

REPLACING THE FEDERAL INCOME TAX

HEARINGS
BEFORE THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
ONE HUNDRED FOURTH CONGRESS
SECOND SESSION

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MARCH 20 and 27, 1996

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CONTENTS

	Page
Advisory of March 6, 1996, announcing the hearings	2

WITNESSES

Armev, Hon. Dick, a Representative in Congress from the State of Texas	161
Auerbach, Alan J., University of California	123
Burnham, David	44
Chrysler, Hon. Dick, a Representative in Congress from the State of Michigan	221
Cook, Ann, South Windsor, CT	88
Dautrich, Kenneth J., University of Connecticut	33
Gephardt, Hon. Richard A., a Representative in Congress from the State of Missouri	181
Hall, Arthur P., II, Tax Foundation	21
Hodges Associates, Inc., Jean H. Hodges	89
Hubbard, R. Glenn, Columbia University	114
Jorgenson, Dale W., Harvard University	102
Lalli, Frank, Money Magazine	17
MacDonald, Elizabeth, Worth Magazine	69
Money Magazine, Frank Lalli	17
National Association of Computer Consultant Businesses, Harvey J. Shulman	77
Reader's Digest, Rachel Wildavsky	33
Schaefer, Hon. Dan., a Representative in Congress from the State of Colorado	188
Shulman, Harvey J., National Association of Computer Consultant Businesses	77
Tauzin, Hon. W.J. "Billy," a Representative in Congress from the State of Louisiana	215
Tax Foundation, Arthur P. Hall II	21
Wildavsky, Rachel, Reader's Digest	33
Worth Magazine, Elizabeth MacDonald	69

SUBMISSIONS FOR THE RECORD

American Constitutional Research Service, Greenbelt, MD, John William Kurowski, statement	236
Bono, Hon. Sonny, a Representative in Congress from the State of California, statement	230
Panter, Eve, Marietta, GA, letter	245
Real Estate Transformation Group, San Francisco, CA, Mark Borsuk, letter and attachments	247
Smith, Hon. Nick, a Representative in Congress from the State of Michigan, statement	232
Thompson, Sam, III, El Paso, TX, letter and attachments	261
Williamson & Co. CPA's, Cartersville, GA, Earl Williamson, Jr., letter and attachment	290

REPLACING THE FEDERAL INCOME TAX

WEDNESDAY, MARCH 20, 1996

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to call, at 10:17 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearings follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
March 6, 1996
No. FC-12

CONTACT: (202) 225-1721

Archer Announces Hearing Series 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 a hearing series on replacing the Federal income tax. **The initial hearing days will take place on Wednesday, March 20, and Wednesday, March 27, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m. each day.**

In view of the limited time available to hear witnesses, oral testimony on these hearing days will be heard from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. Chairman Archer intends to announce additional hearing days in the near future at which the Committee will receive testimony from the public.

BACKGROUND:

Last year, the Committee held three days of preliminary hearings on proposals to replace the current Federal tax system. In 1996, Chairman Archer intends to continue the Committee's examination of fundamental tax reform and to explore in-depth the various issues arising out of such a change.

In announcing the hearing, Chairman Archer stated, "Last weekend, Committee members attended a very productive three-day issues seminar focusing on issues related to replacing our current tax system. As I listened to the members of the Committee, it was clear to me that Members are eager to explore these questions more fully in the months ahead."

Archer added, "For those with a bent for history, the original bill that President Wilson signed to give us the income tax will be on display at the first hearing. It is appropriate that we view the original law as we begin consideration of its potential replacement."

FOCUS OF THE HEARING:

The hearing day on March 20 will review problems inherent in the current tax system giving rise to calls for reform, and the hearing day on March 27 will review the potential economic considerations of replacing our tax system with various alternatives.

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, Wednesday, May 1, 1996, 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 300 additional copies for this purpose to the Full Committee office, room 1102 Longworth House Office Building, at least one hour 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.
2. 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'.

* * * * *

Chairman ARCHER. The Committee will come to order.

Today's hearing, the first of this year on the abolition of the current tax system, marks what I hope will be the beginning of the end for America's complicated, intrusive, loophole-ridden, unfair Tax Code, a code that more often works against the best interest of Americans rather than for their betterment.

We have in this room today the very document that created the income tax that was signed into law by President Woodrow Wilson on October 3, 1913, and it is encased in tamper-proof plastic.

I suspect that perhaps the National Archives that has graciously loaned it to us today has carefully protected it knowing that I am pledged to tear the income tax out by its roots, and this original document represents the basic roots of the income tax that we live under today.

It was very different then, very short, basically a flat tax, taxing only those people in 1913 who earned over \$20,000 a year, which inflated in today's marketplace, would probably be somewhere close to \$100,000 a year. It was originally a tax just on the rich.

Those roots over the years sunk deeper and deeper into the income ladder to where people today earning very small amounts of money are subject to the income tax.

I am grateful to the National Archives for allowing us to view this document this morning, and I have promised the Archives that I do not intend literally to work on the roots of the first income tax.

In 1909 when the House debated and passed the constitutional amendment that allowed for an income tax, Congressman Serenov Payne of New York said the following:

As to the general policy of an 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 the honest men and an exemption—

“men” was generic in those days, for all the ladies in the audience, but this is a quote—

a tax upon the income of the honest men and an exemption to a greater or less extent of the income of the rascals.

Congressman Payne, I couldn't agree with you more.

One other historical note, those who wrote the 1913 income tax recognized that an income tax was tantamount to lowering the compensation of the American people, and because the Constitution prohibits Congress from changing the President's compensation, what did Congress do? They exempted President Woodrow Wilson from personally paying the first tax. It might also have been an encouragement to him to get him to sign the law.

I suppose you could say that that exemption was the first step on the path to Gucci Gulch, but we have come a long way since then, most of it in this room.

Here was the 1913 return, four pages of return and instructions.

Here is what it has grown to. This is for 1995. It is probably a little bigger for 1996. Five volumes of taxpayer information publications and two volumes of forms and instructions. If you have a complicated tax return, there are even more publications that are not included in these volumes that are available to help you.

But my point is not to criticize IRS, the Internal Revenue Service. They merely interpret and enforce the laws written by this body, the Congress of the United States. The problem with the Tax Code begins with Congress, and Congress should fix it. As the first Chairman in recent history who continues to do his own tax returns, and I see April 15 looming ahead for me very shortly, my intention is to fix this Code. If I can't fix it, I will continue to suffer through it personally, so that I know what it does to individual taxpayers and, unfortunately, to tax preparers, because more and more individuals cannot cope with it and have to turn to preparers.

Today, we are going to hear from several witnesses about some of the Tax Code's greatest complexities and problems. As we move forward to change the Code, the issues we discuss today should be kept in mind as we consider fairer, simpler, less intrusive proposals for tax reform.

Next week we will hear from several leading economists about how changing our tax system can lead to a stronger economy, benefiting all Americans, and, for the remainder of the year, we will continue to hold hearings to explore the impact of various tax proposals on individuals from a fairness point of view and on various sectors of the economy as well.

I intend these hearings to be bipartisan and indepth. The subject of tax reform is not limited to party. It is vital to the future of our country, and I, for one, and I am sure the other Members of this Committee, look forward to a learning process this year from the witnesses who appear before the Committee.

Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Chairman.

I think this is an important hearing, and I am glad to be able to participate in this series of hearings on this very serious subject.

First of all, I would like to make it clear that I was not here when the Tax Code was adopted. I do have some recollection, though, of what the tax situation was in the United States at that time.

Historically, our government was largely funded by tariffs, really very high tariffs in some areas, and it was funded by a series of excise taxes, some pretty high. Then, that not being sufficient revenue, the income tax was invented and imposed. It was a tax that had been used during the Civil War to finance the war. It had been declared unconstitutional by the Supreme Court, and the 16th amendment had to be adopted in order to legalize the tax and allow it to be reenacted in the form that it was in at that time.

At that time, it was probably a good modern tax system for its day, but its day has long expired. When we look at other nations on Earth, and there are a lot of them, about 150-some of them altogether, we find that most of them have converted their revenue system from an income tax system, although many of them still have vestiges of income tax systems on their books, to a consumption tax system.

In fact, in raw numbers, everybody but the United States and Australia have gone, essentially, to a consumption tax base for their revenue system.

Now, that causes us financial problems in the world, and I won't try to cover all of those in my opening statement here, but it is a

problem, and I think it is the reason why America continues to export jobs and job opportunities from our society. I think that is one reason there has been middle-income stagnation, and it is a part of the reason for the dissatisfaction with our government, but I think there is, perhaps, an even more serious problem.

The current income tax law is so complicated and, in many ways, so convoluted that it is impossible for the taxpayer to understand, it is impossible for the ordinary American to understand, and I get the impression that the ordinary American comes away from their experience with the tax system very disillusioned.

That disillusionment means that they don't think that Congress has got enough sense or enough fairness to enact a fair revenue system; that they are paying too much in taxes, at least as compared to their friends and neighbors, and their friends and neighbors are all getting some kind of break that they are not getting; and that the rich are getting this kind of break and the poor are getting shafted in some way or the other. So I think it has caused a great deal of dissatisfaction in our society.

It is at a point now where this dissatisfaction has risen to a serious point and has really impacted our ability to govern in a sensible, sane manner. So I think it is time for a change.

Change will not be easy. We should profit by the examples that other nations have had in such a change, and we should not make the same errors that they have made in their change.

Mr. Chairman, I have come to the conclusion that the income tax, both corporate and personal, should be abolished, that the payroll tax should also be abolished—and that is 95 percent of all the revenue that we now collect—and that we should substitute in lieu thereof a consumption tax.

Now, a consumption tax should be broad based. It should tax all goods and all services at the same rate, with no exception, no matter who produces that good or service. It should be adjustable at the international border, so that we can be in step with the rest of the world as far as the economy of this country is concerned.

As I say, we are now exporting jobs because of the way our tax system works on our individuals and on our society.

We do not need to go through a very complicated transition. I know that will come as a shock to many people, but it is possible to do this without a very complicated transition.

A consumption tax should only be adopted if it is a substitute for the repeal of other taxes. It should not be an add-on tax.

Our current revenue system has one characteristic that I think condemns it. It is a very, very expensive system to administer.

Estimates that I have seen, and I think are sound, put the total cost of administering our revenue system at between \$300 billion per year and \$600 billion per year, and if you contrast that to the \$1.4 trillion that we currently collect each year, we are spending an excessive amount of our revenue on just the collection and administration process.

We can't afford it. It makes our economy poorer, it makes our standard of living lower, and we need to change it.

It can be done. It should only be done after a thorough discussion and after the American people understand it, and we do need the help of whoever is in the White House to get it done.

One of the things that I haven't touched upon, Mr. Chairman, is this matter of burden. A consumption tax would be levied at one single rate, and a pure consumption tax standing alone would tend to shift the distribution of tax burden from what it has been in the last 25 or 30 years.

We have some pretty fair figures on what the burden is today. It has, surprisingly, despite all the massive changes that we have gone through in this room, not changed remarkably between income categories in this society, with the exception that we have substantially removed the tax burden from low-income individuals. We are probably not back to where the 1916 law was, but it has certainly been reduced as to low-income individuals.

I think we have to have a burden adjustment system in connection with our consumption tax. It can be simple. It does not have to be a complicated income tax, and at the appropriate time, I will unveil some of the thinking that I have done on this area for your examination, suggestions, and criticism.

I regret—and one of the considerations that I took in account when I decided not to seek reelection—was that I wanted to be here when we got into the nitty-gritty of making the change in the tax system, but I will probably come back after my quarantine has expired and be working with you and Members of this Committee and with the public on trying to think our way through this problem.

It is, perhaps, the most serious problem that this country faces, although I must admit it is not a very dramatic problem.

As we learned at our retreat in Warrenton—2 weeks ago, was it, or maybe 3—the experts told us in that retreat that we could not expect to maintain the current system and meet the needs of the future.

I was surprised when I thought that was a unanimous opinion of all of the experts that had attended there.

So, Mr. Chairman, I have made a long statement, but you have started us in the right direction. We must learn, we must listen, we must discuss, and we must develop a consensus about what needs to be done. We owe nothing less than that to our country.

Thank you.

[The opening statement follows:]

THE HONORABLE SAM M. GIBBONS
Ranking Democrat, Committee on Ways and Means

Statement
Hearing on Tax Reform
Committee on Ways and Means
March 20, 1996

In my 27 years on this esteemed Committee I have given a great deal of thought to the way this country raises 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.

For ten years now I have been a strong advocate of replacing our current income tax system. 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 look forward to discussing my proposal with you next week in this Committee.

As we consider tax reform, it is imperative that we are clear about the problems our current system poses and the peripheral discussions which belong outside of this debate.

First, let me be clear: Our current tax system should be fundamentally restructured. 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 has become burdensome to many taxpayers, particularly small businesses who must struggle through piles of federal tax forms every quarter.

Second, in the process of considering replacement tax proposals we should all remember that two debates should remain outside of this discussion: the amount of revenue the government raises and spends, and the progressive distribution of the tax burden. The former has been discussed to death in this Congress, and perhaps rightly so, but on any count it is a debate that should take place outside of tax reform. The latter, distribution, should remain as it is -- a progressive American system that helps the least of us and ensures that those who have benefitted the most from our democratic government and open economy pay their fair share.

As we consider alternatives to our current system, we must assess any proposal against certain fundamental criteria. No proposal that violates these principles should be entertained.

Revenue Neutrality. This is not a 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. We govern a society that worries about all of its citizens, not just the successful ones, and to that end, we should maintain the current progressivity that provides some relief for the least well-off among us.

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 strive.

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. Our income tax simply has not kept up with the many changes that have occurred in the global marketplace. Income taxes cannot be removed from the price of goods when they cross the border to be exported. 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. A border-adjustable tax system would promote the competitiveness of American companies and invigorate American exports.

As we look to reforming our current system, the implications of replacement must be fully understood and dealt with. We need to educate ourselves and public about the advantages and disadvantages of our current system and of the many alternatives. I applaud Chairman Archer for taking the first step toward that end.

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, but rather, must be well thought out for its practical and long-term advantages both domestically and in the world market.

I look forward to a substantive and informative dialogue here in the Committee and with the American public.

###

Chairman ARCHER. Mr. Gibbons, you have made an outstanding opening witness for this Committee's deliberations.

Mr. RANGEL. Mr. Chairman.

Chairman ARCHER. I would offer to any Member that would like to make an opening statement the opportunity to do so at this time. Hopefully, they will be kept reasonably short, so that we will not keep our witnesses waiting.

Mr. Thomas.

Mr. THOMAS. Just two points. One, I do think we need to fundamentally reexamine our tax system to get us ready for the 21st century, but as Sam indicated, we need to try to pull off the switch in a way that no other country in the world so far has been able to do it.

I am reminded of a B movie where at night the two cars pull up on either side of the bridge, and in trench coats, they escort the hostages to the center of the bridge, and they, in the glare of the headlights, exchange the hostages very carefully.

If we are going to move to some kind of a tax on goods and services, I also am in agreement with the gentleman from Florida, we have to do away with the income tax, both personal and corporate, but we are going to have to be very, very careful that that exchange is made and that we do not wind up with a system which not only has a tax on goods and services, but also on income as well.

It is going to be an exciting time on this Committee, Mr. Chairman. I think no Committee could do a greater service to this country than to rethink the way we finance our country because no country in the world does it poorer than we do, putting us at jeopardy, not only domestically in terms of accumulating savings, but at an economic disadvantage in trading around the world.

It is a very worthwhile endeavor, and I compliment the Chairman on the beginning of the process.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Let me join with those in congratulating you for bringing into focus a problem that most all Americans have. That is, how we can have a system that is more equitable and, at the same time, more simple.

I intended to make a parliamentary inquiry because your written statement is not available, but it was my understanding you said that this Committee was going to spend the rest of our legislative year reviewing a reformation of the tax system, and I gather from previous statements made that you don't intend to reach any legislative conclusions.

Having noticed that this subject matter was of great interest to the Republican's candidate for mayor, I was wondering why we would be pursuing this issue now if we don't intend to do anything about it while we are in session.

Chairman ARCHER. I think Mr. Gibbons spoke to that when he said we must learn, we must build a consensus. This is a major undertaking. It is not something to be done in a short period of time without thoughtful consideration, without input from an awful lot of people in this country.

It is going to take us the better part of this year, I think, to do that job.

Mr. RANGEL. Thank you.

Chairman ARCHER. Mr. Houghton.

[No response.]

Chairman ARCHER. Mr. Herger.

[No response.]

Chairman ARCHER. Mr. McCrery.

[No response.]

Chairman ARCHER. Mr. Payne.

[No response.]

Chairman ARCHER. Mr. Camp.

[No response.]

Chairman ARCHER. Mr. Ramstad.

Mr. RAMSTAD. Mr. Chairman, just very briefly, I, too, want to applaud you for your leadership in this area and for calling the hearings. I know that the level of discourse in this room will be a lot higher concerning tax reform than it has been on the campaign trail.

There have been a lot of misstatements out there, and I am glad we have some true experts here today to clarify some of the misrepresentations that have been very unfortunate, but that are not totally foreign to political campaigns.


I think we all agree, Mr. Chairman, that the present system is not efficient, it is not simple, it is not flexible, it is not responsible, and it is not fair, and with the current system flunking each of these fundamental characteristics or fundamental tests for any tax system, it is imperative, as you suggest, Mr. Chairman, that we do make major changes.

I am very, very concerned about the current system's perverse incentives, to save and invest. We should not have a tax system that discourages savings and investments. This certainly means lost opportunities and lost jobs.

I think we can all agree that the current system isn't working and deserves a major overall, and I look forward to hearing from the witnesses and to reaching some conclusions at the proper time as a Member of this Committee.

Thank you again, Mr. Chairman.

[The opening statement follows:]



STATEMENT OF REP. JIM RAMSTAD
WAYS AND MEANS COMMITTEE
HEARING ON REPLACING THE FEDERAL INCOME TAX
March 20, 1996

Mr. Chairman, thank you for convening these hearings on the need to replace our deeply flawed tax system.

Economists list five traits which should characterize any tax system: economic efficiency, administrative simplicity, flexibility, political responsibility and fairness. I am certain we will hear today about how the current system flunks each of these tests.

We have all heard horror stories about the complexity of the present income tax system. The document on display today which created this current system is an innocuous 16 pages long -- 11,400 words. But it has spawned a tax code of 10,000 pages with over 555 million words.

As we will hear today, even the most expert tax preparers arrive at widely varying bottom lines when faced with the identical set of facts. How can we expect untrained taxpayers to negotiate their way through the tax maze when the experts routinely make mistakes that could expose families to a painful IRS audit?

Today's system is also costly and far from efficient. Revenue lost to the Treasury because of tax evasion exceeds \$100 billion. And total compliance costs for taxpayers are staggering -- estimated at \$225 billion to comply with 1996 federal taxes.

And this is not to mention the perverse incentives in the current system -- disincentives to save and invest. This means lost opportunities and lost jobs.

While we may come to different conclusions about how the tax code should be reformed, I think we can all agree that the current system isn't working and deserves a major overhaul.

Again, Mr. Chairman, thank you for calling this series of hearings. I look forward to hearing the testimony today and look forward to progress on improving the system for all taxpayers.

Chairman ARCHER. Mr. Zimmer.

[No response.]

Chairman ARCHER. Mr. Nussle.

Mr. NUSSLE. Mr. Chairman, I would just ask unanimous consent that Members be allowed to put a statement in the record.

Chairman ARCHER. Absolutely. Without objection, each Member can insert a statement in the record. I will give further opportunity for brief oral comments.

[The opening statement of Mr. Nussle follows:]

**STATEMENT BY
THE HONORABLE JIM NUSSLE
BEFORE THE COMMITTEE ON WAYS AND MEANS
REGARDING ABOLISHING THE INCOME TAX
MARCH 20, 1996**

Thank you Mr. Chairman for calling this landmark hearing in what will be a series of hearings on replacing the current federal income tax system. I also want to thank the distinguished witnesses for their expert testimony.

Today's hearing launches the first phase of a three phase effort to conduct an in-depth study of alternatives to the current federal tax system. We will begin our work by examining the problems with the current system.

To help put today's tax labyrinth into perspective, the National Archives brought to today's hearing the original copy of the 16-page income tax bill signed into law by President Wilson in 1913. This document is in stark contrast to the 2823 pages that comprise the current tax laws.

The second phase of our effort will focus on the economic benefits of changing the tax code. The final and third phase will allow us to examine how proposed changes will affect families, individuals, farmers, businesses and other sectors of our society such as charitable organizations.

Last month I travelled throughout my congressional district in Iowa holding town meetings in 21 counties to listen and learn from my constituents. During those meetings, I heard a lot of concern, criticism and anxiety about the current federal tax system. Iowans want a tax system based on fairness, simplicity and uniformity.

Iowans, like most Americans, are civic minded and want to meet their obligations of citizenry, including paying their taxes. Sadly enough, our current tax system makes it a challenge just to prepare tax returns with the confidence that you are in full compliance with all of the nuances of the complex tax laws.

Our current tax system also places an undue burden on working families, farmers and small businesses. For example, estate and capital gains taxes make it exceedingly difficult for farmers to pass the family farm on to the next generation.

While I have my share of criticisms of the current tax system, I enter today's hearing with an open mind for alternatives.

I do believe, however, that our next tax system should be more fair and simple for Iowa's and America's families and businesses; encourage savings, investment and capital formation; allow our businesses to effectively compete in a global economy; and be based on sound economic principles and not contrived for political gain.

Chairman ARCHER. Mr. Portman.

[No response.]

Chairman ARCHER. Mr. Laughlin.

[No response.]

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman, and I will be brief.

I want to congratulate you for having this hearing. I think it comes at a very important time in this debate. I believe it is very important that this Committee is serving as a catalyst for a debate which is going to have a profound effect on America's economy and on the prospects of working families for many, many years to come.

If we can make the case here in this Committee against the current tax system, I believe that we will lay the groundwork for considering an alternative tax system which will greatly simplify the experience of working families as they deal with their tax returns, greatly simplify the tax system for small business, and at the same time create massive incentives for economic growth.

Our savings rate in this country is far too low, and it is fairly clear that our tax system is a significant burden to international trade, as Mr. Gibbons has most eloquently stated.

I believe that the case for tax reform is powerful and compelling, and I want to congratulate you again, Mr. Chairman, for taking the bull by the horns and helping to set this debate and helping to bring Congress into the thick of it at a time when we desperately need to look to the tax system that we need to have to build the economy of the future.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. McNulty.

Mr. McNULTY. This is going to be a massive undertaking, Mr. Chairman, and I just want to thank you for your leadership in getting us off to an early start.

Thank you.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. Mr. Chairman, I would like to compliment you and Mr. Gibbons on your opening statements and particularly to comment you, Mr. Chairman, for bringing this hearing about. It is certainly bold. It is not for the fainthearted. We are going to find a lot of fishhooks as we go through this and a lot of vested interests that are represented in the present Tax Code.

As the only former CPA that is sitting on this Committee, I can say that the present Tax Code is nonsensical, it doesn't make sense, it defies logic, it is burdensome, it makes people make investments and financial decisions that aren't necessarily in their best interest but for the tax law, and I think it penalizes our business people on a global basis. As I say, this is going to be tough.

Mr. Gibbons was right. A lot of this is going to depend on who is the next occupant of the White House because we certainly will have to have the cooperation of the President of the United States after the next election to make this happen. This is something that is going to have to be a partnership.

I don't expect either of the Presidential candidates to take a firm position with regard to this, nor has this Committee taken a firm position, except that we are interested in following this up; we do

think there is a better way, and there is a better taxation method for the American people.

I think it is going to be a most interesting process that we are going to be going through, and I commend you for bringing this out. I know it is something that you have been thinking about for a long time, Mr. Chairman. I compliment you and look forward to working with you, the other Members of the Committee, and the White House.

Chairman ARCHER. Mr. Christensen.

[No response.]

Chairman ARCHER. All right. Thank you for your patience to our witnesses who have come forward to help us in this process in the beginning.

Mr. Frank Lalli, managing editor, Money magazine, would you lead off and proceed. If you have a longer written statement, without objection, it will be inserted in its entirety in the record, and if you could capsulize your testimony within 5 minutes verbally, we would appreciate it.

Thank you.

**STATEMENT OF FRANK LALLI, MANAGING EDITOR, MONEY
MAGAZINE, NEW YORK, NEW YORK**

Mr. LALLI. Thank you, Mr. Chairman.

Mr. Chairman and esteemed Members, I am Frank Lalli. I have been managing editor of Money magazine for the past 6 years, and it is my honor to represent Money magazine, which is the largest financial publication in this country and its 10 million readers. Thank you for inviting me to testify.

When it comes to the U.S. Tax Code, simplification can get awfully complex. Let me explain.

As you well know, Congress passed one of the most sweeping tax reforms in history in 1986. Still, Money magazine's editors suspected that the Tax Code remains so complex that even informed accountants were having trouble filling accurate returns.

We decided to give an open-book exam to 50 volunteer tax preparers from all walks of the industry, from small-town storefront preparers to enrolled agents to CPAs at what were then called the Big Eight firms.

In January 1988, we mailed the volunteers the financial profile of a hypothetical family, and we asked them to prepare tax returns based on our information.

This was no trick quiz. The experts who helped write our test said it was neither overly optimistic nor too simplistic. It was just right, but the results were startlingly wrong. The 50 pros computed 50 different amounts of tax owed for the same family, and those tax bills varied by nearly 50 percent, from around \$7,200 to about \$12,000. What is more, the fees the tax preparers would have charged our family ranged from around \$200 to \$2,500.

Now, the conclusion was obvious. Though one-half of the Nation's taxpayers seek professional help, the typical taxpayer has no way of knowing how much tax they actually owe—nor what they need to pay to get competent advice.

Despite these depressing results the first year, we figured that diligent professionals would become more familiar with the sweep-

ing changes in the Code and fare better in the future, but we were wrong.

When we tried the test the next year, 50 new tax preparers, once again, came up with 50 different tax estimates.

Now, this time, the taxes ranged from \$12,500 to almost \$36,000. What is more, 11 of them missed our expert's tax target by more than \$5,000, and 4 out of 5 made major mistakes, the kinds that could expose a family to an IRS audit.

When that story made national headlines, we decided at Money to turn our test into an annual event. We had two goals. We wanted to warn the public about the complicated Tax Code. We also hoped to spur the accounting profession to educate its 400,000 members about the various tax complexities.

Unfortunately, we got, essentially, the same results year after year, 50 preparers, 50 different tax bills, 50 different fees for service, all because our convoluted Tax Code is apparently baffling even veteran tax pros.

If I might draw your attention to the easel right here on my right, it illustrates the discrepancies we found in one of our recent tests in 1993. If you could read that table, it shows you that there is little correlation between the tax preparer's fees and the accuracy of their work.

For example, among the seven who came within \$1,000 of hitting our tax target that year, two charged around \$1,000 for their service, but the other five charged double to triple that amount, up to \$3,200.

Better yet, in one year the pro who filed the most accurate return in our test worked for H&R Block. He charged \$187.

Furthermore, throughout the years, our test has shown time and again that neither the ability to pay extra nor the privilege of position guarantees that you will file an accurate tax return.

Let me add this point. I am not here to advocate solutions. I am a journalist. Nor has Money magazine taken any stand on the various reform ideas being debated, but this much is clear. Something has to change.

Each April, Americans should not be faced with the question, How much do I owe Uncle Sam. Is it \$1,000, is it \$5,000, is it some other amount that an IRS auditor will end up dictating?

As our tax test has shown, the taxpayer's guess may be as good as their accountants. That is not the way the Tax Code should work.

Thank you very much for your time and attention.

[The prepared statement follows:]

America's Financial Advisor **Money**

STATEMENT OF FRANK LALLI, MANAGING EDITOR MONEY MAGAZINE

Herewith the testimony of Frank Lalli, managing editor of MONEY magazine, before the U.S. House of Representatives Committee on Ways and Means; Wednesday, March 20, 1996:

Mr. Chairman.

When it comes to the U.S. tax code, simplification can get awfully complex. Let me explain:

As you well know, Congress passed one of the most sweeping tax reforms in history in 1986. Still, MONEY magazine's editors suspected that the tax code remained so complex that even informed accountants were having trouble filing accurate returns.

We decided to give an open-book exam to 50 volunteer tax preparers from all walks of the industry; from small-town storefront preparers to enrolled agents to C.P.A.s at what were then called the Big Eight firms. In January 1988, we mailed the volunteers the financial profile of a hypothetical family, and we asked them to prepare tax returns based on our information.

This was no trick quiz. The experts who helped write our test said it was neither overly optimistic nor too simplistic. It was just right. But the results were startlingly wrong. The 50 pros computed 50 different amounts of tax that the same family owed, and those tax bills varied by nearly 50%--from \$7,200 to about \$12,000. What's more, the fees the tax preparers would have charged our family ranged from around \$200 to \$2,500.

The conclusion was obvious: Though half the nation's taxpayers seek professional help, the typical taxpayer has no way of knowing how much they actually owe--nor what they need to pay to get competent tax advice.

Despite those depressing results the first year, we figured that diligent professionals would become familiar with the sweeping changes in the code and fare better in the future. We were wrong. When we tried the test the next year, 50 new tax preparers once again came up with 50 different tax estimates. This time the taxes ranged from \$12,500 to almost \$36,000. What's more, 11 of them missed our experts' tax target by more than \$5,000. And four out of five made major mistakes--the kinds that could expose a family to an I.R.S. audit.

When that story made national headlines, we decided to turn our test into an annual event. We had two goals: We wanted to warn the public about the complicated tax code; and we also hoped to spur the accounting profession to educate its 400,000 members about the various tax complexities. Unfortunately, we got the same results year after year: 50 preparers; 50 different tax bills; 50 different fees for service--all because our convoluted tax code is apparently baffling even veteran tax pros.

If I may draw your attention to the table on my [direction]. It illustrates the discrepancies we found in one of our recent tests, in 1993. Reading that table, you will see little correlation between the preparers' fees and the accuracy of their work. For example, among the seven who came within about \$1,000 of hitting our tax target, two charged around \$1,000. But the other five charged double to triple that amount--up to \$3,200. Better yet, in one year the pro who filed the most accurate return worked for H&R Block. He charged \$187.

Furthermore, throughout the years our test has shown time and again that neither the ability to pay extra nor the privilege of position guarantees that you'll file an accurate return.

But let me add this point: I'm not here to advocate solutions. Nor has MONEY magazine taken any stand on the various reform ideas being debated. But I would like to share with you the results of a January poll of taxpayers across the country that MONEY conducted.

The vast majority (84%) agreed that the U.S. tax system needs a major overhaul, and 59% said the number-one goal should be fairness. In addition, despite the push for a flat tax, 64% of the taxpayers said the rich should pay more tax than others. But Americans remain divided on how reform should be achieved: 33% favored a flat tax; 16% liked a national sales tax; and 19% wanted a plan to tax income minus savings. And let me add this note: Most taxpayers (59%) said tax reform will not influence their votes in November.

Obviously, Americans haven't yet embraced a remedy for our complex tax code. We trust that your hearings will help educate the public about viable solutions.

But this much is clear: Something has to change. Each April, Americans should not be faced with the question: How much do I owe Uncle Sam? Is it \$1,000? Or \$5,000? Or some other amount an I.R.S. auditor will end up dictating? As our tests have shown, the taxpayers' guesses may be as good as their accountants'. That's not the way our tax code should work.

Thank you for your time and attention.

Chairman ARCHER. Thank you, Mr. Lalli.

Dr. Hall, senior economist with the Tax Foundation. Under the basic format, you can insert your full testimony for the written record.

I will say this for all of the witnesses. Without objection, your entire written record statement will go into the record, and if you will summarize verbally, you may proceed, Dr. Hall.

STATEMENT OF ARTHUR P. HALL II, SENIOR ECONOMIST, TAX FOUNDATION

Mr. HALL. Thank you, Chairman Archer, Members of the Committee. It is an honor for me to represent the Tax Foundation at this important hearing.

Many sound arguments will be made about how replacing the income tax will promote saving, investment, and economic growth, but there is another argument that in and of itself recommends replacing the income tax. That reason is the massive cost of the paperwork burden generated by the income tax laws.

The Tax Foundation estimates that complying with the entire Federal tax system will cost Americans about \$225 billion in 1996. The rules and regulations for the Federal income tax alone account for approximately \$157 billion of this cost. About two-thirds of the cost is borne by the business sector.

I have estimated that 90 percent of U.S. corporations bear a compliance cost burden about 700 percent greater than their collective income tax liability.

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 this \$157 billion income tax surcharge is to imagine wantonly destroying every vehicle produced by the Ford Motor Co. last year.

If Congress were to replace the income tax with any one of the three predominant alternatives currently being discussed, whether that be the flat tax sponsored by Representative Dick Armey and Senator Shelby, the USA Tax System sponsored last year by Senators Domenici and Nunn, or the National Retail Sales Tax Act recently presented by Representatives Schaefer and Tauzin, 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 massive tax surcharge, assuming a reasonable transition period had ensued.

The Armey-Shelby flat tax could reduce the surcharge by 94 percent to \$9.4 billion. The USA Tax System could reduce the surcharge by 77 percent to \$36 billion. The Schaefer-Tauzin tax could reduce the surcharge by about 95 percent to \$8.2 billion, but the entire burden of that sum would fall on retail and service businesses. However, as currently written, the Schaefer-Tauzin plan would compensate businesses for about one-half of this cost.

When considering these estimates, please be mindful that they are based on pure versions of the alternative systems. It is reasonable to assume that the effect of molding any of the alternative plans into a functioning Tax Code could increase their complexity and, therefore, their associated compliance costs.

The cost of complying with the 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 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 an income tax is inherently complex.

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 tax system that date back to 1914, the year immediately following the adoption of the 16th amendment to the Constitution which authorized the income tax.

Indeed, the 1927 report of the Joint Committee on Internal Revenue Taxation states that, "It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not."

The complexity of systems that tax people and businesses directly, like the current income tax, the flat tax, or the USA 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 don't generate much complexity. On the other hand, multiple tax rates do generate complexity in systems that tax people indirectly. Administrative complexity in systems like value-added taxes or retail sales taxes results primarily from the application of multiple tax rates to differentiated products.

The inherent complexity of 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, 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 are direct tax systems that immediately eliminate these timing-related complexities and, therefore, their compliance costs. Both plans accomplish this objective by moving to a cash flow tax base, rather than an 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 business. There is no reason to synchronize the timing of income and expense 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 cost. In fact, adoption

of any of the three replacement alternatives would make obsolete almost every Tax Code provision commonly cited as a major source of complexity.

Although the flat tax, USA tax, or a retail sales tax are inherently far less complex than even the most unadulterated income tax, misguided political tampering can ruin the integrity of any system.

Nevertheless, any one of these plans could be a sound replacement for the current Federal 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 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
March 20, 1996**

The Tax Foundation estimates that complying with the entire federal tax system will cost Americans almost \$225 billion in 1996. The rules and regulations for the federal income tax alone account for approximately \$157 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 \$157 billion federal income tax surcharge is to imagine wantonly destroying every vehicle produced by the Ford Motor Company and more than one-third of the vehicles produced by the Chrysler Corporation.

If Congress were to replace the current federal income tax with any one of the three predominant alternatives currently being discussed — the Flat Tax sponsored by Rep. Arney (R-TX) and Sen. Shelby (R-AL), the USA Tax System sponsored in 1995 by Senators Domenici (R-NM) and Nunn (D-GA), or the National Retail Sales Tax Act recently presented by Reps. Schaefer (R-CO) and Tauzin (R-LA) — 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 \$157 billion tax surcharge, assuming a reasonable transition period had ensued.

The Arney-Shelby Flat Tax could reduce the surcharge by 94 percent to \$9.4 billion. The USA Tax System could reduce the surcharge by 77 percent to \$36 billion. The Schaefer-Tauzin sales tax could reduce the surcharge by about 95 percent to \$8.2, but the entire burden of this sum would fall on retail and service businesses. However, as currently written, the Schaefer-Tauzin plan would compensate businesses for about one-half of this cost.

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.

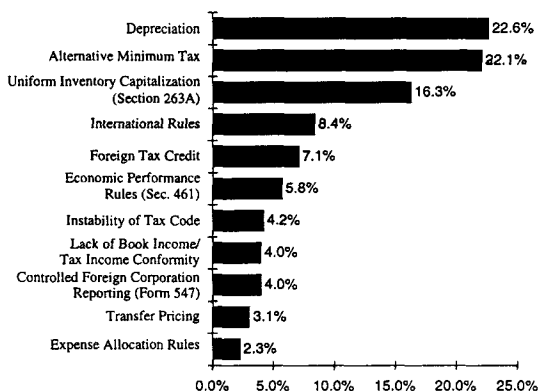
Fundamental Sources of Tax Complexity

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 of 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."

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.

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.

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 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

Table 1
Comparison of 1954 Code and 1986 Code (as of 1994)

Subchapter of Income Tax Code	Number of Sections in Subchapter		Percent Growth
	1954	1994	
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.

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.

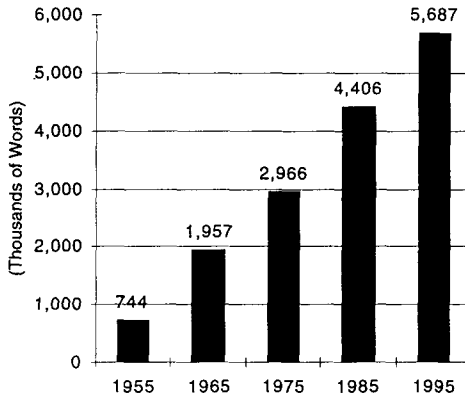
Table 1 reveals the dramatic growth in the income tax code over the past 4 decades. In 1954, the federal income tax law comprised 103 code sections. Today, that law comprises 698 code sections, a 578 percent increase. Almost all of the growth relates to tax base questions. Note that since 1954 the number 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 4 decades the number of words detailing the income tax laws has grown 370 percent. The words detailing income tax regulations, which provide taxpayers with the "guidance" they need to calculate their taxable income, have grown 753 percent. The combined growth is 664 percent.

The growth in the volume of the income tax laws and regulations has resulted piecemeal 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

Figure 2
Growth of the Income Tax Code (Laws and Regulations)



Source: Tax Foundation.

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 1996, based on historical data from the Internal Revenue Service and the Office of Management and Budget, taxpayers will spend about 5.3 billion hours complying with federal tax laws. An hourly cost of \$42.4 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 5.3 billion hours results in a total compliance cost of \$224.7 billion. Historically, about two-thirds of the compliance burden (or \$150.6 billion) is borne by the business sector. The remaining \$74.1 billion is borne by individual taxpayers.

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 \$105.4 billion in 1996 to comply with the federal income tax. For businesses, that figure is up from an estimated \$83.3 billion in 1992 (70 percent of \$119 billion), the latest year for which complete income tax revenue data is available. The 1992 cost of \$83.3 billion amounted to 41 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 an inefficient revenue system for the federal government.

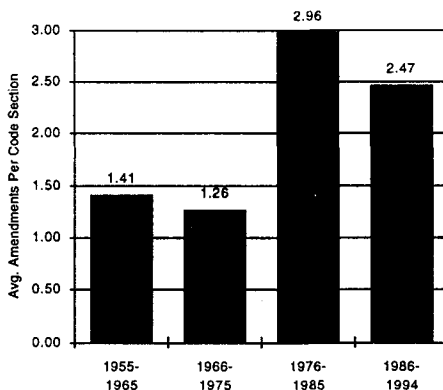
To date, the Tax Foundation has focused its detailed research on the cost to corporations of complying with the federal income tax. The total cost of compliance differs widely across companies of different size. Based on a 1992 survey of large corporations sponsored by the Tax Foundation, the 1996 cost of complying with the federal corporate income tax for the average Fortune 500 firm will amount to an estimated \$1.63 million (or \$815 million for the entire Fortune

Table 2
Estimated Cost of Corporate Income Tax Compliance by Amount of Company's Asset Size, 1996

Asset Size/1 (\$Thousands)	Compliance Cost as % of Assets	Estimated Compliance Cost
\$1,000	0.81%	\$8,100
\$25,000	0.66%	\$165,000
\$50,000	0.49%	\$245,000
\$100,000	0.31%	\$310,000
\$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).

500). For the average small corporation, those with \$1 million or less in assets, the minimum cost amounted to an estimated \$8,160. 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 27.2 times greater (and, on average, perhaps as much as 184 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 of all U.S. corporations (6,290 returns) paid three-quarters of all corporate income taxes in 1992.

More than 90 percent of all U.S. corporations have assets of \$1 million or less and, therefore, bear tremendous relative compliance burdens. In 1992, as a group, these small

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*, February 1992, p. 71. Original data from Cedric Sandford, et. al., *Administrative and Compliance Costs of Taxation* (Bath, England: Fiscal Publications, 1989), p. 116.

corporations had to pay at a minimum \$724 in compliance costs for every \$100 they paid in income tax. (For the subset of small corporations that had net income, the figure is \$361 in compliance costs for every \$100 of income tax paid.) They bore about \$28.6 billion in compliance costs for \$3.9 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 Arme-y-Sheby 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 1996 of the number of tax returns by type. Table 5 compiles a similar list for the business sector. These lists are far from exhaustive. The lists are also incomplete to the degree that adequate tax return information 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 3.6 billion hours of required compliance time for the items reported. This figure is well short of the IRS-estimated 5.3 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 Arney-Shelby 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 to comply with the Arney- Shelby Flat Tax. 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 to individuals on standard forms (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 the Arney-Shelby Flat Tax. 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 1040A Form and suggests two new basic tax forms — Schedule S (Net 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 eight hours and 58 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. The Schaefer-Tauzin 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 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. This figure is adjusted upward to \$6.8 billion in order to reflect the dollar value of all service transactions that would be taxed under the Schaefer-Tauzin plan, but that are typically not taxed under state and local sales tax regimes.

Table 4
A Comparison of the Compliance Burden on Individuals of the Current Income Tax and Alternative Replacement Plans

Individuals Only	1996						Total Hours
	Estimated Number of Returns	Average Time in Hours per Form for 1996 Tax Year					
		Record-keeping	Education Stage	Form Preparation	Packaging/Sending	Total	
Forms							
1040	58,301,036	3.1	2.9	4.7	0.9	11.6	675,320,329
1040A*	17,810,000	2.2	2.8	4.2	2.1	11.2	199,175,167
1040EZ	15,510,000	0.1	0.8	1.3	0.7	2.9	44,979,000
1040ES	38,623,500	1.3	0.3	0.8	0.2	2.6	101,064,825
1040X	1,881,500	1.2	0.4	1.2	0.6	3.4	6,334,383
4868 (Extension of Time)	4,854,000	0.4	0.2	0.3	0.3	1.3	6,067,500
1041 (Estates and Trusts)	3,102,300	41.9	17.7	34.1	4.3	97.9	303,766,875
1041A	41,571	28.7	16.9	30.8	9.9	86.3	3,589,538
1041ES	678,500	0.3	0.2	1.4	0.3	2.2	1,504,008
1040 Schedules							
Sch A	44,858,193	2.5	0.4	1.2	0.5	4.6	205,600,049
Sch B	64,083,132	0.6	0.1	0.3	0.3	1.3	83,308,072
Sch D	22,429,096	0.9	0.7	1.0	0.7	3.3	72,894,563
Sch E	27,235,331	2.9	1.1	1.3	0.6	5.8	158,872,765
Sch EIC	8,010,392	0.0	0.0	0.1	0.1	0.2	1,468,572
Sch R	480,623	0.3	0.3	0.4	0.6	1.5	736,956
Individual Totals— Current Income Tax (Forms + Schedules)	307,899,174	NA	NA	NA	NA	NA	1,864,682,603
Armey-Shelby Flat Tax	91,621,036 ^b	0.04	0.4	0.3	0.4	1.14	104,447,981
USA Tax System							
Basic Form	94,723,336 ^c	0.3	1.8	1.3	1.6	5.00	473,932,423
Sch S (Net Savings Deduction)	66,306,335	0.03	0.3	0.63	0.4	1.36	90,176,616
Sch S-1 (Savings & Withdrawal Info.)	66,306,335	0.14	0.8	1.26	0.4	2.6	172,396,471
Individual Totals— USA Tax (Forms + Schedules)	227,336,006	NA	NA	NA	NA	NA	736,505,509
Schaefer-Tauzin Retail Sales Tax	0	0	0	0	0	0	0

*Schedules 1-3 are included in the average time.

