the fairness and other standpoints. It would prove that we have reached the goals of eliminating escalating tax rates and replacing them with one low flat rate, eliminating taxes on savings and investments, and eliminating many deductions, credits, etc. One problem I have with his plan: he gives exemptions of $13,100 to single people, of $36,800 to married couples with two children, etc. Thus he will enlarge the class of non-taxpaying voters who naturally will use their increasing political clout to support elected officials who promise to maintain their status or increase their level of exemptions and their numbers in a never ending assault on the tax base, with increasing unfairness to the remaining taxpayers. I

fully realize that such large exemptions produce a "progressivity" such that those with higher rates will pay higher effective rates. That point alone may garner enough votes for passage from liberals who remain convinced that the only fair tax is one that taxes the "rich" at ever higher rates. The large exemptions also are a concession to social conservatives who want tax incentives for families, etc.; however, instead of a continuing set of headaches as each deduction is passed, they get only one large exemption in a lump sum. I do doubt they will vote in favor of the initial plan, but they will continue to tinker around the edges. Is it fair to give a big deduction to a handsome hunk who got a homely rich girl pregnant, had a shotgun wedding, and wound up in a cushy vice-president job in her father's office, and not give one to a hard working, ugly guy who cannot get a date much less get a girl to marry him? (I call that "facial discrimination"). Armey proposes a tax rate of 17%, which is reasonable. However, because it is an income-based tax, I would expect the liberal-conservative tug of war to raise or lower the rate to continue indefinitely. Also I see an ongoing battle to add escalating rates and to reinstate a tax on savings and investments. With those problems, I can give the Armey Plan only a 3 rating.

The Brown Plan (No. 5) is rated a 1 because it is slightly fairer than the current tax code, but unfairly hits the public with a double-based tax on both income and consumption. Instead of answering the important question as to whether income or consumption should be taxed on the Federal level, Brown takes the chicken way out and proposes to tax both. One of the greatest fears in the current tax reform debate is that a VAT will be introduced at a low rate in addition to the income tax, and that rather will be eliminated in spite of promises to the contrary. The Brown Plan starts out both with relatively low rates, but the risk is high that one or both will be raised routinely and unfairly.

If the Value-Added Tax Plan (No. 6) passes, and the income tax is eliminated, a great victory in the battle of income vs consumption taxes will have been won. If the income tax with all its inherent problems can be buried forever the focus of the debate can shift to which is better, the VAT or a retail sales tax. A VAT may be designed that could be reasonably fair to all concerned. However, if some European tricks are introduced, the total tax may be hidden from the customer, some items may be exempted (food, medicine, etc) which would be unfair to producers of other goods or services, and a bookkeeping nightmare

may hit the wholesalers and retailers. If the total cost to the consumer would be the same with either the VAT or retail tax, both may appear to be fair. However I expect that the costs to the wholesalers of paying their part of the VAT may be significant, especially if they have to tangle with the IRS or a Federal VAT office, so they would logically add those costs to their prices. Thus the customer would pay a higher price under the VAT plan. Even if the price and the tax would be the same, why not save the wholesaler the grief of calculating, recording, and transmitting their taxes (to the IRS), and have only one tax at the retail level. Because of the potential problems with the VAT I rate it a 3.

If the National Retail Sales Tax Plan (No. 7) passes (and the income tax is eliminated) it would mean that the VAT lost in the consumption tax debate. The customer should be better off than with the VAT. However, the retail business may be unfairly impacted by the entire weight of the new tax. Adding a Federal sales tax of say 20% to a state/local tax of 5 to 15% may scare away a lot of potential customers, at least initially. One suggestion under this type of plan is to hand a cash advance of $5,000 to every low income person in the country. That may be fine to recipients in small towns, but it would be grossly unfair to those in big cities where the cost of living is higher. Moreover, it would be unfair to the high income people, and the line between low and high cannot be drawn fairly on the national (or even the local) level. Another suggestion under this plan is to exempt some necessities from the sales tax, such as food, medicine, rent etc. Not only would that be unfair to producers of other goods and services, but also the tax dodgers would have a field day re-classifying to all brandy as "medicinal", etc. Some who advocate this plan indicate that the taxes would be sent from the retail businesses to the IRS. The number of IRS agents (probably in the form of secret police) spying on businesses may be much less than with the VAT, but there still would be too many prowling the country, and even a small number would put an unfair burden on the retailers. Even with these problems, I rate this plan as a 4.

Finally, we come to the fairest of them all, the Unified Retail Sales Tax Plan (No. 8), rated as a 5. If it passes, the income tax, the I.R.S., the 16th Amendment, the VAT, and many other taxes would be eliminated.

All consumer goods and services, with no exceptions, would be taxed at a uniform Federal rate throughout the country. All consumers would pay that tax, along with the State and local tax with no exceptions. However, two serious problems remain -- the heavy economic impact on retailers and the crushing blow to low income people who may no longer be able to afford bare necessities without economic assistance.

The degree of the impact on retailers will depend on the general economic condition at the time the tax is implemented. If budget reform is successful and Federal spending is reduced down to a reasonable level, the needed revenue would not be so great. Also, and probably closely related, the dual success of both budget and tax reform may allow the GDP to rise a major amount. Thus instead of 20%, the Federal sales tax may only need to be 10% or less. There still would be an impact on the retailers, but at such a low tax rate, it should not be so severe and should not last long.

If the Federal sales tax is to be 20%, at least those who previously paid income tax at an effective rate of 20% or more should break even or do better. Those who had an income tax rate of below 20% may need financial assistance. If the ill-conceived Social Security program could be phased out, low income workers may be exempted early, so the 7.5% F.I.C.A. tax taken out of their paycheck, plus the 7.5% in matching funds sent by the employer, could be added to their paychecks with the instant effect of a 15% raise. Retirees who depend on Social Security for most of their income may get a 20% cost of living increase to be paid out of the new sales-tax revenue (not the trust fund). Any of the above who still need help, low income workers who do not pay the F.I.C.A. tax, and non workers may apply for assistance at a local Community Aid Agency. The CAA can determine what is an adequate amount of assistance based on the need of the individual applicant (not give flat amount or "entitlement"). Funds may be provided by the Local, State, and or Federal revenues; other help may be provided by charities. Again, if the Federal sales tax tax can be lowered to say 10%, the amount of financial assistance would be much less.

9.) Quick - An ideal tax plan will be passed into law so rapidly, will be implemented so easily, and will be accepted so readily that the transition time to change from the current system is minimal. Of course, the current tax code (No. 1) has already been passed, so it gets a maximum 5 rating by default. The Gephardt (No. 2) and Brown (No. 3) plans do not appear to have much support, so they probably will not be passed and are given a 2 rating.

The Nunn-Domenici Plan (No. 3) already has been written and submitted to the Senate as bill number S-722. Because these two moderate conservatives are popular leaders in the Senate, and because they keep an income-based tax, their bill has a fairly good chance of passage, implementation, and acceptance in a fairly short time, so I rate it a 4. (However, I would be disappointed if that bill is considered the best tax reform we can get.)

The Armey Plan (No. 4) has been discussed widely and has much support, especially among House Republicans. It also is an income-based tax, so it too has a good chance of passage, implementation, and acceptance in a short time, so I rate it a 4 also.