^bEquals sum of nonbusiness 1040, 1040A, and 1040EZ Forms.

^cEquals sum of nonbusiness 1040, 1040A, 1040EZ, and 1041 Forms.

Source: Tax Foundation, using Internal Revenue Service data and estimation methods.

The 3.48 percent-of-tax-revenues figure generated by Price-Waterhouse is best viewed as an historic relationship that does not necessarily generalize to future tax collections. Therefore, my adjustment to the 1990 cost figure (\$6.8 billion) is increased by the increase in inflation-adjusted retail sales (20 percent) to yield an \$8.16 billion estimated 1996 compliance cost for the Schaefer-Tauzin national retail sales tax. The total hours reported in Table 5 result from dividing the 1996 cost by the hourly labor cost of \$42.4, the labor cost figure used to generate the Tax Foundation's \$224.7 billion total compliance cost estimate.

To offset the regressive incidence commonly attributed to a broad-based sales tax, the Schaefer-Tauzin plan proposes to provide a rebate to all wage-earning taxpayers. The rebate will be calculated according to a formula that combines family size, official poverty level statistics, and the number of wage earners per family.

Table 5
A Comparison of the Compliance Burden on Businesses of the Current Income Tax and Alternative Replacement Plans

Businesses	1996						Total Hours
	Estimated Number of Returns	Record-keeping	Education Stage	Form Preparation	Packaging/Sending	Total	
Sole Proprietorships*							
Form 1040	20,735,964	3.1	2.9	4.7	0.9	11.58	240,191,587
Sch C	18,791,763	6.4	1.2	2.1	0.6	10.27	192,928,762
Sch F	1,944,202	4.4	0.4	1.3	0.3	6.43	12,507,698
Sch SE	12,112,085	0.4	0.3	0.4	0.3	1.33	16,149,446
Partnerships							
Form 1065	1,485,600	38.4	19.8	35.4	4.0	97.58	144,969,800
Partnership Schedules							
Sch D	1,485,600	5.5	1.2	1.3	0.0	8.03	11,934,320
Sch K-1	1,485,600	24.6	8.6	9.4	0.0	42.68	63,410,360
Sch L	1,485,600	15.5	0.1	0.4	0.0	16.00	23,769,600
Sch M-1	1,485,600	3.4	0.2	0.3	0.0	3.82	5,670,040
Sch M-2	1,485,600	1.6	0.2	0.3	0.0	2.07	3,070,240
Corporations							
Forms							
1120	2,115,000	71.3	41.1	72.0	8.0	192.47	407,067,000
1120A	341,900	43.3	23.3	40.8	4.6	111.88	38,252,912
1120S	2,203,100	62.7	20.7	36.6	4.0	124.02	273,221,118
1120X	23,900	12.2	1.1	3.2	0.5	17.10	408,690
1120L	2,747	75.3	23.9	37.3	3.2	139.77	383,924
1120F	21,300	102.4	36.8	64.5	7.0	210.58	4,485,425
1120PC	2,747	106.4	33.3	54.2	5.1	199.02	546,678
1120RIC	7,100	52.4	15.3	29.9	3.8	101.25	718,875
1120REIT	322	55.7	17.3	33.9	4.3	111.18	35,801
7004	2,303,600	5.5	0.8	1.8	0.3	8.35	19,235,060
4626 (AMT)	339,279	18.4	18.2	15.2	0.0	51.88	17,602,926
4562 (Depreciation)	2,456,900	33.7	4.5	5.2	0.0	43.40	106,629,460
1120 Schedules							
Sch D	2,115,000	6.9	3.5	5.7	0.5	16.63	35,179,500
Sch H	211,500	6.0	0.6	0.7	0.0	7.28	1,540,425
Sch PH	105,750	15.3	6.1	8.5	0.5	30.43	3,218,325
1120S Schedules							
Sch D	2,203,100	9.3	4.2	9.2	1.3	24.10	53,094,710
Sch K-1	2,203,100	14.8	10.3	14.7	1.1	40.95	90,216,945
Business Total (Forms + Schedules)	79,153,958	NA	NA	NA	NA	NA	1,766,439,628
Flat Tax	26,881,564	2.3	0.3	0.4	0.4	3.4	91,397,319
USA Tax System	26,881,564	2.5	0.3	0.4	0.4	3.6	96,773,632
Schaefer-Tauzin Retail							
Sales Tax	NA	NA	NA	NA	NA	NA	192,452,830

* 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.

The plan proposes to administer this rebate through a system of payroll tax credits. The rebate, therefore, will not add to individuals' compliance costs, but will add an addition to the compliance costs businesses must bear in association with the payroll tax. However, the additional compliance would be minimal and the Schaefer-Tauzin plan would allow businesses to keep 0.5 percent of the sales tax revenue that they collect on the federal government's behalf.

Chairman ARCHER. Thank you, Dr. Hall.

Our next witness is a tandem, as I understand it; Rachel Wildavsky, who is accompanied by Mr. Dautrich. Ms. Wildavsky is the senior staff editor of Reader's Digest.

I don't know whether you want to testify and have backup from Mr. Dautrich or whether both of you want to testify, but either way, it is OK.

You may proceed.

STATEMENT OF RACHEL WILDAVSKY, SENIOR STAFF EDITOR, READER'S DIGEST, VIENNA, VIRGINIA; ACCOMPANIED BY KENNETH J. DAUTRICH, PH.D., PROFESSOR OF POLITICAL SCIENCE, AND ASSOCIATE DIRECTOR, ROPER CENTER FOR PUBLIC OPINION RESEARCH, UNIVERSITY OF CONNECTICUT, STORRS, CONNECTICUT

Ms. WILDAVSKY. Thank you, Mr. Chairman, and thank you for inviting Reader's Digest to testify today. Mr. Dautrich will help me in the Q&A, if that is all right with you.

Chairman ARCHER. OK.

Ms. WILDAVSKY. As you requested, I will take a few minutes to brief the Committee on the findings of a survey the Digest commissioned last October. But first, here is how the survey began.

Last fall, the Digest's editors met with Everett Ladd of the Roper Center for Public Opinion Research in the hope of catching up on some polling issues. Over dinner, Ladd mentioned that each year he asks his students what they think most Americans should pay in taxes. Each year his students respond with numbers well below what most Americans actually do pay.

This story at once caught our editors' attention. Why not, we asked Ladd, conduct a major national poll asking the same question?

Over the next few weeks, we worked with Ladd to develop just such a poll. In October 1995, the Roper Center administered the poll to a cross section of over a thousand Americans. I must emphasize that our poll did not ask just about Federal taxes. Each question on our survey asked respondents to consider all the taxes they pay to every branch of government, including Social Security, State income, sales, and property taxes.

In February we published our findings, and today I will highlight our story's two most important revelations.

First, we found that the maximum tax burden Americans think a family of four should bear is 25 percent, in all the family's taxes combined. As I will demonstrate in a moment, we found a remarkable consensus on that point.

Second, we found that most Americans believe they are over-taxed. What is more, they believe their neighbors are, too—their poor neighbors and their rich neighbors alike. The Digest's editors had often heard that what bothered middle- and working-class Americans about their taxes was their belief that affluent Americans were not paying their fair share. Our poll found no support whatsoever for that claim.

What did we ask to get these results? Here is how our poll was structured.

First, we asked respondents what percentage of their total incomes they thought they paid every year when they added all their taxes together. We then asked them if they thought that percentage was fair. If they didn't think it was fair, we asked them what was the highest percentage they thought would be fair.

Then we asked each respondent to consider a few hypothetical families of four, one earning a high but unspecified income, one earning \$200,000 a year, one earning \$100,000, one earning \$50,000, and one earning \$25,000 a year.

For each of those hypothetical families, we asked again, What did the respondent think each of these families paid? Did the respondent think that was fair? What was the highest percentage that would be fair?

The maximum tax burden our respondents thought it fair to impose on any of our hypothetical families was the one they named for the family earning \$200,000 a year. Evaluating median responses, the maximum fair tax burden our respondents named for that family was 25 percent. According to the Tax Foundation, such a family actually pays about 39 percent.

Our most stunning result was the unanimity we found on this belief, and here I will refer you to this chart to my right.

As the chart illustrates, male respondents to our poll thought 25 percent should be the top for any family. So did female respondents. So did respondents earning \$75,000 or more. So did respondents earning less than \$30,000. So did conservatives. So did liberals. I could go on. The median response was 25 percent not just across the board, but for every subgroup we analyzed except one, which was statistically insignificant.

If you asked whether the ocean was wet, you would probably find this kind of unanimity in response to a survey question, but to find agreement this widespread on a matter this important and potentially controversial is nearly unprecedented.

What does it mean? Common sense suggests it means people are very sure of their answers, just as sure as they would be in answering that the ocean was wet. Phone interviews I conducted after our results were in confirmed this commonsense interpretation.

I had been worried that when pressed, our respondents would back down. But the people I called affirmed their answers firmly and rationally. One respondent was on welfare herself, but wanted the rich to keep their money so they could create jobs. Another respondent, a working man, felt the rich were entitled to keep their money "to raise their families, improve their homes, and live a better life."

Our respondents didn't think the rich were the only ones who were overtaxed. Sixty-eight percent of our respondents thought their own taxes were too high, and according to the Tax Foundation, most made a fairly accurate estimate of what they paid.

On this point again, the consensus across diverse groups of Americans was strong. Conservatives, liberals, blacks, whites—they all thought they paid too much.

Today the Committee is considering tax reform. What might the Committee learn from our findings that could help us in this important work?

I believe the Committee might take away two points. The first is that there is in our Nation a widespread and deeply held belief that Americans of every income are paying too much. The point is drawn from our respondents' belief that not even the affluent should pay more than 25 percent. The second point is that Americans do not appear to be as wedded to the principle of progressive tax rates as the current Federal Tax Code is progressive.

The Reader's Digest wishes the Committee well as it ponders the policies toward which these conclusions might point.

[The prepared statement and attachment follow:]

March 20, 1996

Committee on Ways and Means
U. S. House of Representatives

Testimony of Rachel Wildavsky
Senior Staff Editor
The Reader's Digest Magazine

Thank you for inviting **The Reader's Digest** to testify today. As you requested, I'll take a few minutes to brief the Committee on the findings of a survey the **Digest** commissioned last October. But first, here's how the survey began:

Last fall, the **Digest's** editors met with Everett Ladd of the Roper Center for Public Opinion Research, in the hope of catching up on some polling issues. Over dinner, Ladd mentioned that each year, he asks his students what they think most Americans should pay in taxes. Each year, he said, his students respond with numbers well below what most Americans actually do pay.

This story at once caught our editors' attention. Why not, the **Digest** asked Ladd, conduct a major national poll asking the same question?

Over the next few weeks, we worked with Ladd to develop just such a poll. In October, '95 The Roper Center administered the poll to a cross-section of 1015 Americans. I must emphasize that our poll did not ask just about federal taxes. Each question on our survey asked respondents to consider "... all the taxes you pay to the federal, state, and local governments, including Social Security taxes, state income and sales taxes and local property taxes." In February, we published our findings in **The Reader's Digest**, in an article called "How Fair Are Our Taxes?"

What did our survey find? Today, I'll highlight only our two most important discoveries. For more, I'll refer you to a reprint attached to my testimony.

First, we found that the maximum tax burden Americans think a family of four should bear is 25 percent, in all the family's taxes combined. As I'll demonstrate in a moment, we found a remarkable consensus on that point.

Second, we found that most Americans believe they are overtaxed. What's more, they believe their neighbors are too -- their poor neighbors and their rich neighbors alike. The **Digest's** editors had often heard that what bothered middle- and working-class Americans about their taxes was their belief that affluent Americans were not paying "their fair share." Our poll, however, found no support whatsoever for that claim.

What did we ask, to get these results? Here's how our poll was structured:

First, we asked respondents what percentage of their total incomes they thought they paid every year, when they added all their taxes together. We then asked them if they thought that percentage was fair. If they didn't think it was fair, we asked them what was the highest percentage they thought *would* be fair.

Then we asked each respondent to consider a few hypothetical families of four -- one earning a "high" but unspecified income; one earning \$200,000 per year; one earning \$100,000; one earning \$50,000; and one earning \$25,000. For each of those hypothetical families, we asked the same questions we had asked about the respondent himself. What did the respondent think each of these families paid? Did the respondent think that was fair? What was the highest percentage that *would* be fair?

The maximum tax burden our respondents thought it fair to impose on any of our hypothetical families was the one they named for the family earning \$200,000. Evaluating median responses, the maximum fair tax burden our respondents named for that family was 25 percent. According to The Tax Foundation, such a family actually pays about 39 percent.

Our most stunning result was the unanimity we found on this belief. Male respondents to our poll thought 25 percent should be the top for any family. So did female respondents. So did respondents earning \$75,000 per year or more. So did respondents earning less than \$30,000. So did blacks, whites, conservatives, liberals -- I could go on. The median response was 25 percent not just across the board, but for every subgroup we analyzed except one. (Unmarried respondents came in at 29 percent, but this exception was statistically insignificant.)

If you asked whether the ocean was wet you'd probably find this kind of unanimity in response to a survey question. But to find agreement this widespread on a matter this important and potentially controversial is nearly unprecedented. What does it mean? Common sense suggests it means people are very sure of their answers -- just as sure as they would be in answering that the ocean was wet. And phone interviews I conducted with some of our respondents after our results were in confirmed this common-sense interpretation.

I had been anxious about those phone calls -- worried that when pressed, our respondents would back down, or be unable to defend their point of view. But the people I called affirmed their answers firmly and forthrightly, and offered rational and principled reasons for their beliefs. One respondent was on welfare, herself, but wanted the rich to keep their money so they could create jobs. "If we didn't have folks that could make more money," she said, "the poor folks wouldn't be making anything." Another respondent -- a working man -- felt the rich were *entitled* to keep their money, "to raise [their] families, improve [their] home[s], and live a better life."

But our respondents didn't think the rich were the only ones who are overtaxed. 68 percent of our respondents thought their own taxes were "too high" -- and according to the Tax Foundation, most made a fairly accurate estimate of what they paid. On this point, again, the consensus across diverse groups of Americans was strong. 68 percent of "conservatives," 67 percent of "liberals," 70 percent of blacks, and 68 percent of whites thought they paid too much. Of those with children living at home, 74 percent were dissatisfied. I should note that it does not appear always to have been thus. According to The Gallup Organization, as recently as 35 years ago, 46 percent of Americans thought their federal income taxes were "about right."

Today the Committee is considering tax reform. What might the Committee learn from our findings, that could help it in this important work? Nothing direct, I am afraid, about specific measures.

But the Committee might take away two points. The first is that there is in our nation a widespread and deeply held belief that Americans of every income are paying too much. The second point is drawn from our respondents' belief that not even the affluent should pay more than 25 percent. This second point is that Americans do not appear to be as wedded to the principle of progressive tax rates as the current federal tax code is progressive. **The Reader's Digest** wishes the Committee well as it ponders the policies toward which these conclusions might point.



How Fair Are Our Taxes?

BY RACHEL WILDAVSKY

Special Report

A Reader's Digest poll reveals what Americans feel is the most anyone should have to pay

How Fair Are Our Taxes?

BY RACHEL WILDAVSKY

FOR YEARS, we have heard that Americans—rich and poor and those in between—disagree about tax fairness. According to this conventional wisdom, the middle class and the poor think the rich should pay a heavy share. The rich supposedly think otherwise—and manage to pay very little.

True?

Last fall, Reader's Digest commissioned an exclusive poll for the purpose of learning what Americans really think. Our key findings:

- The maximum tax burden that

Americans think a family of four should bear is 25 percent of its total income. That's not just federal income tax. That's 25 percent for all the major levies combined—federal, state and local—including income, Social Security, sales and property taxes. In fact, most Americans pay far more than this maximum.

- There is remarkable consensus on the issue of tax fairness. When asked to name the highest total tax that families of four should pay, respondents across economic, racial and ideological lines answered with

READER'S DIGEST

astounding unanimity. Again and again, the median response was the same: 25 percent. (See chart on page 59.)

"This consensus is the single most extraordinary finding in the history of domestic-policy polling in the United States," says Everett Ladd, a professor of political science and director of the Roper Center for Public Opinion Research at the University of Connecticut. Ladd, who conducted the Reader's Digest poll, has 19 years of experience in international survey research. "America is probably the only country in the world," he says, "where there are no significant differences by party or class in the 'ideal,' fair tax."

Another crucial finding of the poll is Americans' extraordinary personal unhappiness with the amount they themselves pay in taxes. More than two-thirds—68 percent—felt their own total tax payments were "too high."

This broad dissatisfaction with taxes has not always been the case. According to survey research from the Gallup Organization, as recently as 1961, Americans were equally divided between those who thought their federal income taxes were "too high" and those who thought they were "about right" (46 percent for each). Since that date, though, the percent of dissatisfied Americans has risen steadily. By 1982, 60 percent thought their taxes were too high and only 32 percent were satisfied—a 28-point gap. By 1994, the gap had widened to 36 points, with 66 percent dissatisfied and 30 per-

cent thinking their taxes were fair.

What happened in that period? According to William Schneider of the American Enterprise Institute, people lost confidence in the government—even as inflation drove their taxes up, up, up. "People started to think in the mid-1960s that the government was not in control of events and was out of sync with society," Schneider says, basing his comments on polls taken at the time. "People were paying more, and they didn't think they were getting value for their money." He says dissatisfaction with the government remains "the basic political fact of the '90s" and still affects opinions about taxes today.

But other pundits and political leaders offer different explanations for why Americans resent their taxes. One perennial claim is that Americans are angry because they think that others aren't paying enough. House Democratic Leader Richard A. Gephardt (D., Mo.) made this assertion last September. In announcing a plan to reform taxes, Gephardt declared that, from walking door-to-door in St. Louis, he knew Americans were bothered because "a privileged few" pay too little, squeezing everyone else.

Washington analyst and commentator Kevin Phillips made a similar point in his 1993 book *Boiling Point*. Phillips blamed "the dangerous rise of middle-class frustration" on, among other things, "tax rates that hit record highs for average families and record lows for millionaires."

Contrary to these claims, The

Digest's poll found evidence that Americans at every income level think we are all overtaxed.

The Reader's Digest poll was administered by phone to a cross-section of 1015 Americans in late October 1995. For each question, we asked respondents to think about "not just federal income taxes, but all the taxes you pay to the federal, state and local governments, including Social Security taxes, state income and sales taxes and local property taxes."

We asked, "About what percentage of your total income do you think you pay every year, when you add all these taxes together?" Then we asked respondents to consider the same question for various families of four, each of which earned a different income. Evaluating their median responses—which are less susceptible to distortion than are other measurements—we found that respondents did a good job estimating their own overall taxes and the taxes paid by families earning \$25,000 and \$50,000. But they significantly underestimated the taxes paid by higher income families.

We also asked Americans about tax fairness. "What," we asked, "is the highest percentage you think would be fair for a family making \$200,000 a year to pay when you add all their taxes together?"

Despite the oft-heard belief that the poor and middle-class resent "the privileged," Americans earning less than \$30,000 per year agreed with

How Much Is Fair?

Question: What is the highest percentage of income that would be fair for a family of four making \$200,000 to pay in all taxes combined?

Responses:

Males
Females

25%

Whites
Blacks

25%

Those with a high-school degree or less

...with some college

...with college degree or more

25%

Those earning less than \$30,000

...\$30,000-\$49,999

...\$50,000-\$74,999

...\$75,000 or more

25%

Those 35 yrs. of age or younger

...36-49 yrs. of age

...50-64 yrs. of age

...65 yrs. of age and older

25%

Republicans
Democrats *
Independents

25%

Conservatives
Moderates
Liberals

25%

In reality, such a family pays

39%

* The median response for Democrats was 29 percent.
Source: Survey by the Roper Center for Public Opinion Research for Reader's Digest, October 21-29, 1995; The Tax Foundation

READER'S DIGEST

the other income groups that 25 percent was the maximum tax burden that would be fair for a family of four earning \$200,000 a year.

In real life, such a family pays on average 39 percent of its total income in taxes.

Clearly, our respondents felt that's too much. Self-described conservatives agreed with self-described liberals. Singles agreed with marrieds. Blacks agreed with whites. Americans in nearly every group—across racial, economic, age, ideological, religious, educational and sexual lines—had the same median response: a family of four with an income of \$200,000 should pay no more than 25 percent in all its taxes combined. (The median among Democratic respondents was 29 percent. This exception is statistically insignificant.) Says Ladd, "Consensus like this means people have thought about this issue. It indicates an opinion that is rock-solid and national."

When we worded the question a little differently, we got an even lower percentage. In this question we simply asked people to consider a family of four "that makes a high income." What is the "highest percentage that you think would be fair for any family to pay in all their taxes combined, no matter how high their income?" Here the answer was 20 percent. Again, the consensus was striking; that same median amount was suggested by, among others, men, women, the elderly, the young. Even Democrats and Republicans agreed on this question.

Respondents we contacted after

completing our poll were surprised that they had underestimated the taxes people pay. Emery Platt of Garnet, Kan., is now retired from a farmer's co-op where for years he ran the grain elevator, loaded fertilizer and did "about everything else." Platt is not affluent, but he doesn't think that taxes should consume 39 percent of any family's income. He says, "You ought to be able to use your money for your own purposes—to raise your family, improve your home, and live a better life."

Another respondent we contacted is from Elkhart, Ind. This woman, who is on welfare, thinks it only hurts her if the government heavily taxes high earners. They "can create jobs and hire poor people," she says.

To a remarkable degree, different groups of Americans agree they themselves pay too much in taxes. The percentage is the same for men and women (68 percent), virtually the same for blacks and whites (70 percent and 68 percent), conservatives and liberals (68 percent and 67 percent). By party, Republicans (73 percent) and Independents (71 percent) think their taxes are too high; 60 percent of Democrats think so.

Respondents with children living at home were especially dissatisfied; a whopping 74 percent of them said they pay too much, versus 64 percent of those without children at home. The elderly—who in many polls express satisfaction with their financial lives—were less unhappy; only 47 percent complained about what they pay. But, overall, how many

HOW FAIR ARE OUR TAXES?

of our respondents said the taxes they pay are fair? Just 27 percent.

Respondent Shelia Richardson of Philadelphia says she earns "between \$25,000 and \$30,000" per year. Richardson—who is separated, with four children ranging from five to 20 years old—thinks she is "definitely" over-taxed. "When I do a little bit of overtime, they take so much out it's hardly worth it," she says. "But I have to do the overtime, because I need the money. I'm between a rock and a hard place."

Some politicians, sensing wide and profound dissatisfaction with the status quo, have proposed significant changes in our federal income tax. Some call for a flat tax, for

example, which would replace the present complicated system of different rates and deductions with a single, low rate for everyone. Others have proposed replacing the federal income tax with something else entirely, such as a national sales tax.

The Digest did not ask respondents what they thought of any of these proposals. What we did ask, however, clearly revealed that Americans regard the tax burden as unfair. And to an extraordinary extent, diverse groups agree on what the maximum tax burden should be. As the Reader's Digest poll so powerfully reveals, there is in this country a sweeping and deeply held belief that we are all overtaxed.

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Chairman ARCHER. Thank you very much, Ms. Wildavsky.

Our last witness on this panel is Mr. Burnham, an author who has written "A Law Onto Itself: The IRS and the Abuse of Power." Mr. Burnham.

STATEMENT OF DAVID BURNHAM, AUTHOR, "A LAW ONTO ITSELF: THE IRS AND THE ABUSE OF POWER"

Mr. BURNHAM. Thank you, Chairman Archer and Members of the Committee, and thank you for requesting my testimony.

My purpose, as I understand it, is to describe some of the systematic problems that have resulted from the administration of the income tax laws by the IRS. I speak today as an experienced investigative reporter, mostly with the New York Times, and as the author of "A Law Onto Itself: The IRS and the Abuse of Power."

My book, the product of 4 years of scholarship, argues that since the passage of the income tax law in 1913, the IRS has indirectly become the Nation's single most powerful instrument of social control.

Everyone knows that information is power. Everyone knows that when confidential information is collected and stored, it is very hard to prevent its misuse.

If limiting the abuse of tax information only required us to control the wrongdoing of individual rotten apples within the agency, it would be easy to do, but history tells us that the real problems lie not with the individual rotten apples within the barrel, but the barrel itself.

In the case of the IRS, the record is clear. Over and over again, the use of the agency and its information for improper political purposes has gone forward on the basis of direct orders from the most senior officials of the government, including several Presidents.

President Herbert Hoover, for example, angered by conservative attacks on his plan to cut back on military expenditures, ordered an investigation that eventually led to a search of IRS records for confidential information about the Navy League and its members.

Henry Morgenthau, President Franklin Delano Roosevelt's Treasury Secretary, directly ordered the IRS to investigate and bring criminal tax charges against his immediate predecessor, Andrew Mellon. While the IRS reluctantly obeyed Secretary Morgenthau's order, a Federal grand jury, in an unusual show of independence, refused to indict the Republican millionaire.

The Roosevelt administration also used the IRS to investigate and harass a wide range of other political opponents, including Huey Long, the Governor of Louisiana; Rev. Charles E. Coughlin, the rightwing radio commentator; Republican Representative Hamilton Fish, who I believe was a Member of this Committee for many years; and Paul Robeson, the great singer and Communist Party member.

Under John F. Kennedy, the IRS systematically stripped tax-exempt status from conservative religious groups that spoke out against the Kennedy administration.

Under Richard Nixon, the IRS formed the Special Services staff, a secret IRS unit that for a fairly short period of time audited political dissidents who had been nominated for such treatment by local police departments.

During the period Ronald Reagan was in the White House, one organization that openly opposed the President's position in Central America and another that supported the evolutionary theories of Charles Darwin were subjected to heavyhanded IRS challenges that raised the possibility of political policing.

These seven examples of how the IRS were manipulated by various Presidents and their assistants for political purposes have one thing in common. They all involved actions designed to injure a single individual or group, the Navy League, Huey Long, or the North American Congress on Latin America, but there have been instances when the men around the President have sought to use the IRS for a broader political purpose.

Both Kennedy and Nixon, the record shows, attempted to influence the political mood of the American people by secretly pressuring the IRS to alter its handling of income tax refunds.

In the case of Kennedy, the administration ordered the IRS to speed up refunds in an effort to boost the flagging economy at a politically sensitive moment.

In the case of Nixon, Peter Flanigan, a White House aide, sought to arrange widespread overwithholding by corporations so that the national mood would later be elevated when the IRS began sending out more than generous refunds than usual.

This kind of manipulation has happened throughout the IRS history. With the income tax, the collection of all that information makes it almost inevitable.

I will remind you of a little bit of history. The British Government during the Napoleonic wars wanted an income tax, and to get it, the British Parliament was very much against us, and to get it—the government promised that once the war was over, they would destroy the records. With the ultimate British victory and a great public show, all the records were taken into a public square and burned in a huge bonfire. Many years later, however, in an obscure warehouse, evidence was discovered that proved the bonfire was a sham; that a complete copy of the records had been made before the fire for use for whatever the government wanted it for.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

**STATEMENT OF DAVID BURNHAM, AUTHOR
"A LAW ONTO ITSELF: THE IRS AND THE ABUSE OF POWER"**

IRS ABUSES: PRESENT, PAST AND FUTURE

Mr. Chairman and members of the committee. Thank you for requesting my testimony. My purpose, as I understand it, is to describe some of the systematic problems that have resulted from the administration of the income tax law by the Internal Revenue Service. I speak today as an experienced investigative reporter and author of A Law Onto Itself: The IRS and the Abuse of Power. My book, the product of four years of scholarship, argues that since the passage of the income tax law in 1913 the IRS has become the nation's single most powerful instrument of social control.

The growing reach of the IRS, however, is very much a work in progress. Just one month ago, for example, the Computer Science and Technology Board of the prestigious National Research Council released its final report on the IRS's technically troubled multi-billion Tax System Modernization program.¹

News accounts about the NRC report emphasized the finding that IRS's management of the modernization program had not met the challenge of developing a new tax system that will be able to effectively handle the extraordinarily complicated business of collecting income taxes from hundreds of millions of American taxpayers in the 21st century.

The accounts, however, did not emphasize what the NRC indicated could develop into an even more serious shortcoming of the IRS's tax modernization system.

Without immediate, extensive and substantial changes in the security systems now being put in place, the NRC said, highly personal information about the lives of every single American taxpayer and their families will be far more subject to improper and unlawful use and distribution than it is today.

Should the IRS fail to deal with this serious management and technical challenge, the NRC report said, the gap between the agency's security mechanisms and its lawful obligation to protect

¹The GAO, in its 1995 report, Tax System Modernization: Management and Technical Weakness Must Be corrected If Modernization is to Succeed, GAO/AIMD-95-156, documents that as of that period the IRS had already spent \$2.5 billion for TSM since 1986. The National Research Council reports that as of early this year the FY 1996 appropriations for TSM appear to be \$695 million.

individual tax information from unauthorized snooping will continue to widen, "thus virtually ensuring massive security breaches in the coming years."²

The National Research Council prediction of what will happen to tax return information in the future, of course, is extraordinarily utopian. I say this because we all know that serious abuses related to such security breaches -- sometimes for political purposes -- have been a frequent occurrence in the long, and continuing, history of America's income tax.

Very recently, for example, we learned that more than 1,300 IRS employees had been investigated for using IRS computers to improperly snoop of American citizens.³

According to the news reports, about one third of 1,300 employees who were investigated were subjected to sanctions ranging from counseling to discharge from the agency, with several hundred cases still unresolved. (A later analysis by the agency's inspector general indicated that the IRS had been too lenient in its treatment of the snoopers.)

We further know that just a few months ago in Boston a member of the Knights of the Ku Klux Klan named Richard Czubinski was convicted of unlawfully using IRS computers to obtain confidential information about more than 30 people who he had concluded were his political enemies. Among these "enemies" was an assistant district attorney who was prosecuting Czubinski's father and members of a campaign committee that had supported a political candidate who defeated Czubinski in a primary election. Czubinski, of course, was an IRS employee at the time of his snooping.⁴

Czubinski was not the only Boston-area IRS employee caught with his hand in the cookie jar. Also indicted was Walter Higgins, who held a second job as a private investigator. The government

²Final Report, "Continued Review of the Tax System Modernization of the Internal Revenue Service," Computer Science and Telecommunications Board, National Research Council, January 18, 1996, p. 58

³Robert D. Hershey, IRS Staff is Cited in Snooping, The New York Times, July 19, 1994, p. 1.

⁴Information Access Company, IRS Worker Guilty of Snooping Taxpayer Info, December 20, 1995.

said Higgins had waltzed around the theoretically stringent computer controls and extracted IRS information about a former congressional candidate, as well as someone who owed him money.

Naturally enough, the IRS response to all the unpleasant publicity about all this inhouse snooping was to focus a large chunk of its efforts in seeing to it that such unauthorized access to tax records by IRS employees was made more difficult.

This response, however understandable, was wrong headed for several obvious reasons.

First, as emphasized by the National Research Council report, the penetration of IRS computers by outsiders may well be a more serious threat than that posed by insiders.

The committee said that outsiders -- including individuals, corporations and foreign governments -- were seeking to obtain the masses of confidential and extremely valuable taxpayer information stored in the IRS computers for a variety of reasons. Some hoped to sell the information to the highest bidders. Some saw the IRS computers as a rich source of blackmail information. Others wanted to alter their own records and thus eliminate possible legal problems they might have with the IRS. Yet others viewed the information as a good way to improve their negotiating positions in civil and criminal actions of all kinds.

A second reason why the IRS's myopic focus on the wrong doing of individual "rotten apples" within the agency is flawed is that it ignores a historic fact: rogue agents probably are not the central problem. As historical record strongly suggests, the misuse of the tax information collected by the government for improper political purposes frequently has gone forward on the basis of direct orders from the most senior officials of the government, including several presidents.

The research for my book found strong evidence that the abuse IRS tax information by individuals at the highest levels of government has been a continuing problem under both parties. For example:

* President Herbert Hoover, angered by conservative attacks on his plan to cut back on military expenditures, ordered a secret investigation that eventually led to a search of IRS records for confidential information about the Navy League and its members.

* Henry Morgenthau, President Franklin Delano Roosevelt's Treasury Secretary, directly ordered the IRS to investigate and bring criminal tax charges against his immediate processor, Andrew Mellon. While the IRS reluctantly obeyed Secretary Morgenthau's order, a federal grand jury, in an unusual show of independence, refused to indict the Republican millionaire.

* The Roosevelt Administration also used the IRS to investigate and harass a wide range of other political opponents, including Huey Long, the governor of Louisiana; the Reverend Charles E. Coughlin, the right-wing radio commentator, Republican Representative Hamilton Fish, and Paul Robeson, the great singer and Communist.

* At 11:50 AM, on January 13, 1944, a young, well-connected and extremely ambitious congressman named Lyndon Johnson had a private meeting with Franklin Roosevelt. Johnson and his most generous corporate supporter -- Brown & Root -- were the subject of a very serious criminal investigation that was about to erupt in series of criminal tax charges. Four hours after the meeting between FDR and the young LBJ, a senior IRS official named Elmer Irey requested the agency's investigators in Texas to send him a report on Brown & Root's political contribution to Johnson's 1941 campaign. The criminal prosecution was not to be. Some months later, Brown & Root paid \$375,000 in back taxes in a civil proceeding that by law was confidential.

* Under John F. Kennedy, the IRS systematically stripped tax exempt status from conservative groups that spoke out against the Kennedy administration.

* Under Richard Nixon, the IRS formed the Special Service Staff, a secret IRS unit that for a fairly short period of time audited political dissidents. I happen to be a friend of Mae and Robert Churchill, a Los Angeles couple who publicly questioned the operating procedures of the Los Angeles Sheriff's Department and as a result became the subject of four audits by the SSS.

* During the period Ronald Reagan was in the White House, one organization that openly opposed the president's position in Central America and another that supported the evolutionary theories of Charles Darwin were subjected to heavy-handed IRS challenges that raised the specter of a political police operation.

These seven examples of how the IRS powers were manipulated by various presidents and their assistants for political purposes have

one thing in common: they all involve actions designed to either help or injure a single party -- the Navy League, Huey Long, Lyndon Johnson or the North American Congress on Latin America.

But there have been instances when the men around the president have sought to use the IRS for far broader political purposes. Both Kennedy and Nixon, for example, attempted to influence the political mood of the American people by secretly pressuring the IRS to alter its handling of income tax refunds. In the case of Kennedy, the administration ordered the IRS to seep up refunds in a secret effort to boost the economy. In the case of Nixon, Peter Flanigan, a White House aide, sought to arrange widespread over withholding by corporations so that the national mood would be elevated when the IRS began to send out more generous than usual refunds.

Every one knows that information is power. Everyone knows that when confidential information is collected and stored it is very hard to keep it from being abused.

It is this reality that makes so astonishing the December 1994 disclosure by Frank Greve, an investigative reporter with Knight-Ridder's Washington bureau that the IRS was not satisfied with all the information already being provided it each year by the nation's taxpayers.⁵ In an official notice in the Federal Register, Greve reported, the IRS had said that along with all the existing tax data the agency already possessed that it now planned to develop a vast new data base. This new data base would contain every scrap of public and private information that the agency could lay its hands on about every American. Among the desired scraps were the following: credit reports, news stories, tips from informants and information drawn from real estate, motor vehicle and child support records.

"Any individual who has business and/or financial activities," the IRS notice said, can expect the new computer system to make such information available to every IRS auditor upon demand. While the IRS conceded that some of the information it planned to collect would be inaccurate, the agency said that taxpayers would not be permitted to see the raw data so they could rebut any false allegations.

The publication of Frank Greve's report about the tax agency's expansive enforcement plan generated a wave of protests from

⁵Frank Greave, "IRS Is Watching You -- Secret Files to Expand," Knight-ridder Newspapers, January 20, 1995.

citizens all over the United States and within days the IRS announced that it had all been a big mistake, that it never really planned to create the intrusive data base so clearly described in the Federal Register notice.

But as a careful reading of history tells us, we should not put too much faith in the promises of the IRS or any other bureaucracy. During a particular grievous period of the Napoleonic Wars, the British government persuaded a reluctant Parliament to agree to an early income tax on the promise that the tax records would be destroyed at the end of the war. With the ultimate British victory, with great fanfare, the records were apparently burned in a gigantic public bonfire. Many years later, however, in an obscure London warehouse, it was discovered the bon fire had been a sham, that the government had carefully made a second set of records that of course were not put in the bonfire.

Chairman ARCHER. Thank you, Mr. Burnham, and our gratitude to all of you who have come today and given us a good insight into the current system.

Thomas Jefferson wrote in his memoirs that his greatest achievement in public office was the elimination of any direct contact between an individual citizen and a Federal tax collector. He cited that as his greatest achievement. He did not cite the Declaration of Independence. He did not cite his writings on religious liberty. He cited the removal of the Federal tax collector from any direct contact with individual sin in this country.

I guess I have laid the predicate for my question that I want to ask of each of you. How much would each of you pay not to have to deal individually with a Federal tax collector per year?

Mr. Lalli.

Mr. LALLI. Well, it would save me whatever I pay my accountant, and I think that would be a start.

Mr. HALL. I would say—

Chairman ARCHER. That varies depending on which accountant you used, based on your testimony.

Dr. Hall.

Mr. HALL. I would say a couple hundred dollars a year. Happily, I have never had a direct run-in with a Federal tax collector, though.

Chairman ARCHER. But you figure that would be a good insurance premium?

Mr. HALL. Yes, sir, absolutely.

Chairman ARCHER. Ms. Wildavsky.

Ms. WILDAVSKY. I have to say I don't understand the question. You are wondering what it would be worth to pay for a guaranty that you would not have anything to do with a Federal tax collector?

Chairman ARCHER. That you would not individually have to deal with a Federal tax collector.

Ms. WILDAVSKY. I would have to consult with my husband before I could make a commitment on that figure.

Mr. BURNHAM. I would have to consult with my wife. She loves the numbers, and she has a program and she really gets into it, but I know it takes her a lot of time, and I am sure she would love not to have to do it.

Chairman ARCHER. Dr. Dautrich.

Mr. DAUTRICH. At least several hundred dollars.

Chairman ARCHER. Several hundred dollars.

Have any of you placed a value on individual freedom and privacy in that analysis, or just strictly the administrative cost?

Mr. BURNHAM. I was thinking of the administrative cost.

If you add the political manipulation and the controlling, it gets much bigger, much, much bigger.

I think privacy is an enormously important value in our society, and inevitably, with the Tax Code and the IRS, that value is undermined.

Chairman ARCHER. In the opinion of each of you, what would be the simplest form, just from the standpoint of simplicity because you always get into the argument of equity relative to simplicity,

but from simplicity, what would be the best form of taxation for the Federal Government to use to raise its money?

Mr. LALLI. We have taken no stand on that at the magazine.

I would just caution that as I tried to point out in my testimony, past attempts at simplicity have sometimes turned out to be quite complex as well. So I don't have a ready answer for you.

Mr. HALL. I think from a purely administrative standpoint, you would be hard pressed to find anything more simple than a single-rate retail sales tax that exempted nothing and gave no one special privileges.

Chairman ARCHER. Ms. Wildavsky.

Ms. WILDAVSKY. I am afraid I am not prepared to make a recommendation on that today either. I can only tell you about the results of our poll, I am afraid.

Chairman ARCHER. Dr. Dautrich.

Mr. DAUTRICH. I will pass as well. I would have to defer to my accountant.

Chairman ARCHER. You people are supposed to be pretty knowledgeable about the subject matter. It is a little disconcerting.

Mr. BURNHAM. We are all journalists, also, and we are trying to maintain an objective look at each of the possibilities and maintain that position. It is a little bit of a problem for us.

Clearly, the sales tax would appear to be—if you got it in place—it would appear to be less intrusive, though I imagine there are a number of corporations which would find it pretty intrusive, also.

As I understand the administration of the value-added tax in England, the corporations have the tax collectors knocking on their door. No system is going to be surveillance free.

Chairman ARCHER. You have got to have a point of collection. You have got to raise revenue to pay the legitimate government bills. We have to accept that.

Mr. BURNHAM. We agree to that.

Chairman ARCHER. But the question is how do we do it in the simplest way, and I appreciate your responses, although we at some point have got to make a decision. We can't simply say, Well, we are not really sure.

Mr. BURNHAM. We are not elected.

Chairman ARCHER. I understand, but we need your help and the help of every other American to give us their ideas as we develop our concepts during this process.

Let me ask one last question, and then I will turn to my Members. Mr. Lalli, I guess this is primarily directed at you, although others could chip in on it. Tax preparers are not accurate under today's system, would you clearly have established that for this Committee?

Mr. LALLI. Yes.

Chairman ARCHER. Then how can we have confidence in the accuracy of IRS decisions, because I assume that, for the most part, the IRS agents are not better educated or better qualified, individually, as they make their audits and as they pursue compliance, than the outside private tax preparers.

Mr. LALLI. Mr. Chairman, I think you have a fine point there. They are the last word in the debate, and I think there are many ambiguities built into the Tax Code. We knew this when we put

the test together, and we did that with great care to be sure that it would be as fair and accurate as it could be.

We brought experts in to devise the test for us. Then we pretested it. We had other experts take the test and then come to some conclusion about what the correct tax was, but in some cases, we had esteemed experts who came to different conclusions about different entries, and they could defend it, not necessarily by looking to the Tax Code, perhaps looking to a private letter ruling, perhaps looking to a judge's decision, and operated from some base of knowledge and also some base of credibility, but yet reach different decisions.

I think when you get before an IRS auditor, if that happens, the IRS auditor is going to be the final judge unless you take it on to a Tax Court.

Let me add just one other point on your previous question. We did do a poll in January. This is a national poll as well, and I think it points to the task that you face in trying to devise a fairer system.

At this point, the American public has no consensus that we can see on what a fairer system would be. They want reform. Something like 80 percent want reform, and certainly, the number one priority is that it is fair, but when we ask the question what kind of tax would you like, there is no consensus. So only about 30 percent at this point would favor a flat tax, 16 percent would prefer a national sales tax, and then it falls off from there.

So one of the jobs that you will have to do in coming to a conclusion about what a fairer system will be is then to sell it to the American public because at this point they are unsold.

Chairman ARCHER. Thank you.

Mr. GIBBONS.

Mr. GIBBONS. Ms. Wildavsky, your chart over here, the 25 percent that the respondents thought was fair, I assume, included all taxes of all levels of government.

Ms. WILDAVSKY. Yes, it did. That is all the taxes that you pay at every level of the government combined. That was the highest response we got.

Mr. GIBBONS. I certainly don't challenge that. It is probably right, but I would point out that the average American family today pays in Federal taxes just 23.8 percent of their family income. So that doesn't leave the States and the local governments much room to get within the fairness picture or us to get within the fairness picture.

Ms. WILDAVSKY. I should say that the 25-percent figure was not what our respondents said the median family should pay, or it wasn't what our respondents said everyone should pay. That was what our respondents thought a family earning \$200,000 a year should pay.

Mr. GIBBONS. Oh, \$200,000.

Ms. WILDAVSKY. Right. When we asked people what do you think you should pay, what would be the maximum fair tax burden for you, all of the responses at every income level, I mean, for respondents of every income level, it fell between 15 and 20 percent.

So, no matter what the income level of the respondent, the median answer to that question, what do you think would be the max-

imum fair tax burden for you, was somewhere between 15 and 20 percent, a remarkably narrow range, I should add.

Mr. GIBBONS. I don't want to speculate about that, but that would require a revolution beyond, I think, anything that anybody has contemplated in America to ever get to that rate unless there is some magic way to increase our income substantially that no one has ever come up with.

Dr. Hall, you have said that you thought that a retail sales tax would perhaps be the easiest to collect, and let me take issue with you on that.

I happen to be an expert on the retail sales tax. I used to make a considerable amount of money out of litigating the Florida retail sales tax, and a retail sales tax is not as simple as it looks on its face.

The principal problem that you have with a retail sales tax is determining where the final sale takes place. I won't go into an in-depth discussion, but let me tell you, that is a very complex issue that all tax authorities break down on, and it is like defining income in the income tax system. It is extremely complicated when you begin to apply it.

That is the reason why I finally went to a subtraction method, value-added tax system because it does away with that complexity, and also, for the parallel reason, the States have pretty much preempted the retail sales tax as a source. I think we would run into a lot of political problems with the States if we tried to engraft our retail sales tax on their retail sales tax.

Do you have any comments on what I have just said?

Mr. HALL. No, sir. I certainly defer to your experience, and I was speaking strictly from an administrative point of view, and I acknowledge your comments.

Mr. GIBBONS. Thank you very much.

Thank you, Mr. Chairman.

Mr. THOMAS [presiding]. Thank you.

I think all of us are fully cognizant of the fact if there was an easy and painless alternative to the current structure, we wouldn't be here. What we are looking at is the best of options which will have some downside to it.

My big worry is that, as indicated by the Reader's Digest poll and as indicated by other people's guesses as to what they think would be an appropriate structure, my constituents are probably right smack in the middle, and that is every one of them wants to pay their fair share. Currently, they are paying more than their fair share, and that is just about the way it is with everyone. We understand the problem that we have going forward.

You are not elected, but you are more powerful than we are, in bringing the American people to an understanding of the realistic options that they have in front of them.

Take a look at the recent Presidential primaries in terms of an attempt to sell, an alternative which has some attractiveness to it, but which clearly has some negatives to it as well, the flat tax as proposed by several individuals.

It is almost always sold in a political context as a panacea, rather than a choice which gives you some upside and some downside.

In 1993, when President Clinton and the First Lady rolled out their health care proposal, one of the things I honestly believe that led to its defeat was the relatively objective approach of the media in explaining what was in it, so that the more the American people knew what was in it, the less they liked it.

The reason I say you are more powerful than we are is that I think it is going to fall upon you folks as journalists, both in the print and audio, to explain the options to the American people, so that they understand the upsides and the downsides, and especially the secondary benefits from choosing a different system.

Now, you haven't been willing to tell us which one it ought to be, and I understand. You all said you were journalists. I will ask you the question I think you should be asked. Is it your intention, your desire, your willingness, your hope that if we can carry out from our end of the bargain a relatively objective, rational examination that you folks will magnify it through your ability to focus and put it in more understandable terms that we sometimes are able to do, what those options are, what the upsides and the downsides are? Our job will be to roll out the product. Your job will be to compare it with what we do.

Is that a process that over the next year or two, do you think, that can bring the level of the American people in terms of their education and understanding, rationally their options, to a conclusion? Do you think we can create a funnel of a discussion on options that would at least narrow our options with a full understanding that our goal is to replace the income tax? Is that something that you think you could participate in, that you would want to, and that it would be worthwhile?

Mr. BURNHAM. Mr. Thomas, with all due respect to Congress and this Committee, could I point out that one of the chief responsibilities of Congress is to do oversight of the IRS, and that, historically, the GAO and Congress have spent more time worrying about getting the income in than looking for abuses in the agency, and I think all of you know that. If there was more tough-minded IRS oversight about the failings of the way the tax is administered, there would be more public support for your position.

Mr. THOMAS. I will tell the gentleman, I was on the Oversight Committee when J.J. Pickle carried on some fairly extensive oversight hearings of the IRS and some of the abuses and just the complete lack of professionalism being carried on in certain regional branches, but on this one, Mr. Burnham, I really don't think the American people need education about the onerousness of the IRS. They run into it every year.

It isn't something, I think, that is even latent. It is out there on their cuff, and what my concern is, is not generating a desire to pull the IRS out by its roots. I think everybody is in agreement, but once you pull it out by its roots, what do you do with the plot of land? Do you put stones? Do you put cement? Do you brick it in? What is the replacement for pulling the IRS out by its root?

There, I think, you need more of an objective, educational analysis of the alternatives with the pie charts, as was done with the President's health care. You can talk about what the various options are, rather than someone trying to sell something, so that they can use it as a device or a vehicle to move to another office.

That was the point I was trying to make, but it would seem to me that if you could carry out additional polls, if you could run a series of articles, if you could begin this discussion of what other countries have done, where we are at a disadvantage in terms of the underground economy, in terms of trade with other countries, that that would begin a broad, general public discussion of options and without that fertilizing of the public in terms of options.

Everyone agrees the IRS is unacceptable. Where do we go? That is my concern that it ought to be a very rational, objective discussion.

All I am asking is if you are willing to undertake that. It seems to me it may cut down on your ability to run scare articles on why they should buy your magazine, Mr. Lalli, to make sure that they do the best job they can on a very complex system. Maybe it is not a good idea because it will simplify the system and people won't buy your magazine, but it seems to me that it would be exciting where you don't make a decision in buying property or selling property or investing, where you aren't in the back of your mind thinking about the Tax Code which clearly makes it more difficult to make those kinds of financial decisions because they are never financial. They are almost always financial and Tax Code related.

Mr. LALLI. Well, I think there is no question that there is a great feeling in the public that the Code needs to be reformed in some massive way. As I pointed out, there is no meeting of the minds yet on what that solution will be.

We have written a series of articles about ideas for reform. One of the frustrations we faced—let's just take the flat tax, for example—is that the flat tax impact on business, which has been relatively underreported, is very difficult to report because the plans are very sketchy, but it looks to us in articles that we have written that there would be major loopholes there for businesses to leap through.

So we are far from a point where we have a consensus on this, but if we are about to enter a system in which a homeowner loses their deduction for the home mortgage, but a corporation can write off the corporate jet, I think you are going to have to do a lot of explaining before you get the American public behind that idea.

Mr. THOMAS. I think if you wrote an article pointing out that that would be one choice under a flat tax and that these are other choices and that these are the consequences of those choices, people would better understand the problems under the flat tax.

Mr. LALLI. There is in April 1996.

Mr. THOMAS. I am sorry. I didn't want to step on your commercial. Which issue?

Mr. LALLI. In April 1996. It is in the current issue.

Mr. THOMAS. April 1996, Money magazine. Page?

Mr. LALLI. Excuse me?

Mr. THOMAS. Page?

Mr. LALLI. Page 18.

Mr. THOMAS. I mean, if you are going to do it, you might as well go all the way.

Mr. LALLI. Page 18.

Mr. THOMAS. It is something that we are going to have to do together. You people have an ability to present options in a way that

we oftentimes cannot. Working together, perhaps, will carry out a mutual education not only of Congress, but the American people about the consequences of the decision, but none of you disagree that we do have to move forward. Is that correct? There has got to be an alternative.

Thank you very much.

Does the gentleman from Florida wish to inquire?

Mr. SHAW. Briefly, Mr. Chairman.

Mr. Lalli, I would like to follow up on the poll that you mentioned during the questioning period and also in your opening statement where you said 33 percent favored a flat tax, 16 percent liked the national sales tax, and 19 percent wanted a planned tax income minus savings.

How large was that poll?

Mr. LALLI. That was a national poll, statistically valid. I think it was somewhere—about 800 people. I think the Reader's Digest poll was 1,000. Ours was about 800.

Mr. SHAW. So that would be probably within 3 or 4 points.

Mr. LALLI. It would be 3 or 4 points.

Mr. SHAW. In that poll on the sales tax, was the question asked that this would be a replacement, a total replacement for the income tax?

Mr. LALLI. No, I believe it was not.

Mr. SHAW. So a lot of the people being questioned were thinking this is just another tax.

Mr. LALLI. It could be.

Mr. SHAW. With regard to the flat tax, that is probably one of the most abused words in the English language right now. It is like reform. Everybody is for reform, but there are so many differences, whether it is welfare reform, tax reform, or whatever. Also, the flat tax. You really get into it with Mr. Forbes, with his exemption of investment income.

Mr. LALLI. Right.

Mr. SHAW. Then you get into the question of charitable deductions and home mortgages, and then you get into local taxes and things like this.

I would suppose that there is no way that you could have gotten into the details of a flat tax on that particular poll.

Mr. LALLI. We didn't. We tried to describe it in a way that it was 17 percent. If you were a close reader of the newspapers, I think you would have identified it as the Forbes plan, just by the rate, by the 17-percent rate, as opposed to Gramm's 16 percent or someone else's higher number, but in a poll, you can't get into detail like that.

Mr. SHAW. I would guess if this was strictly a random poll, people just being taken off of a voters list or out of the phone book, however the names were chosen, that probably over one-half of the people you contacted didn't have a clue as to what flat tax really meant under any of the definitions. Wouldn't you guess that that is probably true?

Mr. LALLI. There may be something to that.

I think you look for the much bigger numbers. I think if you see 60 percent of the people saying their highest priority is fairness, if you see 64 percent as that poll showed believing that people who

have more money ought to pay more taxes than others, I think those are significant numbers.

When you get down to whether the sales tax, the national sales tax at this point is a 16-percent preference in the public. All it shows and all I was trying to say is there seems to be no consensus at this point on what a fairer replacement tax would be. A simple point.

Mr. SHAW. Do any of you on this distinguished panel wish to comment on the question of regressivity, as to whether or not this tax would be regressive in applying to all income levels at the same percent? Because that is a problem that we are eventually going to have to tackle, and we are going to have to address whether you have people at the lowest income applying for refunds, similar to EITC, the earned income tax credit or something of that nature.

Yes, ma'am.

Ms. WILDAVSKY. We didn't ask in our poll about the flat tax, and in fact, we didn't ask about Federal taxes at all. Our questions concerned all the taxes that you pay to the government, from all branches of government.

We did in our results find something, learn a little bit about how people feel about graduated tax rates, and what we found is that people think the maximum fair tax burden at different income levels should be graduated slightly for income level, but not graduated nearly as steeply as the present tax system is graduated. When I say tax system, I use that word to refer to all the Codes together in their totality because our poll wasn't about Federal tax.

So we found that for maximum fair tax burdens, our respondents identified incomes between \$25,000 and as high as you like, and it ran between 10 percent for a family earning \$25,000 a year, and 25 percent was the highest figure we got.

That is not flat. It is flatter, but it is not flat.

Mr. SHAW. Were the people in your poll advised as to the bottom figure you have up there on the chart, where families with an income of \$200,00 are paying 39 percent? Were they advised of that?

Ms. WILDAVSKY. No, they were not.

After the poll was complete, I called some of the people who had given the median responses to tell them how the poll had come out and to tell them what the actual numbers were and to ask them if they still wanted to stick to their answers once they had that information, and they all stuck like glue to what they had said the first time, nobody should pay more than 25 percent. That was what they said.

Mr. SHAW. Thank you very much.

Chairman ARCHER [presiding]. Just one quick followup. That 25 percent, as I understand your poll, was on all taxes, the aggregate of all taxes—State, local, and Federal. Is that correct?

Ms. WILDAVSKY. Right, and I repeat once again, that isn't what they thought everybody should pay. That is the highest figure they said anybody should pay, and the only way we got that figure was by asking them about a hypothetical family of four earning \$200,000 a year.

When we asked what about a hypothetical family of four earning a high income, but we didn't specify the income, just said no matter how high, they actually said 20 percent. When we asked them what

they thought was the maximum they should pay in taxes, in all of their taxes combined, respondents at every level of income answered between 15 and 20 percent. The affluent answered between 15 and 20 percent.

I could give you the breakdown on that if you want it, but none of the answers, median answers, fell outside of that range.

Mr. SHAW. Mr. Chairman, what is the average? Does anybody know?

Chairman ARCHER. Average of what?

Mr. SHAW. Of what people pay for all taxes.

Ms. WILDAVSKY. I think I can, maybe, answer that.

Chairman ARCHER. State, local, and Federal, percentage of income.

Mr. GIBBONS. She says 39 percent over here.

Ms. WILDAVSKY. No, no. That is—

Mr. SHAW. Well, that is \$200,000, I think.

Ms. WILDAVSKY. The median, according to information provided for us by actually the Tax Foundation, the median family pays about 30 percent in all of its taxes combined.

Mr. GIBBONS. To answer your question, I can't give you the State tax burden. Frankly, in undertaking this task, I just didn't try to change everything in the world at one time. I was just trying to change the Federal system.

In the Federal system, the Congressional Budget Office tells us that the average tax burden on a family in the United States is 23.9 percent of all Federal taxes. That is estate taxes, excise taxes, tariffs, payroll taxes, and income taxes. That is what it is.

Ms. WILDAVSKY. We added non-Federal taxes as well.

Mr. GIBBONS. Yes. You added non-Federal taxes, and I, frankly, just don't know the answer to that.

Chairman ARCHER. I believe the total for the country, Mr. Shaw, of all taxes on average for all income categories is that government takes about 32 percent of the total income that is generated in this country, across the board.

Mr. HALL. The Tax Foundation calculates Tax Freedom Day every year, which was May 6 last year, which, in effect, takes total tax burdens, all levels of government, and divides it by net national product, which is gross domestic product less depreciation, which we believe is the correct income to use. Last year, that figure came to 35 percent.

Chairman ARCHER. Again, you get back into the question that you mentioned in your statement as to what is income. You still have to define income in order to be able to determine the percentage, and different people have different ideas of what ought to go into the definition of income. You just gave us one of them.

Mr. HALL. Yes, sir.

Chairman ARCHER. Thank you.

So, basically, and just to wrap this part of it up, if, in fact, the overwhelming majority of the American people think that no family should pay over 25 percent, then the first thing that has got to happen is we have got to cut the cost of government in this country by 10 percent, both State, local, and Federal, in order to come out at your 25 percent, and if that is the top, we have got to cut it even more, if the average is 35 percent, that is first.

Second, the income tax at the Federal level has got to have a maximum rate that is way below 25 percent, way below 25 percent in order to make the total of all tax come out to 25 percent.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

To follow through with what you just said, if we are going to have to reduce the cost of government by 10 percent, if we have 35 percent and we have to get down to an average of 25 percent, it would seem to me that as a part of this educational process, to make an informed decision, we would also have to share with them where we intend to reduce the size of government. This brings me around to an uncomplicated theory that Senator Long had when he chaired the Senate Finance Committee. It is a theory that most taxpayers would have, and seems to be supported by Ms. Wildavsky. That is, don't tax me, don't tax thee, tax the person behind the tree.

It basically seems what she is saying is that everyone believes someone should be taxed more, but certainly, they themselves should be taxed less, and I assume that everyone is saying that those who are more affluent should carry a heavier burden, but certainly, the affluent, like most people, would want to find out what formula would allow them to pay less taxes. I mean, that is what we are talking about.

All of this education about what happens later—now, this flat tax, Federal tax, sales tax, value-added tax, consumption tax, there is no question that this sounds simple. I have found that most simple formulas don't have the equity and the distribution of burden, but Sam Gibbons said that he is not giving up on me; that he is going to stick with me, at least as long as he can, to make me understand that these things can be done without adding the burden of complexity to the system.

I love the flat tax. I would like to have a little adjustment for the poor and an adjustment for the churches and an adjustment for the hospitals and an adjustment for mortgage deduction. It just seems to me that deductions, depreciation, and tax credits, no matter how much you pay, your accountant is going to say before reform, but this is the system where you can save tens of thousands, if not millions, of dollars.

Having said that, you can bet your life you are not elected, but this room does not normally have the attendance that it has today, and the closer we get to making a decision, they will be in the hallway and in the streets and everywhere, and everyone wants to have it fair the way they see it.

Having said that, it seems to me that even if we had a dramatic change in the system because people were demanding it, as Clay Shaw said, a flat tax or reform without knowing what the heck we are talking about, if we were able to come up with some broad-based solution, the idea of the transition as to how we treat assets that are already taxed and what happens with the tens of billions of dollars that are under the present system, in my opinion, it will take a long time to weed those things out. Since we all believe that we have to tackle this problem, my question to you is, while we are waiting for the final solution, could you state just what was it that irritated the taxpayers the most in terms of outrage of the existing

system, excluding that they are paying too much in taxes? I mean in terms of the complexity of this system.

Is there anything that we could do with the present system to make it more simple without losing a lot of revenue while we are waiting for me and others to understand how fast we can get a flat, more simple tax?

Ms. Wildavsky.

Ms. WILDAVSKY. Yes. I am afraid that the only answer that emerged from our poll in response to your question is the one you excluded, which is just lower it.

What bothered our respondents about their taxes was that they felt their taxes were too high. They didn't just feel that their tax—

Mr. RANGEL. That is never going to change. I don't care—it is not going to change. So that is not a consideration.

Ms. WILDAVSKY. That is up to you.

Mr. RANGEL. We got a range of revenue. We have got to carry government, but excluding that, what was it besides the fear of making a mistake and the fact that the IRS would terrorize them and they will be on the way to jail for a simple mistake, which we all understand. But getting the form, is there any one thing that we can do under the existing system so that we can say we are a long way from flat tax, but at least we have done something to reform the system to make it easier for you?

Mr. BURNHAM. I would think, from looking at the IRS, that a great deal could be done if the IRS was administered better.

In addition to being a writer, I am the codirector of a research organization that collects data from government agencies.

We have looked at the IRS. The audit rates, for example, in different districts are wildly different. The seizure rates are different; the rates that taxpayers are allowed to enter installment agreements. The IRS is not a well-administered agency. It is erratic. It is an ad hococracy.

If the public had the impression that an effort was being made to treat similarly situated citizens in a similar way, I think you would go a long way, but I do not think the IRS has paid enough attention to this internal administrative process.

Mr. RANGEL. Well, you are talking about an irrigation at the IRS and the bias, and what you are saying is legitimate bias against the tax collectors still wouldn't change it.

We have to do a better job in oversight.

Mr. Chairman, I just wanted to ask whether or not—it seems to me that we didn't have those lights on until it was time for me to inquire. Is there any special reason for that?

Mr. SHAW [presiding]. It was on when I inquired.

Mr. RANGEL. It was?

Mr. SHAW. Yes.

Mr. RANGEL. OK. Thank you very much.

Mr. SHAW. Mr. Houghton may inquire.

Mr. HOUGHTON. No.

Mr. SHAW. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman, and I want to thank the members of the panel for coming and being patient today and testifying.

Ms. Wildavsky, first, I want to congratulate your publication, the Reader's Digest. Since Money magazine has gotten a little play here today—

Ms. WILDAVSKY. Thank you.

Mr. MCCRERY [continuing]. I will say that Reader's Digest is certainly a well-respected publication, and we are glad to have you here to share with us your findings.

One thing that you didn't give us the answer to, though, at least not that I heard, you said in your poll you asked the respondents what did they think each of their families paid, what percentage of their income did they think they paid actually in taxes. What was that response?

Ms. WILDAVSKY. Most of our respondents estimated their own income—excuse me—their own total tax burdens fairly accurately.

They also estimated reasonably accurately the tax burdens of the families toward the middle range of income that we asked about, the \$25,000 families and the \$50,000 families.

Stop me if I am wrong, Ken, but I think at the \$75,000 level, too, they estimated taxes actually paid fairly accurately.

At the upper ranges, they underestimated what people actually pay.

Mr. MCCRERY. So, on average, they were estimating that they were paying 30 to 35 percent?

Ms. WILDAVSKY. Pretty close to what they are. People seem to know what they are paying in taxes.

Mr. DAUTRICH. Specifically, in terms of how people responded to the question, What do you pay?, the average response is for the family—if the family is making at least \$75,000 a year, the average response was 35 percent. It was 35 percent for those in the \$50,000 to \$74,000 category, 30 percent for those in the \$30,000 to \$49,000 category. For those under \$30,000, they estimate, on average, that they are paying 25 percent in total taxes.

Mr. MCCRERY. So you are telling me, then, that the average respondent pretty well pegged his own tax burden which was somewhere between 30 and 35 percent, but he thought his tax burden ought to be between 15 and 20 percent. Then the conclusion we can draw from those different responses, then, is that they think they are overtaxed.

Ms. WILDAVSKY. Everyone at every income level that we surveyed thought they were overtaxed. Not every individual. Excuse me. But the median response is that every income level, the majority—excuse me—thought they were overtaxed.

Mr. MCCRERY. So, if we in Congress respond to the public's conception of fairness, we have quite a job to do, don't we, and curtail-ing activities of government and cutting spending at all government levels?

Ms. WILDAVSKY. Not only did everyone think they themselves were overtaxed, but they thought their neighbors who had different income levels were also overtaxed. The middle class thought the affluent were overtaxed. The working class thought the middle class and the affluent were overtaxed, and the other way around.

So it wasn't just that people thought they themselves paid too much. They thought everybody else paid too much, too.

Mr. MCCRERY. Mr. Burnham.

Mr. BURNHAM. The results are very interesting. I wonder what would have happened, however, if they had also—Reader's Digest had also asked whether you want the air controllers in your district removed because that is going to cost money, or fewer cops, or we are going to close down a few schools, and whether that would have changed the answers. I suspect it might have changed them. I mean, in the abstract, I would like to pay less taxes. I think everybody says that.

As you know as a Congressman, when you start saying what are we going to cut, the answer changes.

Mr. MCCRERY. Yes.

Ms. WILDAVSKY. If I may say one more thing on behalf of our respondents, our respondents did not say they didn't think they should pay any tax at all, and they didn't say 1 percent and they didn't say 2 percent. They said between 15 and 20 percent. They stuck with, really, an incredible degree of consensus within that range.

Mr. MCCRERY. The fact is, though, right now government consumes a much greater share of total income in this country than people think is fair.

As Mr. Burnham suggests, it is a very difficult process to get from where we are now in spending down to where the public thinks we should be in terms of what we should take from them, and they are the only place we can get income to finance activities of government.

So, as we go through this process, while this kind of data is interesting and helpful in giving us some guidance, we also have to be mindful of the priorities of government and the demands of people for services of government. In thinking about going toward a system different from the income tax, we have to decide at some point whether we want to be a revenue-neutral transition or a tax reduction transition to accommodate these kinds of responses from the American public.

So this is going to be, in fact, a very long time-consuming debate, an interesting one, and certainly, your testimony today has helped to get us started on that road.

Thank you.

Mr. SHAW. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman, and I want to thank the panel very much for the testimony today.

I think that we, among ourselves, generally have reached a consensus that the Tax Code, indeed, does need to be reformed.

You all have certainly contributed to the evidence that that is, indeed, what ought to happen. I think we generally have concluded that if this were a perfect world and we didn't have any kind of Tax Code and we were inventing one that a consumption tax, whether it is a national sales or value added or something along that line, makes a great deal of sense as we think about how to structure a Tax Code.

The difficulty we are having, though, is that we have a huge Tax Code now. We have a lot of transactions that have occurred. A lot of people have made decisions, investment decisions, home-buying decisions, have bought machinery and equipment, and so forth based on a Tax Code that we currently have.

Part of that Tax Code has a lot of incentives. In fact, just yesterday we increased those incentives in terms of the deductibility of health insurance because we want more people who are not covered to have health insurance.

We have a deductibility of home mortgage interest so people will buy homes. We have deductions for charitable giving so that people will give to their churches and give to other charitable organizations. All of this, of course, would be affected if we change from one Tax Code to another.

So what all of this means for us and what we have to deal with is that, while there are definite rewards that we can see from changing the Tax Codes, there are some huge risks involved as well as it relates to many of the elements that would be affected and to the economy in general.

It seems to me there are really two ways to mitigate this risk. One would be that we fix the existing Code and try to solve the problems that we can identify and keep this Code in place.

Another way to mitigate would be to try to have a transition from the kind of Tax Code we have now to a consumption Tax Code, which means at least for some period of time, we would have both income taxes and consumption taxes. This seems to be what many of the other nations in the world have.

I would just appreciate any advice you might have for us in terms of how we might mitigate the risks that we think will be incurred.

Specifically, Dr. Hall, any comments you might have along that line would be appreciated.

Mr. HALL. Well, I would start off my comment by saying, and it is an easy comment to make, that all roads lead back, ultimately, to the size of government. You can buy yourself a great deal of flexibility if you don't have to raise as much revenue as you are currently raising, OK? It is simple to say.

I would say, my knowledge with regard to complexity itself, and that is, what to do about the current system and, therefore, essentially, avoiding the risks you spoke of, is on the business sector, you could move to a territorial tax system. That is, eliminate all of the complicated rules dealing with foreign source income.

It is only really big corporations in America that deal with that extensively, but nevertheless, a Tax Foundation-sponsored study estimated that about 45 percent of the compliance cost for the Fortune 500 is directly related to foreign source income rules alone, and I believe the Congress raises, at most, about \$5 billion a year from that. It is really not a big revenue item at all, and it is a major headache.

The other is the alternative minimum tax. There is absolutely no good tax policy or economic reason for that tax. It is pure politics. It doesn't raise very much money, and what it does do is get companies that are involved with it in a swap of building up AMT credits, which is a major transaction problem, from the current system to another system. So that is a problem.

Then, the other, for businesses, and this would include small businesses as well, would be to go to expensing, which is what, essentially, the reform plans do, either de facto or explicitly. Depre-

ciation schedules, in and of themselves, are a very complicated part of tax compliance.

For individuals, it is harder to say. It is really the people who have a lot of capital income that face—investment income that face a lot of the complexities.

I would say if you were able to move toward a great expansion of IRAs, back-ended-type IRAs—would lose less revenue—people would not have to worry about the tax consequences of shifting their portfolio around to fund things like, for example, if you took the Contract With America, the American dream savings account, that model where all of your income is taxed prior to putting it into the IRA, but there are no tax consequences of taking it out, and you are allowed to remove money from there for major expenses, medical, college, education—I am sure you know—what that does is eliminate the tax consequences of shifting investment portfolios, and that would relieve a major headache for a lot of people.

Mr. PAYNE. I see my time has expired, but thank you all very much for all the information you have imported to us, and thank you, Dr. Hall, for your answer.

Chairman ARCHER [presiding]. My compliments to each of you, also.

Unfortunately, there are aspects of our life over which we do not have adequate control, and one of them is that when those lights come on and those buzzers go on, it means we are having votes on the floor of the House.

We have about 5 minutes to go over and make this vote, which will be followed by additional votes, and I am going to suggest that if you can come back—we are going to take a break for lunch now, and perhaps some of you are hungry—if you can come back at 1 o'clock, we would be glad to have you back and take further questioning by Members of the Committee who have not questioned.

If you have to leave because of your own schedules, we will understand that.

The Committee will stand in recess until 1 o'clock, and we hope you can come back and spend some more time with us, but if you have to leave, we will understand that.

Mr. Neal.

Mr. NEAL. Mr. Chairman, just one quick observation. Hearings addressing tax reform are precisely what the Presidential election should be about. These kinds of issues give us an opportunity, I think, for all of us to remind the news media and others that a campaign in the end should be about ideas and forming opinion, and what better opportunity to provide that forum for the American people than a Presidential campaign.

The truth is, that unless the Presidential campaign focuses on these kinds of issues and unless the candidates pick up this kind of an issue, we are going to be back here 3, 4, or 5 years from now debating the same topics without a lot of results.

I hope the candidates for President will embrace at least thinking about these notions.

Chairman ARCHER. For those of you who cannot come back at 1 o'clock, thank you very, very much.

For those of you who can, we will see you at 1 o'clock.

[Whereupon, at 12 noon, the Committee recessed, to reconvene at 1:10 p.m., the same day.]

Chairman ARCHER. The Committee will come to order.

Since there are no other Members who have not questioned, who appear eager to question, and, Mr. Gibbons, unless you have a further question you would like to ask—

Mr. GIBBONS. No, I don't, but I want to thank the witnesses for coming and for staying here. We appreciate it very much.

Chairman ARCHER. I feel very bad that we held you over, and I hope it hasn't interfered with your day's schedule, but I am very grateful for your coming. I think you have made a real contribution to our consideration of this very important issue.

The only thing that I might like to just clear up specifically, to be sure we understand fully the nature of your survey, this 25 percent of all aggregate taxes, wherever collected, that the overwhelming majority of the American people believe is the top amount that anybody ought to pay—I am stating what I think your survey said. If not, I would like for you to correct it.

Ms. WILDAVSKY. Our survey said that 25 percent was the amount that a family of four earning \$200,000 a year—excuse me. I have misspoken.

Respondents didn't say that was the amount that family should pay. Our respondents said that would be the most that it would be fair to make that family pay.

Chairman ARCHER. OK, exactly. Well, that is what I understood you to say. I may not have stated it exactly correctly, but I understand that.

So that would be the maximum.

Ms. WILDAVSKY. That is the highest number we got.

Chairman ARCHER. So the average that would be paid for people of lower income, coupled with those of higher income, I assume, would be less than 25 percent.

Ms. WILDAVSKY. It would. Asked what is the maximum fair tax burden any of them should pay, our respondents at every income level answered between 15 and 20 percent, and asked about hypothetical families of lower incomes, like a family earning \$25,000, the median response came in that that family should pay no more than 10 percent of its income. There were different levels.

Chairman ARCHER. So the range was roughly 10 to 25 percent, then.

Ms. WILDAVSKY. Right. That was the range.

Chairman ARCHER. If 25 percent would be the highest that people thought anybody should pay in aggregate, then the amount of our income tax, percentagewise, at the Federal level would have to be way below 20 percent in order to be able to accommodate all of the other taxes to fit under the 25 percent which would be the top rate, not the average rate that would be paid.

So we have got a lot of work to do, to reduce spending on the part of the government in order to be able to get down to that regardless of what method that we use to tax.

Ms. WILDAVSKY. That is a conclusion that seems logical to draw.

Chairman ARCHER. Mr. Christensen may want to inquire.

Mr. CHRISTENSEN. Thanks, Mr. Chairman.

I just caught the tail end of what you were saying, but it might have been what I am going to say. Earlier today, I heard some of the people talking about cutting the taxes 10 percent, but, really, we have got to cut the size of Federal Government 28.5 percent because a 10-percent tax cut from its current 35 percent is only 31.5 percent. So there is a lot more that we have got to do than just to get it down to 25 percent. We have got to cut it 28.5 percent.

The thing that I wanted to ask you, Ms. Wildavsky, was what can we do? Earlier today, when this room was half full or full of special interest groups that have a certain position on this already, all of them are issuing their own position papers relative to their own point of view, whether it be the retail sales tax or the charitable deduction or the mortgage interest deduction, and a lot of them have put pressure on the grassroots movement to get their various interest group to say, Oh, that is a bad idea, we wouldn't want to do that.

Even Presidential politics were affected, and we saw one campaign trash the flat tax for purely political reasons. I think that was unfortunate.

How can the media, and how can you and the "molders" of public opinion, help move this grassroots debate along? I truly believe if we are going to get to a simpler, fair, flatter Tax Code, it has to bubble up from the grassroots. It is going to have to come from the people, and I know we can help in that public opinion debate, but I believe that there has got to be a role and some role that Reader's Digest and Money and the other news magazines can help percolate that debate up from the grassroots. What suggestions do you have?

Ms. WILDAVSKY. For my own industry, I mean, all we can do is try to report the news fairly and to apply the same standard of fairness to our feature work and to think carefully about topics that are worth covering.

Having hearings gives us material to work with. So we thank you for that.

I don't really know how to go beyond that, but I take your point.

Mr. CHRISTENSEN. Dr. Dautrich.

Mr. DAUTRICH. Speaking as a pollster, not a journalist, I think as specific proposals are put forth, it will make it easier for pollsters or those conducting public opinion polls to get specific measures and reactions to a flat tax proposal or a consumption tax proposal.

Right now, these are very nebulous things, and without a specific proposal, it is hard to poll people and find out what their reactions to differing kind of taxes are.

As this Committee and others begin to formulate very specific proposals for change, it will become easier to gauge public reaction to those proposals.

Chairman ARCHER. I want to thank your editors and the people at Reader's Digest who put out the little piece on "How Fair Are Our Taxes?" I think that was an excellent, well-written piece, and a very neutral, factfinding-type of information that I think the American people need to get their hands on and that they need to continue to understand.

For people to come out and say, though, Do you favor a flat tax or a retail sales tax or a VAT tax?, I mean, it is so early in the whole dialog that I think it is totally unfair to even ask that question at this point because people on the Committee don't even know exactly where we are going to go with that, and that is why we are going to be holding these hearings over the next year.

I really applaud your efforts in just getting the debate out there on the idea of taxes, and are we overtaxed or are we undertaxed. I think your poll clearly shows that this country is overtaxed and that the average family in 1950 only paid 5 percent of their earnings in taxes, and today, that average family pays, as your polls have showed, upward in the neighborhood of 35 to 40 percent, if you include local and State taxes as well.

I applaud your efforts, and thank you very much for being here. You have been a wonderful, wonderful witness.

Thank you.

Ms. WILDAVSKY. Thank you.

Chairman ARCHER. Thank you very much for staying around and for your contribution. We wish you well on your trip back home.

Ms. WILDAVSKY. Thank you.

Mr. DAUTRICH. Thanks.

Chairman ARCHER. Would our next panel please take a seat at the witness table; Elizabeth MacDonald, Harvey Shulman, Ann Cook, and Jean Hodges.

Ms. MacDonald, you are the financial editor of Worth?

Ms. MACDONALD. That is right.

Chairman ARCHER. You will be our first witness.

As I mentioned to the other panelists earlier, your written statement, should it be elongated, without objection, will be inserted in the record. Your verbal statement, we hope you will limit to 5 minutes, and you may proceed.

STATEMENT OF ELIZABETH MacDONALD, FINANCIAL EDITOR, WORTH MAGAZINE, NEW YORK, NEW YORK

Ms. MACDONALD. Thank you, Congressman.

I want to commend and congratulate Congressman Archer and the House Ways and Means Committee for its courage in trying to forge a new tax system that, hopefully, will include a less burdensome tax collector, and I applaud you on your efforts to spark this national debate. I am delighted and honored to be a part of Congress' efforts to reform the tax system.

As a journalist, however, I need to make one thing clear. When Americans believe what I report, they do so because they see me as an independent, objective observer. That helps the free flow of information, which I hope in the end is enormously useful to Congress. Please understand that I come here out of a sense of loyalty and civic duty to our government, to Congress, and to American taxpayers. I mean this sincerely. I come here in the spirit of serving and helping you.

Today, something is abroad in the land that is sharpening the division between the American people and the government, and I firmly believe that this division is largely rooted in the IRS' intrusive, stone-cold, and intractable behavior.

The agency routinely severs the connection between the government and the American taxpayer, and as a result, the American tax system is losing its sense of fairness and moral suasion.

Because of this division, few Americans realize that many compassionate workers at the IRS want to treat taxpayers fairly. This division also obscures the fact that there are way too many people who cheat the government. Even so, negative perceptions about the IRS continue to deeply roil the American electorate, largely because these perceptions are often based on reality.

The most illuminating example about the IRS' attitude toward taxpayers is this. In the past, I have attended numerous hearings on the IRS where I have listened to the Commissioner and the Assistant Commissioners testify about the agency's problems. However, the minute Congress calls any subsequent panel of taxpayers to testify, what do these IRS officials do? They get up and walk out without waiting to hear what these taxpayers have to say. I really feel that this behavior exemplifies the agency's lack of humility and their treatment of taxpayers.

I have been thinking really hard about how I can help you in your efforts, and I have decided to try to explain how the IRS' lack of concern is embedded in the rigid way it conducts its business of collecting taxes. I will base my testimony on confidential reports prepared by the IRS' internal auditors, which I obtained through the Freedom of Information Act.

In the final analysis, I will show you how in the shadowy corners of this bureaucracy apathy manages to nestle and thrive. Such apathy is largely due to the agency's sclerotic approach to its business of collecting taxes. As a result, now what we have is an agency that spends more time dissembling than speaking the truth.

To be sure, the IRS is charged with an awesome task. The IRS administers a circa sixties computer system that swallows an enormous amount of paper each year, and if the IRS taped together all of the pieces of paper it receives annually, the trail would wrap around the Earth roughly 36 times.

I am sure you also know that the average tenure of the IRS Commissioner has been about 37 months, and between 1992 and 1995, four individuals have walked through the turnstile at the IRS Commissioner's office. So there is a revolving door at the top, and it is largely left to the middle managers, the career bureaucrats, to run the agency.

My question to you is, Have you ever looked at how these bureaucrats, how these middle managers run its business? An IRS internal audit report that I read shows that the IRS uses a management approach that would be hooted right out of Harvard Business School. Let me explain.

As early as 1988, the Office of Management and Budget, the General Accounting Office, and the IRS acknowledged an alarming increase in the amount of uncollected IRS assessments. Those amounts are referred to as taxes, interest, and penalties. They are basically the bills that the IRS assesses against taxpayers every year, and that amount is known as the accounts receivables inventory. This inventory amount has mushroomed from \$61 billion in fiscal year 1989 to \$200 billion by the end of fiscal year 1995. It

is due to, according to the IRS, zoom to about \$220 billion by the end of 1997.

I am all for getting a team together to finish off a project, especially if that task involves hauling in a heck of a lot of money that hopefully will prevent future tax increases. But the IRS didn't do that according to this confidential January 1993 report that I read.

Instead, here is what it did. In June 1991, it appointed an accounts receivable executive officer to handle the problem, but this really mystifies me. The IRS gave that person no authority whatsoever to bring in that revenue. According to this report, the IRS' mindset when it comes to such problems is this. Ostensibly appoint an executive to fix a problem and then forget about it. That is the way the IRS runs its business. That way, it no longer becomes the IRS' problem, but that executive's problem.

Let me explain further. To do his job, the IRS gave this official instructions which oozed with bureaucratic molasses. The IRS told this official that he had to abide by the IRS' matrix management structure, this policy that often keeps the IRS from getting much of its work done.

At this point, I would like to define this management policy. It is a real jawbreaker, but it is a key and it is a clue to a lot of the IRS' problems. The IRS refers to it as a "multidimensional system of sharing decisions, results, and rewards in an organizational culture characterized by multiple authority/responsibility/accountability relationships."

Now, again, as I pointed out earlier, I am all for getting a team together, but when you have a division of accountability amongst a whole slew of people, that is going to create problems, and it will up the odds of errors and slippage.

You can see, given the cavernous IRS building and its long hallways, that the IRS has willfully upped its chance of errors and slippage because of this matrix management structure.

Furthermore, the IRS ordered this official to answer to the IRS' chief financial officer, but that person has no authority to make any decisions whatsoever about the accounts receivable inventory. So, here is what happened.

In December 1991, the accounts receivable officer, along with IRS top management, issued numerous plans to rake in the money due and owing the government. But when internal auditors looked at 13 of these plans in the spring of 1992, they found that IRS Commissioners had postponed their deadlines 81 times in a 10-month period, from August 1991 through May 1992.

When the inspectors took a closer look at why the IRS was blowing off its deadlines, they found that IRS officials failed to approve or gave no reasons for 38 of these delays.

I think a similar story can be told about tax systems modernization which many are referring to as TSM, which now seems to be an acronym for time to stop moving.

Given this approach, the IRS is an example of the triumph of form over function. Even the current IRS Commissioner, Margaret Richardson, admitted recently that "the sheer number of distinct functions and layers of management delay decisionmaking." There is bureaucratic foot dragging all over the place, not only with tax systems modernization, but also with a pretty severe problem with

the crediting of Social Security earnings to the proper taxpayer accounts at Social Security.

Currently there is about \$25 billion sitting in the Social Security suspense file, which the IRS could help whittle down by giving taxpayer identify information, such as correct names and Social Security numbers. But the agency and the Social Security Administration are at an impasse on fixing that problem. This problem has been outstanding since 1978.

So, in conclusion, the problems at the IRS remind me of an old saying by George Bernard Shaw, that if all economists were laid end to end, they would never reach a conclusion. It seems to me that the way the IRS runs its business, in large part, lies at the root of the problems that we are going to talk about today and its effect on taxpayers. This management problem lies at the root of the IRS' problems.

I thank you.

[The prepared statement follows:]

STATEMENT BY ELIZABETH MACDONALD
FINANCIAL EDITOR
WORTH MAGAZINE

I want to commend and congratulate Congressman Archer and the House Ways and Means Committee for its courage in trying to forge a new tax system that, hopefully, will include a less burdensome tax collector. I applaud you on your efforts to spark this national debate. I am delighted and honored to be a part of Congress's efforts to reform the tax system.

As a journalist, however, I need to make one thing clear: When Americans believe what I report, they do so because they see me as an independent, objective observer. That helps the free flow of information, which, I hope, in the end is enormously useful to Congress. So, please understand that I come here out of a sense of loyalty and civic duty, to our government, to Congress, and to American taxpayers. I mean this sincerely—I come here in the spirit of serving and helping you.

Today, something is abroad in the land that is sharpening the division between the American people and the government. I firmly believe that this division is largely rooted in the IRS's intrusive, stone-cold, and intractable behavior. The agency routinely severs the connection between the government and the American taxpayer. As a result, the American tax system is losing its sense of fairness and its moral suasion. When thinking about this subject, one idea stayed uppermost in my mind—it's at the intersections where real life begins. Today, the point where the American public intersects with the U.S. government—the federal tax system—is jammed with bureaucratic gridlock and justifiable anger.

Because of this division, few Americans realize that many compassionate workers at the IRS want to treat taxpayers fairly. This division also obscures the fact that there are way too many people who cheat the government. Even so, negative perceptions about the IRS continue to deeply roil the American electorate, because these perceptions are often based on reality.

The most illuminating example about the IRS's attitude toward taxpayers is this: In the past, I've attended numerous hearings on the IRS, where I have listened to the commissioner and assistant commissioners testify about the agency's problems. However, the minute Congress calls any subsequent panel of taxpayers to testify about their personal IRS problems, what do these IRS officials do? They get up and walk out, without listening to a word of what the taxpayers have to say. That behavior exemplifies the agency's lack of humility, but Congress can fix that problem. You can make it mandatory for IRS officials to wait until the conclusion of each and every hearing you convene on this issue, since the IRS's problems strike at the heart of America's discontent with the government today.

In your efforts to reform the system, one fact remains—we'll still need a tax collector. I've been thinking hard about how I can help you in our efforts, and I have decided to try to explain how the IRS's lack of concern is embedded in the rigid way it conducts its business of collecting taxes. I will base my testimony on confidential reports prepared by the IRS's internal auditors, which I obtained through the Freedom of Information Act. In the final analysis, I'll show you how, in the shadowy corners of this bureaucracy, apathy manages to nestle and thrive. Because of the agency's sclerotic approach to its business of collecting taxes, we now have an agency that spends more time dissembling than speaking the truth.

To be sure, the IRS is charged with an awesome task. It is the biggest government agency in the land, employing 109,656 people, a workforce equal in size to Eastman Kodak, Merrill Lynch and Apple Computer combined. Today, as you know, the IRS administers a circa 1960s computer system that is choking on a massive annual paper load. If the IRS taped together all the pieces of paper it receives annually, the trail would wrap around the earth roughly 36 times.

However, a good portion of the IRS's problems stems from weak leadership and low morale that would sink any organization. A revolving door at the top post guarantees that the agency's commissioners can never fairly be held accountable for the IRS's successes or its failures. Since the end of World War II, the average tenure of the IRS commissioner has been 37 months. Between 1992 and 1995, four individuals have walked through the turnstile at the IRS commissioner's office.