The push for a change to a consumption-based tax is led by the Chairman of the House Ways and Means Committee, Bill Archer (R-TX). Although he has not yet decided on a sales tax, a VAT, or even a Nunn-Domenici type consumed income plan, he will have a strong voice in the direction of tax reform from his position in charge of that tax-writing committee. The Ranking Member, Sam Gibbons (D-FL) is working on a Value Added Tax (No. 6.) Sen. Richard Lugar (R-IN) has proposed a plan for a National Retail Sales Tax (No. 7) (but I have not seen it yet.) However, I rate both of these plans as a 3 - Fair, because in spite of the compelling logic to switch to a consumption-based tax, such a radical change from the current system will need to be widely debated both inside and outside of Congress before passage. My proposal for a Unified Retail Sales Tax (No. 8) is the most radical departure from the current plan, and until it gets a sponsor in Congress, I can rate it only as a 2.

The VAT and retail sales plans (Nos. 6, 7, 8) could be implemented quickly, but if they would have a high rate of 20% or more, they would raise everyones cost of living by that amount, and thus would not be readily accepted. Acceptance would be better if the rate is 10% or less, but that would require favorable economic conditions.

Acceptance of the switch to a consumption tax may come hard to some of us senior citizens who have paid a lot of taxes through the years on our hard-earned savings and investments. As we enter our retirement years, we now would be faced with an unexpectedly high tax when we use our nest egg for necessary consumption. Those of us who have appreciable investments should feel that their exemption from taxation is a fair tradeoff. Those who do not may be bitter. In the discussion on fairness (p. 20), I proposed that retirees who depend on Social Security for most of their income may get a 20% (or what ever the consumption tax rate is) cost of living increase to be paid out of the new consumption tax revenue (not the trust fund). That action may bring the others down the road to acceptance.

Many of the tax-reform plans include provisions for eliminating taxes on savings and investments. Such a policy is long overdue. However, before such plans are implemented, some arrangement must be made regarding tax-deferred investments with pre-tax money that have been placed in IRA's, 401K's, 403b's, etc. I suggest that all such money be taxed at a flat rate of 10%, and then all investment money should be treated the same under the new tax laws.

10.) Rigid - An ideal tax plan will be so rigidly constructed that there is no room for political manipulation (vote buying, pork barreling, log rolling, etc.), and that no longer will the tax code be used for social engineering, only to raise revenue. Again the current tax code rates a 0. I fear that the Gephardt (No 2) and the Kemp-Pomeroy (No 3) plans would be subject to such manipulation, so I rate them also as 0. I suspect that the Brown Plan (No. 5) is not much better so I rate it a 1.

The Armey (No 4) and VAT (No 6) plans are much more rigidly constructed, so I rate them each as a 3. However, they could be subjected to some manipulation. The National Retail Sales Tax (No. 7) could be twisted out of shape with a lot of exemptions etc., but I rate it a 4. I see my Unified Retail Sales Tax as being rock-solid rigid, with no room for political manipulation. A few years ago, I would not have had any hope that such a plan could be passed by Congress. But with the new leadership, I am mildly optimistic.

4.) Stable - An ideal tax plan will be so well prepared that no other tax plan will pass for at least 30 years. (May have minor adjustments of tax rates.) With such long-term stability, individuals and businesses can do more accurate financial planning. (Still have unknown rate of inflation.)

The current tax code is doomed and the current fever for tax reform so it is rated a 0 again. The Gephardt (No. 2) and Nunn-Domenici (No. 3) Plans appear to me to be so unbearable that they probably would not last as much as five years, so I rate them also as 0. If the Brown Plan (No. 5) ever passed, it might last a while longer because many would want to give the VAT part a chance, so I rate it a 1.

The Dorney Plan (No. 4) has at least a fair chance at longevity, so I rate it a 3. However, I fear that a liberal-conservative tug-of-war would break out with wide swings of raising and lowering of tax rates, depending upon who is in power. The swings would have to be at least a year or two apart, because it would take that much time to pass new laws on an income-based tax.

The VAT Plan (No. 6) is also rated a 3. If it is passed, it may last a few years, but I foresee so many problems with regulation by the IRS, that there may be a nationwide revolt, especially by wholesalers to have it repealed.

The National Retail Sales Tax (No. 7) is given a 4 because it could last many years if the regulations of the retailers by the IRS does not get out of hand. The Unified Retail Sales Tax (No. 8) is given a 5, because as the ultimate in tax reform it could last forever.

The income-based tax plans are not stable in the long run, but they are the most run because the political process moves so slowly. On the other hand, the VAT and sales taxes are more stable in the long run, but the rates may be changed often, if economic conditions dictated, and the tax law would permit such adjustments by an independent board of reasonable experts. Market forces would keep any such adjustments in a narrow range.

Would it be wonderful if we could make our friends' plans and have some hope that the tax code would last 30 years or more?! (We would still have the unknown evil of inflation, but does anyone want to join my movement to phase out the Fed and reinstitute the gold standard.)

1[illegible]) Liberating - An ideal tax plan will result in the abolition of the Internal Revenue Service and repeal of the 16th Amendment to the U.S. Constitution (which brought us the income tax in 1913).

The current tax code, the Gephardt Plan (No 2), the Nunn-Domenici Plan (No. 3) and the Brown Plan (No 5) are so tied to both the IRS and the income tax concept that they all are rated as 0-Useful. The Armey Plan (No 4) is based on the 16th Amendment, but it could reduce the role of the IRS so it is rated as 2-Poor. The VAT Plan (No 6) is more dependent on the IRS but not the 16th Amendment, so it is rated also as 2. The National Retail Sales Tax (No 7) is less dependent upon the IRS, so it is rated as 3.

Only under the Unified Retail Sales Tax Plan (No 8) would it be possible to both abolish the IRS (may replace it with a Federal Tax Office to collect the revenue from the States) and repeal the 16th Amendment. Under this plan, it would be possible to abolish the IRS and keep the 16th Amendment on the books, but we would always dread the possibility of the return of the income tax. We need to get rid of both to restore some of our lost liberty, and increase our freedom from fear.

Chairman Bill Archer is our heroic leader and standard bearer in this movement to "pull the present income tax system up by its roots", abolish the IRS and repeal the 16th Amendment. These goals appear to be so important to him that it seems as if he wants these to be the first priorities of tax reform. However, I believe they belong at the end of the analysis of the qualities of tax reform in logical order. Thus they will be magnificent rewards at the end of the glorious tax reform process!

Sam Thompson III
UTEP P.O. Box 68306
El Paso, Texas 79968-9991

June 22, 1995

JUNE 9, 1995

PHILIP MOSLEY- CHAIRMAN
WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES
LONGWORTH HOUSE, WASHINGTON, D.C. 20515

SUBJECT: HEARINGS REGARDING FEDERAL TAX SYSTEM

ATTENTION: MR. PHILIP MOSLEY

DEAR MR. MOSLEY:

WE APPRECIATE THIS OPPORTUNITY TO HAVE A DIRECT VOICE IN THIS VERY CRUCIAL ISSUE PRETAINING THE FEDERAL TAX SYSTEM.

WE WOULD LIKE TO SEE THE INTERNAL REVENUE SERVICE ABOLISHED. MOST OF OUR HARD EARNED MONEY IS GOING FOR TAXES. THE I R S IS GAINING MORE AND MORE CONTROL. IF YOU HAVE A PROBLEM, YOU ARE GUILTY UNTIL PROVEN INNOCENT.