However, such rapid turnover at the top begs this question: how do the IRS middle managers, the career bureaucrats, go about making important decisions that affect taxpayers as well as Congress's attempt to cut the \$3.6 trillion federal deficit? The answer: The IRS uses a management approach that would be hooted right out of Harvard Business School. Let me explain.

As you know, as early as 1988, the Office of Management and Budget, the General Accounting Office and the IRS acknowledged an alarming increase in the amount of uncollected IRS assessments, (taxes, interest and penalties). That amount, known as the accounts receivable inventory, mushroomed from \$61 billion in fiscal year 1989 to \$200 billion by the end of fiscal year 1995. The IRS expects that figure to balloon to \$220 billion by the end of 1997. This figure represents outstanding tax bills owed by taxpayers. Currently, the IRS is trying to figure out, based on these numbers, how much it should bill taxpayers, how much it can realistically collect, either through installment plans, offers in compromises, liens or levies.

Now, I'm all for getting a team together to finish off a project, especially if the task involves hauling in money that will, hopefully, prevent future tax increases. But the IRS didn't do that. Instead, in June of 1991, it appointed an accounts receivable executive officer to handle the problem. Yet, and this still mystifies me, the IRS gave that person no authority whatsoever to bring in that revenue. A January 1993 IRS internal audit report reveals, in sharp relief, the IRS mindset when it comes to such problems: Ostensibly appoint an executive to fix a problem, then forget about it. That way, it becomes no longer the IRS's problem, but the executive's problem. That's the way the IRS operates. So, right from the start, the IRS bureaucracy doomed this official's efforts to bring in this money.

Let me explain. To do his job, the IRS gave this official instructions which oozed with bureaucratic molasses. The IRS told this official that he had to abide by the IRS's 'matrix management structure,' a policy that often keeps the IRS from getting much of its work done.

The IRS defines this management policy, and this one is a real jawbreaker, as a "multidimensional system of sharing decisions, results and rewards in an organizational culture characterized by multiple authority/responsibility/accountability relationships." What this means is, before the official could make any moves to whittle down this mushrooming balance, he first had to get numerous assistant commissioners and more senior persons to sign off on his decisions. So, given the cavernous IRS building and its long hallways, you can see why the IRS has willfully upped its odds of errors and slippage. I sure would like to sit around all day and wait for one of my co-workers to send me a memo telling me that I can

start to do my work. If any company in the private sector conducted its business in this manner, they'd be bankrupt within a year.

Furthermore, the IRS ordered this official to answer to the IRS's chief financial officer, a person who has no authority to make decisions about the accounts receivable inventory, (the chief compliance officer retains that power).

So, here's what happened. In December 1991, the accounts receivable officer, along with IRS top management, issued numerous plans to rake in the money due and owing the government. But when internal auditors looked at 13 of these plans in the spring of 1992, they found that IRS commissioners had postponed their deadlines 81 times in a ten-month period, from August 1991 through May 1992. When the inspectors took a closer look at why the IRS was blowing off its deadlines, they found that IRS officials failed to approve or gave no reasons for 38 of these delays. A similar story can be told about decision-making on tax systems modernization, or TSM, (which some say really stands for 'time to stop moving.')

This approach shows that the IRS is an example of the triumph of form over function. This may be why top IRS officials seem driven to distraction on the agency's problems—getting them to move on a project is the equivalent of squeezing 1,000 crickets into a jelly jar. It reminds me of an old saying by George Bernard Shaw, that if all economists were laid end to end, they would never reach a conclusion. Even the current IRS commissioner, Margaret Richardson, admitted recently that "the sheer number of distinct functions and layers of management delay decision-making." In 1994, after two years of foot dragging, the IRS finally abolished this official's job, and split the task of collecting this money between the IRS chief financial officer and chief compliance officer.

Bureaucratic foot dragging affects taxpayers in another way. Currently, an estimated \$25.1 billion in Social Security earnings sit uncredited to taxpayer accounts at the Social Security Administration, based on data provided by this agency. Why? For one, taxpayers and employers are to blame. Routinely, workers' incorrectly enter their last names or Social Security numbers on their W-2 earnings statements. When that happens, the SSA cannot match their Social Security contributions to their accounts. Also, the GAO says each year thousands of defunct businesses fail to send in W-2s for their former employees.

The GAO says much of this problem could be fixed if the IRS shared its more current taxpayer information with the Social Security Administration. However, the IRS and the Social Security Administration have been locked in a feud since 1978 over which agency is responsible for cleaning up this situation, according to the GAO and confidential IRS reports. Like it or not, the government's problems are our problems—the GAO says at least 10 million workers could miss out on thousands of dollars in annual benefits, partly because the IRS and the Social Security Administration are not cooperating on this matter.

The GAO says the IRS, because it constantly updates records, should help resolve this problem. To keep its records current, the agency can wave its big stick by, say, holding on to refund checks until taxpayers correct faulty records. The IRS also penalizes businesses if they don't provide accurate tax records on their workers.

The IRS, however, "refuses to give the Social Security Administration its more up to date taxpayer name and Social Security information so we can correct our benefits records for individuals," says an SSA official. In its defense, an IRS spokesperson told me that doing so would violate the IRS's 'disclosure policy,' meaning, the agency is restricted by law in giving out this confidential information. However, it is hard to understand this rationale, particularly as the IRS willingly shares its taxpayer information with more than 200 state and local taxing authorities across the country to catch criminals, such as the Oregon Public Utility Commission and the Washington Department of Fisheries. The IRS does say it tells taxpayers to correct their name and Social Security numbers with the SSA when the IRS notifies them about a mismatch in its records. To date, for the most part, the two agencies are still at an impasse.

So, in conclusion, these anecdotes show that a step toward straightening up the gridlock at the IRS would help avert future tax increases and slice the budget deficit, among other things. Here's one recommendation: Make it a job requirement for the top IRS posts that an applicant have a management or even a military background, someone who knows what it's like to handle tens of thousands of people. Most all IRS commissioners are tax lawyers. They're probably perfectly good lawyers, but I truly do wonder about their managerial abilities.

Chairman ARCHER. Harvey Shulman, general counsel, National Association of Computer Consultant Businesses.

Mr. Shulman, we would be pleased to receive your testimony.

**STATEMENT OF HARVEY J. SHULMAN, GENERAL COUNSEL,
NATIONAL ASSOCIATION OF COMPUTER CONSULTANT
BUSINESSES**

Mr. SHULMAN. Thank you, Mr. Chairman.

My message today is simple. I am concerned that your debate over tax reform will emphasize only issues like economic growth, tax equity, and simplicity. These are important issues, but I fear that lost in the debate will be something that is not a Democratic issue or Republican issue, but, rather, something fundamentally and uniquely American, the right to privacy.

My experiences as a partner at Ginsburg, Feldman & Bress, Chtd., representing hundreds of clients throughout the country, compel me to urge that there should be no higher priority than protecting against unwarranted government intrusions.

Mr. Chairman, I represent clients where the rubber meets the road. I sit across the table from IRS examiners throughout the United States. Unfortunately—and I had to think a lot about using these words—I have seen how the Internal Revenue Code has become a “peephole on America.”

We have gone far beyond mere revenue generation to create an army of auditors who delve into almost every day-to-day transaction of America’s individuals and businesses.

The four instances of IRS intrusiveness I will address here are not the worst I have seen, but they do illustrate a general course of conduct in many of the IRS matters I have handled. These are exhibits to my written testimony, and they will be presented on the easel as well.

First, our current tax system allows IRS examiners to intrude into the lives of individuals who are not even under an IRS audit. These individuals are considered third parties whom the IRS thinks may possess information helpful to the IRS in its audits of a business.

For example, in one case, my client received a call from the wife of a man who had provided some services to my client as an independent contractor. As the wife related in essence,

My husband is at work today, but there was an IRS examiner here. He says that my husband and I are not being investigated, but he was in our home, sitting on our living room sofa, using our telephone, trying to track down my husband and ask him questions about the services he provided for your company. What is going on here?

On the easel as exhibit A is a letter sent by the IRS a few days before Christmas to 30 self-employed contractors who worked for a heating and air-conditioning business that was being audited. Even though these contractors themselves were not being audited, the auditor demanded that they come to her office the week after New Year’s with hundreds of documents, including their own tax returns and all of their canceled business checks, billings to clients, lists of suppliers, and on and on.

Unfortunately, Mr. Chairman, under our tax system, intrusive contacts like these happen all of the time, including by phone or

even IRS visits to the homes of such third parties not being audited.

Second, our tax system allows IRS examiners to intrude deeply into a businesses' relationships with its customers. The examiners seek information from the customers about the businesses' operations, revenues, or expenses. These intrusions can destroy a business, even if it wins the audit.

By way of example, on exhibit B are excerpts from one IRS examiner's notes which report on his field visits to track down the customers of a high-tech firm he was auditing. He literally drove around the Boston beltway and stopped at big buildings with high-tech logos to ask companies if they did business with firm X, the firm being audited.

Only two of the companies visited had done any business with firm X. Yet, through his visits, surely all seven learned of the IRS investigation of high-tech firm X.

As in similar cases of IRS contacts with customers, the damage to firm X's reputation was irreparable.

Third, our current tax system allows examiners to take private information from the tax returns of taxpayers who are not being audited and use that information against taxpayers who are being audited.

Exhibit C on the easel shows how an IRS examiner retrieved from IRS files the income tax returns of 15 independent contractor specialists who provided services to a business the examiner was auditing, and then shows how she used selective information of those returns against the business.

Because the business could not fairly defend itself without seeing the information used against it, the government had to give us copies of these specialists' private tax returns. Unfortunately, such IRS use of tax returns is not uncommon.

Finally, Mr. Chairman, our current tax system encourages and rewards snitching, and other practices that turn taxpayers against one another.

Exhibit D on the easel is what one IRS examiner called a "snitch sheet." It was used in the late eighties in California until later condemned by the IRS Commissioner, but the principle behind the snitch sheet is still alive and well today. The IRS still encourages, rewards, and sometimes even requires a taxpayer who is being audited, especially small business taxpayers, to turn in competitors.

In conclusion, Mr. Chairman, the intrusiveness of the IRS is deeply embedded, and perhaps it is even inherent, in our current income tax-based system. It is time to look toward a system which is free from government-sponsored financial voyeurism into the lives of America's individuals and businesses.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

Before the
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C.
March 20, 1996

TESTIMONY OF
HARVEY J. SHULMAN
PARTNER in GINSBURG, FELDMAN & BRESS, CHTD. (WASHINGTON, D.C.)
AND
GENERAL COUNSEL of NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

I. INTRODUCTION: My name is Harvey Shulman. I am a partner in the Washington, D.C. law firm of Ginsburg, Feldman & Bress, Chtd. and have been a lawyer for 24 years. I am also general counsel of the National Association of Computer Consultant Businesses ("NACCB"), which is the largest national association that exclusively represents high-tech firms that provide computer and engineering professional consultants to customers in need of temporary support for special projects. NACCB has actively participated in many Congressional hearings, including those involving the Taxpayer Bill of Rights¹, pension simplification (including the need to re-define who is a "leased employee")², and worker classification (including the need to repeal Section 1706 of the 1986 Tax Reform Act).³

I come to these hearings after years of providing counsel to mostly mid-sized and small businesses, with gross revenues of between one million and one hundred million dollars. Many of my clients are high-tech professional services firms, though others have been in health care, securities and financial services, telecommunications, biotechnology and pharmaceuticals, oil and gas, heating and air conditioning, and construction and real estate.

My message today is a simple but critical one. I am concerned that as you go through months and probably years of hearings, dominating the evolving debate over tax reform will be factors like providing adequate revenue, encouraging economic growth and the investment needed to compete in a global marketplace, assuring some sense of "fairness", and replacing complexity with simplicity. These are all valuable considerations. Yet, I am greatly concerned that lost in the debate -- or at least minimized -- will be the recognition that we must protect something else that is not a Democratic issue or a Republican issue, but rather something that is uniquely American, i.e., the "right to privacy". My years of experience with the intrusive nature of our present tax system compel me to urge that in your debate on tax reform there should be no higher priority than protecting this right.

II. CLOSE THE INTERNAL REVENUE SERVICE'S "PEEPHOLE ON AMERICA": For me, meaningful tax reform is not merely an academic, political or philosophical issue. Rather, I am "where the rubber meets the road". After representing clients in countless IRS investigations, and sitting across the table from IRS tax examiners throughout the United States, the broad picture that emerges of our tax system is not a pretty one. The Internal Revenue Code, with all of its complexity particularly in the areas of income and employment taxes, has become a "peephole on America". What I mean is that, unfortunately, our tax system delves too often into almost every aspect of the day-to-day transactions of America's businesses, whether they are sole proprietors working out of home-based offices or mid-sized firms with multi-state facilities. I know that it is very difficult to fully appreciate this perspective well unless you have been intimately involved in dozens and dozens of IRS investigations, but I hope that my first-hand experience will give you an insight into the problem.

Preliminarily, let me note that the income tax started out during the Civil War as a temporary and simple 3% federal income tax that affected few Americans -- because only extremely high incomes were taxed. Yet, in 100 years the income tax has been transformed into a complex morass of double-

¹ Our position has been that Congress must do far more, even beyond last year's proposed Taxpayer Bill of Rights 2 ("T-2"), to protect the rights of all taxpayers, particularly small and mid sized businesses.

² NACCB believes that Congress should include an updated version of last year's pension simplification proposals (that were in the vetoed budget reconciliation bill) in a debt ceiling bill, continuing appropriations bill, "tax extenders" bill, or other appropriate legislation as soon as possible. There is strong bi-partisan support for such simplification, including a consensus for further clarification of the "leased employee" definition as it applies to computer professionals.

³ It is now time to repeal Section 1706. In the past two Congresses, a majority of the Senate -- and much of the House, including the then- House Government Operations Committee -- have called for repeal of Section 1706 of the 1986 Tax Reform Act. Fourteen national associations representing businesses and workers have also urged repeal of this law which uniquely discriminates against the use of self-employed computer and engineering consultants by America's high-tech industries. A 100-page Treasury Department study of this law found a key aspect of its coverage to be "difficult to justify on equity or other policy grounds" and noted that tax "compliance" by the technical workers targeted by Section 1706 has been "somewhat better" than other types of workers not subject to the same restrictions.

digit taxes on gross income less numerous deductions, with withholding and employment taxes thrown in, that affects virtually every working person and business in America. In the process of this transformation, we have created a systems that literally requires an army of tax examiners and collectors who have the right to probe the conduct of ordinary citizens in connection with just about every financial transaction in which we engage.

After hearing my testimony, I hope that you will have a better understanding of my deeply held concern about the need to create a tax system that gives much greater weight to protecting the privacy of all Americans, including small and mid-sized businesses. Please let me assure you that the examples I provide are not isolated instances. The general conduct I am about to describe has occurred in close to half of the IRS investigations in which I have been involved. In fact, I am not even mentioning some of the more egregious IRS conduct because of my duty to protect some of my clients who have done nothing wrong, but are frightened about attracting even more IRS examinations. Further, based upon the information I will present, it will become apparent that neither the good faith and honesty of the overwhelming number of IRS employees, nor the enactment of additional procedural protections, can solve the intrusiveness concerns that are inherent in our current tax system. Here are some of the areas where the IRS's intrusiveness has been prominent in my experience.

A. Intrusion Into Homes and Offices of Individuals Not Under IRS Examination: Under our current tax system, it is not unusual for the IRS to seek out information from "third-parties" who are not themselves being audited. Although these persons are accused of no wrongdoing, the IRS may believe that they have information about another taxpayer under audit. In these situations, the IRS has chosen to intrude into the homes and offices of these persons as part of its investigation -- not only is the privacy of the individual invaded, but the individual's relationship with the business being audited is often seriously hurt. For example:

* The IRS was examining one of our mid-sized high-tech clients in New England. The IRS showed up -- without an appointment -- at the homes or new places of employment of a number of consultants who had worked for this firm in order to ask them about their work for the firm. Our client reported receiving a phone call from the wife of one of these consultants. The conversation was along these lines (with names changed): "John, this is Mary Jones. I'm Tom's wife. Of course, Tom's at work today. But there was an IRS examiner here. He says that Tom and I are not being investigated, but he was in our home, sitting in our living room on our sofa, using our phone, trying to track down Tom and ask him questions about the work he did for your company. Maybe Tom never should have worked for you. What is going on here?".

* We saw similar scenarios in audits being conducted in Maryland, New Jersey, Minnesota and other states. By way of example, I have attached as Exhibit A to my testimony a sample letter written by an IRS examiner to an individual who was not being audited, but who had provided services as a self-employed contractor to a business that was being audited. As you can see, two days before Christmas 1991 the IRS examiner sent a certified letter to these workers stating that one week after New Years they should come to her office and bring with them, among other things, copies of their licenses, their billing statements to their other clients, their list of suppliers, the Schedule C's on their personal income tax returns, their commercial bank account statements and all cancelled business checks, advertisements they had run, invoices for the purchase of their business cards and business stationery, and other items. Now let me emphasize: the individuals who received these letters were not being audited, but were being asked to provide this information about themselves in connection with the audit of a client to whom they had provided services! The most surprising thing to me about this letter was that the IRS examiner's request was in written form; on many other occasions similar requests have been made orally by other IRS examiners to workers in similar situations. It is hard to imagine anything more intrusive than this type of communication directed to a third-party who is not being audited.

B. Intrusion Into the Relationships with a Taxpayer's Customers: Another type of IRS "third-party" interview may be done with the customers of a business which is being audited, even though those customers are accused of no misconduct. Such IRS intrusions into customer relationships can literally destroy a business before an audit is even over. For example:

* In the Midwest, an IRS examiner simply showed up -- again, without an appointment -- at the major customer of our client, which was a small high-tech firm under audit. The IRS examiner flashed her credentials and demanded, on the spot, that the customer provide her with copies of certain contracts between the high-tech firm and its customer and allow her to interview an official of the customer. She refused to leave until her demands were met. After the incident, the customer complained to our client that there were many firms it could do business with other than our client, and that these

firms were not being audited and the customer would not have to risk these types of offensive IRS intrusions if it took its business to these other firms.

* In New England, an IRS examiner auditing a high-tech consulting firm admitted how he literally drove around the Rte. 128 beltway trying to find the firm's customers. When he saw high-tech logos on large buildings, he assumed that these businesses might be customers of the consulting firm. He would then stop, enter the building, identify himself as an IRS examiner, and ask if they were doing business with "ABC Company" (the firm under audit). The IRS examiner made 7 such visits, but only 2 firms had ever heard of ABC Company. Let me quote from portions of his notes, attached as Exhibit B, which illustrate the kind of "fishing expedition" that was conducted:

Field Visit to Rt. 128 area of MA re: third party contacts to attempt to receive information on the operation of [ABC] and the business of computer programming industries in general....

[In one Dedham, MA firm], security was tight -- they would pass my c/c [calling card] on but would not disclose any further info at this time -- they do have computer programs....

[At another firm] I asked if they ever did receive programs from [ABC] or if they did business with them -- She said she did not recall ... but records may be located in Garden City, N.Y.....

[At still another firm] I asked if he had used the services of [ABC] ... ans. neg.

Field Visit [to another firm]. Security was tight -- probably due to corp. espionage & Gov't. work. Got apt. for tomorrow

In a couple of days of visits, the IRS examiner's intrusive conduct probably did more harm to the business and reputation of our client than its competitors could do to it in years of tough but fair competition. Responding to my complaint that this conduct is unfair, an IRS examiner in New Jersey - who suggested that she might similarly visit my client's customers -- said to me words like these: "Under our tax system, that's your problem. It's what we call life in the audit lane".

C. Use and Disclosure of Tax Returns of a Taxpayer NOT Under Audit. Under our current tax system for income and employment taxes, it has become common practice in certain types of income tax audits (e.g., transfer pricing cases) and employment tax audits (e.g., worker classification cases) for many IRS examiners to look at the private tax returns of taxpayers who are NOT being audited and then to use information from those returns against another taxpayer who is being audited. Part of an IRS examiner's file, attached as Exhibit C, shows how she made use of such tax returns. By this type of conduct, the IRS has created a "no win" situation. Unless it provides this private information to the taxpayer under audit and against whom the information is being used, the IRS is denying due process to the taxpayer under audit. Imagine having "secret" information being used to make an assessment that could shut down your business, and then being told that you cannot see this information even though you want to rebut it. It seems fundamental in a democracy that a citizen is entitled to access to information being used against him or her. Yet, if the IRS reveals to the taxpayer under audit the private tax information from another taxpayer, the IRS invaded the privacy of that other taxpayer.

We have handled several cases in at least eight different states in which an IRS examiner has used another taxpayer's private tax return information against our client. In cases where we pursued our requests, the IRS had to provide us with copies of that private tax return information. You can imagine how strange it felt, having in front of me, income and expense information from hundreds of tax returns of persons whom I had never met. Yet my clients could not defend themselves against proposed tax assessments that would have destroyed their businesses without seeing the information that the IRS used against them. You can imagine how I was even more amazed when I found out, after seeing this information, that much of the private tax information used against my client was taken completely out of context or even helped --rather than hurt -- my client's case.

These situations are exemplified by a conversation we had with one individual whom we told that the IRS was auditing our client and was using information against us that was supposedly contained in his tax return. When we asked him if he would voluntarily give us his tax return so we could rebut the

IRS, his response was along these lines: "I have done nothing wrong, nor has your client. All I will tell you is that the IRS is not honestly describing the information on my tax return. But there is no way that I'm going to give you a copy of my tax return. The IRS may be denying your client due process, but I don't want them taking away my privacy." Ultimately in that audit the IRS backed off and closed its examination without any assessment against our client.

Here again, the intrusiveness of our tax system is apparent. What type of tax system have we created when information on one taxpayer's return can be used against a second taxpayer -- and when the price to be paid for protecting the due process rights of the second taxpayer is to reveal information that invades the privacy rights of the first taxpayer?

D. "Snitch Sheets" and Other Government-Sponsored Informing: In April 1990 I testified before the Senate Finance Committee's Subcommittee on Private Retirement Plans and Oversight of the IRS regarding the Taxpayer Bill of Rights. I revealed that an IRS District Office in California had distributed a document that it called a "snitch sheet", attached as Exhibit D, to members of a local business association. The IRS official distributing the sheet noted that it would be used to pursue audit "leads" on the names of businesses who were "turned in". The "snitches" themselves were told not to put their own names on the sheets, lest the IRS want to visit them as well. To his credit, then-IRS Commissioner Goldberg called the District Office's conduct "reprehensible" and promised to put an end to it. Here's what then-Chairman Pryor said:

[W]e have created a monster... A bureaucratic Frankenstein. They are tearing down walls in Eastern Europe. They are doing something with the KGB. They are doing something with Secret Police. I do not want to see us creating an underworld of IRS agents in this country, who could use their leverage to turn people against people.

I was in China some years ago, and on every floor of the hotel there was someone posted to monitor the comings and goings of everyone there. To find something on someone and turn them in. We are not going to create that system here, Mr. Commissioner.

Yet, despite the unanimous condemnation of the "snitch" program considered at that hearing, our current tax system still encourages and rewards -- and sometimes even requires -- that one taxpayer "turn in" another.

For example, Section 7623 still authorizes the IRS to pay awards to informers who provide information that leads to the collection of taxes from another person. In my experience, only a tiny percentage of "snitches" ever qualify for such awards. Rather, in most cases, at least in the business community, "snitching" to the IRS has become a "competitive tool" for some companies to make baseless charges against their competitors with the goal of bringing the intrusive, expensive, and time-consuming IRS audit process into the lives of their competitors. A good illustration of this point is a situation in which I was involved where a "snitch" turned in the names of six of its competitors to the IRS, claiming that they needed to be investigated for costing the IRS millions of dollars in tax revenues. The "snitch" helped trigger audits of these six competitors in four states. The audits were conducted using many of the intrusive techniques discussed above. Yet, over four years later, when the last of these audits ended, the IRS determined that four of the companies owed no additional taxes and the other two companies -- which had several million dollars in income -- owed a tiny additional amount in taxes (about \$10,000 each) due to a couple of small, technical violations. Meanwhile, compared to the \$20,000 paid to the IRS, these six companies paid a total of about \$500,000 to lawyers and accountants to go through these audits -- or about one additional dollar in taxes for every fifteen dollars it cost them to defend themselves. These figures do not even include the cost to the IRS of conducting these audits. Even though the "snitch" who triggered these audits collected no award, he -- like many others -- was able to use our current tax system in a way that seriously and unfairly hurt his competitors who committed no wrongs.

In another example of how "snitching" is inherent under our tax system, it is useful to look at how IRS examiners conduct income tax examinations that trace a business's multiple sources of income and recipients of business expenditures. In this process, each new "source" and "recipient" becomes a potential new lead for an examiner to make certain that there is not a "whipsaw" situation. That is a situation in which two taxpayers to a transaction treat it differently for tax purposes, each to its own advantage and to the disadvantage of the IRS. By the very nature of our income tax system, however, many business transactions involve potential "whipsaw" situations where honest differences of legal

interpretation abound. For example, one business taxpayer may treat a payment it receives for selling part of its business as a long-term capital gain subject to lower tax rates, whereas the maker of that payment may treat part of it as a payment for a covenant not to compete and the other part as depreciable assets. In such situations, the IRS examiner of the first taxpayer is encouraged to assure that the other taxpayer who is not being audited is not placing the IRS in a "whipsaw" situation. One taxpayer, in effect, must thereby become a witness against another taxpayer if it wants to protect its own tax treatment of the transaction. Unfortunately, this is but another and sanctioned variant of the "snitching" that is inherent in our current tax system.

A final example of government-induced "snitching" that is even more troublesome exists in the employment tax area. In Section 530 of the Revenue Act of 1978, Congress stated that a taxpayer may treat a worker as an independent contractor if, among other things, the taxpayer can show reasonable reliance on a long-standing practice of a significant segment of the industry in which the taxpayer is engaged. In order to support its position that the use of self-employed workers is common practice, the taxpayer will present the results of studies by trade associations which provide data as to the percentage of firms in the industry which treat their workers as independent contractors. Yet the IRS requires more information from the taxpayer under audit. According to IRM 5(10)26.4, the taxpayer must also provide "the names of the currently in business entities for the same industry with whom the taxpayer is competing which treat the same class of workers as independent contractors" In such cases I have explained to IRS examiners that my client does not want to become a "snitch", but that if my client provides this type of information to "save itself", we are concerned that the IRS may pursue potential audits against these competitors. The typical response I have received from IRS examiners is along these lines and is troubling: "The survey is not enough. I need the names of specific companies that also use self-employed workers. If we decide that we must audit them also, that's just the way the system operates."

*** *** *** ***

III. STOP "GOVERNMENT SPONSORED FINANCIAL VOYEURISM" OF INDIVIDUALS AND BUSINESSES: Although it may not be easy to understand all of the details in my message, I hope that one overriding message has emerged: in the debate over tax reform, the "right to privacy" must receive the highest priority. We can no longer embrace a tax system that depends upon "government sponsored financial voyeurism" into the lives of America's individuals and businesses.

Mr. Chairman, because I strongly identify with your concern about privacy, I understand your interest in replacing the current income and employment tax system with another system -- such as a consumption or VAT tax. While it may be too early to reach the ultimate conclusion on what type of system is appropriate, I urge Congress to keep an open mind on this issue. And if you determine that a broadly-based income and employment tax system inherently intrudes too deeply into our lives, I urge you to have the courage to move to an alternative system.

As an alternative to the present tax system, Americans want a system that is equitable, produces adequate revenue, and encourages the economic growth and investment needed in today's global marketplace. But the voices of many Americans that I hear are also insisting that this alternative must rekindle the flame of individual entrepreneurship that has sustained our country since its founding and must protect individual freedoms and privacy. Indeed, these Americans are willing to pay a reasonable price just to re-gain their independence from the intrusiveness of the IRS. Don't let these voices go unanswered.

Internal Revenue Service

Department of the Treasury

District Director

District

Person to Contact:

Telephone Number:

Refer Reply To:

Date: 23 December 1992

Get Shulman
Rec'd 12/21/92



Dear MA.

I would appreciate your furnishing the information indicated below, for use in a Federal tax matter. We have scheduled an appointment for you on January 8, 1992 at 10:30 AM at the address listed below. It is pertinent that we received this information for verification of the independent nature of your business enterprise during the years of 1988 and 1989.

This request is made under the authority of section 7602 of the Internal Revenue Code. Thank you for your cooperation, we may have some questions regarding your performance of service to your client(s).

Sincerely,

Rayanne Off:

IRS

Enclosure:
Self-addressed envelope

Information Requested:

- Proof of advertisements in any news media
- Business telephone number (bills)
- Proof of Office location
- Proof of Vehicle and Uniform Logo
- Proof-of-Permits and Licenses Acquired
- Federal and State Identification Numbers
- Worker's Compensation Policy
- Copy of contracts and billings to client(s).
- List of your suppliers and clients
- Form 1040, Schedule C in 1988 and 1989
- Copies of your Form 1099, Earning Statements for years 1988 and 1989
- Copies of your commercial bank account statements and cancelled checks
- Invoices of purchases of business cards and business letterhead stationery
- Copy of business liability insurance, including commercial auto insurance
- Copies of earning statements to your workers
- Any work-related injury claims?

Definitely not
a "Happy New Year
greeting!
Joe

DATE	PERSON CONTACTED	SUBSEQUENT CONTACTS	REMARKS, HOTEL ACTION TAKEN
4/28	[REDACTED]	FIV - to LT-128 one of MA's third party contacts attempt to ascertain info on the report of the [REDACTED] of the Bureau of computer program information re given FIV unable to locate source in either personnel or payroll Dept. - all on to lunch - left office to return later # [REDACTED]	security was tight - they would pass any c/c on but would not disclose any further info at this time - they do have computer [REDACTED]
4/28 cont	[REDACTED]	FIV & spoke to [REDACTED] # [REDACTED] asked if they rather employed or used computer program in their business	asked if they even did receive program for [REDACTED] or if they did business with them. She said she did not recall (as was the prior info) but she records may be located in [REDACTED]
[REDACTED]	[REDACTED]	FIV again security very tight & spoke to [REDACTED] who he is in charge of [REDACTED] asked if he had used the services of [REDACTED] in program field - Troy Kelly - area rep. FIV security very tight - probably due to computer program & [REDACTED] work Get report for [REDACTED] [REDACTED]	[REDACTED]

For use by the Appeals Officer only

Income tax returns of a sampling of [REDACTED] technical specialists are enclosed for Appeals review. Of significant importance is the correlation between the specialists' [REDACTED] from [REDACTED] and the "matching" gross sales shown on the Schedule C of the 1040 or the 1120\ 1120s of the "personal service" corporations.

[REDACTED]

Information is enclosed for the following technical specialists:

- 1) Ge [REDACTED]
- 2) An [REDACTED]
- 3) Ba [REDACTED]
- 4) Jo [REDACTED]
- 5) Ro [REDACTED]
- 6) Ha [REDACTED]
- 7) Eo [REDACTED]
- 8) Ke [REDACTED]
- 9) An [REDACTED]
- 10) St [REDACTED]
- 11) RV [REDACTED]
- 12) Ro [REDACTED]
- 13) St [REDACTED]
- 14) Ri [REDACTED]
- 15) Wi [REDACTED]

Attached to each specialist's income tax returns and [REDACTED] information are the corresponding payroll records, time & expense records, invoices, and contracts. These records have been assembled to facilitate analysis of each specialist's individual situation.

EXHIBIT C - SHULMAN TESTIMONY

"SNITCH SHEET"

(as orally described)

REFERRAL TO EMPLOYMENT TAX EXAMINATION PROGRAM

PLEASE COMPLETE THE FOLLOWING ITEMS (IF KNOWN)

NAME OF FIRM: _____

FIRM'S ADDRESS: _____

TELEPHONE: _____

TAXPAYER FEDERAL IDENTIFICATION NUMBER: _____

ISSUES INVOLVED: (CIRCLE ONE)

- A. NO REPORTING OF WAGES.
- B. UNDERREPORTING ON EMPLOYMENT TAX RETURNS (FORM 940, 941)
- C. EMPLOYEES PAID AS INDEPENDENT CONTRACTOR.
- D. OTHER:

JOB DESCRIPTION(S) OF WORKER(S) : _____

NUMBER OF WORKERS INVOLVED : _____

PLEASE SEND THIS FORM TO:

INTERNAL REVENUE SERVICE
EMPLOYMENT TAX EXAMINATION GROUP 58
3660 WILSHIRE BLVD. SUITE 400
LOS ANGELES, CA 90010

ATTN: LEAD COORDINATOR

PLEASE INCLUDE ALL PERTINENT DOCUMENTATION, W2'S , 1099'S, 941'S , NAMES OF WORKERS WITH ADDITIONAL INFORMATION.

Chairman ARCHER. Thank you, Mr. Shulman.

Our next witness is Ann Cook from South Windsor, Connecticut.

STATEMENT OF ANN COOK, SOUTH WINDSOR, CONNECTICUT

Ms. COOK. Thank you, Mr. Chairman.

Our life was turned into shambles when in 1983 we were informed that our 1981 joint return was selected for audit. During the course of this audit, we were informed that American Express card credit receipts were insufficient proof of purchase. We were told "vendor invoices" would be the only acceptable proof of deductions.

This examiner was made aware of our recent sale and purchase of a home in Seattle and should we have any problem locating invoices, we would contact the vendors for copies. After several phone calls to inform this examiner that vendors were forwarding invoices, within 3 weeks of our last phone conversation we received the revised audit findings.

Even after contacting this examiner and confirming that we had all invoices, we were told the matter was closed.

This revised audit, completely erroneous, was the beginning of multiple garnishments of wages, tax liens on property we did not own, documents being sent to incorrect mailing addresses, false tax returns with tax liabilities filed in Ogden, Utah, and without any notification from the IRS, an audit of our 1982 return by the same examiner who refused to review our documentation for 1981.

Our anger is not directed at the fact of being taxed, but rather, the process which allowed such travesties to occur.

We are angry that we lost our savings, our life insurance policies, angry that we lost the ability to support our family, personal possessions, and ultimately the loss of our home.

More importantly, we suffered the indignity of being put in a position of impoverishment, literally overnight, the indignity of being labeled as tax evaders by friends and relatives because few people realized that a Federal agency is capable of such actions without due process and without having to account for them.

Because the situation was so complex and overwhelming, it seemed we were doomed to be simply a statistic, and through the efforts of our attorney, who worked pro bono, and Elizabeth MacDonald, an editor at Worth magazine, we were able to hold onto the knowledge that we were not crazy and we were not stupid and, yes, these things happen more frequently than imagined. It is through Ms. MacDonald that I am able to be here today.

Ladies and gentlemen, over the course of 10 years of exhaustive efforts to bring this horrendous episode to a conclusion, while barely keeping our body and souls together, we found that the IRS continues to have a \$25,000 lien against us.

Thank you.

Chairman ARCHER. Thank you, Ms. Cook.

Our last witness of this panel is Ms. Hodges, chief executive officer, Hodges Associates, from Fayetteville, North Carolina.

Ms. Hodges, you may proceed.

STATEMENT OF JEAN H. HODGES, CHIEF EXECUTIVE OFFICER, HODGES ASSOCIATES, INC., FAYETTEVILLE, NORTH CAROLINA

Ms. HODGES. Thank you for allowing me to share my story with you which I am sure is common among many, many small businesses.

In February 1994, Hodges' bookkeeper-in-charge came to me in a near hysterical state and told me that she had to resign right now. After more than 1 hour's time trying to calm her, I learned that she had not paid our payroll taxes for the entire year of 1993. She took complete blame for this and gave very little explanation of why this had happened, and quite naturally, we allowed her to resign.

I immediately contacted our financial consultant, who has been retained by our agency for 20 years, and asked him to come and investigate and to take steps immediately to resolve this matter with the IRS. Incidentally, the IRS never came to us with this problem. We went to the IRS with the problem.

After further investigation, we discovered the third and fourth quarters for 1992 had never been mailed or filed. The checks for payment for these two quarters were written and signed, but the deposits for the fourth quarter were not made, and this discovery was made at the same time.

We also discovered that the first and second quarter 941s for 1993 were never filed, although the checks for the liability had been written. They had not been sent. The third and fourth quarters had not been filed, nor had the taxes been paid.

Because the State reports were signed by the bookkeeper and filed, we assumed the Federal reports had also been filed and paid.

The bookkeeper-in-charge had been employed by this agency for 10 years and had our complete trust and confidence. She also had the authority to sign and file these reports. More than one person at Hodges Associates has the authority to sign checks. It was not unusual for someone other than myself to sign these checks, and if the bookkeeper was questioned, she would name another person as having signed them.

We never received notice from the IRS that these reports were not filed or payment was not received. At the time, we were, and still are, a small agency. At that time, we were billing about \$2 million.

Checks for \$5,000 to \$15,000 are not unusual, and it is not unusual to have outstanding checks in the amount of \$75,000 to \$100,000 each month.

During the examination process by the local collection officer, we were able to show evidence of checks written for tax liabilities, but never sent, and the bank reconciliations that indicated that funds were available to pay the liability.

We also provided a letter signed by the employee responsible for this problem stating her actions and lack of diligence in filing and paying the taxes.

We also discovered that probably one of the reasons that started this bookkeeper's actions was a penalty that had been imposed for the nonfiling of W-2 forms in 1989 for \$23,000-plus, and rather than the bookkeeper coming and finding out that this was really

not an error and these W-2s had been filed, she paid this check. Even later, the IRS discovered that these W-2 forms had been filed. They had not rebated our \$23,000 in penalties. They had simply been holding it because they said they didn't know where to apply it.

We also asked them to pay any interest on this expense that was their error.

After meeting with our local IRS representative on more than one occasion, we paid \$60,000-plus in 941 taxes. We asked for an abatement of penalties in the amount of almost \$52,500. We were waiting for some kind of direction on interest and penalties, but when this did not come in August, we paid the interest of \$3,000.

Our consultant who had been sure this was going to be a very simple matter to settle, if for no other reason we had reported this to the IRS, they had not advised us of it, had not been easy to resolve. It was just becoming more problematic.

At this time, I turned it over to my attorney who is a corporate tax specialist. We received a letter in December 1994 wherein our revenue officer said that our request for an abatement of the civil penalties had been requested for the 1989 W-2 forms, which I mentioned before was their error. She advised that they could not recommend an abatement of the penalties for the late filing, depositing, and paying of the 941s and 40s.

They would apply \$22,500 from 1989 to the \$52,000 as a credit, and that we should pay the balance no later than January 15. That gave us 15 days to pay that balance to avoid further collection, which could include the filing of a Federal lien against our property.

This, in spite of the fact that we had already paid all back taxes and interest, our attorney filed for an appeal of these findings. Time goes by, and to make short of a lot more detail, we paid the government an additional \$30,000 on April 18, all in penalties.

In all of this reporting, we have found so many errors by the IRS that we have had to go back and spend hours and hours proving where we were right. You would think that they would feel a little embarrassment.

In June of last year, my attorney filed a claim for refund amounting to almost \$29,000. This claim was disallowed, and we will be taking this matter to court.

Discounting my time when I could have been making money for this small business and the time I have had to pay my own accounting department, the time taken from the secretarial staff, the over \$2,000 I have paid to the attorney and the almost \$4,000 to the business consultant, and the fees go on and on, I feel that the Internal Revenue Service has far too much power over the taxpayer.

It is my understanding that the rules of our country state that you are innocent until proven guilty. This is certainly not the case with the IRS. I think that they should be held accountable for the mistakes they make. Small businesses need relief from onerous and intimidating IRS regulations, as well as penalties for actual and perceived noncompliance, and I certainly feel that people should be treated with a little more dignity.

Last, I thank you for confirming that small voices can still be heard in America.

Chairman ARCHER. Ms. Hodges, thank you very much.

We want it to be the hallmark of the Committee's hearings that we talk to real people in real life at the point of application in our society, rather than simply have witnesses come and testify from ivory towers. We are very grateful to you for coming, and to you, Ms. Cook, for coming.

I am going to ask you the same question that I asked the panelists ahead of you. How much would you pay each year not to have any interface with the IRS, not to file a return, nor to keep any records, to be totally free as individuals in your individual life relative to your individual return? How much would each of you pay annually, or would you not be willing to pay anything?

Ms. MACDONALD. That is an interesting question. It presumes that we would be paying the government a fee for keeping the government out of our lives. Is that correct?

Chairman ARCHER. I am not saying who would receive it. I am just asking you hypothetically how much it would be worth to you.

Ms. MACDONALD. What I would pay my tax preparer.

Chairman ARCHER. Mr. Shulman.

Mr. SHULMAN. I would pay a lot more than that, and I really analogize it to the national defense. We pay a lot of money to have our security and freedom. It is really hard to put a figure on it.

Most of the small business people I know would pay a lot in taxes if there was a simple way to send in a check and be left alone and let the government get on and do its other work. That is what I am trying to do today: to give a sense that the right of privacy in America today is as important as a lot of other unquantifiable things, like the right to national defense.

Chairman ARCHER. Ms. Hodges.

Ms. HODGES. First of all, I really think it is a shame that we even have to equate money with having to deal with the IRS, but I would be willing to pay several, several thousands of dollars because it costs me more than that to have to deal with them.

Chairman ARCHER. Ms. Cook.

Ms. COOK. I would give up my first born.

Chairman ARCHER. Wow.

Ms. COOK. I have already given them over \$75,000. So I think I am free and clear for the rest of my life.

Chairman ARCHER. I really did want to get a little bit at what Mr. Shulman said, because with the previous panel, they were thinking in terms of administrative cost, and as Ms. MacDonald said what she paid her tax preparer. To me there is a far greater value to individuals, and that is the value of privacy and freedom.

I know that it is hard to place a quantitative value in dollars and sense, but it surely is worth something to every one of us, and probably more to some than others; but too often, we lose sight of that.

I thank you, Mr. Shulman, for the testimony you have given that really concentrates on that issue in our lives.

Frankly, I wish that each of you could have been with me over the last year and a half to listen to the speeches I have made along this very line.

Let me ask you this. How many of you are familiar with what the flat tax proposal contains and how it would work?

Ms. MACDONALD. I have written about it in the October 1995 issue of Worth. We also reported about it in April 1995.

Chairman ARCHER. Mr. Shulman, I am sure you are familiar with it, generally.

Mr. SHULMAN. Yes, sir.

Chairman ARCHER. Ms. Hodges, are you?

Ms. HODGES. Yes.

Chairman ARCHER. Ms. Cook.

Ms. COOK. A sketchy background.

Chairman ARCHER. Let me ask you this question, first, to Mr. Shulman. The intrusion that you are concerned about in which I share your concern, would that continue under the flat tax?

Mr. SHULMAN. I believe, Mr. Chairman, that it would be less, but it would continue.

I think Mr. Gibbons and others this morning were right on the mark when they said that in any tax system based on income tax, one of the first things you have to do is determine what is income.

It would blow your mind to read the Internal Revenue Manual and see the techniques that examiners are taught to determine whether a taxpayer is or is not receiving income.

So, putting aside the whole issue of deductions, let's just talk about a tax on income. For 30 seconds I would like to read something that just came out a few months ago on the auditing of gasoline stations: this is an IRS training manual. The IRS is telling the examiner to visit the station prior to the start of the audit which will make the audit a lot easier:

Compare the prices of the taxpayer's station to competitor's stations nearby. Do they offer discounts for cash? One important thing to observe is how many customers are pumping their own gas and how many are getting full service. There are potential sources of additional income that may be hidden. For example, inquire whether the service station sells beer or liquor, does it have vending machines, how many pumps does it have, does it engage in snow plowing, how far away is the nearest recreation area, does it have a walk-in cooler.

These are all questions geared to find out whether that little service station owner is getting income, and in a flat tax system, you would have those same questions, unfortunately, that would have to be asked.

Chairman ARCHER. What about the intrusion to which you testified in third parties and the possible revealing of confidential tax information in a third party situation? Would that continue under a flat tax?

Mr. SHULMAN. Absolutely, Mr. Chairman, because whether one party to a transaction considers something income may depend in part how the other party to a transaction considers it, and that requires looking into both taxpayers' tax returns, including the return of someone not being audited.

I know I sound a little bit like a broken record here and I apologize, but when you have sat through as many audits as I have with people like the two witnesses next to me, it even breaks a lawyer's heart to see some of the things that are going on in this country, and you just throw up your arms and you say, We have got to do better.

Chairman ARCHER. Would any of the rest of you like to comment on that? Then I am going to yield to Mr. Gibbons.

Ms. Cook.

Ms. COOK. Yes. Mr. Chairman, I am not so sure it is the structure of the way taxes are being collected because I don't think it would matter if we had a structure like we have now, a flat tax, or any kind of consumption tax.

If you have an agency such as we have now doing the collecting, they are going to abuse it, no matter what system comes out of it, as you just said.

I think that aspect of it should be addressed as well as the structure of the tax collection.

Chairman ARCHER. I certainly appreciate that. I agree with you that we are always going to have to have some method of collecting money to pay the government's bills; and we must forever be doing oversight and be conscious that it be done in the proper way. I personally think we could take a giant step forward, if we could eliminate the need for every individual in this country to have any interface with the IRS. We can then concentrate on potential abuses that deal with how money is collected through business as a vehicle, and we can concentrate on it better; but we can eliminate over 100 million tax returns every year if we go to a consumption tax. Certainly, your personal problem on the sale of your house would have been totally eliminated.

The other thing, Mr. Shulman, would you not still keep records for at least 7 years under the flat tax, so that if you are ever audited for what you report, you would be able to support it from those records?

Mr. SHULMAN. Yes, sir. I think it would be impossible to have any type of tax system that looks at taxing incomes of individuals and allows the government to go back without keeping those records. You make a good point, sir. Also, I think one of the witnesses, perhaps unknowingly, made a brilliant point. Under our tax system, there is no such thing as innocent until proven guilty. The taxpayer under this system has to prove that they did the right thing. The government does not have to prove that you did the wrong thing.

Chairman ARCHER. So, under the flat tax, you would still be subject to having to produce your records to prove the number that you sent in was accurate, if the IRS contested the accuracy of that number?

Mr. SHULMAN. Absolutely.

Ms. MACDONALD. I am not so sure of that because 90 percent of the revenue that the IRS collects is through withholding, and the complexities due to the deductions and the credits and the exemptions, and that is what largely the IRS is examining every year. I would argue that the IRS does a pretty decent job of matching through 1099s and W-2s the amount that they do get through withholding.

So what the IRS is really setting out to do is to go after the erroneous deductions and the underreporting. Yes, I would think that the IRS would still need to audit for that and to go after the underground economy which is where I hope the resources would be directed.

I think under a flat tax, given that it would ideally abolish all deductions, it would, I think, cut it to its intrusiveness.

The problem is, yes, there is a presumption of correctness on the part of the IRS which leads to the notion that guilty until proven innocent, but inside the IRS, there are 66,000 people who have access to taxpayer records, and these people can assess infinite amounts in fines.

We have to look at it from the inside out and understand what the IRS is about as a tax collector and how it operates internally.

Chairman ARCHER. I am just trying to explore a little bit, though, the practical application if we were to decide that the flat tax was the best way to go. Each individual would send in one aggregate amount on a postcard and pay their tax on that. You can get into the debate if you can have any deductions or not, or are you going to tax dividends or interest, and different people disagree on that and still say that they have a flat tax.

Let's push that aside for the moment. You still have to have that aggregate number, and that aggregate number is a total of all of the taxable income that you have, which may be from more than one source. In fact, it would probably be from more than one source.

I know from my own experience in doing my own tax return, in handling any problem with the IRS myself, that under the matching process, if I don't positively identify the item in the way that it is reported on the form 1099, they will come back and contest that—

Ms. MACDONALD. I agree with you on that.

Chairman ARCHER [continuing]. Even though I put the accurate number on there. They will come back and contest it. I then have to do the proving, and I think that is the point that Mr. Shulman is making.

If I aggregated all of that into one number, it would be subject to even greater dispute because they could not be sure precisely the cumulation of the numbers I had put in there. They would then be more likely to come back and dispute what I had sent in and demand that I produce the records to prove that number was accurate.

Am I wrong about that or not?

Ms. MACDONALD. No, Mr. Chairman, you are correct, and I agree with you on that. I was just speaking to the fact that inner flat tax deductions would be wiped out, but, yes, the IRS would still—

Chairman ARCHER. Not too quick about deductions all being wiped out.

Ms. MACDONALD. Under ideal, that is what a flat tax could clearly do.

Chairman ARCHER. Under someone's ideal.

Ms. MACDONALD. That is right.

Chairman ARCHER. Under other politicians' ideals, they would continue to have deductions—

Ms. MACDONALD. I am aware of that.

Chairman ARCHER [continuing]. But we don't want to get into that debate today.

Ms. MACDONALD. No, but what I am saying is that I agree with you that the IRS would still check to make sure that you reported your income correctly.

Mr. SHULMAN. Mr. Chairman, I would go a step further. I would say that not only would the IRS in many cases—perhaps not in your case, but in many cases—not only ask you to prove your income, but they will start doing a number of the things that I have tried to testify to here, particularly when they are examining the income of a small businessowner, like a retail gasoline station.

They are going to start investigating how you run your business and how you live your life because there is some doubt that if your income didn't quite match up in the first place, maybe there is actually something else there you are not reporting, like income from a candy vending machine or some of these other things on this list that they look at in small businesses. It goes beyond looking at papers. That is the problem.

Chairman ARCHER. Thank you.

Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Chairman.

I want to express my appreciation to the panel for coming today and for informing us of the problems they have. I feel and hear you very clearly, and I think a lot of your problem is because we just outlived the ability to provide a sensible income tax system. It is functionally obsolete, and no matter what we do to it, all the tinkering we can do, I have seen 27 years of tinkering with it, and attempts to major reforms, and they just haven't worked. We have to take another crack.

So thank you for coming and helping us with this.

Chairman ARCHER. Mr. Christensen.

[No response.]

Chairman ARCHER. Mr. Laughlin.

[No response.]

Chairman ARCHER. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I just want to thank Ms. Cook for coming to Washington today. You came really at great effort, and I appreciate your sharing with us the experience that you and your husband went through over so many years.

I would like to say for the record that one of the things that I found most appalling about your case was the inaccuracy of the information that the IRS gave you and the lack of timely response. There simply is no excuse for the government not responding in a more timely and accurate fashion, and I thought, Ms. Hodges, your case was a very interesting example because if we are going to increase compliance, we have to reward people who come forward and report problems and not put them through the kind of abusive experience that you endured.

I don't know that our penalty structure is able to take into account the kinds of circumstances or the voluntary effort that you made, but we will look into that.

We are, in our Taxpayer's Bill of Rights that will be up on the floor for debate next week, I believe, shifting the burden of proof onto the IRS at least in the appeals process.

We are looking at those issues, and we will make at least some progress in addressing the balance between the taxpayer and the IRS in the near future.

Thank you.

Ms. HODGES. Could I say to you that we know that we all have the right for an appeal, and this was not granted to us. This was the reason that we felt we could take this case to court, is they denied an appeal. We can always go from Fayetteville to Greensboro, and they said no.

Mrs. JOHNSON. I am glad you are taking it to court because that shouldn't be.

Ms. COOK. Mrs. Johnson, just as a footnote to this, I was stunned to find out that when I was being garnished and being left \$150 a week for my family to live on—

Mrs. JOHNSON. Three children, as I recall.

Ms. COOK. Three children, yes. It took me, with the help of your office, 9 months before I could find someone in the agency who would sit down and figure out why I was being garnished because I couldn't find anyone who would give me that information for 9 months.

Mrs. JOHNSON. That was what was so appalling to us. Even as a team, we simply couldn't get a response.

Thank you very much for coming today, Ms. Cook.

Chairman ARCHER. If I may just briefly follow up and say there are a lot of very conscientious people working with the IRS trying hard to be fair, trying hard to do a good job. There are also some abuses in the IRS, but I believe that the major problem is what the Congress assigned the IRS to do. They assigned the IRS a virtually impossible task, and they gave them all types of subjective power, but even beyond that—and Mr. Gibbons and I both were in this room when this has happened over and over again during the eighties. When the Congress was unwilling to raise taxes, they simply gave the IRS more power, more penalties, more interest, more ability to go out and pull money from taxpayers on the basis that way nobody paid any increased taxes.

You two people, Ms. Hodges and Ms. Cook, can testify that those are increased taxes. The Congress may call them penalties. The Congress may call them interest and say, Oh, we didn't raise anybody's taxes, just give the IRS more power, and they will bring more money in out of the current system.

The Congress itself—and I voted against every one of those, so I can say this without any participation on my part in those laws, and I spoke out against it over and over and over again, and you are living proof of what has happened in the past, and sadly enough, it has not been partisan. It has been bipartisan in giving that power to the IRS. We have got to turn that around and change it and stop thinking in terms of how we are going to raise money and nobody pays any extra taxes as a result of it.

I didn't mean to get into this, but you two ladies, after what you have suffered, I thought maybe you might like to hear that there are some of us up here that understand this and have understood it for many, many years.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. I apologize to the panel for missing your presentation, but I appreciate very much your coming today and sharing with us your testimony.

Ms. Hodges, what kind of business are you in?

Ms. HODGES. It is a full-service advertising agency.

Mr. MCCRERY. Advertising.

Ms. HODGES. Right.

Mr. MCCRERY. That is interesting.

Mr. Shulman, you are connected with the computer business in some way.

That brings up a point about tradeoffs in how we collect revenues to run the government's activities. We have heard a lot today about how the income tax is perhaps not the ideal way to tax citizens, but then, if you do away with the income tax, you have to collect revenue some other way. Obviously, the Chairman and Mr. Gibbons prefer some kind of consumption tax.

Most retail folks that I talked to that probably do a lot of advertising and sell a lot of computers are not real enamored with the consumption tax. So, can you talk a little bit about where we go and what the tradeoffs are?

We are going to have to collect revenues. We all agree, I think, that there is a necessity for a government in a civilized society, and the government has an obligation to provide certain services, national defense being probably the number one priority, and then it goes down from there. So we have to collect revenues.

How do we get around all of the problems you have discussed today, and then when we try to suggest VAT, a value-added tax, or a consumption tax of some sort, a national sales tax, we get met with the objection from people that pay your bills saying we don't want to be taxed in a way that would cut down on consumption?

Would anybody like to address that while you are here?

Mr. SHULMAN. I could probably take a stab at it. I think there are really two components to it. One which was discussed a bit this morning with the Committee was the transition, the whole transition issue.

It is ironic to me that we look at what has happened in Eastern Europe and we tell the countries and the people over there:

Don't look just to next year or 2 years down the road, look 10 years down the road and realize that the price that you are paying now in terms of some dislocations in your economy and some of the other personal sacrifices that you are making, that when you eventually make that transition, hopefully, from a Communist system to a capitalistic system, you will look back 10 years earlier and see that whatever the transition was, the price was worth it.

I think it is up to the journalists, it is up to Congress, it is up to professionals like myself, and small business people and the average citizen to educate themselves and similarly to take the long-term look of things.

Now, when you go to the long term, I agree with you. There are going to be, to some degree, greater winners and greater losers in any reformulated tax system, but ultimately, I think all of us at the end of the chain are the ones paying the taxes.

It would be ideal if we could all drop our money in a box and that would be the end of it. We are going to have to come up with something that is not quite that simple.

Most of the businesses I know who have been through sales tax audits, for example, tell you that the State sales tax auditor was in for a day, they looked through some records, they wanted a few more things, and they made a slight adjustment. This is a totally different scenario from talking to someone who has gone through an IRS audit.

So, as strange and as unfair to a lot of people as the sales tax or VAT tax seems today, I think it can be enacted only after educational process and after trying to deal with some of the inequities that may happen with low-income people, and so forth. We are a very creative society, and we can come up with something that is less intrusive and meets revenue-generating requirements.

Ms. COOK. Ms. Hodges or Ms. MacDonald, since your magazine depends on advertising from retailers, I just saw an advertisement in here from Brooks Brothers. How would they look at a consumption tax?

Ms. MACDONALD. There are about 21 million self-employed people in the United States, and if, in fact, we move to a tax where there would be no deductions, for example, the 25-percent deduction for premiums for self health insurance and the taxation of fringe benefits, that, to me, is the biggest stumbling box, and I think that is the reason why you may be hearing a lot of complaints about the various forms of taxation.

In the future I would like to do more stories, and I am going to throw this idea out to any journalist who is sitting here. We should compare these different forms of taxation to real life and what is happening, for example, in Europe with Britain's pay-as-you-learn system or France's VAT.

France, I know, is paying, effectively, I think, 60 percent in taxes. They pay tax on everything, tax on their rent, tax for even renting an apartment. It can lead to absurdity, too, these different forms of taxation.

So, as long as we keep it clean, simple, pure, and honest, which is an ideal, but if we stick to those ideals, I think that we are going to be OK.

Ms. HODGES. Clearly, I am not a tax expert or I wouldn't have been in the mess that I was in in the first place. I am getting to be somewhat of one, but I think, logically, if you went to a consumption tax, your customers might not think that was a bad thing when they eliminated all of these other taxes over here.

Right now, in the State of North Carolina, we have an ongoing fight with the State over taxes, charging us sales and use tax on service. They don't charge attorneys that, but they happen to want to do us that way.

I feel that in the study of this with people who are much more aware and have more information than I, they might be able to weigh the difference between this being a consumption tax versus a flat tax.

As you said, you couldn't debate the deductions. We clearly know that we have people with low income that could not afford to pay a 17-percent flat tax. I am sure those things would have to be weighed.

Mr. MCCRERY. Thank you, Mr. Chairman.
Thank you all.

Chairman ARCHER. Mr. Christensen, did you have a followup?

Mr. CHRISTENSEN. Yes, just a quick question and also a comment to Mr. Shulman.

In the computer business, I know you have a lot of independent contractors, and some reference was made to the independent contractor issues and the onslaught that the IRS inspectors have over that area.

Interestingly enough, this year I introduced a bill that is going to simplify the 20-point test, providing an alternate 3-point test for the independent contractor issue.

Just last month, the IRS, coincidentally, said that they are going to reexamine the independent contractor issue, and it seems the closer we get to 218 cosponsors, the more they are laying off their audits of the independent contractor employee issues, and we are now at 217. So, hopefully, we will be able to clear up that issue for some of your computer operators and some of the small businessowners out there; that each year 4.5 million of our small businesses are targeted on the independent contractor issue alone.

So, until we get the current code pulled out by its roots and move to a fairer, flatter system for the American people, hopefully, this legislation, if we can get it through, will be able to give some temporary relief to those independent contractors out there that you represent.

Thank you, Mr. Chairman, and thank you for being here. This has been a very good hearing.

Thank you, Ms. MacDonald.

Chairman ARCHER. Thank you, Mr. Christensen.

That brings up another question. Mr. Shulman, under a flat tax, irrespective of the deductions or whether you tax income or dividends, but a flat tax concept, would you still have problems on the independent contractor issue, which is plaguing this country right now in creating tremendous controversy?

Mr. SHULMAN. Mr. Chairman, we have to remember that part of the reason there is a problem with the whole independent contractor issue is that we have an income tax which is tied to withholding, and that relates to the status of a worker. Everything is tied together.

Now, 50 percent of the time that I spend on tax matters involves independent contractors. I can guarantee both you and Mr. Christensen that I can tell you stories without exaggerating of things that have happened on the independent contractor front with the IRS that you wouldn't believe.

I really commend Mr. Christensen. I think it is remarkable that a bill on this issue has 217 cosponsors in the House.

Now, I realize there are a lot of questions about the bill. I like a lot of things about the bill, but we may be able, as Mr. Gibbons said this morning, to deal with the tax reform issues in a way that we can get away from the whole classification issue.

Certainly, with the flat tax, we are going to continue to have the payroll tax questions, the withholding, and a lot of the other things we are talking about.

If you move to some sort of consumption-based tax, depending on the rate and what is taxed and a number of other details, there may not be a need to decide who is an independent contractor or

who is an employee, and to have income tax withholding done and some of the other things.

I urge you when you take up your discussion of the Tax Code—and I know, Mr. Chairman, you said this in your announcement because I looked for it—that it is not only the income tax issue you are looking at, but you are also looking at how it ties into employment taxes.

Many of us have talked before about the computer industry and about the need to repeal laws, like section 1706 of the 1986 Tax Reform Act, in which Congress penalized independent contractors in the computer industry. We need to be moving in this direction, and I hope you all do that because the IRS announcements, like the other week on the training manual, fall far short of where we need to go.

Chairman ARCHER. Thank you very much, and my thanks to each of the four of you. My heart really goes out to Ms. Hodges and Ms. Cook. We have got to do everything that we can to see that the treatment of our citizens does not continue along those lines.

We are committed to do that. Congresswoman Johnson, who is the Chairman of our Oversight Subcommittee, is going to be moving ahead on the Taxpayer Bill of Rights next week, and that, hopefully, will be somewhat helpful to your two situations, although, generically, it doesn't get at some of the other problems that we talked about. I am very grateful to you for taking the time to come and give us your ideas today, and we will benefit from them.

Thank you very much.

[Whereupon, at 2:19 p.m., the hearing was adjourned, to reconvene on Wednesday, March 27, 1996, at 10 a.m.]

REPLACING THE FEDERAL INCOME TAX

WEDNESDAY, MARCH 27, 1996

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to call, at 10:08 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.

Today's hearing continues the Committee's inquiry into the fundamental reform of our Nation's income tax system.

I have said over and over again that I believe the time has come for us to tear the income tax out by its roots and throw it away so they can never grow again, and I believe that the witnesses who testified at our hearing last week certainly made the case that the current income tax system does not serve this country well in any regard, and that it is so broken that it cannot be fixed.

Professional tax return preparers can't tell you how much tax you owe. These are people who are trained to be knowledgeable about this Tax Code, and when given the financial information of an average family of 4, 50 preparers come back with 50 different tax returns, with 50 different tax liabilities, with fees for the preparation of those returns ranging from \$200 to \$2,500. Clearly, something needs to be done about this system.

The IRS income tax audit machine, once started, is almost impossible to turn off, and the tax system has or soon will outstrip the ability of the IRS to administer it. Continued development of electronic capability poses greater problems for tracking and pursuing income for the purpose of gaining compliance of this Code. It is vital that fundamental tax reform improve the economy for all Americans.

In fact, I believe that our economy can become the economic juggernaut of the world if we make the right changes in our tax system. That means that if we do, American workers will once again be able to realize their dream, which is more real pay in their family paychecks and that their children will be able to do better than they have done. That is why I look forward to hearing the testimony today of the eminent economists who are with us.

I also look forward to hearing from Members of Congress who will explain the benefits of their own tax reform proposals. So many Members of Congress share the common goal of fundamental tax reform, and I am confident we can achieve that goal. Current differences of opinion in how we achieve that goal will not, in my opinion, prevent or delay the ultimate outcome.

I am today announcing a further hearing on April 24 that will focus on the impact of tax reform on small business. That hearing will be the first in a series of hearings on the effects of tax reform on various sectors of our economy.

Now I will recognize Mr. Gibbons for any opening statement he might like to make, and as usual, without objection, each Member will have the opportunity to insert a written statement in the record.

[The opening statement of Mr. Ramstad follows:]

OPENING STATEMENT OF HON. JIM RAMSTAD

Mr. Chairman, thank you for your commitment to reforming our deeply flawed tax system and for giving the American people a public forum to examine the options available to us.

We already know that the current system flunks the critical tests of efficiency, simplicity, flexibility, political responsibility, and fairness.

We also know that our current system discourages saving and investment, robbing Americans of economic opportunities and incentives to be innovators.

While our distinguished guests—many of whom also happen to be our distinguished colleagues—may have different ideas about how the Tax Code should be reformed, I know they will all help to improve the quality of this debate. I am grateful for their willingness to help this Committee and the American public grapple with the challenges of overhauling our tax system.

Again, Mr. Chairman, thank you for convening these critical hearings. I look forward to hearing the testimony today and appreciate the opportunity to further my own education.

Mr. GIBBONS. Mr. Chairman, I commend you for these hearings. I don't have a statement at this time. I am testifying a little later, and I would be glad to listen to these witnesses first.

Chairman ARCHER. Thank you, Mr. Gibbons.

We do have three eminent economists with us today. First, I would like to ask Dale Jorgenson, professor, Department of Economics, Harvard University, to give us his testimony.

I think you gentlemen know the rules here that we would appreciate it if you would keep your oral testimony within 5 minutes, and without objection, each of you will have the right to insert a full written statement of a lengthier nature in the record.

Mr. Jorgenson, you may proceed.

STATEMENT OF DALE W. JORGENSON, PROFESSOR, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MASSACHUSETTS

Mr. JORGENSON. Thank you, Mr. Chairman.

Honorable Members of the Committee and ladies and gentlemen of the audience, I would like to begin my testimony by drawing your attention to a series of charts that I have appended to my prepared statement.

Adoption of a consumption tax would be the most dramatic change in tax policy since the adoption of the Federal income tax in 1913. It is not surprising that the economic impact would be truly staggering.

As an illustration, I have considered in my prepared statement the impact of substituting a tax on consumption for corporate and individual taxes at Federal, State, and local levels; in other words, all income taxes.

For this purpose, I have simulated U.S. economic growth with and without a change in tax policy. For simplicity, I have limited

my analysis to a tax substitution that would leave government expenditure programs fully funded.

Since State and local income taxes typically employ the same legal tax base as the Federal taxes, it does not make very much sense to assume that existing tax rules would continue to govern State and local taxes even if the Federal income tax were abolished.

Finally, I have focused on the impact of tax reform on economic growth, leaving progressivity to be determined by the adjustment of expenditures.

My conclusions about the adoption of a consumption tax with a very comprehensive, all-inclusive tax base are illustrated in the charts, and I can summarize them in the following six points.

First, substitution of a consumption tax for all of our existing income taxes, beginning January 1 of this year, would have had an immediate and powerful impact on the level of economic activity. U.S. domestic product would have increased initially by about 13 percent, and this increase would gradually have declined over the long run, indicated in the first chart, to about 9 percent.

Second, the imposition of a consumption tax would obviously produce a sharply higher tax rate on consumer goods and services. The consumption tax rate required to finance existing government programs at Federal, State, and local levels would be around 15 percent. That is Federal, State, and local.

This would gradually rise over time, ultimately reaching 21 percent. As a consequence of the total transformation of the tax system, individuals would obviously sharply curtail their consumption of goods and services, but they would also curtail their consumption of leisure. In other words, they would increase their labor supply.

There would, in fact, be a dramatic jump in savings and a very substantial rise in the supply of labor. These increases would subside only very gradually over time.

Fourth, taxation of consumption would induce a radical shift away from consumption and toward investment. Real investment would leap upward by about 80 percent, as shown in the chart. Real consumption would initially decline by about 5 percent, again, shown in the chart, but would gradually grow and overtake the level under the income tax within 2 years.

Since producers would no longer pay taxes on profits and workers would no longer pay taxes on wages, prices would fall by an average of 20 percent, while consumers would pay about the same taxes, face practically the same prices as they do now.

Industry outputs would rise by an average of about 20 percent with substantial relative gains for investment goods producers. That is also shown in the two charts.

Finally, in the long run, aftertax prices would fall by more than 25 percent, there would be a shift toward investment and away from consumption that would redistribute economic activity among industries, and while output would increase in all industries, as you can see in my final chart, the rise would be greatest for investment goods producers.

Obviously, these conclusions are preliminary, and they are subject to many qualifications which are spelled out in my prepared statement. However, they illustrate the quantitative importance of the impact of a consumption tax on U.S. economic growth, and I would like to submit that that is the central issue facing this Committee.

Thank you very much.

[The prepared statement and attachments follow:]

THE ECONOMIC IMPACT OF TAXING CONSUMPTION

by

Dale W. Jorgenson

INTRODUCTION AND SUMMARY

In this testimony I consider the economic impact of substituting a tax on consumption for corporate and individual income taxes at federal, state, and local levels. I limit my analysis to a revenue neutral substitution—one that would leave the government deficit unchanged. Finally, I focus on the impact of this fundamental tax reform on economic growth, leaving progressivity of the resulting combination of taxes and government expenditures to be determined on the expenditure side of the government ledger. I have summarized my conclusions in a series of charts.

1. The revenue neutral substitution of a consumption tax for existing income taxes at both federal and state and local levels would have an immediate and powerful impact on the level of economic activity. The first chart shows that U.S. gross domestic product (GDP) would increase initially by about fifteen percent and this increase would be sustained for a substantial time period.

2. The imposition of a consumption tax would produce a sharply higher tax rate on consumer goods and services. Elimination of the individual income tax would result in a dramatic decline in the implicit subsidy rate on leisure time. The implied rate of subsidy on leisure is equal to the marginal tax rate on labor income and would drop to zero if the tax were abolished.

3. As a consequence of the total transformation of the tax system, individuals would sharply curtail consumption of both goods and leisure. This would produce a dramatic jump in saving and a substantial rise in labor supply. These increases would subside only very gradually.

4. Taxation of consumption would induce a radical shift away from consumption toward investment. The second chart shows that real investment would leap upward by a staggering eighty percent! The third chart shows that real consumption would initially decline by more than ten percent, but the level would grow rapidly and would overtake that under the income tax within five years.

5. The fourth chart shows that the consumption tax rate required for replacing existing revenues from individual and corporate income taxes at both federal and state and local levels would be around fifteen percent. This would gradually rise over time, ultimately reaching twenty-one percent.

6. Since producers would no longer pay taxes on profits or other forms of income from capital and workers would no longer pay taxes on wages, prices received by producers, shown in the fifth chart, would fall by an average of twenty percent. The sixth chart shows that industry outputs would rise by an average of fourteen percent with substantial relative gains for investment goods producers.

7. In the long run producers' prices, shown in the seventh chart, would fall by almost twenty-five percent, relative to prices under an income tax. The shift in the composition of economic activity toward investment and away from consumption would drastically redistribute economic activity. The eighth chart shows that production would increase in all industries, but the rise in production of investment goods would be much more dramatic.

IMPLEMENTATION OF A CONSUMPTION TAX

In *Hearings on Replacing the Federal Income Tax*, held by the Committee on Ways and Means last June, testimony focused on alternative methods for implementing a consumption tax. The consumption tax base can be defined in three alternative and equivalent ways. First, subtracting investment from value added produces consumption as a tax base, where value added is the sum of

capital and labor incomes. A second definition is the difference between business receipts and all purchases from other businesses, including purchases of investment goods. A third definition of the tax base is retail sales to consumers.

The three principal methods for implementation of a consumption tax correspond to these three definitions of the tax base:

1. The subtraction method. Business purchases from other businesses, including investment goods, would be subtracted from business receipts, including proceeds from the sale of assets. This could be implemented within the framework of the existing tax system by integrating individual and corporate income taxes, as proposed by the U.S. Treasury (1994). In this approach all businesses would be treated as partnerships or "sub-chapter S" corporations. The second step would be to allow full expensing of investment goods purchases in the year of acquisition. If no business receipts were excluded and no deductions and tax credits were permitted, the tax return could be reduced to the now familiar postcard size, as in the Flat Tax proposal of Majority Leader Dick Armey and Senator Richard Shelby (1995).¹ Enforcement problems could be reduced by drastically simplifying the tax rules, but the principal method of enforcement, auditing of taxpayer records by the Internal Revenue Service, would remain.

2. The credit method. Business purchases would produce a credit against tax liabilities for value added taxes paid on goods and services received. This method is used in Canada and all European countries that impose a value added tax. From the point of view of tax administration the credit method has the advantage that both purchases and sales generate records of all tax credits. The idea of substituting a value added tax for existing income taxes is a novel one. European and Canadian value added taxes were added to pre-existing income taxes. In Canada and many other countries the value added tax replaced an earlier and more complex system of retail and wholesale sales taxes. The credit method would require substantial modification of collection procedures, but decades of experience in Europe have ironed out many of the bugs.

3. National retail sales tax. Like existing state sales taxes, a national retail sales tax would be collected by retail establishments, including service providers and real estate developers. This would also require a new system for tax administration, possibly sub-contracting the actual collection to existing state agencies. Enforcement procedures would be similar to those used by the states and the Internal Revenue Service could be transformed into an agency that would sub-contract collections. Alternatively, a new agency could be created for this purpose and the IRS abolished.

The crucial point is that all three methods for implementing a consumption tax could be based on the same definition of the tax base. This greatly simplifies the tax economist's task, since the economic impact would be the same for all three approaches. This leaves important issues to be resolved by other tax professionals, including especially, tax lawyers who would write the legislation and the implementing regulations and tax accountants who would translate the laws and regulations into accounting practice and advise economic decision-makers about their implications.

From the economic point of view the definition of consumption is straightforward and a useful starting point is Personal Consumption Expenditures (PCE) as defined in the U.S. national income and product accounts. However, the taxation of services poses important administrative problems reviewed in the U.S. Treasury (1984) monograph on the value added tax. First, PCE includes the rental equivalent value of the services of owner-occupied housing, but does not include the services of consumers' durables. Both are substantial in magnitude, but could be taxed by the "prepayment method" described by David Bradford (1986). In this approach taxes on the consumption of the services would be prepaid by including investment rather than consumption in the definition of the tax base.

The prepayment of taxes on services of owner-occupied housing would remove an important

¹Economists will recognize the Flat Tax proposal as a variant of the consumption-base value added tax proposed by Robert Hall and Alvin Rabushka (1995).

political obstacle to substitution of a consumption tax for existing income taxes. At the time the substitution takes place all owner-occupiers would be treated as having prepaid all future taxes on the services of their dwellings. This is equivalent to excluding not only mortgage interest from the tax base, but also returns to equity, which might be taxed upon the sale of residence with no corresponding purchase of residential property of equal or greater value. Of course, this argument is vulnerable to the criticism that home owners should be allowed to take the mortgage interest deduction twice-once when the substitution occurs and again when consumption tax liabilities are assessed.

Under the prepayment method purchases of consumers' durables by households for their own use would be subject to tax. This would include automobiles, appliances, home furnishings, and so on. In addition, new construction of owner-occupied housing would be subject to tax, as would sales of existing renter-occupied housing to owner-occupiers. These are politically sensitive issues and it is important to be clear about the implications of prepayment as the debate proceeds. Housing and consumers' durables must be included in the tax base in order to reap the substantial economic benefits of putting household and business capital onto the same footing.²

Other purchases of services especially problematical under a consumption tax would include services provided by nonprofit institutions, such as schools and colleges, hospitals, and religious and eleemosynary institutions. The traditional, tax-favored status of these forms of consumption would be defended tenaciously by recipients of the services and even more tenaciously by the providers. Elegant and, in some cases, persuasive arguments could be made that schools and colleges provide services that represent investment in human capital rather than consumption. However, consumption of the resulting enhancements in human capital often takes the form of leisure time, which would remain as the principal untaxed form of consumption. Taxes could, however, be prepaid by including educational services in the tax base.

Finally, any definition of a consumption tax base will have to distinguish between consumption for personal and business purposes. On-going disputes over exclusion of home offices, business-provided automobiles, equipment, and clothing, and business-related lodging, entertainment and meals would continue to plague tax officials, the entertainment and hospitality industries, and holders of expense accounts. In short, substitution of a consumption tax for the federal income tax system would not eliminate all the practical issues that arise from the necessity of distinguishing between business and personal activities in defining consumption. However, these issues are common to the two tax systems.

CONCLUSION

Under any one of the three approaches to implementation of a value added tax, substitution of a consumption tax for existing individual and corporate income taxes would be the most drastic change in federal tax policy since the introduction of the income tax in 1913. It should not be surprising that the economic impact I have already summarized would be truly staggering in its dimensions. It is easy to foresee that as Americans become more fully apprized of the manifold ramifications of fundamental tax reform that Gucci Gulch³ will be transformed into the political equivalent of the Grand Canyon.

The coming debate over tax reform is a both a challenge and an opportunity for economists. It is a challenge because the impact of fundamental tax reform will involve almost every aspect of economic life. Economists who have spent their lives pre-occupied by the latest debating points in

²See, for example, my testimony before the Committee on Ways and Means of June 6, 1995.

³It is difficult to believe that anyone reading this testimony will be unaware of this colloquial expression for the corridor outside the hearing room of the Committee on Ways and Means. The expression appeared in the title of the definitive journalistic account of the Tax Reform Act of 1986 by Jeffrey H. Birnbaum and Alan S. Murray (1987).

professional journals read only by other economists will suddenly find themselves swept up in the journalistic maelstrom of American political life. The fine points that dominate scholarly discussions will be subjected to the refiner's fire of public exposure. While translation of professional debating points into sound bites requires considerable talent and experience, a substantial number of economists have acquired the requisite skills.

The debate will be an opportunity for economists because economic research has generated an enormous amount of valuable information about the impacts of tax policy. Provided that the economic debate can be properly focused, economists and policy makers will learn a great deal about the U.S. economy and its potential for achieving a higher level of performance. I am personally very gratified that the Joint Committee on Taxation has taken the initiative in this daunting enterprise and will shortly convene a group of leading tax economists to begin serious work on shaping the professional discussion. In my remaining testimony I will outline my own recommendations at the beginning of this landmark debate.

The first issue that will surface in the tax reform debate is progressivity or the use of the federal tax system to redistribute resources. My first recommendation is that this issue be set aside at the outset. Fiscal economists of varying persuasions can agree that progressivity or the lack of it should be used to characterize all of government activity, including both taxes and expenditures. Policies to achieve progressivity could and should be limited to the expenditure side of the government budget. This initial policy stance would immeasurably simplify the debate over the economic impact of fundamental tax reform. I view this radical simplification as essential to intellectual progress, since there is no agreed upon economic methodology for trading off efficiency and equity in tax policy or anywhere else.

The second issue to be debated is fiscal federalism or the role of state and local governments. Since state and local income taxes usually employ the same tax bases as the corresponding federal taxes, it is reasonable to assume that substitution of consumption for income taxes at the federal level would be followed by similar substitutions at the state and local level. For simplicity I propose to consider the economic impact of substitution at all levels simultaneously. Since an important advantage of a fundamental tax reform is the possibility, at least at the outset, of radically simplifying tax rules, it does not make much sense to assume that these rules would continue to govern state and local income taxes, even if the federal income tax were abolished.

The third issue in the debate will be the economic impact of the federal deficit. Nearly two decades of economic dispute over this issue has failed to produce resolution. No doubt this dispute could continue well into the next century and preoccupy the next generation of fiscal economists, as it has the previous generation. An effective rhetorical device for insulating the discussion of fundamental tax reform from the budget debate is to limit consideration to deficit neutral proposals. This device was critical to the eventual enactment of the Tax Reform Act of 1986 and is, I believe, essential to progress in the debate fundamental tax reform.

APPENDIX

The simulations of U.S. economic growth summarized in the charts appended to this testimony are based on an intertemporal equilibrium model of the U.S. economy that I have constructed with Peter J. Wilcoxon. The details of the model and more than a dozen applications are summarized in our survey paper, "Energy, the Environment, and Economic Growth," published in 1993. The model has been continuously revised and updated since it was first published in 1990 and Version Nine incorporates the detailed representation of the U.S. tax structure published in my 1991 book with Kun-Young Yun, *Tax Reform and the Cost of Capital*.

Our model of U.S. economic growth is disaggregated to the thirty-five industries listed in the final four charts of my testimony. In addition, the model distinguishes among 1344 types of households, disaggregated by family size, age and gender of household head, region of residence, race, and urban versus rural location. The model is built around sub-models of investment and saving based on rational expectations. The price of investment goods in every period is based on

expectations of future capital services and discount rates that are fulfilled by the solution of the model.

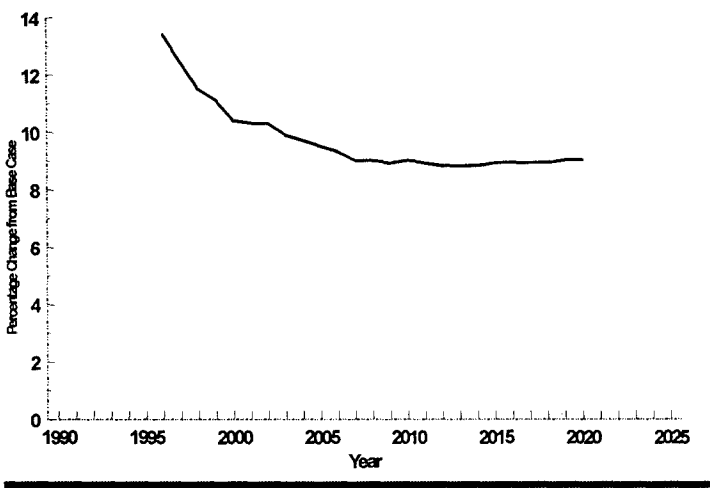
In order to analyze the economic impact of changes in tax policy, we simulate the growth of the U.S. economy with and without changes in these policies. The first and most difficult step is to generate a simulation based on current tax policy. We call this the *base case*. We then produce an alternative simulation based on a consumption tax. This represents the *alternative case*. Finally, we compare the base case with the alternative case in order to assess the effects of the substitution of a consumption tax for the existing income tax system.

The most difficult part of tax policy evaluation is to project U.S. economic growth under the existing tax system. For this purpose I have introduced the characteristic features of U.S. tax law into the cost of capital, distinguishing among assets employed in three legal forms of organization—households and nonprofit institutions, nonprofit business, and corporations. Income from corporate business is subject to the corporate tax, while distributions to households are subject to the individual income tax. Income from unincorporated business—partnerships and sole proprietorships—are taxed only at the individual level, while income from equity in household assets is not subject to the income tax.

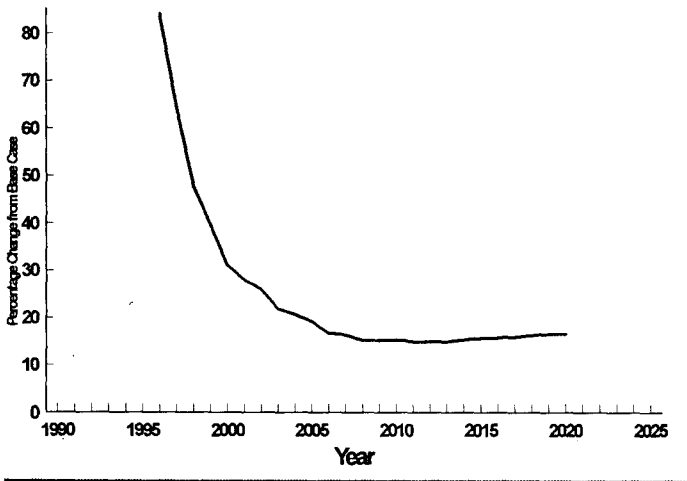
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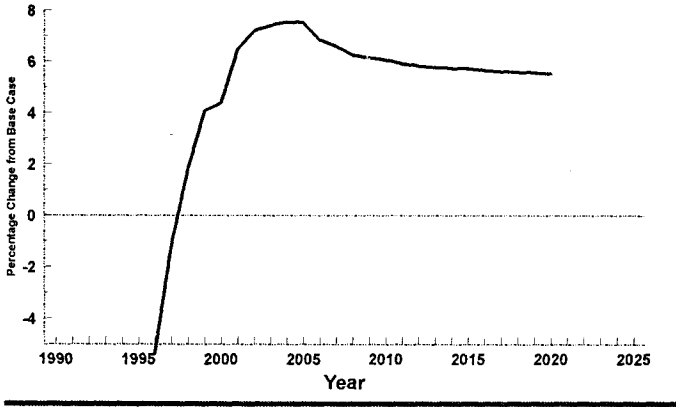
Effect of Consumption Tax on Real GDP



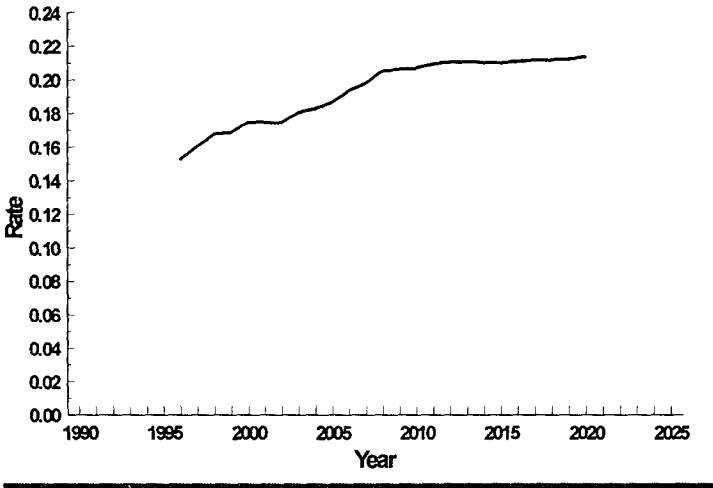
Effect of Consumption Tax on Real Investment



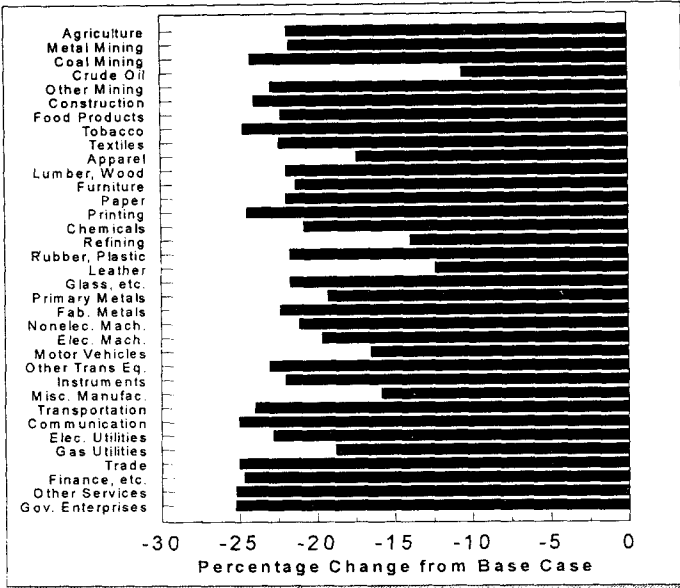
Effect of Consumption Tax on Real Consumption



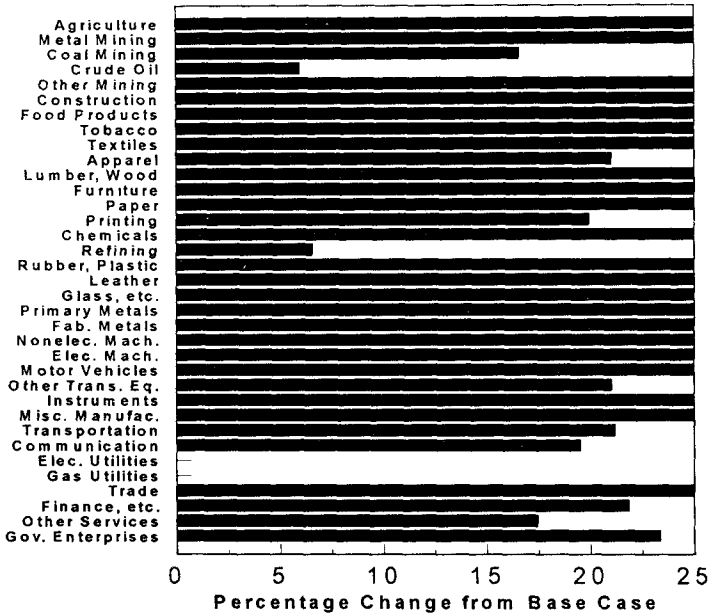
Consumption Tax Rate

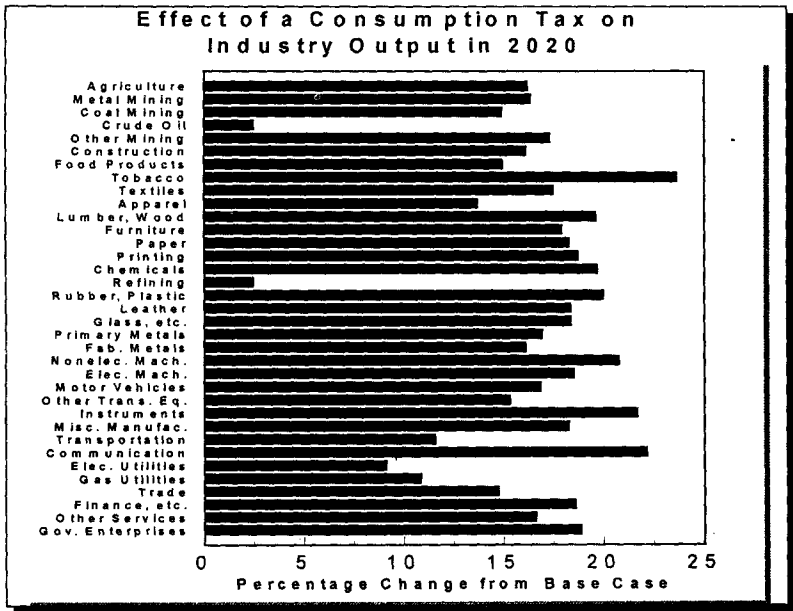
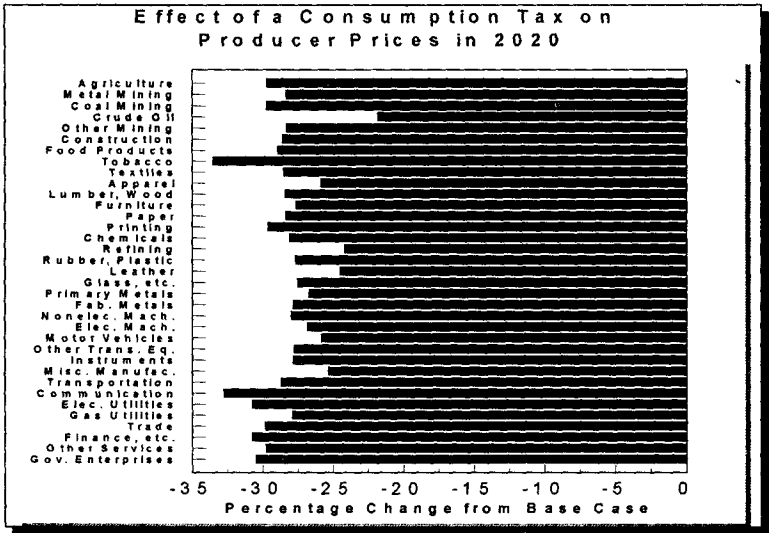


**Effect of a Consumption Tax on
Producer Prices in 1996**



**Effect of a Consumption Tax on
Industry Output in 1996**





Chairman ARCHER. Thank you, Mr. Jorgenson.