AS SMALL BUSINESS OWNERS BESIDES BEING CITIZEN TAXPAYERS, WE HAVE HAD MORE THAN OUR SHARE OF PROBLEMS WITH THE IRS. SOMETIMES THESE PROBLEMS HAVE TAKEN MONTHS TO RESOLVE. THEY ARE EXTREMELY DISORGANIZED AND EVEN WITH CANCELLED CHECKS AND COMPLETE BACKUP RECORDS, THE AVERAGE PERSON HAS EXTREME DIFFICULTY IN PROVING THEIR CASE BECAUSE THE IRS WILL NOT LISTEN. WE HAVE BEEN HARASSED, THREATENED ETC AND WE ARE REALLY SICK OF THEIR TACTICS.

LETS GET BACK TO THE CONSTITUTION AS IT WAS WRITTEN. LETS GET BACK TO A GOVERNMENT RUN BY THE PEOPLE, FOR THE PEOPLE.

VERY TRULY YOURS,

GAIL E. TIEMAN

ROGER K. TIEMAN

14206 MINES RD. LIVERMORE,CA. 94550

United States of America
Zero National Debt and
National Economic Stimulus Foundation

"Zero Debt"

Became a project of mine in early 1993 after seeing Senators Rudman and Tsongas on television, addressing the deficit and the lack of action to reduce it, or even make it Revenue Consumption Neutral, or even slow the pace of ever increasing debt.

During this approximate time frame, I read an article, "Paying Back Your Uncle" - "One Man's Plan to Put a Dent in the National Debt" by John Rothchild in the local, national, print media: Kay Fishburn, a registered nurse, of New Berlin, Wisconsin, formed a group, "Citizen's for a Debt-Free America"; utilizing mailing lists; sent cards to addresses, soliciting donations to the Bureau of the Public Debt, Dept. "G", Washington, DC.

The result of this effort was 20 million dollars donated by the addresses from 1982 to 1993. If this amount was applied against the National Deficit, and this was converted to annual taxes, it would amount to two million dollars in annual taxes that did not have to be paid or could be used for some other purpose.

The immediate effect on me was, all of this without any real incentive, only the patriotic generosity of the citizens, who populate this wonderful United States of America. What would be the result of a program, which included an understandable incentive - ***MONEY?***

The people desperately want to help their country and at the same time help themselves. The government has not provided a medium by which they can participate in this reformation.

This program must be self-supporting, uncomplicated, with immediate payment action, and perpetual endurance.

The main bi-product of this program is new employment, with a living wage and benefits: The Postal Service, New Revenue; the Foundation Banking Facility, New Accounts with increasing volume of deposits, and finally, the Foundation Staff required, around the clock, to produce and process the print, out and in, generated to successfully conclude each unit in this perpetual cycle.

The rethink, rewrite process over this approximately two year period can be addressed descriptively in a poem which originated in my mind in late 1993:

HOPE
By W. E. McLeod

May your dreams become expectations
May your expectations become possibilities
May your possibilities become probabilities
And
May your probabilities become facts

The public awaits your positive action in the establishment of this foundation, in order that they may begin their financial assistance in this reformation to make a positive change, regardless of how small, in our individual condition.

The "Zero Debt" presentation follows and I have the implementation in mind. Initial contact has been made with the telephone/computer entity capable of successfully completing the project in minimum time.

I shall proceed in the private sector; however, I favor Government action. I am available at your convenience for your questions, and may God bless you all.

W.E. McLeod

VETS HOME OF CA
PO Box 1200
Yountville, CA 94599-1297

(707) 944-0462

(800) ZERO DEBT
(800) 376-3328

(800) GRANTXR
(800) 472-6897

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

DEDICATION

I dedicate this foundation to my mother, Johni, who gave her life for mine at my birth; my grandmother and grandfather, Maggie C. and John H. Givens, of Laurel Hill, Okaloosa County, Florida, who gave me their best for the remainder of their lives; my family(ies); my children, their children, et. seq.; Harry Martin, Editor and Publisher, Napa Sentinel, and Napa Sentinel the Magazine, "North American Investigative Journal", who rendered invaluable assistance; my publisher and contributors, who had faith and took a chance on this unknown; the endless dear friends and wonderful people throughout our great country and the world, with whom I have very special friendships, associates, acquaintances, and or have met only briefly in passing; those with whom I have differed in not seeing eye-to-eye on issues, as well as those who have been unable to utilize my qualifications for whatever reasons; and those, who, I hope, even in some small way, through the effect(s) of our effort(s) in this fellowship, may benefit in improving their lives. I am eternally grateful, and my sincere thanks to you all.

W.E. McLeod
Founder

HOPE
By W.E. McLeod

May your dreams become expectations
May your expectations become possibilities
May your possibilities become probabilities
and
May your probabilities become facts

© W.E. MCLEOD 1994

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A Non-Profit Foundation"

Not affiliated with the U.S. Government, or any other government, state, county, or city

CHARTER

The State of _____

PURPOSE

Receive grant applications with donations and/or fees; account for; and prudently manage same.

ACTIVITY

Disposal of donations and/or fees received, in one million dollar, $1,000,000, units, less actual, prudent, foundation expenses, to the "Deficit Reduction Fund", created by the President of the United States, through Executive Order 12858 of August 4, 1993, and to disseminate timely national economic stimulus grants of one million dollar, $1,000,000, units to individual applicants.

W.E. McLeod
Founder

© W.E. MCLEOD 1995

United States of America

A Non-Profit Organization

Help Your Country - Help Yourself

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"
"A Non-profit Foundation"

Not affiliated with the U.S. Government, or
any other government, state, county, or city

Information concerning Economic Stimulus Grants

ONE MILLION DOLLARS

Readily available

PLEASE CALL TOLL-FREE
1 (800) Zero-Debt
1 (800) 376-3328

_____

Location)

© W.E. MCLEOD 1994

"ZERO DEBT" Voice Tape

You have reached "Zero Debt", _____.
(location)

For information concerning your application for a National Economic Stimulus Grant of one million dollars

at the tone:

please leave your name, and mailing address. Complete information and instructions will be mailed to you.

Your name and mailing address will be used for this mailing, only, and will be destroyed immediately upon completion of this mailing.

Thank you for your interest

Beep:

© W.E. MCLEOD 1994

"ZERO DEBT" Mailgram

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A non-profit foundation"

Not affiliated with the U.S. Government, or any other government, state, county or city

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Receive grant applications with donations and/or fees; account for; and prudently manage same.

ACTIVITY
Disposal of donations and/or fees received, in one million dollar, $1,000,000, units, less actual, prudent, foundation expenses, to the "Deficit Reduction Fund", created by the President of the United States, through executive order 12858 of August 4, 1993, and to disseminate timely national economic stimulus grants of one million dollar, $1,000,000, units to individual applicants.

Dear fellow American,

I feel sure, that you have been made aware of the existing and estimated future condition of our national debt and our economy, by the newspapers, TV, etc.

This deplorable situation motivated me, hopefully, with the support of my fellow Americans, to found the above described foundation for the purpose of making a positive change, regardless of how small, in our individual condition.

The successful effects of this program are dependent upon the financial assistance from those of you, who desire to be a part of this reformation.

PLEASE HELP YOUR COUNTRY - HELP YOURSELF!