Our next witness is Glenn Hubbard, professor of economics and finance at Columbia University.

Mr. Hubbard, welcome to the Committee. You may proceed.

**STATEMENT OF R. GLENN HUBBARD, RUSSELL L. CARSON
PROFESSOR OF ECONOMICS AND FINANCE, COLUMBIA
UNIVERSITY, NEW YORK, NEW YORK**

Mr. HUBBARD. Thank you.

Mr. Chairman, Ranking Member Gibbons and distinguished Members of the Committee, I think it is clear as an opening observation that the current Federal tax system violates economists' norms of efficiency, fairness, and simplicity. There is no need for a litany of the current ills.

The big economic issues have to do with the distortions in the way our Nation allocates its capital and savings, and with the level of savings and investment. Both the allocation of capital and the level of saving are strange and distorted in sometimes very complex ways by the Tax Code.

Fundamental tax reform, whether it is broad-based income tax reform or consumption tax reform, should be judged by its ability to alleviate these distortions, while not giving ground on fairness or simplicity.

The bottom line of my remarks is that there is a very good case to be made for some broad-based consumption tax proposals. Let me also add a word of caution: Don't let the best be the enemy of the good. Many of the gains from major currently proposed consumption tax proposals could be achieved from principal income tax reform.

I join many economists in supporting the use of broad-based consumption taxes, and that support is primarily grounded in economic efficiency considerations.

As Dale Jorgenson just highlighted in his remarks, there are likely to be significant gains in capital accumulation and ultimately family incomes from a switch to a consumption tax, as well as the removal of the distortions and the way we allocate capital and the way businesses finance and organize themselves.

There is also an important fairness issue. Most economists would argue that consumption is a better measure of ability to pay than current income, and, regarding simplicity, a properly designed consumption tax can avoid a lot of the costly complexity with the current income tax. The \$64,000 question, of course, is how would we get there, wherever that is, from here, wherever that is.

As we move there, we would like to know some concrete steps for tax reform, and to fix ideas, I have taken one of the major tax reform proposals, the flat tax proposal of Robert Hall and Alvin Rabushka from the Hoover Institution. In exhibit 1 of my prepared testimony, at the risk of oversimplifying, I outline nine steps that one could take to go from the current broken Federal Tax Code to the flat tax.

Without walking through all of those steps, let me mention three general themes. The first theme is "tax income once." That is achieved in the first three steps by integrating the corporate and individual tax systems—that is, eliminating the perverse double

taxation of dividends and capital gains and taking the Tax Code out of business people's decisions about organization and finance.

The second theme is "broaden the base and lower the rates." Eliminate special provisions in the business tax base and the individual tax base, and lower marginal tax rates for both individuals and businesses.

The first seven steps in the exhibit that I submitted with my testimony are consistent with broad-based income tax reform. Indeed, the Treasury Department submitted them in a comprehensive business income tax proposal during the Bush administration. Those reforms would capture a good chunk of the efficiency gains being discussed.

Steps 8 and 9 in the table; moving to expensing and moving to a territorial tax system, would be necessary to get to the flat tax and would also introduce very significant gains in economic efficiency.

Let me leave you with two thoughts. One, there are very large gains in economic efficiency to be obtained from tax reform. Two, if you break down tax reform into, for lack of a better term, bite-sized pieces, you can see that there are very large gains associated with proposals that economists, policymakers, and many Members of this Committee have advocated for years.

So, again, let me commend the Committee's interest in fundamental tax reform and urge you to consider tax reform very broadly in your deliberations.

[The prepared statement and attachments follow:]

STATEMENT ON "ISSUES IN FUNDAMENTAL TAX REFORM"
 BY
 R. GLENN HUBBARD
 RUSSELL L. CARSON PROFESSOR OF ECONOMICS AND FINANCE
 COLUMBIA UNIVERSITY
 FOR
 HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS
 OF THE ONE HUNDRED AND FOURTH CONGRESS
 ON
 MARCH 27, 1996

Mr. Chairman, Ranking Member Gibbons, and distinguished members of this committee, I am delighted to appear before you today to discuss economic considerations of replacing our tax system with various alternatives. To preview my remarks, I believe that the current federal income tax is fundamentally flawed, generating adverse consequences for economic efficiency, costly complexity, and significant violations of conventional norms of fairness. Fundamental income tax reform or a switch to a broader based consumption tax would likely lead to significant improvements in efficiency, simplicity, and fairness. Mr. Chairman, I salute this Committee's interest in economic issues surrounding fundamental tax reform.

THE NEED FOR FUNDAMENTAL TAX REFORM

Current U.S. tax law distorts the allocation of the nation's capital stock and reduces saving and investment. To begin, current law treats corporations and their investors as separate entities. Under this so-called "classical" system of corporate taxation, two levels of tax are levied on earnings from investments in corporate equity. First, income earned by corporations is taxed at the corporate level. Second, when the corporation distributes dividends to shareholders, the income is taxed at the shareholder level as ordinary income. Undistributed earnings, which increase share values, are also double taxed, since they are taxed at capital gains rates when shares are sold.

In contrast, investors who conduct business activity in noncorporate form, such as a sole proprietorship or partnership (or in corporate form through an S corporation), are taxed once on their earnings at their individual tax rate. Corporate earnings distributed as interest to suppliers of debt capital are generally taxed to U.S. taxpayers as ordinary income. However, interest paid is generally deductible by the corporation, and thus not subject to tax at the corporate level.

"Integration" of the corporate and individual income taxes refers to any plan in which corporate income is taxed only once, rather than taxed both when earned and when distributed to shareholders as dividends. Integration has many variants. In January 1992, the U.S. Treasury Department released a study of corporate tax integration, *Integration of the Individual and Corporate Tax Systems*. The American Law Institute also released a report on integration. The two reports document the economic distortions caused by the current two-tier tax system and the need to change the way in which the United States taxes corporations and their shareholders, and presents the issues involved with alternative approaches.

Despite their differences, methods of integration reflect a common goal: To the extent practicable, fundamental economic considerations, not the tax structure, should guide investment, organizational, and financial decisions. Although the Tax Reform Act of 1986 reduced the effect of taxation on many business decisions, that reform did not directly address distortions in business organizational and financing decisions under current law. Thus, integration can be viewed as the next logical step in tax reform.

The current system of business income taxation raises questions of fairness because it creates differences in the taxation of alternative sources of income from capital. A taxpayer conducting an equity-financed business in corporate form faces a different tax burden than a taxpayer conducting the same business in noncorporate form. A corporation that raises capital in the form of equity faces a different tax burden than a corporation that raises the same amount of capital from debt. A similar disparity exists in the treatment of corporations that finance investment with retained earnings and those that pay dividends and finance investment with new equity. Because of its bias towards debt, the current tax system encourages taxpayers to engage in practices that tend to disguise equity as debt. This effort represents a wasteful use of resources, and imposes significant administrative costs in attempting to distinguish debt from equity. These arguments for integrating the corporate and individual income tax systems have been put forth by economists and legal specialists for more than a generation. Three factors have maintained tax integration's place in the tax reform debate over the past decade.

First, the 1980s witnessed an explosion of corporate borrowing in the United States. Indeed, many observers believe that this activity—and the accompanying financial distress it brought in many sectors of the economy—was influenced significantly by the tax bias against equity finance. While the greatest reliance on debt had its origin in many factors, the use of debt contracts with virtually no provisions to index repayments to shifts in industry-wide or economy-wide conditions almost surely reflects the tax preference given such debt under current law. Financial decisions, which may leave firms more vulnerable to a downturn in the economy, should be based on fundamental economic considerations, not the tax code. The tax bias against equity finance needs to be addressed.

Second, these distortions have economic costs. Integration of the individual and corporate tax systems would reduce or eliminate these economic distortions. The potential economic gains could be substantial, as suggested in the Treasury Report.

Third, aside from these efficiency gains, the various integration prototypes, especially those that also focus on the taxation of interest, provide a mechanism for addressing a problem which has increasingly troubled many governments—the difficulty of taxing income from capital in a global economy. It is desirable to keep the overall tax rate on income from capital as low as possible. However, the ability of some investors to avoid or reduce taxation of capital income, while other investors cannot, is not an adequate surrogate for a uniform lower rate of taxation on all income from capital.

Finally, the thrust of integration on tax reform—taxing income once—still leaves a single level of tax on capital income. Many economists believe that the resulting intertemporal distortions of household saving decisions and business investment decisions are large, reducing growth opportunities and economic efficiency.

A CONSUMPTION TAX AS FUNDAMENTAL TAX REFORM

The term "consumption tax" actually applies to a range of tax systems. The base of a broad-based consumption tax is households' consumption, not households' net income. "Consumption taxes" can be collected from businesses, households, or both. They can be familiar sales taxes, but do not have to be. Further, consumption taxes can incorporate exemptions and graduated marginal tax rates, as under the income tax. Many economists support the use of consumption taxes to replace the current individual and corporate income taxes. This support reflects efficiency, fairness, and simplicity concerns.

The nation would enjoy three sources of efficiency gains from moving to a broad-based consumption tax. First, the removal of the current tax on returns to new saving and investment increases capital accumulation and, ultimately, household incomes.¹ Second, the consumption tax

¹ Many economists have argued that switching from an income tax to a consumption tax significantly increases saving and capital accumulation. This is because a consumption tax exempts returns to new saving, thereby increasing households' willingness to save. In the early 1980s, Laurence Summers, currently Deputy Secretary of the Treasury Department, concluded that a move to a consumption tax would lead to major increases in capital accumulation and economic well being. See Laurence H. Summers, "Capital Taxation and Accumulation in a Life-Cycle Growth Model," *American Economic Review* 71 (September 1981): 533-544.

There are two reasons to suspect that gains in saving may be smaller than researchers originally guessed. The first is that the current "income" tax already embodies some elements of a consumption tax. For example, saving through pension plans, IRAs, Keoghs, or 401(k) arrangements already enjoy cash flow treatment. In addition, investment incentives offer a form of partial expensing. Second, recent research on saving suggests that a significant function of household saving is "precautionary saving" against uncertainty over future earnings, medical expenses, or length of life as opposed to saving for retirement *per se*. Such saving decisions are less influenced by changes in the after-tax interest rates than retirement saving decisions, implying a smaller overall response of saving to tax reform. Nonetheless, combining these two caveats, a recent Brookings Institution study concluded that saving rates would fall by between 5 and 10 percent. See Eric Engen and William Gale, "The Effects of Fundamental Tax Reform on Saving," Mimeograph, The Brookings Institutions, February, 1996.

Another reason that many economists and policymakers favor fundamental tax reform emphasizing consumption taxation over income taxation is that such reform may stimulate

removes distortions in the allocation of capital across sectors and types of capital. Third, a broad-based consumption tax avoids potentially costly distortions of firms' financial and organizational structure.² Taken together, efficiency gains from moving to a consumption tax are potentially dramatic. Professor Dale Jorgenson of Harvard University estimates the present value of growth opportunities created by the move from the 1985 law to the Tax Reform Act of 1986 to be about \$1 trillion (1987 dollars). Jorgenson also estimates that, had the United States moved from the 1985 income tax law to a broad-based consumption tax, gains in growth opportunities would have doubled to about \$2 trillion. The additional gains are due to leveling the playing field and to expensing business investment.

With respect to fairness, many economists believe that consumption represents a better measure of "ability to pay" than does current income, because households' consumption decisions depend on wealth and expected future income as well as current income. Finally, a properly designed broad-based consumption tax promotes simplicity. Several consumption tax systems avoid much of the costly complexity associated with the present income tax.

STEPS TOWARD FUNDAMENTAL TAX REFORM

How might we move from the current tax system to a broad-based consumption tax? What aspects of reform generate significant improvements in efficiency, simplicity, and fairness? To fix ideas, I focus on the "flat tax" proposal of Robert Hall and Alvin Rabushka of the Hoover Institution.³ While I abstract from many details of the proposal and from transition complications, I show in Exhibit 1 that it is possible to characterize this fundamental tax reform as a nine-step process. While each step represents a significant change in tax policy, virtually all of the steps are consistent with fundamental *income* tax reform. Moreover, many of the steps to reform have been advanced for many years by economists and policymakers. I consider the steps in turn below under three themes: (1) integrating the corporate and individual tax, (2) broadening the base and reducing marginal tax rates, and (3) moving to consumption taxation.

Integrating the Corporate and Individual Income Tax

The first three steps toward fundamental tax reform integrate the corporate and individual tax system. Step 1 ends the double taxation of corporate equity returns. The Treasury Department's integration report recommended a dividend exclusion prototype for dividend relief. Under this prototype, corporations would pay the corporate income tax, computing taxable income in the same way as under current law. However, dividends paid would not be taxed again at the investor level. The Treasury model also ended double taxation of retained earnings by allowing shareholders to

business investment. Under the current income, tax businesses are permitted to depreciate capital investment over time. Under a consumption tax, investment is expensed. Under current law, the present value of one dollar of depreciation allowance is about \$0.83 for equipment investment; under expensing, that present value is, of course, \$1.00. In a study of effects of the cost of capital on investment, Kevin Hassett and I estimate that this change would raise the annual business equipment rate by 10 percent. See Kevin A. Hassett and R. Glenn Hubbard, "Tax Policy and Investment," Mimeograph, Columbia University, January 1996.

² Distortions in the allocation of capital and in financial and organizational structure can also be reduced through fundamental income tax reform. The Treasury Department's 1992 study of corporate tax integration study estimated increases in economic well-being from integration in many cases as large as gains accompanying reforms in the Tax Reform Act of 1986. The gains result from improved allocation of real resources, reductions in the likelihood of firms experiencing financial distress, and the shift toward allowing corporations to make capital structure and dividend decisions based on nontax benefits and costs. See U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, Washington, D.C.: U.S. Government Printing Office, 1992.

³ In the *Appendix* of this testimony, I offer a brief comparison of alternative forms of broad-based consumption taxes and arguments for favoring the flat tax over a value-added tax or a national retail sales tax.

increase stock basis for retained earnings, thereby avoiding a subsequent capital gains tax on retained earnings.

Step 2 ends the tax bias against equity finance in favor of debt finance. The Treasury Department's integration study proposed to accomplish this by extending the dividend exclusion prototype to interest. Treasury's model—the Comprehensive Business Income Tax (CBIT)—would apply to all businesses, noncorporate and corporate. Under CBIT, neither deductions for payments to debtholders nor to shareholders would be permitted, and a tax would be collected at the entity level (at a rate equal to the highest marginal individual tax rate). However, both interest and equity distributions would be excludable from income by investors. Step 3, which would consolidate reporting of business income for tax purposes, would be accomplished by a proposal such as CBIT.

Broadening the Tax Base and Reducing Marginal Tax Rates

The next four steps implement the maxim guiding the Tax Reform Act of 1986—"broaden the base and lower the rates." Step 4 broadens the base of the business tax by eliminating preferential tax provisions for particular industries and firms and by repealing the alternative minimum tax. Step 5 continues the theme of "taxing income once" by collecting taxes on employee fringe benefits at the business level. In practice, this could be accomplished by disallowing business deductions for expenditures on employee fringe benefits and removing tax liability for such benefits from the individual tax. Step 6 broadens the base of the individual tax—eliminating all itemized deductions, the standard deduction, and any adjustments to gross income and repealing the alternative minimum tax. Having accomplished base broadening under the income tax, one can lower marginal rates on individuals and businesses. In practice, this could be accomplished by replacing the graduated-rate individual tax system with a single-rate system and reducing the business tax rate to the same single rate as the individual tax rate. To maintain progressivity, one could retain and expand the generosity of the personal exemption. A refundable individual tax credit could also be added for low-income households.

Steps 1-7 attempt to accomplish broad-based *income* tax reform by taxing income exactly once, broadening the tax base, and reducing marginal rates. These steps have, in one form or another been advocated by many economists and policymakers for many years. Enacting tax reform that embraced the missions of these steps would stimulate saving and investment, significantly reduce tax distortions of financing and organization decisions, and improve the efficiency with which the nation's capital stock is allocated.

Moving to Consumption Taxation

It is only in Step 8 that we begin to introduce fundamental *consumption* tax reform. After the first seven steps, the tax base is (approximately) employee compensation plus business income (receipts less the sum of expenditures, compensation, materials, and depreciation of capital assets). The tax base under the consumption tax should be employee compensation plus business cash flow. Accordingly, Step 8 replaced accrual accounting for businesses with cash flow accounting. Most important, this step allows expensing for all purchases from other firms including purchases of capital assets. Relative to the business income tax, the move to expensing exempts from taxation the return on marginal investment projects—projects for which expected returns just cover the opportunity cost of funds.⁴ Economic profits—based on entrepreneurial skill or good fortune—are taxed equally in the business income tax and in the business cash flow tax.⁵

The first eight steps essentially treat the United States as a closed economy. A broad-based consumption tax would not tax overseas income of U.S. enterprises. Hence Step 9 shifts the tax base from a residence-based tax system to a territorial tax system. This step would remove foreign-source

⁴ One could also implement a broad-based consumption tax by taxing compensation once at the business level by using a subtraction-method value-added tax. Relative to Step 8, this would require eliminating the individual tax and disallowing businesses' deductions of payments to labor.

⁵ For a general discussion of this point, see William M. Gentry and R. Glenn Hubbard, "Distributional Implications of Moving to a Broad-Based Consumption Tax," Mimeograph, Columbia University, March 1996.

income from the U.S. tax base.⁶

As I noted earlier, enacting the set of nine steps would lead to large gains in economic efficiency, simplicity, and tax fairness. It is important to note that even if one wanted to enact all nine—and move to a broad-based consumption tax such as the flat tax—significant gains can be accomplished by focusing on themes of "taxing income once" and "broadening the base and lowering the rates."

Mr. Chairman, let me again commend this Committee's interest in fundamental tax reform and urge you to continue your investigation of economic gains from tax reform and how tax reform might be implemented.

• • • •

APPENDIX

DESIGNING A BROAD-BASED CONSUMPTION TAX

The discussion below reviews salient features of four consumption tax system: (1) a retail sales tax, (2) a value-added tax, (3) a two-tiered cash flow tax, and (4) a full-fledged personal cash flow tax. The first two systems collect revenue only from businesses, while the last two collect revenue from households and businesses. As broad-based consumption taxes, each is borne by consumption. While, under some conditions, these systems are roughly equivalent in their economic effects, they differ in their ease of administration and in their ability to achieve objectives for progressivity.

OPTIONS FOR A BROAD-BASED CONSUMPTION TAX

Taxes Collected from Businesses

Retail Sales Tax. Perhaps the most familiar "consumption tax" in the public imagination is the retail sales tax, in which tax is collected on businesses' sales of goods and services to households. Most states have retail sales taxes. As a broad-based consumption tax, a retail sales tax should exempt sales between businesses and tax all goods and services. Conventional state-level sales taxes are not broad-based consumption taxes because they generally do not apply to all forms of consumption (for example, food and health care expenditures and certain services). Only domestic consumers pay the retail sales tax, so that it taxes imports and exempts exports.

Two-Tiered Cash Flow Tax. The two-tiered cash flow tax involves two tax-collecting vehicles, a business tax and an individual compensation tax. The coordinated use of these two instruments allows one to tax consumption at different rates for different people.

Calculating the business tax base begins with value added (sales less purchases from other firms), as with value-added taxes. In a cash flow tax, payments to workers (for current, past, or future labor services) are deducted. Investment is expensed, so there are no depreciation allowances. Similarly, no interest is deductible. Firms then pay a flat rate of tax on the final amount, cash flow.

The base for the individual tax is the set of payments received by individuals for current, past, and future labor services. Capital income is not taxed. The rate of individual tax could be flat or graduated, and further progressivity can be incorporated by adding an exemption.

One popular variant, the Simple Flat Tax of Robert Hall and Alvin Rabushka, in which the business and individual tax share a common flat marginal rate, is related to a value-added tax. Under a value-added tax, payments for compensation are not deductible by businesses, but they are not taxed for individuals. Under the Simple Flat Tax, payments for compensation are deductible by businesses, but taxable for individuals. If the businesses and individual marginal rates are identical, the value-added tax and the simple flat tax are identical, if the flat tax has no individual exemption. This is not a coincidence, of course. It is a consequence of the fact that they are different ways of taxing the same base—personal consumption. Progressivity can be introduced by allowing an exemption. Other variants of the two-tiered cash flow tax can incorporate graduated marginal rates.

While "pure" two-tiered cash flow taxes do not embody deductions, it is possible to include

⁶ One can also make a principled argument for moving to a territorial tax system as part of fundamental income tax reform. See R. Glenn Hubbard, "U.S. Tax Policy and Foreign Direct Investment: Incentives, Problems, and Reform," In *Tax Policy and Economic Growth*, Washington, D.C.: American Council for Capital Formation, 1995.

certain deductions in a consistent manner. Because the objective is to design a consumption tax, allowing interest deductions would be inconsistent. However, deductions for state and local taxes or charitable contributions, if desired, are consistent with the approach. The costs of such deductions are additional complexity and the need for a higher rate of tax on the remaining tax base.

Full-Fledged Personal Cash-Flow Tax. A full-fledged cash flow tax (or "consumed income tax") would be collected solely from individuals. The tax base is a cash flow rather than the current accrued-income base. Individuals pay tax on reported cash flow less net saving. Because consumption equals the difference between income and net saving, the base of the personal cash flow tax is consumption. While saving is deductible, proceeds from borrowing, as a cash inflow, are included in the base to measure cash flow properly. A personal cash flow tax can incorporate a flat rate, an exemption and flat marginal rate, or an exemption and graduated marginal rates.

A full-fledged personal cash-flow tax allows elimination of the corporate income tax. With cash flow tax treatment, individual shareholders are permitted a deduction for the purchase of shares; dividends and the value of shares sold are included in taxable cash flow. Similar treatment is given to partnership and proprietorship organizations. Partners and proprietors pay tax on net cash flow; cash receipts are included in the base, and net contributions are deducted.

Under some circumstances, the personal consumption tax and the two-tiered cash flow tax discussed earlier are equivalent. If there were no exemptions and businesses and individual taxpayers pay tax at a uniform rate, the systems are equivalent. This equivalence assumes that all financial transactions are in the tax base.

One drawback of full-fledged personal cash flow taxes is administrative burden. For example, the government would have to monitor returns on savings deducted by taxpayers in the past. It is possible to limit this monitoring problem by requiring funds to be placed in qualified accounts (for example, accounts maintained by financial intermediaries or pension plans or closely held businesses). Dealing with fringe benefits is also more difficult in a personal consumption tax than in a two-tiered cash flow tax. On the one hand, under a personal consumption tax, a value of employee fringe benefits would have to be included in the employee's taxable cash flow. On the other hand, under a two-tiered cash flow tax, denial of a deduction at the entity level can replace the inclusion of fringe benefits in the individual tax base.

IMPLICATIONS FOR DESIGN OF A BROAD-BASED CONSUMPTION TAX

Goals

- Achieving the *efficiency* goal of moving to a consumption tax requires the selection of the broadest possible tax base: *A desirable system should not make it easy to have different rates of tax for different goods and services.*
- Achieving the *fairness* goal of moving to a consumption tax requires the ability to make the system progressive. Retail sales taxes and VATs alone are unlikely to be fair in this sense.
- Achieving the *simplicity* goal of moving to a consumption tax requires reduction in complexity (and rent-seeking activities) associated with the current income tax: *A desirable system should not extend information and monitoring requirements beyond those associated with the current income tax (and, hopefully, would reduce them).*

Steps Toward Designing a Proposal

A two-tiered cash flow tax—such as the simple flat tax or a business transfer tax plus a wage tax—probably comes closest to achieving efficiency, fairness, and simplicity goals of the reform. Such a tax is also more likely to be politically acceptable than a uniform sales tax or value-added tax because progressivity can be maintained even under current rules for distributional analysis.

EXHIBIT 1
MOVING FROM THE CURRENT TAX SYSTEM TO A CONSUMPTION TAX

Steps 1-3: Integrate the tax system.

Step 1: End the double taxation of corporate equity returns.

Integrate the corporate and individual tax systems by excluding dividends from taxable income at the individual level (Treasury proposal) or by fully crediting taxes paid at the corporate level to recipients of dividends (American Law Institute proposal). Eliminate the capital gains tax on accumulated retained earnings.

Step 2: End the tax bias against equity finance in favor of debt finance.

Collect the tax on returns to debt at the entity level by disallowing business deductions for interest payments and removing interest receipts from taxable income at the individual level (Treasury proposal).

Step 3: Consolidate reporting of business income for tax purposes.

Report all business income on a single business tax form—including income currently reported from sole proprietorships, partnerships, rental property, and Subchapter S corporations (Treasury proposal). *Note:* Because we eliminated the corporate/noncorporate business distinction in Step 1, all businesses can use the same tax form.

Steps 4-7: Broaden the base and lower the rates.

Step 4: Broaden the base of the business tax.

Eliminate any preferential tax provisions for particular industries and firms. Repeal the alternative minimum tax.

Step 5: Collect taxes on employee fringe benefits at the business level.

Disallow business deductions for expenditures on employee fringe benefits. Remove tax liability for such benefits from the individual tax.

Step 6: Broaden the base of the individual tax.

Eliminate all itemized deductions, the standard deduction, and any adjustments to gross income. Repeal the alternative minimum tax.

Step 7: Lower marginal tax rates on individuals and businesses.

Replace the graduated-rate individual tax system with a system with a single rate. Reduce the business tax rate to the same single rate as the individual tax rate. To maintain progressivity, retain and expand the generosity of the personal exemption. *Note:* A refundable individual tax credit could also be added for low-income households.

BOTTOM LINE: BROAD-BASED INCOME TAX REFORM

Steps 8-9: Move to a consumption tax.

Step 8: Replace accrual accounting for businesses with cash flow accounting.

Allow expensing for all purchases from other firms including purchases of capital assets.

Step 9: Shift from a residence-based tax system to a territorial tax system.

Remove foreign-source income from the U.S. tax base.

BOTTOM LINE: THE FLAT TAX (STYLIZED VERSION)

Chairman ARCHER. Thank you, Mr. Hubbard.

Our third witness this morning is no stranger to this Committee. You have worked with us for a period of several years. Alan Auerbach, now professor of tax policy at the University of California at Berkeley, welcome back to the Committee.

You may proceed.

**STATEMENT OF ALAN J. AUERBACH, ROBERT D. BURCH
PROFESSOR OF TAX POLICY AND PUBLIC FINANCE,
UNIVERSITY OF CALIFORNIA, BERKELEY, CALIFORNIA**

Mr. AUERBACH. Thank you very much.

Mr. Chairman and other Members of the Committee, few doubt the wisdom of seeking to reform the current income tax, both because it is rife with distortions and because of the complexities that frustrate honest taxpayers and, at the same time, facilitate avoidance by the opportunistic. But, of course, your task is to decide how to effect this reform and whether that reform should include replacement of the individual and corporate income taxes.

Contemplating replacement of the income tax is a challenge compared to which the past reform efforts, including those in the mideighties, seem simple and straightforward, but it is important to recognize that under a system such as ours that relies so heavily on voluntary compliance, a tax structure that loses favor among taxpayers cannot long be maintained.

In my written remarks, I address several questions having to do with the economics of tax reform. First, what are the most important defects of the current system? Second, what alternatives are available to the current tax system, and how would they address these defects? Third, what new problems arise under these reforms? Fourth, what transition problems would arise under a move to a new tax system, and how might we address these transition problems? Finally, what alternatives exist for reform within the current tax system?

As Glenn said, reform of the current system is something that ultimately may need to be considered, comparing the benefits of these reforms to the benefits of replacing the income tax with an alternative tax system. In my comments here, I will simply summarize the conclusions in my written testimony.

First, in order to focus one's thinking, among the myriad distortions present in the current income tax—and we could be here forever if we tried to enumerate them—the three of greatest significance are those that discourage work, discourage saving, and distort the allocation of capital from nonresidential uses to residential uses.

Currently, both the labor supply decision and the saving decision face a significant marginal tax rate which discourages those activities, while residential investment, which is about one-half of the Nation's capital stock, is taxed much more lightly.

Second, a shift to a broad-based consumption tax would reduce two of these distortions, that affecting the taxation of saving and that causing a misallocation of capital between residential and nonresidential uses. However, it would not necessarily alleviate the distortion facing the labor supply decision, even if we were not to tax labor income directly, because the tax on consumption, by re-

ducing the purchasing power of income, would have the same effect as taxing labor directly and would, therefore, discourage work. The extent to which it would discourage work would depend on the rate, about which I will say more shortly.

Third, a consumption tax can be achieved in many ways. It can be achieved by taxing sales, by taxing value added, or as an individual consumption tax. These tax systems are a lot more similar than they may first appear, although they can differ in the extent to which they can accommodate certain specific features; for example, progressivity. A sales tax or value-added tax, as practiced by the United States and in European countries, typically attempts to achieve some progressivity by exempting commodities or certain taxpayers, which tends to make the system a lot more complicated. A flat tax, by shifting the burden of labor taxes to workers, can allow personal exemptions and a standard deduction to get progressivity.

Fourth, consumption taxes improve international competitiveness primarily to the extent that they increase national saving. Border adjustment should not be seen as a major part of that process in a world of flexible exchange rates.

Fifth, while I do find that significant gains in economic efficiency and production can occur under a move to consumption tax, close evaluation of these results suggest that a large part of this gain would be diminished if we tried to provide very generous transition relief for existing assets and, at the same time, tried to maintain a degree of progressivity comparable to that under the current income tax.

Thus, taking progressivity and taking transition relief into account, it may very well turn out that what may appear in the long run to be an attractive system—a consumption tax—it may be very difficult to get to, and that under the current income tax system, there are alternatives that can help in alleviating the same three major distortions that I mentioned before.

Therefore, it is really up to you, and it is a matter of politics rather than economics, to decide whether it is easier or more feasible to move to a new system to try to attack these distortions rather than trying to work within the current system.

Thank you very much.

[The prepared statement follows:]

Replacing the Federal Income Tax: Economic Considerations

Testimony before the Committee on Ways and Means, U.S. House of Representatives

by

Alan J. Auerbach
Robert D. Burch Professor of Tax Policy and Public Finance
University of California, Berkeley

March 27, 1996

Mr. Chairman and Members of the Committee:

I am grateful for the invitation to give my views on the economic effects of replacing the federal income tax as this country's major source of revenue.

Few doubt the wisdom of seeking to reform the current income tax, as it is rife with distortions that waste resources and complexities that frustrate the honest taxpayer and facilitate avoidance by the opportunistic. It is your task to determine *how* to effect reform. If the income tax is to be repealed, what should take its place and how should the transition be structured? Alternatively, if it is better to restructure the income tax than to repeal it, what are the most important improvements to make? Yours is a challenge compared to which the arduous tax reform efforts of the past seem simple and straightforward. But under a system that relies so much on voluntary compliance, a tax structure that has lost favor among many taxpayers cannot long survive.

In my testimony, I will address several questions related to the economics of tax reform:

1. What are the most important defects of the current federal income tax?
2. What alternatives are available to the current tax system, and how would they address these defects?
3. What new problems would arise under alternative reforms?
4. What transition problems would arise if we adopted a new system, and how might these be addressed?
5. What alternatives for reform exist within the current tax system, and how would the benefits of these reforms compare to the benefits from replacing the income tax with an alternative system?

Let me begin by summarizing my conclusions:

1. Among the myriad distortions present in the current income tax, the three of greatest economic significance are those that discourage work, discourage saving, and distort the allocation of capital from nonresidential to residential uses.
2. A shift to broad-based consumption-based taxation would reduce two of these distortions, encouraging saving and improving the allocation of capital. It would not necessarily lessen distortions in the labor market.
3. A consumption tax may be achieved by taxing sales, value added, or individual consumption expenditures. These approaches are fundamentally equivalent, although they differ in the extent to which they can accommodate a progressive tax structure. For example, a flat tax is a progressive variant of a subtraction-method value-added tax.

4. Consumption taxes will improve international competitiveness to the extent that they increase national saving. Border adjustments do not play a significant role in this process and should not be viewed as an economic benefit of shifting to consumption taxation.

5. Adoption of a consumption tax will raise taxes on previously accumulated wealth and reduce the relative value of previously tax-favored assets. However, providing generous transition relief can eliminate much of the gain in economic efficiency from the reform, as the relief will require higher tax rates in the future that will worsen the distortion of labor supply permanently. A consumption tax reform that maintains a reasonable degree of progressivity and provides generous transition relief may well *reduce* economic efficiency.

6. It is possible to encourage work and saving and improve the allocation of capital within the present tax system. It is within the realm of politics, rather than economics, to determine whether such changes are more or less feasible than the adoption of an entirely new tax system.

Distortions of the Current Income Tax

The income tax distorts behavior by altering the relative economic benefits from engaging in different activities. Decisions about whether to enter the labor force, whether to save for retirement or education, or whether to invest in corporate equity or an apartment building, are all influenced by the income tax. Taxpayers are encouraged to choose less productive alternatives in order to lessen their tax burdens. The income tax reduces economic efficiency further to the extent that it requires that government or private resources be devoted to compliance, administration and enforcement rather than to productive uses. A more efficient tax system is surely feasible, but the most efficient tax system -- a "lump sum" or head tax on each individual -- is widely viewed as inequitably regressive. The challenge is to find a more realistic tax system that also reduces the existing distortions.

There are so many distortions in the current tax system that, if this committee were to devote a day's hearing to each one, few current members would still be around at the completion of the hearings (even without the enactment of term limits). But counting the number of distortions isn't particularly worthwhile; it is their overall magnitude that matters. In a recent evaluation of the combined effect of the federal taxes on individual and corporate income¹, I concluded that the most significant economic distortions are those affecting labor supply, saving, and the allocation of capital between residential and nonresidential uses. The economic significance of each distortion relates not only to the scale of the activity involved, but also to the marginal income tax rate it faces; the marginal tax rate indicates how large the gap is between what an activity produces and what a taxpayer keeps. The larger the gap, the less attractive the activity becomes. The average marginal federal tax rate on labor income is now approximately 24 percent (without taking into account the additional payroll taxes of the Social Security system). The average marginal tax rate on the return to saving in nonresidential assets is about 26 percent, and the tax rate on the income from investments in housing is close to zero. Thus, taxpayers are discouraged from working, discouraged from saving, and particularly discouraged from investing in assets other than housing.

Consumption Taxation as An Alternative

Many argue that a consumption tax would provide a less distortionary tax system than the present one. As I discuss below, a consumption tax effectively would eliminate the federal marginal tax rate on nonresidential investment, thus wiping out two of the three distortions just identified. Taxpayer choice would no longer be tilted toward residential investment, nor would the tax system discourage saving overall. But, although this might not be immediately obvious, the distortion of labor supply would remain, even with the elimination of any direct tax on labor income. This is because taxing consumption reduces the purchasing power of income in the same manner that a direct income tax would.

¹ "Tax Reform, Capital Allocation, Efficiency and Growth," presented to the Brookings Conference on Fundamental Tax Reform, February 15-16, 1996; revised March 21, 1996.

The magnitude of the labor supply distortion would depend on the breadth of the consumption tax base; the broader the base, the lower the rate and hence the distortion. Two factors contribute to a narrowing of the base and a worsening of the labor supply distortion: progressivity (reducing the tax burden on consumption by poorer individuals) and transition relief (reducing the tax burden on consumption by owners of certain assets). This does not mean that progressivity and transition relief are bad, but simply that they come at a cost for which account must be taken.

Approaches to Consumption Taxation

There are several different approaches to taxing consumption. Whether these taxes are collected from households or businesses, whether they are imposed on consumption directly or only indirectly, however, all approaches are basically equivalent in underlying structure and economic impact. The economic effects of one consumption tax will be similar to those of another, with differences introduced only to the extent that one consumption tax base is broader than another, or has a different rate of tax.

The most commonly discussed method of taxing consumption is through a national sales tax, similar in form to the sales taxes currently imposed by states but extended to cover services as well. To ensure that such a tax falls only on consumption, it would be necessary not to collect any tax on the sales of investment goods to businesses.

Like a sales tax, a value-added tax (VAT) imposed on businesses could also be used to implement a tax on consumption. Because of the national income identity that equates income and production, taxing all value added at each stage of domestic production produces a tax on all domestic income -- an *origin-based* income tax. To convert this to a tax on consumption, it is necessary only to alleviate the tax on the income that is not consumed -- on investment goods (most easily through a deduction for those who purchase them) and on exports -- and to include in the tax base the consumption that does not arise from domestic production -- imports. The result is a *destination-based* consumption tax with the same tax base and economic effects as those of a national sales tax.

While both the sales tax and the VAT are collected from businesses, it is also possible to tax consumption by individuals, not by keeping track of their consumption directly, but by taxing them on income and providing a deduction for all income that is saved and not consumed. If assessed at a single rate, such a personal consumption tax would have the same base as the sales tax and the VAT. The flat tax, as proposed by Representative Arney, is a final approach to consumption taxation that adopts a hybrid approach of collecting part of the tax from businesses and part from individuals. It differs from the VAT by collecting the tax on wages from individuals rather than from businesses.

The flat tax differs from a VAT in two other respects. First, it has no border adjustments -- it is an origin-based tax. Second, it is progressive, in that the tax on wages is reduced by personal exemptions and a standard deduction, as under the present income tax. Indeed, this is one of the attractions of the flat tax, as providing progressivity at the personal level in this manner is simpler and less distortionary than by exempting basic commodities, the approach taken under existing VATs in Europe and under many state sales taxes. However, neither of these differences alters the conclusion that the flat tax is a value added tax on consumption. One may like or dislike its lack of border adjustments or its progressivity but, for better or for worse, the flat tax is no less a consumption tax than is a national sales tax or a destination-based VAT.

Consumption Taxes and Competitiveness

Because so much of the support for consumption taxes is associated with the perceived impact on international competitiveness, it is important to clarify the extent to which adopting a consumption tax would encourage U.S. exports or otherwise improve our competitive position. The point can be put quite bluntly: a consumption tax promotes competitiveness through its impact on national saving and income, not through border adjustments. Thus, the distinction between a destination-based consumption tax, such as a national sales tax or VAT, and an origin-

based consumption tax, such as a flat tax, is of little consequence: both types of consumption taxes promote competitiveness by promoting saving.

The intuition that border adjustments promote exports and discourage imports ignores the fact that the exchange rate, like other prices, is free to move in response to demand and supply. If the foreign exchange market is in equilibrium without border adjustments, then it will be driven out of equilibrium if border adjustments are imposed, with the relative cheapness of U.S. goods stimulating demand for dollars and causing the exchange rate to appreciate. Once this appreciation occurs, the economy will essentially be back where it started, with U.S. goods no cheaper to foreigners, foreign goods no more expensive to U.S. residents, and no change in the trade imbalance.

Why can't border adjustments induce a change in the trade balance? The answer is that the trade balance is basically a residual, the difference between what we, as a nation, produce and what we consume (privately and publicly) and invest. If we don't change the level of government purchases, and don't wish to reduce domestic investment, then we can improve our trade balance only by raising income or increasing saving. Income, in turn can increase only if we raise the level of productive inputs of capital, labor and technology or utilize these inputs more efficiently. Saving can contribute to increased capital formation, and a less distortionary tax system might also contribute to increased labor supply and technological innovation and the efficient use of capital, labor and technology. Thus, adopting a consumption tax might well spur competitiveness, but not through border adjustments.

Aside from having no direct influence on competitiveness, border adjustments actually would cost the United States revenue over the long run. For a country that is a net debtor, as the United States has become in recent years, an origin-based VAT will raise more revenue in the long run by denying border adjustments for the future trade surpluses needed to service our foreign debt.

Efficiency Gains, Transition Relief and Progressivity

Adopting a consumption tax can contribute significantly to increasing the level of national saving and production. For example, my own estimates are that immediate adoption of a broad-based national sales or value-added tax, with no transition relief and no progressivity, could raise output by perhaps 6 percent within ten years and 9 percent in the long run, as the result not only of increased saving but also a reduction in the effective marginal tax rate on labor supply.² However, leaving aside questions concerning implementation and administration, this result hinges crucially on the lack of any progressivity or transition relief under the new tax system.

Under a national sales tax or a broad-based VAT, each household's tax burden would be in fixed proportion to its consumption. Because consumption falls with income, it is customary to refer to such a tax as regressive — its burden falls as a share of income as income rises. In recent years, many economists have come to challenge annual income as an accurate measure of one's ability to pay, because much of the observed variation in income is temporary or related to life-cycle factors. This critique implies that consumption, or at least some longer run measure of family income, is a more accurate measure of a family's taxpaying capacity. If this is true, a proportional consumption tax is not as regressive as has traditionally been thought. Still, by any measure, it is considerably less progressive than the current income tax. This has led to the formulation of consumption tax alternatives that provide at least some level of progressivity at the low end of the income distribution, such as the flat tax, or that try to replicate the current level of progressivity at all income levels, such as the Domenici-Nunn "USA" tax system, which combines a VAT and a progressive individual consumption tax. Based on my simulation results, reintroducing progressivity back into the tax system, as under current flat tax proposals, would raise the average marginal tax rate on labor supply by 4 to 8 percentage points and reduce the potential increase in output roughly in half, to between 2 and 4 percent after 10 years.

² "Tax Reform, Capital Allocation, Efficiency and Growth," *Op. Cit.*, Table 4.

The economic benefits of a shift to consumption taxation also hinge on the absence of transition relief. As many have pointed out, a consumption tax may impose a higher burden on taxpayers, particularly older individuals, who have accumulated assets in order to finance future consumption. This is because they will be taxed on all consumption financed by these assets, not just the additional income the assets generate. The losses to such taxpayers would be at least partially offset by increases in asset values that a consumption tax might generate through a boom in saving and asset demand. Still, there may be considerable pressure to provide transition relief. Under a value-added tax, for example, newly purchased investment goods qualify for immediate expensing, while existing capital receives no depreciation deductions at all. Owners of existing assets might well lobby for a continuation of depreciation allowances on these existing assets. Similarly, under an individual consumption tax, there are bound to be objections to the provision that treats existing assets as having zero basis, regardless of what their basis was under the prior income tax.

While the arguments may seem compelling, adding full transition relief for existing assets would drive output gains, and overall gains in economic efficiency, close to zero.³ Even though national saving would still rise under the shift to consumption taxation, the higher marginal tax rates on labor supply needed to pay for transition relief and progressivity together would essentially offset these gains with the losses from a more distorted labor market.

In addition to overall effects on asset values, a shift to consumption taxation would also induce a shift in *relative* asset values, with previously tax-favored assets, such as housing and municipal bonds, suffering considerable declines in value even as other assets, notably corporate equity, fared relatively well. While the interest rate would fall, it probably would not drop by enough to offset the increased cost of home-ownership produced by the elimination of the deductions for mortgage interest and property taxes. These capital losses might well call forth further provisions such as a continuation of the mortgage interest deduction. Again, the revenue cost of such provisions would have to be offset by an increase in marginal tax rates, further reducing the economic gains from adopting a consumption tax.

In summary, while the exact magnitudes of gains and losses would depend on the degree of progressivity and the extent of transition relief included in any proposal, the message is clear: to achieve significant economic benefits from a shift to a consumption tax, we must accept either a decline in tax progressivity or a limit on the relief given to existing assets. If neither of these conditions is met, then a consumption tax, no matter how attractive in the abstract, will not improve economic efficiency or increase output when implemented.

Searching for Other Alternatives

Above, I argued that there are three major distortions in the current income tax, with respect to decisions regarding work, saving, and the allocation of capital between residential and nonresidential uses. Adopting a consumption tax would eliminate two of these distortions but, under realistic assumptions, make the remaining distortion worse and leave us with little overall gain in economic efficiency. But there are other ways to attack these distortions, without necessarily inducing adverse distributional effects. Without attempting to be comprehensive, I will offer one example of the type of reform that might be considered.

In 1993, the top marginal tax rate on high income individuals was raised, with the introduction of the 36% and 39.6% brackets. One year later, the marginal income tax rate on the labor income of roughly the same group of individuals rose by an additional 2.9 percentage points as a result of the uncapping of the Medicare payroll tax. While these changes clearly made the tax system more progressive, they did so at the cost of a considerable increase in the distortion of the labor supply of affected individuals, and an increased incentive for them to seek compensation in sheltered forms. By scaling back these tax increases, and making up the lost

³ *Ibid.* This result holds both for a flat tax that maintains depreciation deductions and the Domenici-Nunn USA tax, which provides this transition relief for depreciation deductions and preserves basis under its individual consumption tax.

revenue through cutbacks in residential tax expenditures benefitting the same general group of taxpayers (for example, by capping the deductions for mortgage interest and local property taxes at levels that would affect only the affluent), you would simultaneously lessen the labor supply distortion, the distortion in favor of residential investment and (by discouraging borrowing) the bias against saving without altering the general progressivity of the tax system.

Finally, there are other reforms that, while not as specifically directed at the three major distortions emphasized here, would work to lessen other distortions that help contribute to the overall mess that is today's tax system. Here, there are too many options to be enumerated, except for one illustrative example. Imagine a tax package that raised excise taxes on commodities that cause demonstrated social damage (such as tobacco, alcohol and gasoline), eliminated the tax benefits on certain employer-provided fringe benefits, and used the revenues so generated to reduce marginal income tax rates in a distributionally neutral manner. Such sweeping changes may begin to appear more realistic when the chief alternative is replacing the income tax with an entirely new tax system.

Conclusions

In evaluating the current income tax, it is important not to use an unrealistic alternative as a standard of comparison. Moving without transition relief to a broad-based, low-rate national consumption tax would enhance economic efficiency, but these economic gains would not necessarily accompany a more measured transition to a progressive consumption tax. In light of this, more modest improvements in the income tax itself take on more appeal, and deserve serious consideration.

Chairman ARCHER. Thank you, Mr. Auerbach, and I thank all three of you for, I think, some very constructive testimony.

I am sure that a lot of this will be developed in greater detail during the question-and-answer period.

I would like to ask you just a couple of preliminary questions to start this round. Do economists place any economic value on freedom and privacy? Would any one of you or all three of you like to respond to that?

Mr. JORGENSEN. I would respond to that by saying that one of the fundamental principles under which we conduct our business professionally is the idea of consumer sovereignty. Translated into plain English, that certainly is a principle of individual freedom and privacy. So that certainly is a fundamental value.

Chairman ARCHER. Mr. Hubbard.

Mr. HUBBARD. I would agree with that, although in point of fact, most of the models that are reported to you don't really distinguish among freedom and privacy differences in these alternative forms of consumption taxes.

Chairman ARCHER. Mr. Auerbach.

Mr. AUERBACH. I would say that economists by their nature place a lot of weight on those factors as individuals, but I don't think it plays an important role in our economic analysis.

Chairman ARCHER. It is very difficult to quantify, in any event, and I would expect that the computer models and the analyses really do not place a dollar value on it, but it is very interesting that when we had witnesses before this Committee in our previous hearing, I asked them how much they would pay annually not to have any interface personally with the IRS every year. The minimum response was what it cost them to pay their preparer to prepare their return. The most fascinating response was from one woman who said she would give her first-born child.

Obviously, the weight that individual Americans attach to removing the IRS from their individual lives, completely and totally, is different from one person to another, but it is significant for everyone, and yet, it does not show up in any of these computer models.

Does it show up as an increase in economic activity and productivity when we have released some of the brightest minds in this country who are currently spending full time dealing with the tax system? Does that show up in the computer models?

Mr. JORGENSEN. It certainly doesn't, Mr. Chairman, and you are on to a very important point here.

You received testimony last year in great detail on both the issue of the cost of compliance and the enforcement costs that are involved in collecting a tax.

A retail sales tax, which you have often advocated, involves 10 million retail establishments. Whereas, anything involving something like the income tax, for example, a subtraction-basis VAT which would be administered by an income tax-like return, is going to involve every family in the country, plus every business. So there is no doubt that there is a very, very significant difference in terms of the people who are involved and the costs that are imposed on them associated with these different proposals, and that

is certainly something to be taken into account in the final reckoning.

Chairman ARCHER. Thank you very much.

Mr. Gibbons.

[No response.]

Chairman ARCHER. We will hold Mr. Gibbons for a moment.

Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

I have just one question about the consumption tax, and I would address it to all of you, and that is how we deal with the impact that it could have on the working poor.

Mr. AUERBACH. As I mentioned in my comments, a retail sales tax or a European-style value-added tax attempts to deal with it either through the transfer system, that is, not through the tax system at all, or by exempting commodities such as food or certain necessities.

I think the general consensus is that is a fairly inefficient way of achieving help for the poor because most of the expenditures made on these items aren't made by poor people. So there is a lot of leakage.

For that, a system such as a flat tax, which is a consumption tax, but which has an individual tax component, makes taking care of the poor easier because it would allow provisions such as an earned income credit or personal exemptions and a standard deduction, that are present now to be maintained, to provide the same relief as is provided under the current system.

Mr. CRANE. Would it not go beyond just food? I mean, that you would have to exempt medical expenses, would that be fair to include?

Mr. AUERBACH. If you were trying to do it under a retail sales tax or under a value-added tax, it would be up to you to decide how to do it, but, ultimately, it wouldn't be targeted assistance for the poor because for medical expenditures, food, or any item you choose, although the poor may benefit, so will the rest of the population.

Mr. CRANE. That was the question in my mind. How do you separate the extension of the benefit between, say, people who are in the wealthy category and those who are truly needy that are working and not on welfare?

Mr. AUERBACH. Ultimately, if you want to target it toward individuals, it has to be an individual-based system, not a commodity-based system, and it can be a hybrid. You can have part of the tax system based on sales and commodities as a value-added tax or a sales tax, and then you could have elements of the system which would be based on the individual taxpayer and, therefore, could be tailored toward the individual's ability to pay.

Mr. JORGENSEN. I think there is a point here that you have alluded to that is worth a little bit more consideration.

Take, for example, the case of medical care, the case you cited. You are going to hear many, many arguments about exempting medical care, but think about the alternative.

Under the income tax, medical providers pay income taxes. Doctors pay income taxes. Nurses pay income taxes. All of the people who work in the health care industry pay income taxes.

Therefore, there would be a very powerful argument, it seems to me, on equity grounds for people who are receiving these services versus people who aren't of essentially substituting for the income taxes paid by the providers, some kind of sales tax or value-added tax, and I think that is a fundamental point that can be extended further.

That applies to all nonprofit institutions, the people who are employed by those institutions. The expenses that they incur in providing their services are all now covered by the income tax and, therefore, should be covered by some kind of sales or consumption tax.

It is, therefore, very, very important to have an all-inclusive consumption tax base.

Mr. HUBBARD. The simple answer to your question is that the flat tax really does offer you a chance to maintain the progressivity you have at the low-income levels. Use of exemptions, even refundable tax credits are possible.

When you try to exempt certain commodities, you run into the problems that Alan Auerbach and Dale Jorgenson alluded to of having a very loose and leaky system.

Mr. CRANE. Is it possible that you could have some kind of a refund in effect to people in that category at the end of each year?

Mr. JORGENSEN. One idea that has been proposed, and you are going to hear it again, is the idea of a "demigrant." The whole idea is to avoid having an exemption or a refund that depends on people's specific behavior. You want to avoid the distortions. That was Glenn's point in his testimony. Therefore, you could have a system of demigrants that would be given uniformly across the population. That would obviously affect the poor, including the working poor, more than in proportion to their consumption and more than in proportion to their income. So that is an alternative approach that avoids building that into the tax base, which I think inevitably would cause distortions.

Mr. CRANE. Thank you. My time has expired.

Chairman ARCHER. Mr. Gibbons.

Mr. GIBBONS. I think I will pass at this time, Mr. Chairman.

Chairman ARCHER. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

At some point, Mr. Jorgenson, I thought in response to Mr. Crane's question that you had suggested the earned income tax credit as a possible way to cushion the impact on the working poor. Other suggestions that were not in the testimony, but given as an afterthought to Mr. Crane's question, it would manipulate or put variances in there so that the working poor would be cushioned, which to me is you get out of the flat tax.

Mr. Jorgenson, if we decided just how much relief we are prepared to give to the working poor, would that not ultimately end up with a minimum wage standard?

Mr. JORGENSEN. No. I think the minimum wage standard is something quite different. It really affects an hourly figure that would apply to part-time workers.

Mr. RANGEL. Strike that out. Strike that out.

At what basis would you determine the earned income tax credit should level off?

Mr. JORGENSEN. My preference would be to treat this, as Alan Auerbach just said, as a transfer program.

Mr. RANGEL. But you mention an earned income tax credit in your testimony. So I just was figuring, since we want the free marketplace to work its will—

Mr. JORGENSEN. Right.

Mr. RANGEL [continuing]. Then how are you going to do that? All of you agree you have to make exceptions for the poor, and somebody is going to have to determine who is poor, at what level are we talking about, and at what income group. I don't want to say "income" or any word that you economists can grab on to, but I am talking about disposable income. Do you say that is enough for those people?

Mr. JORGENSEN. Mr. Rangel, we have a federally defined standard of poverty that is used in compiling our poverty figures that are routinely published by this Committee, and that would give us the standard to work from.

Mr. RANGEL. The working poor are above the poverty line. We have the earned income tax credit to take them up to the poverty line. Obviously, where we find poorer people who are not wealthy, consuming more of their disposable income than people who have a larger amount of income, you have to give relief beyond poverty.

I am only attacking what you people give with such ease. This is an economist delight, but it is a politician's nightmare. At what point do we determine as lawmakers what relief should be given to those people who cannot protect themselves against this free market.

Mr. HUBBARD. The principal point, I think, Mr. Rangel, is that whatever progressivity you deem desirable, you could accomplish under either the current system or under something like the flat tax. That doesn't diminish the significance of the measurement questions you asked.

Mr. RANGEL. How would you do it? Just tell me how you would do it.

Mr. HUBBARD. You could do it by any of the means that were suggested. You could have a refundable credit, a demigrant, or a special transfer program. All the tools that are open to you currently, you would still have. That doesn't diminish your measurement questions, but the same issues arise under either the income tax or the consumption tax.

Mr. RANGEL. Someone mentioned the fact that this would eliminate the local and State income tax system and corporate system as we know it because if they were to do it, they would piggyback on this consumption tax or whatever you want to call it.

They would determine the rates of their own consumption tax, right?

Mr. JORGENSEN. That is right.

Mr. RANGEL. So, while the other system piggybacks in our income tax system, any one of our local or State governments could distort the national system, in my opinion, by how far they are prepared to decide what services they want to render and how high they want their consumption tax.

So, unless we wipe them out completely, under today's system, we can deduct whatever they pay to the city and State. Under this system, there would be no deductions. Is that correct?

Mr. JORGENSEN. Let's just focus on the rates involved. We are talking about a 15-percent consumption tax rate including State and local taxes. That is a very, very low rate. That would be the average across the—

Mr. RANGEL. How do you include the State and local tax in determining what the Federal taxes are going to be?

Mr. JORGENSEN. By taking all of the receipts from State and local income taxes, along with Federal income taxes at both the individual and the corporate level, and asking the question, What would it cost to maintain the existing level of government services at the Federal, the State, and local levels?

Mr. RANGEL. That doesn't work. That doesn't work.

In New York State and California, we are so way ahead of the rest of the States in what we thought it would take in local and State taxes, and indeed, we are now going backward.

Are you saying that once we decide what the Federal tax is going to be that the city and States are stuck with that?

Mr. JORGENSEN. No. I am saying that the cities and States, as they do now, would have to raise the same amount of money that they do under the income tax to fund these programs, but the governments involved would have to pay a lot less.

Why? Because the providers are no longer subject to the income tax. All of the people who are working for these State and local governments, all of the agencies that they depend on would no longer be subject to the income tax, and that being the case, the prices that these governments would have to pay to maintain their services would be radically reduced. That is where you arrive at the 15 percent.

Mr. RANGEL. Isn't it true, Dr. Jorgenson, that while they may no longer have to pay the income tax that, indeed, they would not be able to enjoy the present deductions which lowers their tax?

Mr. JORGENSEN. That is exactly how we get to the 15 percent, Mr. Rangel. We eliminate all of the deductions. We have a totally comprehensive tax base and a very low rate, and that is reinforced by the fact that the governments, Federal, State, and local would be paying much lower prices for the services that they provide to the public than they are now because the providers are not subject to the tax.

Mr. RANGEL. Then, that would be a reduction in salary and wages, right?

Mr. JORGENSEN. Precisely, exactly.

Mr. RANGEL. Who is going to be around here to make that determination?

Mr. JORGENSEN. I hope you are, Mr. Rangel. I certainly hope you will be.

Chairman ARCHER. The gentleman's time has long since expired.

Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman, and I want to thank all of you for your testimony.

I have a question regarding those who are maybe newly entering the business world as small businessowners or young family farm-

ers who may have a high level of debt because they are just getting their businesses or their farms off the ground, and obviously, the current tax system gives them deductions, existing deductions in order to borrow at high levels.

In your opinions, and any of you can answer if you choose to, what would a consumption tax do to those newly entering the business or agricultural world, compared to already existing, established businesses?

Mr. HUBBARD. You referred to the loss of the interest deduction which clearly would not be a plus for those businesses. Offsetting that are two points. First, expense, write off capital goods as they are purchased rather than depreciating them. Second, pretax interest rates should come down in response to the introduction of the consumption tax. In the short run, it would still be true that small businesses or any business that had done a lot of financing with debt would lose.

Mr. JORGENSEN. I would like to respond to that because I think it is a fundamental point, and that is, you must focus on the idea that the suppliers of capital, people who lend money or who provide it in the form of equity, are no longer going to be subject to tax.

Think about a mortgage lender or, relevant to your point, think about a banker. These people are no longer going to be subject to taxes on their capital income. They are going to be able to provide financing for small businesses and small farms on the same terms that people who are providing tax-free financing to municipal governments are doing at present because the treatment will be the same.

Furthermore, most of the accumulation of capital for small businesses, including small farms, is from retained earnings in equity. That will no longer be subject to tax. That is the implication of substituting a consumption tax for an income tax. Neither debt nor equity income will be subject to tax; only consumption.

Mr. CAMP. Thank you.

I appreciate the answers. There have been some differences on how much economic growth potential might come out of changing our current tax system, and I think there are slight differences in your projections, the three of you.

Can you explain to me why those differences might be there?

Mr. JORGENSEN. Let me try that and then give Alan Auerbach a chance to respond.

Looking over our two sets of testimony, the main difference is not in the level of the impact in the long run. It is about 9 or 10 percent. That is toward the upper end of his impact calculations, but it is right on the center of mine. So there is no disagreement.

The big disagreement is on the short-run impact, what would happen next year, what would happen the following year, and so on.

The big difference between our calculations came out in his testimony, which was that he assumes that eliminating the income tax and imposing a consumption tax would leave the labor supply decision unaffected.

I disagree with that, with all due respect to my former collaborator and colleague, and the reason that I disagree is that the aver-

age marginal rate on labor income in this country is now around 28 percent.

The consumption tax, as I said before, that would have to be imposed is about 15 percent. In other words, there is a substantial increase in the incentive to supply labor. That, in a nutshell, is responsible for the differences.

Mr. AUERBACH. I think I would modify that only slightly to say that I think even at best there is a relatively small increase in the incentive to supply labor based on the parameters and the data that I use in my simulations.

I also think it is important to keep in mind, however, that a lot of the juice from apparent increases in the incentive to supply labor and reductions in marginal tax rates comes from a sharp decline in progressivity in the tax system. While that might be appropriate, there is an economic tradeoff here, and it is something that shouldn't be seen as a costless gain.

Mr. HUBBARD. If I could just add one thing, the sense in which short-run differences may not be innocuous is that transition issues matter. If you try to mitigate transition costs for everyone in the tax system, you will ultimately have to have a much larger, at least somewhat larger rate and lose some of your gain. So the two are somewhat connected.

Mr. CAMP. Thank you very much.

Chairman ARCHER. Mr. Hayes.

Mr. HAYES. Thank you.

I was looking at your start, Mr. Auerbach. In your testimony, one of the things I noticed in regard to border adjustments—

Mr. AUERBACH. Yes.

Mr. HAYES [continuing]. Was the statement that you made, which I think is correct if you think of it only in terms of a generic statement, about border adjustments can't change trade balance because the balance is basically residual, the difference between what we as a nation produce and consume, but it doesn't think in terms of individual industries. In other words, it talks about having a market of currency markets reacting back, but they don't react to a generic question, and they are too small on individual winners and losers to react if you pick, for example, petrochemicals and move an individual entity that can pick up gigantically through those adjustments.

So my question to you is, I don't disagree with your statement, but doesn't it, in effect, weigh both winners and losers and reach a conclusion without identifying who wins and who loses because you certainly can't adjust currency, item at a time, day by day, based on individual industries being treated differently than the whole?

Mr. AUERBACH. Perhaps I am not understanding your argument, but my point is that if we think of the difference between an origin base or a tax without border adjustments and a destination-based tax, that is, one with border adjustments, a movement in the exchange rate can offset entirely all changes in the cheapness of American goods or the higher price of foreign goods, and that will happen across the board.

That is, if we put in a 10-percent border adjustment and the exchange rate appreciated by 10 percent, then from every industry's

point of view, both American industries trying to export or competing against imports and foreign industries trying to sell in the United States, the relative price of American goods and foreign goods will be exactly the same as it was before. That will be true across industries.

So, unless I am missing something, I think I would disagree with you and say that there really won't be any effect across industries.

Mr. HAYES. The point I am making is that that is a generic statement, taking the whole. In other words, when you are looking at an interest rate, you are looking at its impact on the country under current tax law. Fine. That interest rate moves here and there, but if you start dividing it by individual entities, you are going to find where an interest rate move had a big difference on activity A versus activity Z.

The point I am making is that there will still be a substantial number of those who are able to take the border adjustment rate and dramatically improve their level of sales, and what we ought to be doing is looking at who those winners and losers are then determining our national interest from it.

Mr. AUERBACH. There is a big difference between this and the effect of an interest rate change, which really is going to affect different entities differently.

Mr. HAYES. No, no. I am using it as an example.

Mr. AUERBACH. But it is not an applicable example because, in the case of an exchange rate change, what matters to importers and exporters is a real exchange rate; that is, taking account of the taxes as well as the underlying price of the goods, what a foreign good costs, what a domestic good costs.

Putting in a border adjustment alters that relative price by alleviating the tax of domestic goods, and it does this proportionately under a uniform sales tax.

Having an exchange rate readjustment in response to that completely undoes it. The only circumstance in which I would agree with you is if the sales tax or the value-added tax were not applied in a proportional way; if it applied to some industries and not others.

A uniform value-added tax with border adjustment accompanied by a revaluation of the exchange rate will be completely offsetting and not have any effect on the relative competitiveness of different industries.

Mr. JORGENSON. Mr. Hayes, I would like to agree with you, and I would like to direct your attention to the last chart where I give the individual industry results. That is what you are looking for, and there it is.

What you will notice here is that in the long run, in fact, even in the short run, the industries that are adversely affected are those in which we have a major amount of imports, and those that are stimulated by a consumption tax are those in which we have leadership in exports.

So, even though I agree with Alan Auerbach that there will be essentially no net effect on the trade balance, there will be differential impacts on industries, and you can see them in this table. I agree with you that that is highly relevant especially in view of the fact that this Committee is going to be holding hearings in April

that deal with the circumstances of particular producers in particular industries.

Mr. HUBBARD. I strongly suspect that these differences probably relate to other aspects of the consumption tax rather than the border adjustment. An example would be differences in capital intensity. I don't think the border adjustments, per se, could be accounting for this.

Mr. HAYES. Gentlemen, thank you, and thank you for your indulgence, Mr. Chairman.

Chairman ARCHER. Let me just briefly jump in and piggyback on this issue. It is interesting that economists come down on the side that border adjustability makes no difference, because the surveys that have been run recently with foreign corporations report that up to 80 percent of them would build factories in the United States if we eliminated the income tax and went to a consumption tax.

So, in the real economic world, there are a lot of people who believe it will assist them competitively to build factories and to export from the United States of America. I mean, that is just a reality in today's world. Even though in the long term, the argument can be made, economically, that the monetary exchanges adjust to this. Certainly you can respond to this, but before you respond, let me add one other thing, and you can include this in your responses.

If, in fact, this economic theory works in practice, then the cost of government is basically no different than the cost of doing business in many, many other areas. It is an administrative cost. It is an economic cost that must be paid, and the price of the product, and I think you have alluded to this, Mr. Jorgenson, ultimately has to include that. It is a cost of doing business, just as much as hiring an accountant or any other administrative cost of doing business. Labor is also a cost of doing business, which must factor through into the price of products.

If this theory is accurate, why do we have any concern about countries that have lower wage rates than we do, as taking jobs away from this country? They are going to be offset by an adjustment in the monetary exchange rates. Those advantages, those cost advantages for businesses are going to be offset by the exchange rates.

So we need to have no concern about government subsidies overseas to companies competing with our domestic companies that don't have subsidies. We have no concern about the dollar-an-hour wage rates, which Charlie Rangel speaks of too frequently, in other countries that are costing us jobs and costing us exports. It all adjusts out in the monetary exchange rates. Now, how about that?

Mr. JORGENSON. The thing to focus on, Chairman Archer, is that, regrettably, economists merge two different arguments and, therefore, appear to be in disagreement with the arguments that you and Mr. Hayes have put forward.

Those two arguments have to do with the grade balance on the one hand and exports versus imports on the other.

Economists focusing on the trade balance will tell you, as Alan Auerbach just did, that any border tax adjustment can be undone from the point of view of the trade balance by a compensating change in the exchange rates, but a consumption tax has other im-

pacts; namely, that there will be a very, very pronounced differential change in the relative prices of different producers, and that is going to produce a very dramatic impact on the circumstances of particular producers, particular industries.

Exporters, people who are already in businesses where they specialize in exports, are going to be favored. People who are in the businesses where imports are very important, and as you know, there is no business in which imports are more important than the oil business, are going to be disfavored.

So what my chart shows is exactly that result; that even though the trade balance remains unchanged, as Alan Auerbach suggested, the circumstances of different industries are going to change, and it is not surprising that the kind of poll results that you just cited are cited over and over again, and they are very relevant to your deliberations. I am not saying they aren't.

Mr. AUERBACH. Two further points. I agree with everything Dale said, but these differential industry effects would occur even under a consumption tax without border adjustments. It is the movement to a consumption tax, not the border adjustments that are typically part of a consumption tax that lead to this differential.

The same point applies with respect to low-wage countries. We are now worried about low-wage countries reducing output in the United States. We are worried about the industries in the United States that compete; that is, low-wage jobs in the United States. That is what we are worried about. We are not worried about U.S. output, per se, when we are talking about U.S. trade with Mexico. We are worried about specific industries which depend very heavily on low-wage labor in the United States against which other countries will be competing. It is a relative industry effect, rather than overall effect.

Chairman ARCHER. Thank you, gentlemen.

I apologize to the other Members of the Committee for indulging me that little insertion.

Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman.

This is a question, I guess, for any of the panelists, and it really has to do with systems in other countries of the world.

It is my understanding that there is no other industrialized nation that has a consumption tax of the magnitude or in terms of the percentage of its income that we are thinking about generating with the changes, the reforms that we are considering here. Is that correct?

Mr. JORGENSON. No, that is not correct, Mr. Payne.

Typically, consumption taxes in the major countries of Europe—Germany, the United Kingdom, Italy, and France—are at about the same rate of 15 percent or higher than the rate that I described, but there is a very important difference in those countries from the United States. They have much larger public sectors when you take into account the Federal, State, and local versus their counterparts overseas.

So we are not talking about a consumption tax that is different in order of magnitude from that you already see in many industrialized countries.

Mr. PAYNE. In spite of the fact that a country such as Great Britain and other nations would find that a greater percentage of their revenues are derived from income taxes than from consumption taxes?

Mr. JORGENSEN. That is the point; that these other countries combine the consumption tax, the value-added tax, in most cases, with an existing income tax, which is also quite comparable in scope to our income tax.

We are talking about something totally different here. We are talking about abolishing the income tax and replacing it with a consumption tax while maintaining the size of our government sector at the Federal, State, and local levels. That is a rather different situation from the ones that European countries face with public sectors that are, in many cases, twice or more the size of ours and a combination of consumption taxation and income taxation to finance those public sectors.

Mr. PAYNE. I think we Americans like our system the way it is now in terms of a smaller public sector, and in fact, the movement is for an even smaller public sector, but are there any models for us to look at, places where there has been a transformation from an income tax system to a consumption tax system? Are there places that have replaced their income tax systems with consumption taxes because they, like us, have realized over time that we are, perhaps, on the wrong track and need to change that?

Mr. JORGENSEN. Not yet, but it is no small likelihood that this country would become, as it has been in so many cases previously, the model, and I wouldn't be surprised that other countries would follow in the footsteps of such a change.

Mr. AUERBACH. Under the Thatcher government in Britain, at the very beginning of the Thatcher government, they didn't replace the income tax with a consumption tax, but they did sharply reduce the top marginal income tax rates and raise the levels of the value-added tax.

To me, that is the closest experiment, although it is only a partial experiment in that direction.

Mr. HUBBARD. Also, going to something like a flat tax here is not unlike having a standard European-style VAT, with some differences in progressivity on top of it. So the differences are not as large as they might seem.

Mr. PAYNE. It seems that making a change such as the one that we are contemplating certainly implies there are risks involved, and to some extent, we can't quantify those risks because we are going into uncharted waters. Is that correct?

Mr. JORGENSEN. Yes, exactly, and that is why it is so important for you to do what you are doing now, which is to try to chart those waters.

It is an unprecedented situation. I couldn't emphasize that more. This is a very drastic change in policy that we are discussing here.

Mr. PAYNE. In terms of the policy, the specifics of the policy, you have noted that if we make a change, imposition of a consumption tax would produce sharply higher tax rates on consumer goods and go on to say that by replacing both Federal-, State-, and local-level taxes, income taxes, that the tax then would be about 15 percent, rising to 21 percent on consumption, on goods, and services. That

is a much lower number than those that we have looked at in terms of others who have come to testify, and you are including not only the Federal, but State and local income taxes as well.

Why is there a difference between your numbers and others?

Mr. JORGENSEN. There is a difference because most of the calculations that people do in this kind of tax analysis keeps the dollar value of government expenditures the same, the dollar value.

That overlooks a fundamental point, which is that the prices that will be paid by the government are going to change under this tax system, and government is a very labor-intensive activity. The prices that the government is going to have to pay to maintain its services are going to be materially reduced. That is the main reason.

When you take that into account, you can maintain government services at a much lower tax rate than people have discussed; for example, in the rate that you are going to hear from Mr. Armev this afternoon.

Mr. PAYNE. If, in fact, your analysis were revenue-neutral, as we know it today, what would the rates be in that instance?

Mr. JORGENSEN. Approximately 20 percent at the Federal level, and maybe another 6 or 8 percent, but, again, the same amount of revenue is going to buy a lot more government services, and that is what you have to take into account. I think that that is fundamental in this discussion.

Mr. PAYNE. Thank you very much.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Under our current tax system, we have a system that favors the savings through pension plans, through qualified plans, through IRAs. How much is the current system as far as savings in those areas?

I wanted to ask another question, and that would be, concerning the inside buildup of life insurance products, which a lot of Americans use as another savings vehicle, how do you tax and how do we propose to address the issue of the life insurance product?

Mr. AUERBACH. You are basically putting all savings on the same footing that pension savings and life insurance inside buildup currently are on, which might seem innocuous from the point of view of those industries. This is an example of one of the transition effects that one has to think about. This is likely to sharply curtail the whole-life insurance business, and it may also sharply curtail the business of entities involved in pension saving, and for that matter, pension saving as a whole because there will no longer be any tax advantage for firm and workers to join in having pension plans.

In fact, whatever restrictions continue to exist on pension plans, pension plans will be less attractive than saving outside of pension plans.

Mr. JORGENSEN. I think there is another way to answer your question, Mr. Christensen, which is to say, what we are talking about here is deregulating the pension industry; in other words, having all providers, insurance companies and the other providers of these services, on an equal footing rather than have the insurance companies be tax favored.

With regard to your specific question about the life insurance area, we would have to tax the term portion of life insurance as opposed to the inside buildup which reflects investment. So it is very important to include that in the tax base, and that is not a very difficult thing to do. We have lots of sharp-penciled people out there who can tell you exactly what the term portion is.

Mr. CHRISTENSEN. Do you think there will be greater enhanced opportunities for savings with a consumption base rather than the current system?

Mr. JORGENSEN. There will be a tremendous growth in savings.

I estimate that the growth in investment is going to be about 80 percent. That is comparable to the growth in savings. Most of that would be financed out of domestic savings.

Mr. HUBBARD. The growth in savings is clearly good news for the financial services industry.

The piece of the industry that will take a hit will be whole life insurance, but for the financial services industry as a whole, the increase in saving is a boon.

Mr. JORGENSEN. They are going to take a hit because they are going to be subjected to competition, not because their tax circumstances are going to be changed.

Mr. CHRISTENSEN. The transition question is the million-dollar question. How do we move to a consumption-based tax and treat the current products that already have the inside buildup protection? How do we treat the past products?

Mr. HUBBARD. Again, they would still have inside buildup. Everything has tax-free inside buildup under the consumption tax. That wouldn't be a problem.

The issue would be from the perspective of the insurance companies going forward. As Dale Jorgenson said, they would then have many more competitors to sell currently tax-favored products, but the policyholders aren't going to lose.

Mr. AUERBACH. There is a general question that applies to assets more broadly. You mentioned life insurance and pension assets. There are State and local bonds. There is housing. All of these things are currently tax-favored investments. They wouldn't be harmed directly by these changes, but the fact that there would be so much competition from other assets would reduce the value of these assets.

Mr. CHRISTENSEN. Mr. Auerbach, you mentioned housing. Do you think there would be a slowdown in the purchase of homes by first-time buyers if we don't have the interest deduction on the mortgage?

Mr. AUERBACH. I think it is not just the interest deduction, but it is also the loss of the deduction for State and local property taxes. It almost certainly would be, yes.

Mr. CHRISTENSEN. Mr. Jorgenson.

Mr. JORGENSEN. I think there is another point here. What about the asset values? You have heard a lot of testimony about that. You are going to hear more.

The fact is that subjecting new construction—that is what you were talking about, first home buyers—to the sales tax, which I estimate at 15 percent, is something which is going to help maintain the value of those properties.

You might ask, what about the existing homes. They are going to be grandfathered. They are going to be subject to what is called prepayment treatment. All further taxes that would be due on the rental value of those properties are going to be forgiven at the outset, and therefore, existing assets will maintain their value.

That is a fundamental fact about housing that I think should be borne in mind, but you are absolutely right. If you think about the first home buyer, that first home buyer is now going to be confronted by a sales tax, and should be, because one of the important objectives of the consumption tax is to put businesses and households on an equal footing when it comes to competing for capital.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

People of the Third District of Georgia constantly speak to me about the need for balance in two areas. One is a balanced budget. In their minds, they think we can balance the budget by addressing spending habits of Congress and addressing the policy that governs those spending habits. I fully agree with them. I think we can do that, also.

The other is in the balance of trade, and in the balance of trade when you are importing more than you are exporting, you must address the area of export.

I don't know of a worker in the Third District of Georgia who would not like to manufacture a product and ship it worldwide.

We have no jurisdiction over the labor rates in other countries. So, therefore, we cannot do anything to affect how another nation governs their labor rates. We do have jurisdiction over areas of the government that impose additional cost on products that are manufactured in this country. Those areas include the area of taxation and regulations and costly litigation. We are holding these hearings to examine ways we can address the cost of taxation as it affects business, affects the manufacturing of products, the exporting of those products, which ultimately affect the jobs of the people of the Third District of Georgia and all across this country.

Having said that, my question to you is, If we implement a consumption tax, should we roll in the payroll tax, FICA tax, and an income tax? If so, what calendar year do you recommend as the implementation of the new tax?

Mr. HUBBARD. Your general question is very broad. I will make a couple of responses.

On the issue of the link between the balanced budget and the balance of trade, there is definitely a link between the difference between what we as an economy save and invest and the balance of trade.

To the extent that a balanced budget or a consumption tax raises the level of saving, that is clearly going to show up in the balance of trade as well through an accounting identity.

On the issue of the payroll tax being rolled into the consumption tax, the Social Security reform is itself a very important subject that ought not to be just tied into the general consumption tax discussion, and I would urge you to think about a lot of the proposals for partial privatization of Social Security that could dovetail with some of these consumption tax proposals.

Mr. JORGENSEN. I would like to register my agreement. I think that one of the important responsibilities facing this Congress is how to respond to the report which you have heard testimony about in the Senate Finance Committee yesterday, or on Monday. It is very important to reform Social Security. It is very important to keep that separate from the tax debate. I think it is very important not to include FICA and payroll taxes in any kind of tax substitution.

Mr. COLLINS. As a followup to that, under the current system, EITC, the two purposes of implementing the EITC were to reimburse those who pay FICA tax.

However, upon reaching the age of qualification, even though all of those taxes have been refunded through the EITC, those same people are eligible for FICA tax programs, such as Medicare and Social Security. So they, in a sense, are already intermingled. Is that not true?

Mr. JORGENSEN. That is true. If you regard Medicare and Social Security as part of the taxes, the EITC does commingle the two, and I think that is a weakness, not a strength, of the EITC.

Mr. COLLINS. I have one quick last question. As we go through the interim, and you never gave me a date—I don't know if you want to just evade that question or not, but in the interim, as we go from this date to an implementation date or a calendar year, what do you recommend we do to the current system that would stimulate economic growth and create jobs?

As we had testimony the other day in the Subcommittee on Human Resources, real paychecks, real jobs is real welfare reform, and it is also real economic reform.

Thank you, Mr. Chairman.

Mr. HUBBARD. As I mentioned in my remarks, there are many steps you could take prior to consumption tax reform that put you on the same path. So you could begin by doing anything that broadens the tax base and lowers rates or eliminates the double taxation of dividends and capital gains. Those would all put you on the path.

Mr. COLLINS. Thank you, Madam Chairman.

Mrs. JOHNSON [presiding]. Mr. Kleczka.

Mr. KLECZKA. No questions, Madam Chair.

Mrs. JOHNSON. Mr. Houghton.

Mr. HOUGHTON. Thank you, Madam Chairman.

Gentlemen, it is good to have you here, and thank you for your testimony.

I think I agree with what you are saying, but I am not sure. I'll tell you why I am not sure. I am worried about this thing called transition, and it has been referred to here several times, and, of course, the old law of unintended consequences. What we are trying to do is to dramatically change a system which has been in existence for a long time, and the goals are worthy. They are sound, and you can see some of the consequences, but you can't see some of the other consequences.

For example, we changed our real estate tax system a few years ago, and you could argue very cogently the fact that with a drop of about one-third in the real estate values, it created the S&L crisis.

So the question to me really is that bridge. You can look over the Grand Canyon and you see Eden on the other side. The question is what do you have to go through. Because in the process of going through where we are now into where we ultimately want to be, a lot of people could be hurt, and maybe you could describe or spell out some of the things which we really ought to be concerned with.

Mr. JORGENSEN. We talked about housing, Mr. Houghton. I think that that is something that is often of concern in transition discussions, and I think there, attention tends to focus on the mortgage interest deduction and the possibility of retaining that deduction. That just doesn't make sense, and the reason is that rental values, which is the way we think of consumption, on owner-occupied housing are going to be totally exempted from the consumption tax, under the kind of scheme that I believe that you will adopt, and by that, I mean that only new construction will be subject to the tax.

That is referred to as the prepayment method. Every existing owner-occupied house will be treated as if all future taxes on that consumption will have been paid at the outset, and each new home buyer will have to pay a tax that will prepay all the taxes, will never face tax liabilities again.

It seems to me, that is exactly the right treatment. It provides exactly the right transition for the most mettlesome of all of the issues that you face having to do with transition; namely, owner-occupied housing.

This is something that requires careful thinking-through. It is not a trivial matter, as you suggested. It is not something that should be left unexamined, but I believe that when the chips are down, it will turn out that what I would like to refer to as the "cold turkey approach," which is do it now, don't worry about the transition rules, transition will take care of itself, if you use the prepayment method with regard to housing, that will turn out to be the simplest, fairest, and best way from the political point of view of achieving a transition in the housing area.

Another area that people are often concerned about—

Mr. HOUGHTON. Let's just wait 1 minute here.

Ms. JORGENSEN. Go ahead. I am sorry.

Mr. HOUGHTON. We are sitting around here in a great big room intellectualizing about something, and obviously, you gentlemen are very creative and very knowledgeable, but you talk about cold turkey and you talk about the chips are down, and it doesn't make any sense.

What about the baby boomer who has just bought a house and is deducting the interest on that mortgage, and you say, hey, you know, we have got to face up to these things, we have got to go cold turkey, in the long run, it is going to be good for you? Tell me how that plays out.

Mr. JORGENSEN. OK. Here is the way this is going to play out. People don't pay mortgage interest into a vacuum. They pay it to mortgage providers. Mortgage providers are currently subject to tax.

If I offer you a mortgage and you are willing to take it, I am going to be taxed on that. I am going to have to report the interest

payments on my form 1040. Even if it is a postcard size, it is going to be there.

If you focus on the fact that my tax circumstances have changed after the tax reform and you are going to be treated as if you have prepaid all of the taxes on the consumption value of your house forever, by the simple device of refinancing, going to a mortgage lender whose tax circumstances have changed, who will no longer be paying taxes on the interest, you will receive exactly the same benefits as you do for your existing deductions. That is why I mean what I say when I indicate that the prepayment method for treating housing is, I believe, the way to facilitate the transition.

It is a special treatment. I am not proposing to use the prepayment method for business assets, to give every corporation the right to, essentially, claim prepayment of all taxes on their business assets, but for housing, I think it makes sense, both from the administrative and the policy point of view. It happens to make sense from the political point of view as well.

Mr. HUBBARD. If I could follow up on that, the only consumption tax piece of this reform in the transition, if housing receives Dale Jorgenson's treatment, would be the issue of business assets, the expensing. The rest of these issues would have happened under broad-based income tax reform, too. The transition problems are not unique to any particular tax reform, but to tax reform, generally, and I think one reason to think about broad-based tax reform is so you don't keep changing the Internal Revenue Code so regularly and produce the kind of results that you have suggested.

Mrs. JOHNSON. Thank you, Mr. Houghton.

Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman.

Let me thank all of you for your testimony today. We are embarking on a major change in our tax structure. Obviously, it is controversial, and it is going to take a lot of time for us to get it done right.

I am one of those who support moving toward a consumption-based national tax and replacing some of our income taxes or all of our income taxes, but let me follow up on the issue of how it is going to affect State and local taxes.

I know Mr. Rangel touched on this, but let me just go into more detail, if I might. First, if we eliminate the Federal income tax, it is going to be extremely difficult for States to be able to maintain their income tax system as they have it today without the type of information that is available nationally on reporting income and without the Federal Government using an income tax base.

Second, if we move toward a national consumption tax, it is going to be difficult for States to be able to continue their retail sales tax revenues.

So it seems to me on two fronts directly, we impact on the ability of State and local governments to be able to finance their local needs.

When you put on top of that the difficulties of eliminating tax preference for State and local financing on tax-exempt bonds, it seems to me that we have some serious transition problems or serious fundamental problems that we need to be able to deal with before we move forward with these proposals.

Let me just state my own view. I don't look at State and local governments as special interests. They are our partners in government, and we have a responsibility to make sure that tax reform at the national level is mindful of the needs of State and local governments and financing their needs.

So I would appreciate any thoughts that you might have as to how you could integrate a reform of a national income tax to consumption tax with the problems that that could unveil with State and local governments.

Mr. JORGENSEN. The one thing that I would like to focus on, Mr. Cardin, is something you didn't mention, but I think it is really central, and I tried to include this in my response to Mr. Rangel a few moments ago.

We have to ask ourselves the question, What will State and local governments, which provide very essential services in this partnership that you have just described, have to pay for the services that they provide, what will they actually have to pay out in terms of resources to finance those programs.