Please make your grant application donation and/or fee payable to "ZERO DEBT". Please place your grant application and donation and/or fee, $20.00, in the envelope enclosed. Please do not send cash!

Upon receipt of your grant application and donation and/or fee, a letter of receipt, containing an identifying application number, will be mailed to you.

All donations and/or fees shall be utilized as described above, and this program shall be conducted by the undersigned as described above, and in accordance with all applicable law(s).

Thank you,

W.E. McLeod
Founder
© W.E. MCLEOD 1995

"ZERO DEBT" National Economic Stimulus Grant Application

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A non-profit foundation"

Not affiliated with the U.S. Government, or any other government, state, county, or city

I, hereby, declare, that I am a legal adult, and I apply for a National Economic Stimulus Grant of one million dollars, $1,000,000, from the United States of America, Zero National Debt and National Economic Stimulus Foundation, "ZERO DEBT".

I understand, that it is necessary that I complete this grant application with an accompanying donation and/or fee, $20.00, to constitute a filing; that the grant will be made to one of the 100,000 applicants comprising each unit; one application number being selected at random from each unit of 100,000 applications and donations and/or fees received, as received; that application identifying number 100,000 shall end each unit, with the next application and donation and/or fee being applied to and beginning the next unit, 100,000; and that I may apply again to any new unit.

I understand, further, that a portion of my donation and/or fee will be utilized to pay on reducing our national debt through the payment of one million dollar units to the "Deficit Reduction Fund", created by the President of the United States, through executive order 12858 of August 4, 1993, and prudent, foundation related expenses.

A letter of receipt, containing an identifying application number, will be mailed to me, by the foundation, upon the receipt of my application and donation and/or fee; however, a donation and/or fee drawn on "Insufficient Funds", releases "ZERO DEBT" from any and all obligation(s) to the applicant.

$ _____ .00 Date: _____

_____ _____
Signature Address

_____

_____ _____
Name: First - Initial - Last

Please do not write below this line

$ _____ .00 IDENTIFYING NUMBER

__/_ _ _ _/_ _ _ _

© W.E. MCLEOD 1995

"ZERO DEBT" National Economic Stimulus Grant Application Receipt

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A non-profit foundation"

Not affiliated with the U.S. Government, or any other government, state, county, or city

Dear fellow American,

Thank you for your fellowship, support, and participation, your grant application and donation and/or fee, $20.00, in the program, "HELP YOUR COUNTRY - HELP YOURSELF", of the United States of America, Zero National Debt and National Economic Stimulus Foundation, "ZERO DEBT".

I hope that your interest and participation will continue, as subsequent grants are funded and granted, and a grant application form, and a, "POSTAGE PAID", return envelope is enclosed with each grant application receipt. Subsequently, should you find yourself without a grant application form, you may call, TOLL FREE, 1-800-ZERO-DEBT-376-3328, and the items/information will arrive immediately.

Information concerning the disposition of your donation and/or fee is as follows:
(name of bank and location)
50% "Zero Debt" General Account and the "Deficit Reduction Fund" Trust Account
50% National Economic Stimulus Grant Trust Account.

The active disposition of the accounts will be made on the next bank working day after the individual unit total reaches two million dollars, $2,000,000 or 100,000 applicants with $20.00 filing donations and/or fees; the one million dollar, $1,000,000, National Economic Stimulus Grant procedure will begin; the recipient of the National Economic Stimulus Grant will be notified via Western Union at the mailing address contained in the grant application; the balance in the "ZERO DEBT" General Account will be transferred to the "Deficit Reduction Fund" Trust Account; and the interest from the two trust accounts will be transferred to the "ZERO DEBT" General Account to meet prudent foundation expenses prior to the arrival of sufficient grant applications with donations and/or fees for the subsequent unit.

The remuneration to the founder will be a fee of one-tenth-of-one percent, 0.1%, decimal 0.001, or one thousand dollars, $1,000, from each one million dollars, $1,000,000, received, plus prudent personal, foundation related expenses, supported by valid receipts.

I trust, that the foregoing information is sufficient to satisfy your interest in the disposition of your donation and/or fee; your continued interest is appreciated; and your identifying application number appears below.

Date: _____ $ _____ .00 Number: __/__ __ __-__ __ __

Thank you

W.E. McLeod
Founder

© W.E. MCLEOD 1995

"ZERO DEBT" National Economic Stimulus Grant Application

HELP YOUR COUNTRY - HELP YOURSELF

United States of America
Zero National Debt
and
National Economic Stimulus Foundation
"ZERO DEBT"

"A non-profit foundation"

Not affiliated with the U.S. Government, or any other government, state, county, or city

I, hereby, declare, that I am a legal adult, and I apply for a National Economic Stimulus Grant of one million dollars, $1,000,000, from the United States of America, Zero National Debt and National Economic Stimulus Foundation, "ZERO DEBT".

I understand, that it is necessary that I complete this grant application with an accompanying donation and/or fee, $20.00, to constitute a filing; that the grant will be made to one of the 100,000 applicants comprising each unit; one application number being selected at random from each unit of 100,000 applications and donations and/or fees received, as received; that application identifying number 100,000 shall end each unit, with the next application and donation and/or fee being applied to and beginning the next unit, 100,000; and that I may apply again to any new unit.

I understand, further, that a portion of my donation and/or fee will be utilized to pay on reducing our national debt through the payment of one million dollar units to the "Deficit Reduction Fund", created by the President of the United States, through executive order 12858 of August 4, 1993, and prudent, foundation related expenses.

A letter of receipt, containing an identifying application number, will be mailed to me, by the foundation, upon the receipt of my application and donation and/or fee; however, a donation and/or fee drawn on "Insufficient Funds", releases "ZERO DEBT" from any and all obligation(s) to the applicant.

$ _____ .00 Date: _____

_____ _____
Signature Address

_____

_____ _____
Name: First - Initial - Last

Please do not write below this line

$ _____ .00 IDENTIFYING NUMBER

__/__ __ __/__ __ __

© W.E. MCLEOD 1995

Western Union Mailgram

Congratulations,

Your faith, support, and participation in the program, "Help Your Country - Help Yourself", of the United States of America, Zero National Debt and National Economic Stimulus Foundation, "Zero Debt", has resulted in your being selected to receive the National Economic Stimulus Grant Unit "___", of one million dollars, $1,000,000. Please telephone, toll free, 1-800-GRANTXR, 472-6897 to discuss the arrangements for transferring this grant to you. Looking forward to hearing from you soon.

Sincerely,

W.E. McLeod
Founder

© W.E. MCLEOD 1994

WESTERN UNION FSI
RENO, NEVADA 89502-2375

WESTERN UNION MAILGRAM

014128001744 08/06/93 OKAC

W E MCLEOD
VETS HOME OF CALIFORNIA C220B PO BOX 120
YOUNTVILLE CA 94599

THIS IS A CONFIRMATION COPY OF THE FOLLOWING MESSAGE:

7079440462 TDBN YOUNTVILLE CA 38 08-06 0555A EST
93218099927026 73-1

PRESIDENT BILL CLINTON
WHITE HOUSE DC 20500

DEAR MR PRESIDENT

RESPECTFULLY REQUEST "A CERTIFIED TRUE COPY" OF EXECUTIVE ORDER CREATING "DEFICIT REDUCTION TRUST FUND". MY HUMBLE OPINION: HISTORY WILL EQUATE THIS/YOUR USE OF EXECUTIVE POWER ON THE VERY HIGHEST ORDER. THANK YOU VERY MUCH.

RESPECTFULLY,

W E MCLEOD
(707) 944-0462
VETS HOME OF CALIFORNIA C220B PO BOX 1200
YOUNTVILLE CA 94599

14959

12:09 EST

MGMCOMP

To reply by Mailgram Message, see reverse side for Western Union's toll-free numbers.

THE WHITE HOUSE

WASHINGTON

October 26, 1993

W. E. McLeod
Post Office Box 1200
Yountville, California 94599-1297

Dear Friend:

Thank you for your letter regarding the economic package I signed into law on August 10, 1993.

The passage of this plan will help us put America back in control of its economic destiny, create 8 million new jobs, and improve our standard of living. To accomplish these goals, my plan will cut the deficit by over $500 billion over five years. Half of this reduction will come from the largest decrease in deficit spending in the history of our nation, cutting over $250 billion through more than 200 specific budget cuts.

The other nearly $250 billion in deficit reduction will come from restoring fairness to the tax code, by asking those who have the most to contribute the most to reducing the deficit. For every $10 of deficit reduction, more than $5 will come from spending cuts, almost $4 will be paid by the wealthiest Americans -- those making more than $100,000 per year -- and only $1 will be paid by the middle class. The working poor -- those earning less than $27,000 per year -- will be protected by a tax break. Moreover, to lock in these savings, every penny of spending cuts and tax increases will be put in a Deficit Reduction Trust Fund.

Since I proposed my plan, home mortgage interest rates have fallen to their lowest level in more than 20 years, and over 1 million new jobs have been created. The low interest rates that this plan can help us maintain and the plan's tax incentives for small businesses will help us to continue this economic growth and job creation.

America has chosen change over gridlock. I hope I can count on your future support.

Sincerely,

Bill Clinton

PRESIDENT OF THE UNITED STATES
Executive Order 12858 of August 4, 1993 -- By the President of the United States of America: Deficit Reduction Fund
(FEDREGISTER 58 FR 42185 08/06/93; 93 lines.)
Presidential Documents
Item Key: 19245
--- --- --- --- --- --- --- --- --- --- --- --- --- --- --- --- --- ---

Executive Order 12858 of August 4, 1993

Deficit Reduction Fund

By the authority vested in me as President of the United States by the Constitution and the laws of the United States of America, including sections 1104 and 1105 of title 31, United States Code, it is hereby ordered as follows:

Section 1. Purpose. It is essential to guarantee that the net deficit
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reduction achieved by the Omnibus Budget Reconciliation Act of 1993 is dedicated exclusively to reducing the deficit.

Sec. 2. Deficit Reduction Fund.

(a). Establishment of the Fund. There is established a separate account in the Treasury, known as the Deficit Reduction Fund, which shall receive the net deficit reduction achieved by the Omnibus Budget Reconciliation Act of 1993 as called for in subsection (b) of this order.

(b) Amounts in Fund. Beginning upon enactment of the Omnibus Budget Reconciliation Act of 1993, the Deficit Reduction Fund shall receive any increases in total revenues resulting from enactment of such Act on a daily basis. In addition, on a daily basis, the Secretary of the Treasury shall enter into such account an amount equivalent to the net deficit reduction achieved as a result of all spending reductions resulting from such Act. The cumulative fiscal year amounts for the combination of all such revenue increases and spending reductions shall be equal to:

(1) for fiscal year 1994, $ 60,292,000,000;

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(2) for fiscal year 1995, $ 70,437,000,000;

(3) for fiscal year 1996, $ 92,061,000,000;

(4) for fiscal year 1997, $ 125,881,000,000;

(5) for fiscal year 1998, $ 146,939,000,000.

Within 30 days of enactment of the Omnibus Budget Reconciliation Act of 1993, the foregoing amounts may be adjusted by the Director of the Office of Management and Budget to reflect the final scoring of such Act.

(c) Status of Amounts in Fund. (i) The amounts in the Deficit Reduction Fund shall be used exclusively to redeem maturing debt obligations of the Treasury of the United States held by foreign governments in the amounts specified in subsection (b)

(ii) The amounts in the Deficit Reduction Fund as set forth in subsection (b) that result from increases in total revenues and spending reductions shall not be available for new spending or to finance measures that increase the deficit for purposes of budget enforcement procedures under the Balanced Budget and Emergency Deficit
-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)
Control Act of 1985 (2 U.S.C. 901-922).

(d) Effect on Other Funds. Establishment of and transfers to the Deficit Reduction Fund shall not affect trust fund transfers that may be authorized or required by provisions of the Omnibus Reconciliation Act of 1993 or any other provision of law.

Sec. 3. Requirement for the President To Report Annually on the Status of the Fund. The Director of the Office of Management and Budget shall include in the President's Budget transmitted under section 1105 of title 31, United States Code, information about the Deficit Reduction Fund, including a separate statement of amounts in and Federal debt redeemed by that Fund.

Sec. 4. Implementation. The Secretary of the Treasury and the Director of the Office of Management and Budget shall each take such actions as may be necessary, within their respective authorities, promptly to carry out this order.

Sec. 5. Effective Date. This order shall take effect upon enactment of the Omnibus Budget Reconciliation Act of 1993.

WILLIAM J. CLINTON
-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)

WILLIAM J. CLINTON
-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)

-More- (Q = Quit, G = Go, Space Bar = Next Line, Return = Next Screen)-

THE WHITE HOUSE,

August 4, 1993.

Editorial note: For the President's remarks on signing this Executive order, see issue 31 of the Weekly Compilation of Presidential Documents.

[FR Doc. 93-19101

Filed 8-5-93; 10:30 am]

Billing code 3195-01-P

Press return to display next item or enter GO, BACK, HELP or STOP

STATEMENT OF VHA INC.
TO THE COMMITTEE ON WAYS AND MEANS
OF THE UNITED STATES HOUSE OF REPRESENTATIVES
ON REPLACING THE FEDERAL INCOME TAX

Submitted by Mr. Daniel P. Bourque
Senior Vice President
VHA Inc.
220 East Las Colinas Blvd.
Irving, TX 75039-5500

VHA Inc. (formerly, Voluntary Hospitals of America, Inc.) appreciates the opportunity to submit this testimony on proposals to replace the current Federal income and estate taxes. Structural tax reform is of great interest to not-for-profit organizations nationwide, and a serious matter for charitable hospitals throughout the United States.

VHA is the largest alliance of not-for-profit hospitals in the United States. It is comprised of more than 1,200 health care organizations. The purpose of VHA is to offer health care organizations information, products, and services to improve community health, clinical quality, and operational efficiency.

VHA's mission is directly related to the viability of the charitable not-for-profit community hospital in the face of increasingly competitive economic pressures. Indeed, the need to develop economic strategies to preserve the not-for-profit hospital's charitable mission, and at the same time ensure its financial survival, is the principal policy goal which underlies VHA programs and activities.

Role of the Not-for-Profit Sector

Historically, the not-for-profit sector has filled an important role in American society. First, it has served to lessen the burdens of Federal and State government. It has done so by taking on tasks which might otherwise fall to governmental agencies, but which are handled more efficiently and humanely by publicly supported charities. Such tasks have included providing food and shelter for the poor, and urgent and routine medical care for the indigent. Second, it has provided goods and services deemed to be inherently beneficial to the public--e.g., education, care for the elderly, and community-focused health care. Traditionally, the not-for-profit sector has used volunteers and funds provided by charitable contributions to subsidize the cost of such goods and services so that they may be distributed more widely.

Today, the not-for-profit sector has an even larger role. Nearly one million charitable, educational, religious, health and social welfare organizations nurture and sustain the values that frame American life. They promote altruism in a society that rewards individual achievement; and pluralism in a society sometimes threatened with divisiveness. In so doing, they teach, mediate, inspire and heal.

Struggling to contain and ultimately eliminate deficit spending, the U.S. Congress is considering substantial cutbacks in the Federal government's funding of education, various social welfare and insurance programs (including Medicare and Medicaid), and the arts. Budgetary cuts in these areas would put even greater pressure on not-for-profit organizations to provide these important services and programs.

Special Role of Not-for-Profit Health Care

Not-for-profit hospitals continue a centuries-old tradition of healing and comforting those who suffer -- the sick and dying, victims of accidents and crime. Through them, the burdens of meeting the health care needs of communities and the special populations within them are shared with government. Historically, they have shouldered with the Federal, State and local governments the responsibility for meeting a broad range of health care needs of the communities in which they are located. Indeed, throughout American history, most general

hospital care, institutional outpatient services, and formal home care have been provided by not-for-profit, non-governmental organizations. Moreover, many of the critical improvements in medical care have been developed at not-for-profit institutions.

Not-for-profit hospitals, which comprise approximately 60% of all community hospitals in the United States, have consistently provided a different and broader range of services than their for-profit counterparts. Not-for-profit hospitals provide more medical research, education, community health care services, and specialty services than their proprietary counterparts. They are also committed to providing essential -- if sometimes unprofitable -- services such as 24-hour emergency rooms, neonatal intensive care, burn units and care for AIDS patients. Not-for-profit hospitals are social charities as well as providers of medical services. Volunteers provide a wide range of practical help from transportation to hospital visits.

Not-for-profit hospitals today have grown into sophisticated health care provider organizations, but their charitable role is no less important. Moreover, Congress' decision not to enact health reform legislation mandating universal coverage suggests that voluntary hospitals may be required to assume even greater burdens now and in future years. Impending Medicaid and Medicare budget cuts will pose additional challenges for community-based health care providers. As in the past, not-for-profit charitable hospitals will be called upon to meet community health needs that government is unable or unwilling to fulfill.

Importance of Tax Benefits for Not-for-Profit Organizations

The exemption from income tax of charitable and other not-for-profit organizations is long-standing.[1] The exemption from income tax permits not-for-profit organizations to set aside or retain earnings for future capital improvements. It also provides a uniform foundation for many state tax exemptions.

A second key provision is the deduction for charitable contributions. Congress has long sought to encourage charitable donations through the tax system. The deduction for charitable giving has existed almost as long as the income tax itself. Charitable giving goes hand in hand with volunteering as the primary means by which many not-for-profit organizations are able to carry out their mission. In the health care context, individual and corporate contributions are essential funding sources for medical research and education.

A third tax provision that directly benefits charitable organizations is the exclusion for tax-exempt bond interest. Charitable organizations with significant capital needs, such as hospitals and universities, rely on tax-exempt financing to lower their cost of capital. Since not-for-profit hospitals cannot by law issue stock to raise money through the equity markets, debt and retained earnings are their only sources of capital for much needed expansions, renovations and consolidations.

Income Tax Restructuring

VHA strongly supports the Congress' efforts to make the federal tax system simpler and more efficient. It also applauds Chairman Archer for pursuing reforms that would encourage savings and investment, improve the international competitiveness of U.S. business and increase tax revenues from the underground economy and non-compliant taxpayers. In addition, VHA appreciates the Chairman's decision to defer offering a specific consumption tax proposal until he has had an opportunity to fully examine the various alternatives.

However, the movement to completely replace the federal tax system poses a number of problems for not-for-profit organizations. It is our hope that these problems will be

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[1] Prior to the enactment of the first corporate income tax, the tax "exemption" of non-profits existed primarily by statutory omission. Customs and excise taxes applied only to specified business entities and activities. When the income tax of 1894 imposed a flat two percent rate on all corporate income, Congress provided exemption for not-for-profit charitable, religious and educational organizations, as well as certain not-for-profit mutual organizations. Comparable measures were subsequently enacted after the Sixteenth Amendment was ratified, firmly establishing the principle of tax exemption of not-for-profit organizations.

faced squarely and resolved creatively so that the unique role of not-for-profit organizations will not be compromised or their influence eroded.

Issues Posed for Not-for-Profit Organizations by Structural Tax Reform

Structural tax reform could adversely affect many not-for-profit organizations. Issues that particularly concern VHA as an alliance of not-for-profit health care organizations include the following:

- Whether the New Taxes Will Apply to Not-for-Profit Organizations

  Most, but not all, of the proposed consumption taxes apparently would apply to not-for-profit organizations that provide goods and services. Exemption from such taxes may be tied to a particular service or product, rather than the type of entity that supplies it. Moreover, it is unclear whether the "Business Tax" portion of the proposed "Flat Tax" would apply to tax the income that not-for-profit organizations derive from activities related to their exempt purpose.[2] **VHA believes that Section 501(c)(3) organizations should be exempted from any such new taxes, except with respect to unrelated business income (or valued-added) that would be subject to tax under current law.**

- Whether Exemption from a Consumption Tax May Result in Partial Taxation

  Exemption from income tax completely eliminates tax on not-for-profit organizations. Exemption from a consumption tax only exempts the value added by the not-for-profit organization from tax, not the tax on the goods and services it purchases from other businesses. Under Canada's goods and services tax ("GST"), charitable not-for-profit organizations are exempt with regard to most of their services, but also are allowed a 50 percent input credit.[3] **VHA strongly suggests that the Committee consider a mechanism to enable a not-for-profit organization to receive a credit for tax previously paid on inputs, as well as an exemption for its own valued added.**

- Whether Essential Tax Incentives Will be Eliminated or Diluted

  Not-for-profit organizations depend not only on exemption from income tax, but also on current law incentives for charitable deductions and tax-exempt bond financing. Many of the reform proposals, by eliminating or diluting the exclusion for tax-exempt bond interest, would sharply increase not-for-profit hospitals' "cost of capital" at a time when they simply cannot afford it. Such proposals would also eliminate or restrict the tax incentives for individual and corporate donations that fund medical research and community health initiatives. **VHA would like to work with Chairman Archer and his staff to maintain appropriate incentives for meeting not-for-profit hospitals' capital needs and charitable giving objectives.**

- Whether a Consumption Tax Will be Imposed on Value Added When Goods or Services are Provided at Low or No Cost

  Although it may seem absurd to even suggest that hospitals' "charity care" or university scholarships could be subject to a consumption tax, the staff of the Joint Committee on Taxation has noted that under some consumption tax theories, tax would be imposed on all value added by a

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[2] See Staff of the Joint Committee on Taxation, Description and Analysis of Proposals to Replace the Federal Income Tax (JCS-18-95: June 5, 1995), p. 36.

[3] Id. at p. 102, fn. 175.

not-for profit organization or governmental entity, including any foregone profit or subsidy element in goods or services offered at no charge or at "below-market" prices.[4] **VHA strongly urges the Committee to reject any approach that would impose tax on charity or subsidized care.**

- Any Erosion in the Federal Tax Exemption for Charitable Health Care Organizations May Trigger Increased State Taxes

  Many State tax exemptions derive at least in part from exemption from federal income tax under Section 501(c)(3). Even hospitals that operate on extremely narrow margins or at a loss for income tax purposes would have substantial property tax liability if exemption standards were altered. In addition, repeal of Section 501(c)(3) could trigger adverse income and sales tax consequences in many States. **VHA urges the Committee to retain Section 501(c)(3) even if it changes the basic framework of the tax code.**

Summary

The not-for-profit sector contributes significantly to the public good by lessening the burdens of government. It provides many essential services efficiently and compassionately. It promotes and nurtures American values of altruism, volunteerism, and pluralism. In view of anticipated cuts in Medicaid and Medicare, not-for-profit hospitals and health care organizations will be challenged to do more than ever before to maintain access to quality care for all Americans.

Although VHA strongly supports Chairman Archer's structural tax reform initiatives, it has several concerns regarding the possible impact of any new tax system on not-for-profit organizations. These include concerns regarding (i) the scope and applicability of a consumption or flat tax, (ii) the difficulty of fashioning revenue-neutral exemptions, (iii) the possible elimination of essential tax incentives, such as the exclusion for tax-exempt financing or the deduction for charitable contributions, and (iv) the theoretical imposition of a consumption tax on the value of goods and services provided for free or on a subsidized basis.

VHA looks forward to the opportunity to work with Chairman Archer, the Members of the Committee, and their respective staffs to address these concerns in a creative and appropriate manner.

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[4] Id. at pp. 102-106.

MICHAEL WARD
5153 HWY P. S.
WEST BEND, WI. 53095

6-15-95

MR. PHILLIP MOSELY
COMMITTEE ON WAYS + MEANS

SIR:

I BELIEVE THE PRESENT TAX SYSTEM IS UNFAIR, DESTRUCTIVE, AND FAR TOO COMPLEX.

I BELIEVE A NATIONAL SALES TAX IS THE BEST SOLUTION, AS IT WOULD ALLOW THE IRS TO BE ELIMINATED.

ANY SYSTEM EXCEPT A VAT TAX WOULD BE BETTER THAN WHAT WE HAVE NOW.

SINCERELY,

Michael Ward

DEAR SIRS:

AN I.R.S. STORY (TRUE)

(HOTTUB)

MY SON STARTED A SPA MANUFACTURING BUSINESS HE GOT HIS PRODUCT LINE TO MARKET AFTER THE ECONOMIC DIP OF APROX. ~~1986~~ 1985-1986

HE LOST ALL OF HIS INVESTMENT IN THE BUSINESS, HE LOST HIS HOUSE AND EVERYTHING ELSE.

IN AN EFFORT TO TRY TO SAVE HIS BUSINESS, I LOANED HIM $18000.00. THIS MONEY WAS ALSO LOST IN THE PROCESS.

THEN COMES THE I.R.S. THEY PULLED HIS BANK RECORDS + SAID THE MONEY I LOANED HIM, WAS INCOME. THEY SAID BECAUSE HE DIDNT HAVE TO PAY FOR HIS HOUSE, THAT HE OWED INCOME TAX ON THAT MONEY. I BELIEVE THEY REFFERED TO IT AS RELIEVED DEBT?

ALL TOTALED WITH FINES PENALTIES THEY SAID HE OWED JUST SHY OF $250000.00, AND SAID HE SHOULD SEND IN A CHECK TO PAY THIS AMOUNT IMMEDIATLY.

I HAVE A PROBLEM WITH THE WAY THEY DO BUSINESS. I DONT BELIEVE THAT THE PEOPLE SHOULD HAVE TO FEAR THE GOVERNMENT. I BELIEVE THAT THE I.R.S. IS AN ILLEGAL CORP. ACCORDING TO THE CONSTITUTION.

THANK YOU

RON WILSON

Ron Wilson

2289 FALCON RIDGE LN.
LOS OSOS CA. 93402
1-805-528-5645

Jeff Wimer
P.O. Box 502
Fort Klamath, OR 97626
June 5, 1995

Longwirth Building
co Ways and Means Committee
Washington, DC 20515

RE: taxes

Dear ladies, gentlemen, honorable, dishonorable (that ought to cover all the bases):

Something to strive for: 10% of tax revenues saved over 9 years, accumulated interest over 9 years, expenditures flat or preferably declining over 9 years, equals no taxes every 10 years and a declining national debt.

Please make this a way of life and a part of the record.

Sincerely,

Jeff Wimer

Enclosed: 6 copies

Wren Services

SUITE W256
117 W. HARRISON BLDG.
CHICAGO, IL 60605
(708) 499-2280

Thank you for the opportunity to express my views to the House Ways and Means Committee. The reason I am here is to indict the Congress for violations of the basic law of the land, the U.S. Constitution, and to straighten out the mess you have made as a result of your violating the law. The purpose of the hearing is stated as being a "review of problems with the current Federal income, estate, and gift taxes, and examine various alternative tax systems, including consumption taxes, a flat tax, and the Unlimited Savings Account tax proposal".

We, the People, the real government of the United States, a government of the people, by the people, and for the people, have delineated in the Constitution, article one, section 8, those few tasks that we as states united wish the Congress to do on our behalf. The Congress has proceeded to do many things that it as no power to do, and those things that we have told it to do, it does not do. In the area of taxes, we have empowered the Congress to lay and collect taxes. The purpose is to pay the debts of the country. We have empowered the Congress to borrow money for that purpose. We have empowered the Congress to coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures. We as sovereign individuals have decreed that the States may not use any Thing but gold and silver coin as a tender in payment of debts, article one, section ten.

So the purpose of taxing is to pay the bills. To pay the bills, we need money. Money is gold and silver coin. In a famous desegregation case, the Supreme Court said that it would be unthinkable that the Constitution would impose a lesser obligation upon the Federal government than it imposes on the states. That was in regard to segregation in the Federal enclave, Washington, D.C. If the states cannot make any thing but gold and silver coin a tender in payment of debts, then the federal government cannot make any thing but gold and silver coin a tender in payment of debts. Payment requires specie. No specie, no payment.

Borrowing likewise requires specie. If We, the People, gave the Congress the power to borrow money and coin money, then what should that coined money be? It has to be gold and silver coin, because the states need gold and silver coin for the purpose of carrying on business, charging court fees and fines, levying taxes, and for the settlement of financial obligations. It follows, therefore, that the Congress of the United States must coin such gold and silver money. If the only thing that can be

coined is gold and silver money, then it follows that the only thing that can be borrowed is coined gold and silver money. Nothing else in this country is money. The Congress has not been empowered to print money, and it has not been empowered to monetized the debt. Since the Congress has not coined any money since the 60's, it follows that it has not borrowed any money since the 60's. There is no 4 trillion dollar debt, that is a figment of someone's imagination.

What the Congress has done is issue debt, bonds, bills, and notes when no money was borrowed. This monetizing of the debt is clearly beyond the powers of the Congress, it is illegal, immoral, and fraudulent. The Congress has no hidden power to tax by way of inflating the so-called money supply. Inflation is against the law here in the States United.

When talking about the debt, about taxes, and about the budget, the term "dollar" is used. Many people believe that the pieces of green paper we use as money are "Dollar Bills". But a careful research of the terms, "Dollar" and the term "Bill", will bring us the te amazing conclusion tat our currency is neither a dollar nor a bill, and in fact is not even money.

The truth is, the paper we use as money clearly states on its face that it is a "Federal Reserve Note". Now, the term "Note", means something different from the term "bill". A bill is short term debt, i.e., 30 an 90 day T-bills. Notes, however, intermediate-term debt, i.e., five and ten year Treasury Notes. Therefore, our currency declares itself to be intermediate-term debt.

If, then, we are holding notes, whose debt are we holding, and what was borrowed? Since the Federal Reserve iis merely thhe fiiscal agent for the Treasury, and since the note iis signed by both the Secretary of the treasury and the Treasurer of the United States, it appears as though the Congress has perhaps borrowed some money.

This then brings us to the definition of a dollar. Legally, the dollar is a silver coin, 371 1/4 grains of silver, 9/10ths (.90) fine, as defined by the Coinage Act of 1792. The Coinage Act arises from article one, section eight, clause five of the Constitution, wherein We, the People, the real government of the United States, empower the Congress to "coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures". The Congress has also been given the power (under clause two) to borrow money; and article one, section 10, declares that money is gold and silver coin. So the Congress has the power to coin gold and silver money, borrow such money, and pay the debts of the country with such money.

Clause 5 empowers the Congress to fix the standard of weights and measures, and so the Congress has established the standard of linear measurements, the inch, the foot, and the yard; and the standards for dry and liquid measures. Under this same power, it likewise fixed, it established for all time (that's what the word "fix" means), what our standard of value would be. Standard of value means 'what is the thing by which we will measure the value of goods and services, what will be the common denominator that we will use for the buying and selling of goods and services? What will be the pricing mechanism, the medium of exchange that we would use, instead of barter, for commerce?'

The Congress declared our fixed standard of value to be a certain weight and fineness of silver coin, called that silver standard the dollar, and put us on the silver standard. Since a standard cannot be changed (if it were changeable, it would not be "fixed"; "fixed" means unchanging), we are thus still on the silver standard today. For those who wish to go back to a gold standard, they must realize that in order to go off the silver standard or adopt some other standard, the Constitution would have to have been amended, and clause five of article one, section eight would have to have been deleted or changed. Since that has not happened, a case can be made that we have never really legally been on a gold standard.

Under the Coinage Act of 1792, Congress allowed for the coining of gold coins along with silver coins, but the gold coins were called "Eagles", and were of the "value of so-many dollars". For example, there was a twenty dollar gold eagle. That particular gold coin was of the value of twenty silver dollars, based on the ratio of gold to silver as established by law. The standard, however, was always, and still is, silver.

If you argue that a piece of paper, which says that it is a note, is a dollar, while in fact, that piece of paper says that it is a note (debt), then how can the Congress borrow debt? The Congress is only empowered to borrow money, and article one, section 10, says that "No State shall....make any Thing but gold and silver Coin a Tender in Payment of Debts." If the states

cannot use anything but gold and silver coined money for the payment of debts, i.e., court costs, fines, state and local taxes, the settling of financial obligations, then the Federal government is limited in like manner. The Federal government, the United States, is merely the states united for the few limited tasks found in article one, section eight, that We, the People gave to the Congress to perform on our behalf. In addition, the Supreme Court has stated that it would be unthinkable that the Constitution would impose a lesser obligation upon the Federal government than it imposes on the States, so if the states are prohibited from using any Thing but gold and silver coined money, then that prohibition likewise extends to the Federal government as well.

If the Congress is empowered to fix the standard of weights and measures, it cannot change or devalue the standard of value. Would we not think it ludicrous if some Congressman were to propose a law to devalue the inch for the purpose of giving everyone in the country a bigger house? Likewise, it is just as ludicrous to suggest that the dollar (the silver coin, remember?) can be devalued. That would be illegal. Congress has been empowered to "fix" the standard of value. It did just that, and the standard it adopted is the silver coin. If the Congress has not coined any dollars in over thirty years, then the Congress has not borrowed any dollars in over thirty years. There is therefore, no 4 trillion dollar debt, and the paper that you hold in your hand is bogus, it is illegal. Congress is issuing notes, bonds, and bills, without borrowing money. It is monetizing the debt, an act that is clearly beyond its power. Continuing this activity will lead to further depreciation of the "fiat currency", the Federal Reserve Note, erroneously called a dollar.

The only solution to the attendant problems caused by monetizing the debt (i.e., usurious interest rates, a falling currency, rising prices) is a return to law, to the coining of gold and silver coin. This does not mean that we cannot have paper currency, but any paper currency circulating must be redeemable on demand for the borrowed money. History has shown that a failure to address this problem always results in a eventual total repudiation of the fiat paper "money" and an economic crash.

Such a disaster can be avoided by the restoration of sound money. The existing illegal debt must be legitimized. This can be done by immediately putting Congress on a cash basis and by restructuring our tax system to collect taxes in advance of the fiscal year in which they will be spent. This will eliminate borrowing and the need for a Balanced Budget Amendment by requiring that spending be limited to the amount raised. With borrowing eliminated, that portion of the yearly budget that services the interest on the debt would soon be available to begin retiring the principal on the illegitimate debt.

These problem did not happen overnight, but began decades ago. I suggest that one year of sacrifice would put this problem behind us quickly, and the one year of sacrifice would be worth it to get ourselves out of debt. I call my proposal "The Year of the Double-Tax".

Under the present system, tax funds are coming in as expenditures are going out. The present system of income, corporate, and estate taxes would run for one final year while a National Sales Tax would run alongside of it. The old tax system would be funding the present spending, while the National Sales Tax would be collected by the states in advance of the fiscal year in which it would be spent. At the beginning of the following fiscal year, the states would turn these funds over to the Congress with the admonition, "Here is what you can spend, don't spend a penny more, don't' go into debt, and don't borrow". That would be the last year for the income tax and the current system would be trashed. A Washington think tank has suggested that a National Sales Tax in the amount of 20% would raise an amount in line with current expenditures. There would be no need for a Balance Budget Amendment to the Constitution, as the Congress would be limited in its spending to that amount raised by the previous year's tax levy.

Now, once the borrowing was ended, many good things would happen. First off, the Treasury would no longer be coming to the credit markets every three months to suck 30 to 40 billion out of that market. Interest rates would therefore be very favorable for business, and the cost of goods and services would reflect that. A great boom would result with the elimination of high interest rates, and with the elimination of the income tax. Once people realized they could work as hard as they wanted, and not be penalized, industry would boom. Once the world saw that we had finally put our fiscal house in order, our currency would soar vis-a-vis the other currencies of the world, and investment funds would pour into this country. The Congress would go back to coining gold and silver coins, and the dollar would once again become the premier money of the world. The monetized debt currency would be gradually changed from a fiat currency to one that was once again convertible and redeemable in real money. The restoration of precious metal coinage would create a boom in our mining industry, and the need for new mining equipment would be a boost to our manufacturing sector. Both of these areas are creators of real wealth.

Now, if you do not go back to obeying the law, if you do not implement this or some similar plan, one day you will wake up and find out that this country has become nothing more than a banana republic, and a shock wave will roll through the economy that will close the stock, credit, and currency markets. An economic Pearl Harbor looms before us because of your ignorance and violation of the law. I demand that you cease and desist in your unlawful behavior before it is too late. Thank you.

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