Remember now, that governments will not be subject to the consumption tax. The consumption tax pertains to individuals, households. So we are not talking about including governments in the tax. What does that mean?

That means that the providers of these services, whether they are providing them on contract or they are providing them by working in State and local agencies, are no longer going to be subject to the income taxes that they are now paying, and that means that the cost of State and local government is going to go down radically. That is the fundamental fact about State and local governments. Their costs are going to be decreased.

Mr. CARDIN. I might point out that it seems to me that the largest cost to government is labor.

Mr. JORGENSEN. That is exactly right, and when you think of the implication of the fact that many State and local government officials are well above the poverty line, they are not part of the working poor, those folks are people who are paying marginal tax rates on their labor income of 30 percent. That is going to be replaced by a consumption tax of 15 percent if we look at it from the point of view of the consumer and zero if we look at it from the point of view of the governments. So taxes are going to be reduced, and cost of State and local governments are going to be radically reduced.

Mr. CARDIN. I want to give Mr. Auerbach a chance, but I am not sure I follow that logic. I don't want the record to reflect that that analysis would go unchallenged.

Mr. AUERBACH. I cannot comment on Dale's particular conclusions without knowing more about the simulation results. I would have thought that some States, particularly those with relatively high taxes now who benefit a lot from the deductibility of State and local taxes, might have been hurt more than others. That is one of the transition questions about which, no matter what simulation model results we present to you, there is a lot of uncertainty. There has to be a lot of uncertainty about it because we have never undergone a change of this magnitude before.

I wanted to make one other comment. You mentioned the difficulty of collecting taxes, saying it would be difficult to collect retail sales taxes if there was a national sales tax or a value-added tax.

That argument about tax competition, and I am not sure I understand it, though I have heard it made before. It seems to me, it would actually be easier because of the mutual enforcement of the Federal and State taxes that piggybacking would permit. It is true that existing taxes might have to be modified to conform more to a national one.

Mr. CARDIN. Wouldn't it be more efficient if we use a value-added tax built into the value-added tax rather than have two separate types of collections? Wouldn't that be a more efficient way to deal with the tax?

Mr. AUERBACH. If you used the value-added tax at the national level, it would make more sense to convert from a retail sales tax.

Currently, retail sales taxes at the State levels are much narrower than a national sales tax would be. They only apply to goods. They typically don't apply to services, and they often exempt many goods.

Mr. CARDIN. I am just wondering if when we are looking at tax reform, we should look at the State and local and see whether there is some way to integrate a consumption tax at the State level, also.

Mr. HUBBARD. The issue is not so much coordination because you could coordinate under either the national sales tax model or the flat tax, but States might have less—and likely would have less—flexibility in the kinds of taxes that they use.

For example, under the flat tax, it would be difficult for a State to decide to tax capital income if the Federal Government weren't collecting the information at the individual level. So I don't think that coordination necessarily is the issue, but States may be a little more limited in their choices about progressivity than they are now.

Mr. CARDIN. We need to continue this debate, and I appreciate your responses.

Mrs. JOHNSON. Thank you.

I am next to be recognized. However, I do have to leave. So I would just like to make a couple of statements on the record as to things I need to pursue with you over the course, and then I will pass both the gavel and the recognition to other Committee Members.

Mr. Jorgenson, I found your testimony very, very interesting, but you recognize a drop in consumption, though an increase in investment. The drop in consumption, it seems to me, is going to cause layoffs.

Mr. JORGENSEN. Look at the results on the industries. I am sorry to refer you to these charts. I realize it is a little burdensome.

Look at the impact on individual industries in the chart labeled "Effect of a Consumption Tax on Industry Output in 1996." Remember, these simulations are based on a tax imposed on January 1 of this year. In other words, this is a hypothetical, not an actual prediction.

What you will find there is that industry outputs increased by an average of 20 percent. You are going to see the creation of jobs on an unprecedented scale. That is what these charts show.

Mrs. JOHNSON. I need to understand that more clearly. It is not unlike this issue of prices falling that you point to and the impact on State and local government. Are you assuming that cost will decline for State and local government because wages will go down?

Mr. JORGENSEN. No. I am assuming that the costs are no longer going to include the taxes that are now being paid on those wages, and the aftertax wages are going to be skyrocketing. They are going to go up by about 15 percent. Real wages are going to go up by 15 percent. Why? Because you are trading off a 30-percent tax at the margin.

We are not talking about the working poor, Mr. Rangel. We are talking now about the middle class and upward.

Those folks face an average marginal tax rate of around 30 percent. They are going to be facing a consumption tax of around 15 percent, and if you look at it from that point of view, it is not surprising that prices are going to go down after you take out the tax because the producers only get the proceeds after the taxes have been paid, and that is the result.

So what happens is that there will be a boom, and that will be primarily a boom in investment, as you correctly point out. There is a big difference here. Consumption will decline. There is no other way to get more investment than to have consumption go down. That is the purpose of imposing a consumption tax.

Mrs. JOHNSON. I appreciate that. My concern is in the transition. Could we create problems that are so serious in the transition that government costs would escalate in such a way as to undercut?

Mr. JORGENSEN. The transition problems are just the opposite of what you suggested, if I may respectfully disagree. It is not that we are going to have problems with jobs. We are going to have problems finding people. We are going to have problems getting people into the jobs that are going to be created under this tax change. That is what is going to happen under the transition, and that is something to worry about.

It is not something that I think is reflected in the questions that we have heard today. People are concerned about creating jobs, as they always should be, but we are going to be creating jobs on an unprecedented scale.

Mrs. JOHNSON. The other thing that I think we do have to think about is, as we do more study, the kind of study that is being stimulated by the balanced budget initiative, looking at the real cost and the real impact of appropriated programs versus tax-incentivized actions, if we discover, as I think we may, that tax-incentivized benefits are much cheaper to administer and more effective in their delivery, that is, an earned income tax credit versus energy assistance or food stamps, then I think that has to be taken into account. What kind of leverage do we want for the tax versus its cost and the appropriated programs?

Mr. JORGENSEN. There are two points here. One point is that you have to ask yourself what are the costs that Federal Government is going to face.

I have already made it a point in response to Mr. Cardin's question that State and local governments are going to be faced by lower costs. That applies with a vengeance to the Federal Government. The Federal Government costs are going to be lower because of the switchover. That is something that has extremely important ramifications for the budget debate. You are absolutely right about that. It should be taken into account.

So that just reinforces what your colleague, Mr. Houghton, was saying. We have to study this very, very carefully because it has many far-reaching ramifications.

Mrs. JOHNSON. There are certainly a lot of things that we need to understand better than I at least at this point understand them.

Mr. CHRISTENSEN. Will the gentlelady yield?

Mrs. JOHNSON. I am going to recognize Ms. Dunn and yield, to Mr. Ramstad, the gavel, since I really must leave.

Mr. CHRISTENSEN. Would the gentlelady yield for a moment?

Ms. DUNN. Yes.

Mr. CHRISTENSEN. Dr. Jorgenson, do you think we will ever get there?

Mr. JORGENSON. I am sorry?

Mr. CHRISTENSEN. Do you think we can ever get there?

Mr. JORGENSON. Yes, I do.

Ms. DUNN. A quick answer, please. I shouldn't have yielded.

Mr. JORGENSON. Yes, I do believe we can, Mr. Christensen.

Ms. DUNN. It could take a very long time.

Did you get your answer, Jon?

Mr. CHRISTENSEN. Yes.

Ms. DUNN. OK.

I wanted to ask the panel a question that comes up a lot in the townhall meetings that I have had on this particular topic.

The folks in my district in Washington State are very interested in what is going to become of the IRS. So I would like to ask each of you this. As we well know, nobody looks forward to an audit. A lot of folks think that the simplification relating to our replacement of the current income tax would include a streamlining or doing-away of the IRS. I wonder if you could take both the consumption and income-based taxes or the four or five major plans and tell me how you see the IRS, in reality, existing at the end of that time.

Mr. HUBBARD. The IRS will be here, for good or for bad, under almost any of these plans. Some of the complexity that occupies a lot of IRS staff time—international transactions, depreciation issues, and certain special provisions—would be greatly reduced. So, in that sense, a lot of the burden would be gone, but if you think about the information and monitoring requirements for something like a flat tax, for example, or the USA tax, for example, it is information and reporting that is currently being collected. So it would still have to be analyzed.

Even if we were to go to a national sales tax, there would still have to be a great deal of coordination and monitoring.

So I think the IRS as an institution, if it can be called that, would be here to stay, but I think some of its most intrusive aspects, at least in the cost of doing business, could be cut back.

Mr. AUERBACH. Under the sales tax or a value-added tax, certainly, individuals who are not in small businesses would cease to

have any contact with the IRS. But a lot of the complaints about the IRS come now from owners of small businesses. It is hard to believe that they would be complaining less if they were facing a value-added tax or a national sales tax, because they would have a lot of contact with the IRS under that plan.

Mr. JORGENSON. I think it is important to focus on the difference between a sales tax and a value-added tax. A sales tax would involve an administration very much like the States sales tax collection agencies. There would have to be a Federal agency to subcontract the collection of Federal revenues. I don't know if you are going to call that the IRS or give it a different name, but it is doing something totally different than it is now.

If we think about a value-added tax, the method that I think is going to be discussed the most among the major proposals—it is the only one that is represented—is what is called the subtraction method, which is the tax-on-a-postcard version that you are going to hear about from Congressman Armev. That is going to require a value-added type of administration that is very much like the IRS, and it is going to involve auditing individuals' returns.

One very important feature of a consumption-type tax is that it is possible to exempt small businesses because they essentially pay the taxes on everything that they purchase, and that is something that could be considered very seriously.

You heard testimony on that last year from a Dutch economist named Cnossen, and he talked about European experience with that kind of exemption. That would also apply to a small farmer, a small fisherman, and so on.

So I think that these administrative issues are very, very important, but there is a fundamental difference between a value-added tax that would preserve something like the IRS and a retail sales tax as advocated by Chairman Archer which would involve something more like the State agencies that now administer those taxes.

Ms. DUNN. I want to go back with a message of hope to my constituents, but not an unrealistic hope.

Let me ask you, on a second topic, about the area of barter or the underground economy. Do you have a sense of which of these areas of change would most discourage barter, why it would, and is there really a chance for us to get our hands around the problems that are created by folks who are not reporting income? Would it be better on the consumption?

Mr. AUERBACH. I think a misconception that exists is that a consumption tax, say a value-added tax or a retail sales tax, would get around the problem of the underground economy by taxing people on their consumption.

It is true that such a tax would tax their consumption, but it wouldn't tax them on their production. Imagine a small contractor. I won't choose a profession for fear of offending anybody, but imagine a small contractor who is not paying taxes under the income tax. That contractor ought to be subject to a retail sales tax if we had one because it would include services, ought to be subject to a value-added tax if we had one, and ought to be subject to the current income tax. Presumably, that person would continue not to pay taxes under any of the systems, and there is nothing fundamentally different about the different systems that is automati-

cally going to cause that person to bear taxes that aren't being borne today.

Mr. HUBBARD. The sense in which the tax reform is being discussed might help with the underground economies by lowering marginal tax rates. The incentive for evasion is much lower. That is not a consumption tax point, per se, but lower rates should shrink the underground economy.

Mr. JORGENSEN. I think that is a very, very important point.

We are not going to be getting into the business, just to take an example, of taxing illegal activities. They are still going to be conducted by people who are going to be evading tax authorities, along with other authorities.

On the other hand, their consumption, what they do with the proceeds is, indeed, going to be subject to tax. So I would say that, from a practical point of view, the effect on the underground economy is there, but not unlimited.

Ms. DUNN. Thank you.

Thank you, Mr. Chairman.

Mr. RAMSTAD [presiding]. Thank you.

I, too, want to express my appreciation to this impressive and distinguished panel of witnesses for your insights and your excellent testimony. It is refreshing when academicians not only present the empirical data well, but also have such good common sense, and your recommendations certainly are important.

I also appreciate the fact that my colleagues on the other side of the aisle have been here this morning. I know it is important that we work together in a bipartisan, pragmatic way to enact tax reform, and I applaud them for their efforts as well.

I would just like to follow up on the line of questioning by my colleague from Michigan earlier this morning, Mr. Camp.

I was just listening the other day to a program on population growth on public radio, and the estimates are that by the year 2040, this Nation will have a population of 400 million. Somewhere between the year 2040 and the year 2050, we will grow from our current 225 million population to 400 million people. We have to, obviously, grow this economy, create the jobs necessary to put people to work.

I was impressed by your testimony, Professor Auerbach, and yours as well, Professor Jorgenson, that the long-term effect of a broad-based national sales or consumption tax would raise output by 9 percent.

I have also heard the chairman of the Commission, Mr. Kemp, say that his favored proposal, that is, the flat tax, and I have heard Professor Wininski, his economic guru, corroborate this, that it would possibly grow or double the growth of the economy, that we could go from a \$7 trillion economy to a \$14 trillion economy in the long run.

I would like your inputs in comparing and contrasting a consumption tax with the growth implications of a flat tax. Is this just hyperbolic rhetoric? I imagine you wouldn't dispute it, but that is very impressive, obviously. If we could double the output from a flat tax, why should we go with a consumption tax?

Mr. AUERBACH. A flat tax is a consumption tax.

As proposed, a flat tax would be a consumption tax that provides low-income relief and trades off that relief for a higher tax rate. Therefore, logically, compared to a national sales tax or a national value-added tax without that kind of low-income relief and, hence, with lower rates, the growth would have to be moderated. It would have to be lower because there would be larger distortions facing work decisions.

So whatever the ultimate growth would be under one tax system or another, you are trading off some growth for some progressivity in adopting a flat tax rather than adopting a national sales tax or a value-added tax.

I would find doubling of the economy a wonderful thing. I think it would be fairly unlikely.

Mr. HUBBARD. Also, you have to keep straight the difference between a change in the level of output and its rate of growth.

What Alan Auerbach and Dale Jorgenson were talking about were changes in the long-run level of output or output per worker. To get to a higher level, you obviously have to grow faster, and I think that is part of the difference, combined with some healthy hyperbole on the flat tax.

Mr. JORGENSEN. I had the pleasure of testifying, Mr. Ramstad, before the Commission. In fact, the calculations that I have described here were presented to them in an earlier version, assuming implementation January 1, 1995. They even found their way into the report.

So it turns out that Mr. Kemp at some level has bought off on this idea, but the Wininski viewpoint that you can double the growth rate is perfectly correct if you are talking about a sufficiently short period of time.

If you talk about tomorrow, it turns out that you can have a huge increase. I estimate the initial increase to be 13 percent. If you talk about 5 years, you can double the growth rate, but the idea that you are going to double the economy requires allowing growth to take place over an extended period of time, and we will certainly see a doubled economy over the next, say, 20 years under a consumption tax, whether it is the flat tax variety or another one.

Beyond that, if we assume this is going to go on forever, we are fooling ourselves. That would be my view.

Mr. RAMSTAD. All of you concur that the status quo is unacceptable in terms of growth. I mean, the projections are hardly impressive under the current tax system.

Mr. JORGENSEN. Exactly. Under the current tax system, the growth rate would be around 2 percent, declining over time to around 1 percent, and under any one of the consumption tax proposals, as Ms. Dunn said a moment ago, any one of the five major proposals, you would have a very, very substantial stimulus.

Mr. RAMSTAD. Thank you again, gentlemen. We look forward to working with you on a continuing basis as we go to, hopefully, enact tax reform next year.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Dr. Jorgenson, we are going through these hearings, as you know, for an educational purpose, so that people would better understand how important it is to get away from this present system.

You passed nonchalantly over this transition thing and talked about cold turkey. Perhaps I was too caustic in saying who is going to make the decisions. You said you, but you recognize that when you are bringing about this dramatic change, you are asking local and State governments, employers, and savers to just change everything, and we are now going to have to staple you to the bill to explain "not to worry," that everything is going to work out.

Have you put any paper together, questions that those who don't believe in the flat tax would like to ask, but never do, or are these the answers to these questions?

You just indicated in your document that there is going to be a dramatic jump in savings and a substantial rise in labor supply. Why would there be a rise and a reduction in the consumption of goods and leisure? Why would this happen?

Mr. JORGENSEN. It would happen because the burden of the tax would be shifted from labor and from saving to consumption.

Mr. RANGEL. I thought that.

Would this not be a renegotiation of every labor contract we have in the United States of America?

Mr. JORGENSEN. That is largely an administrative question, and let me indicate what I mean by that. If it turned out that we decided to administer the consumption tax by means of a two-part system, a business tax and a personal tax, as in the flat tax or the USA tax that you have heard so many times now, it would not be necessary to renegotiate every labor contract. The labor contracts would be written in such a way that they would take into account the fact that people were going to pay taxes on income under the current system and would be liable for paying part of the taxes not because that is an income tax, but because it is just a way that it is passed along.

Mr. RANGEL. When people negotiate a contract, they take into consideration the present tax system, and the wife or the husband or their friends and loved ones say, "That is nice, Darling, but how much money are we going to have left?"

Mr. JORGENSEN. Bring home.

Mr. RANGEL. Exactly.

Mr. JORGENSEN. Exactly.

Mr. RANGEL. If you are considering the deductions and all of the things that we have in the system and now all of a sudden they are removed and the cost of my labor has been dramatically reduced, how do I become whole again? What happens?

Mr. JORGENSEN. Because your aftertax income has increased by 15 percent, Mr. Rangel.

Mr. RANGEL. What happened to my Social Security?

Mr. JORGENSEN. The take-home pay is going to jump.

Mr. RANGEL. Do you take away the Social Security deduction? Will that not still be there?

Mr. JORGENSEN. The Social Security deduction is certainly going to be there, at least under my version of the story.

Mr. RANGEL. Then you crowd on top of that a consumption tax. What is left? Where is this dramatic reduction in my expenses if the Social Security is there and your tax is there?

Mr. JORGENSEN. Where is this benefit going to accrue? It is not going to accrue with regard to Social Security or FICA. It is going to accrue with regard to your individual income tax.

Mr. RANGEL. I know, but I am still talking about disposable income.

Mr. JORGENSEN. You are now paying an average market rate.

Mr. RANGEL. It will not dramatically increase as a result of this if I still have FICA and the Social Security burden to carry.

Mr. JORGENSEN. Still, your income is now your aftertax income. Your take-home pay is now affected by the individual income tax.

The thing to focus on, Mr. Rangel, is that that is going to be removed. You are not going to be paying the individual income tax again, and you might ask what does that amount to. It amounts to about 30 percent of your income, if you are the average American citizen. That is going to be replaced by a consumption tax of 15 percent. That is going to bring you a tremendous increase in your take-home pay.

Mr. RANGEL. I am a New Yorker. Of course, that is parochial when you are dealing with the national interest, but we have very high city and State taxes. You are going to remove my Federal tax, and my city and State taxes won't have that to piggyback on. So, are we going to mandate that they go to a consumption tax as well? What does my mayor and Governor do now that I have dramatically reached the decision that we are changing the Federal system?

Mr. JORGENSEN. That is up to the New York City Council and the legislature of the State of New York, but I would predict that they are going to find it very convenient to move to exactly the same system that the Federal Government does now.

The New York State income tax is very closely modeled on the Federal tax, as you are well aware, and I am sure that there would be a movement in the legislature to shift the tax system in the same direction the Federal Government tax system is going to be shifted.

Mr. RANGEL. The reason we follow the Federal Government system now is because we do so much to give them a structure of information and enforcement, but once you pull the Federal Government out—

Mr. JORGENSEN. No, no, no. The Federal Government is going to have a closer relationship.

Remember now that we are talking about the Federal Government subcontracting. I am just thinking now of Chairman Archer's proposal in particular, subcontracting its administration to the State collection agencies. There is going to be a very intimate relationship, as Alan Auerbach pointed out 1 minute ago. The two agencies are going to use basically the same enforcement mechanism. It is going to bring the two partners, to use Mr. Cardin's term, in our Federal system into a closer relationship with regard to taxation.

Mr. RANGEL. Have you written anything or can we get anything up there at Harvard or Columbia that would answer some of the questions that I know may sound political to you but has to get us through this transition? Do you have anything?

Mr. HUBBARD. There is a general point you are raising, Mr. Rangel, about transition that is common to most of the major tax reforms.

We have seen in ERTA and in the Tax Reform Act of 1986 also very large swings in the taxation of alternative assets. So the idea of these major tax changes is certainly not unprecedented. These issues are old.

Mr. RANGEL. Our transition rules have been the nightmare of every reform we have had.

Mr. JORGENSEN. That is exactly why I will bet, Mr. Rangel, that after you deal with the prepayment treatment that I described for housing, that the rest of it is something that you will choose to go cold turkey on.

I am not being nonchalant, and I don't want to give you the impression that I am not worried about this. I am worried about it, and I hope you are.

Mr. RAMSTAD. The gentleman's time, yielded from the very generous Chair, has expired.

What we are going to do is recess the Committee after the next two questioners and resume the hearing at 1 o'clock.

The gentleman from Texas, Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

You did speak about prepayment in housing, Mr. Jorgenson, and I was wondering how you are going to handle that. You indicated that if a loan is restructured a person would not pay new tax, but aren't you pitting new homes against old homes when you are talking about that sort of thing?

Mr. JORGENSEN. Yes, we are, and I think that is a fundamental feature that new homes should be subject to the tax.

What that means is that a person who develops new residential real estate for sale to owner-occupiers, whether it is a home or an apartment or whatever, it would be subject to the tax at the rate that I have suggested, 15 percent. That would keep the asset values on residential real estate, more or less, where they are now.

People who already own existing homes or apartments would be treated as if they had prepaid all of their taxes. They would never be taxed, and that is the equivalent of the combination of the home mortgage interest deduction, plus a total exemption on any capital gains that people would have to pay when they sell their home or sell their apartment, as they would if they move to a smaller abode after their children have grown up and so on. That would be an added benefit.

So existing homeowners would be not only made whole, but they would be given an added advantage that they would never have to face capital gains taxes on their home should they decide to move into a smaller home, and I think that is going to be a very important feature.

Mr. JOHNSON. I sort of understand. If I am renegotiating a mortgage, and I am a new buyer and choose to buy an old home, am I paying tax on it?

Mr. JORGENSEN. You are paying taxes on any new construction.

Mr. JOHNSON. I want to differentiate between new construction and existing homes and new buyers.

Mr. JORGENSEN. No. You are not paying your taxes on existing homes. Those taxes are going to be paid by the developer. They are going to be paid at the time that the home is actually first brought on to the market. There will never be another tax.

Mr. JOHNSON. Are you saying that if I go buy a house, I am not going to pay the tax, the developer is going to pay the tax?

Mr. JORGENSEN. Absolutely. Furthermore, the individual who is going to sell an existing home, who may have a substantial capital gain that would otherwise produce tax liability, they are not going to be faced with that tax liability. Therefore, they get the mortgage deduction and they get the capital gains exemption. They are going to be made whole.

Mr. JOHNSON. Yes, as we know it today, but as I understand you, a buyer is not going to pay the consumption or sales tax. The developer is going to pay it.

Mr. JORGENSEN. The developer is going to pay it.

Mr. JOHNSON. So that is what you are talking about, keeping the price of the property up.

Mr. JORGENSEN. Exactly, and that is what I mean by the prepayment method. The developer pays.

Mr. JOHNSON. I understand that.

Let me ask you one other question that has been alluded to, and all three of you can answer. If the collection agencies enter into some sort of contractual arrangement with the States in order to achieve a collection, why, then, do we need very much bureaucracy in Washington, so to speak? Why can't we get rid of the IRS, per se?

Mr. HUBBARD. That close partnership is really from the sales tax model.

If you were to go to the model of the USA tax or the flat tax, you would still need something, essentially, like the IRS. It is only the sales tax that you would be contracting out.

Mr. JOHNSON. You would be able to reduce the size of Federal Government considerably under that situation?

Mr. HUBBARD. Yes.

Mr. AUERBACH. Although under a sales tax, which would follow the model of the broad-based sales tax, you would be adding a lot of taxpayers who are service providers. For all of it to be done at the State level, there would be an increase in the burden.

Mr. JOHNSON. I understand you have got to have something up here.

Let me ask one other question. How do we prevent double taxation? In other words, if we went to a sales or consumption tax, how do we prevent an income tax from reappearing, as we know it today?

Mr. AUERBACH. Do you mean an income tax at the State level?

Mr. JOHNSON. Double tax.

Mr. AUERBACH. Federal level.

Mr. JOHNSON. Yes.

Mr. JORGENSEN. There is a suggestion which has been, as we say, bruted about, which is having a constitutional amendment that there will never be an income tax, at least at the Federal level. I don't know whether you can have a constitutional amendment that would prevent that at the State level, but, certainly, that

has been suggested. So, if you are up for a constitutional amendment, you might think about that.

Mr. JOHNSON. I am glad you brought that up. I intend to file that next month.

Thank you very much.

Mr. RAMSTAD. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Last week, we had testimony about the compliance cost of the current income tax, and it was estimated that the compliance cost was about \$225 billion. That is, I think, a very conservative estimate, if we include the IRS and all of those things that go along with it.

Can you as a panel see how much difference there would be as far as compliance? In other words, I am trying to ask you to compare the alternatives to the current Federal income tax as far as compliance cost to the average taxpayer and overall.

Mr. HUBBARD. Moving to lower rates, generally, would reduce compliance cost because many of the games that are played are rate-based games. They are trying to arbitrage situations in the Tax Code. To the extent that you simplify greatly international taxation, as the consumption tax models would, you eliminate a lot of complexity. These proposals would also eliminate alternative minimum taxes, a big source of complexity.

So many of the things that the business people can identify, at least, as the largest cost of complexity will be gone or greatly reduced. You will still have some complexity in any tax system, but many of the most egregious issues, at least, should be smaller.

Mr. BUNNING. What about the normal, average taxpayer, which I consider myself to be, and others who are sitting out here in our audience, who have to pay, generally, a CPA or a tax consultant, whoever that might be?

We had 50 returns. We had a case of 4 people, and we gave it to 50 accountants, and they all came back with 50 different tax liabilities. What I have tried to ask you is how much can we save for the average taxpayer if we go to a consumption-based tax.

Mr. HUBBARD. A Member of Congress probably isn't quite the average taxpayer, but you could certainly say for the average taxpayer, to the extent that forms and filing are very, very simple, a lot of people that complain about tax filing now already have very simple systems.

Part of this gets, I think, more to the issues that Chairman Archer has raised repeatedly that people have a fear of the IRS. It is not so much the reform.

Mr. BUNNING. I understand that. Therefore, they go out and have somebody else sign the bottom line, so that even though they are still responsible, they have a partner in crime to go help them defend themselves if they are called in.

Mr. JORGENSON. Mr. Bunning, there are still going to be 10 million retailers out there. If you think of a consumption tax in the narrow sense of a tax on sales, there are going to be 10 million retailers out there, and I include every service provider in this country, not just the retailers that provide goods and services, but medical offices, legal offices, and all the rest.

Mr. BUNNING. Right.

Mr. JORGENSON. Those people are going to have compliance cost.

You ask what is the appropriate figure to use to compare with your \$250 billion or whatever. You have received testimony on this, and I believe that the figure is something like \$6 billion. It is a lot less. That is the main point.

Mr. BUNNING. A lot less. Would you agree?

Mr. AUERBACH. I wouldn't venture a number.

Mr. BUNNING. Do you see compliance being less?

Mr. AUERBACH. Any tax system that removes individuals and households, except small businesses, from the tax base, it is obviously going to reduce compliance costs a lot, particularly among people who are not that educated about the tax system. A lot of people, even who file simple tax forms, 1040A, 1040E, are still using tax preparers, and they, obviously, are nervous about the tax system, even though their tax situations aren't that complicated.

Mr. BUNNING. I have a followup question. Since there is this cost that we know now, and when we have withholding, we have about a 99-percent compliance, and we have anything less than withholding, we have compliance overall at 82 percent. How many did you say?

Mr. JORGENSON. Ten million retailers.

Mr. BUNNING. Ten million retailers.

What percentage of compliance do you anticipate they have now at the retail level as far as the State sales tax is concerned?

Mr. JORGENSON. If you think about the two figures you mentioned between 80 and 90 percent, I would say that it is probably going to be closer to 80 than 90 percent.

A lot of those 10 million retailers are pretty small operations, and when you think about the enforcement problems that are involved, they obviously relate to the government's potential gain in generating tax revenues by audits and so on, by scrutiny of the taxpayers.

So I would say that there are certainly going to be very serious problems, and you are right to draw attention to them.

Mr. BUNNING. Thank you very much, Mr. Chairman.

Mr. RAMSTAD. Thank you, Mr. Bunning.

You might be just an average taxpayer, but nobody could ever accuse you of being just an average pitcher.

With that, I want to, again, thank all three of you distinguished professors for being here today, and for helping us as we start on the effort of tax reform. We are very grateful to you.

The Committee stands in recess until 1 o'clock.

[Whereupon, at 12:04 p.m., the Committee recessed, to reconvene at 1:10 p.m., the same day.]

Mr. SHAW [presiding]. Several of the senior Members of our Committee are in the Rules Committee this afternoon, and they will be coming in shortly. Chairman Archer asked me to go ahead and start off by introducing our distinguished Majority Leader, Dick Armev.

Mr. Armev.

**STATEMENT OF HON. DICK ARMEY, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF TEXAS**

Mr. ARMEY. Thank you, Mr. Chairman.

Mr. Chairman, let me make some brief comments. I have a written statement that I will submit for the record.

I have for some time, Mr. Chairman, been aware of the fact that the American people are thoroughly disenchanted with the current Tax Code. It has been fairly evident to me for some time that the American people will not tolerate this Tax Code much longer, and well they should not.

As we examine the impact of the Tax Code as we know it today, we have to see this Tax Code as we have it, as a principal cause for the inability of this economy to achieve any respectable, lasting growth rate. The relatively high marginal tax rate, the complexity of the Tax Code that results in us spending a deadweight loss of \$150 billion a year just for compliance, the treatment of the Tax Code as we have it today on both savings and investment, leaving us with a deficiency of both, which are the lifeblood of economic growth in any economy, all of these things are well understood by the American people, not to mention the personal aggravation they experience each year as they go through the Tax Code.

I was amused the other day while walking through a bookstore to find that for \$39.50, I could buy a manual of some 350 pages that would make it possible for me to file my taxes and avoid an audit. It is amazing to me that Americans are buying such a manual, while we continue to believe that we have a voluntary Tax Code.

So the fact of the matter is the American people understand that they are experiencing a stagnation of economic growth, resulting in a decline of personal income that is coupled with an increasing share of taxes, to the point that today, the average taxpayer gives up 24.5 percent of his income in Federal taxes, leaving them with a falling real family income.

I have said many times that the reason you have a second wage earner in most families today is not to support the family, but to support the Federal Government.

This declining family income, coupled with this rising tax burden, has caught the American family in what I call the "Clinton crunch." They have been particularly aggravated since the tax increases of 1993 and are in a position where the American people are demanding relief.

Having studied these things, I devised in 1994, based on the work of two economists from the Hoover Institution, Professors Hall and Rabushka, a flat tax with a single tax rate.

If I may turn to one quote, "The single tax rate is extremely important if we are going to have the simplicity as well as fairness and the growth effects."

Joseph Stiglitz, President Clinton's chairman of the Council of Economic Advisers, in his own textbook, "Economics of the Public Sector," writes, "The uniformity of flat marginal tax rates means that income can be taxed at its source. Taxing income at its source will reduce compliance cost an increase compliance rates." This is an extremely important part of a flat tax and a part that is not properly focused upon. If you tax income at its source, you have the

avenue to simplicity that you cannot get anyplace else, and you cannot tax income at its source without a flat tax rate.

If we accept that proposition, we then can see that a growing number of scholars, both for and against the flat tax—in fact, even some scholars that are paid, expressly for the purpose of finding fault with a flat tax—are finding that under a flat tax, you are going to have economic growth. The growth is a result of increased investment activity, which comes back to the economy principally through increased productivity, which, in turn, has its major impact on the wage earners' increased wages and a direct correlation between fair treatment of savings and investment, increased investment, increased productivity, and increased wages. It means that the working men and women in this country are the first best beneficiaries of a flat tax and a growing economy.

The other point of consensus that we have found showing up in the literature is that in a flat tax world, there should be declining interest rates.

I will leave you with this thought before I conclude. So much of the current debate about the flat tax that we hear in America today focuses on the question of home ownership. I will argue that in a flat tax world, there will be more people more able to afford finer homes for their families than you will have today. And if I were a person who made my living out of real estate transactions, I would pray for the flat tax world because I would know I would have a better living, selling finer homes to more families.

With those comments, and if you will accept my written statement for the record, I will be happy to answer any questions.

[The prepared statement follows.]

**STATEMENT BY REPRESENTATIVE DICK ARMEY
HOUSE WAYS AND MEANS COMMITTEE**

March 27, 1996

Mr. Chairman and Members of the Committee, thank you for this opportunity to visit you again to discuss the issue of tax reform.

Mr. Chairman, I believe the hearings you are conducting on the subject of tax reform could not be more timely. Today, Americans are beleaguered by a tax regime that is depressing their wages and stifling economic opportunity. At the same time, Americans are forced to surrender a growing share of their stagnant incomes to the government.

Too many Americans are paying higher taxes while their incomes are stuck in place or even falling. This middle class squeeze of falling wages and rising taxes is what I call the Clinton Crunch.

Here are the facts:

1. During each of the last three years, the typical American family has had less real income. Last year alone, the typical family earned \$790 less than in 1992.
2. As a result of recent tax increases, the typical family now devotes 24.5 percent of its hard-earned income to federal taxes -- a greater share than at any time in America's peacetime history.

Our current tax code is one of the leading causes of stagnant wages. Countless studies show that today's tax code is placing an unnecessarily high cost on the economy for the amount of revenue raised. Let me mention just a few.

- ▶ According to Dale Jorgenson, the chairman of the Department of Economics at Harvard University, who testified earlier today, under our current system 39 cents in output is lost for the marginal dollar of revenue raised.
- ▶ According to a study by Jane Gravelle, of the Congressional Research Service, and Larry Kotlikoff, of Boston University, the corporate income tax costs more in lost output than it raises for the Treasury.
- ▶ A Tax Foundation study found that the cost of complying with the income tax alone reaches \$150 billion annually. More man hours, 5.4 billion, are spent complying with the tax system than building every car, truck, and van manufactured in the U.S.

The flat tax that I have introduced with Senator Richard Shelby would reverse the Clinton Crunch. Because the flat tax is a tax cut, it would let the American people keep more of their own income. Our proposal would reduce revenues by \$33 billion in the first year, leaving middle-income Americans with more income in their own pockets. This modest tax cut is paid for with spending offsets.

The flat tax would also reverse wage stagnation and bring about higher levels of economic growth and greater take-home pay. This is what I will focus my testimony on today.

There are five main reasons why the flat tax that I have proposed will increase the standard of living for the American people.

First, by significantly reducing compliance costs, the flat tax would put to productive use resources that are now wasted complying with the tax code. As I mentioned, complying with the income tax alone costs Americans \$150 billion. According to the Tax Foundation, these costs would be cut by 94 percent under a flat tax -- a savings of about \$1,000 for the typical family of four.

A flat tax simplifies the tax code for a number of reasons, and one of the most important

is the single rate. The flat rate allows the tax on investment income to be collected at the business level, rendering unnecessary the one billion 1099 forms Americans file today. This is explained by Joseph Stiglitz, President Clinton's chairman of the Council of Economic Advisors, in his textbook *Economics of the Public Sector*. Stiglitz writes, "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."

If further evidence of compliance savings was needed, one can stop in at any local H&R Block office and review the brochure explaining why the flat tax is too simple. There couldn't be a greater testament to the simplicity of the flat tax than the fact that it has invited the active opposition of H&R Block.

Second, by putting all economic activity on a level playing field, the flat tax will, as economist say, "allow resources to seek their most efficient use." When economic decisions are made based on underlying economic criteria, resources are used more efficiently and the nation is wealthier as a result. The flat tax ends the preferences in our current tax code which divert resources away from their most productive use. As Alvin Rabushka, the father of the flat tax, has observed, the goal of tax reform should be to take the tax system out of economic decision-making.

Third, by ending the bias against saving and investment, the flat tax will encourage more saving and free up additional dollars for investment. Investment, as you know Mr. Chairman, is the key to increased productivity and higher wages.

When workers are equipped with more advanced technology, their output is higher and they get paid more. This common-sense observation is one of the most important truths in economics.

This very point was made in the 1994 Economic Report of the President, which reported:

The reasons for wanting to raise the investment share of the GDP are straightforward: Workers are more productive when they are equipped with more and better capital, more productive workers earn higher real wages, and higher real wages are the mainspring of higher living standards. Few economic propositions are better supported than these--or more important.

Last year administration officials testified before this committee that they believe it is unclear whether ending the double-taxation of saving would result in higher levels of saving. Before joining the Clinton Administration as the Deputy Secretary of the Treasury, Laurence H. Summers reached just the opposite conclusion in a number of different studies.

In a paper for the economic profession's leading economic journal, the *American Economic Review*, Dr. Summers found that "increases in the real after-tax rate of return received by savers would lead to substantial increases in long-run capital accumulation." Dr. Michael Boskin, a former chairman of the Council of Economic Advisors has also found a strong link between the return to saving and the level of saving.

Fourth, the flat tax lowers marginal tax rates, which will encourage more work effort, saving and risk-taking. Economists have long theorized and demonstrated empirically that higher tax rates lead to lower levels of economic activity, and thus a smaller economy. In fact, the economic evidence that higher taxes reduce entrepreneurial and work effort is rich.

A study by economist Robert Genetski shows that high marginal tax rates are inversely related to productivity gains. That is, productivity, and thus wages, tend to rise when marginal income tax rates are low, but productivity falls or grows very slowly when marginal income tax rates are high.

I should note that economists have also shown that higher tax rates lead to higher levels of evasion, resulting in lower-than-expected revenues to government.

Fifth, because the flat tax is a tax cut and would lower federal spending, it would raise the level of economic growth. A recent Joint Economic Committee study by economists Lowell Gallaway and Richard Vedder of Ohio University estimated that each dollar of federal spending restraint increases private sector spending by \$1.38.

As federal spending rises, the benefit of that spending declines while the cost it imposes on the economy rises. After an optimal level, which we long ago surpassed, each dollar of new spending weighs the economy down with more costs than benefits. By shrinking the size of government, my flat tax will bring benefits more in line with the costs, thus stimulating growth and creating jobs.

For all these reasons the flat tax will increase the growth rate of the economy. Every study of the flat tax that I have seen, including those studies offered by paid opponents of the flat tax, has concluded that it would improve the performance of the economy. Here is what economists studying the flat tax have found.

Nobel Laureates Milton Freidman, Gary Becker, James Buchanan and Robert Lucas have indicated that a flat tax would improve the performance of the U.S. economy.

Dr. Dale Jorgenson, the chairman of the Department of Economics at Harvard University, testified before the Kemp Commission that under a flat tax the economy would be 15 to 20 percent larger within a decade than it would be if we did nothing.

Dr. Alan Auerbach, an economics professor from the University of California at Berkeley and an associate of the National Bureau of Economic Research, who testified earlier today, found that under the flat tax proposed by Hall and Rabushka the economy would be 2.9 to 5.9 percent larger within five years.

Dr. Michael Boskin, a former chairman of the Council of Economic Advisors, testified to this committee last year that the economy would be 10 percent larger under a flat tax than it otherwise would be.

Even DRI/McGraw-Hill, which was paid \$70,000 by the National Association of Realtors to rough-up the flat tax, found that it would add tens of billions of dollars to the nation's GDP.

Mr. Chairman, I believe the economic evidence for a flat-rate tax, which taxes all income only one time, is overwhelming. And in this era of slow economic growth, it affords the best opportunity to raise the living standards of the American people.

Thank you again for this opportunity to appear before the committee today.

Mr. SHAW. Without objection, your complete statement will be placed in the record, as will the statement of all of the witnesses scheduled for today.

Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Congressman, thanks for testifying, and thanks for your lead in getting us focused in on an alternative tax system and ripping the Tax Code out by its roots.

I have heard the Chairman oftentimes say, though, that a flat tax would not necessarily eliminate the IRS from our lives like a consumption tax would. Could you respond to that question?

Mr. ARMEY. My favorite response comes from my mother who told me when I was a boy that there were two things that were certain, death and taxes. Death has the grim reaper, and taxes has the IRS. As long as there is a government, a government will have to raise revenue. As long as it raises revenue, there will be an enforcement agency. You can call it the IRS. You can call it what you like.

The best we can hope for is to make the Tax Code minimal and civil and, thereby, allow the agency that enforces it to be minimal and civil.

In a flat tax world—one of the things that we were amazed and pleased to find out—as I have written the bill, most of the data points now required to be traced by the IRS go away. Therefore, their enforcement ability is much greater.

There is less incentive for tax evasion, because the marginal rate is so low, and less opportunity for it.

So the experience we have had in 22 other nations that have tried a national sales tax has, strangely enough, resulted in increased tax evasion. The underground economy has actually grown. The enforcement agency has grown larger.

I know of no way to enforce a national sales tax except to ask the retailers of America to collect the taxes on behalf of the government, and I always point out to a retailer, you are going to have somebody from the IRS or some such-named organization in your shop. They are going to say, Let me see your sales receipts, let me see your purchase orders, let me see your inventory, and let me see if you are doing my job good enough to suit me.

My own view is that you are going to have a larger, less congenial enforcement agency under a national sales tax than what you will have under the flat tax.

Mr. CHRISTENSEN. How does the Armeiy flat tax address the life insurance aspect? How would you tax that?

The inside buildup of life insurance products, as you know, are tax free. How does the Armeiy flat tax address that savings vehicle?

Mr. ARMEY. We would not tax that.

The fundamental principle is that we would gather every dollar's worth of income earned in the economy in any year and tax that dollar in that year at the same rate as every other dollar.

If, in fact, you had an inside buildup in a whole life insurance policy—I assume this is what you are talking about—that policy would have been purchased with aftertax income.

Mr. CHRISTENSEN. No further questions, Mr. Chairman.

Mr. SHAW. Mr. Rangel.

Mr. RANGEL. You are the ultimate House leader in legislation, and here we are having these series of hearings before the election without knowing that we are going to mark up a bill. We are not taking anything to the floor. How does that fit into the leadership concept as to why we are having these hearings, knowing that it is not for political reasons?

Mr. ARMEY. I have no idea. The Chairman of the Ways and Means Committee does not consult with me before he schedules hearings. I had no idea this hearing was being held or that I was going to testify until I got up this morning and looked at my schedule.

Frankly, I would say, Mr. Rangel, I am not the person to whom you ought to address the question about the scheduling of hearings for this or any other thing.

Mr. RANGEL. I made a mistake. I didn't know that anybody scheduled anything without checking with the leadership, but having said that, this is one of the—

Mr. ARMEY. That may have been the way it was in the old days. I don't recall.

Mr. RANGEL. No. Listen, I welcome back at least that we have the authority, at least the Republicans have the authority to have hearings as long as we don't go beyond that, because it is my understanding that a tax bill is not on the agenda. That would be a part of your jurisdiction as to whether or not legislation is scheduled for this year.

So, even though you are not in charge of hearings that go nowhere, could you share with me whether or not we intend to have a tax bill, or is that up to Chairman Archer?

Mr. ARMEY. I would think that, obviously, especially if you were going to talk about a tax bill of the magnitude of major tax reform, such as a flat tax or a national sales tax, that the appropriate Committee, the Ways and Means Committee, would have to receive legislation, elect or mark the legislation up, hold the hearings, and then go through an appropriate markup and bring the legislation to the floor.

I, as a Member of this body, even given my status as Majority Leader, reserve the right to write legislation and submit it to the process. My bill has been referred to this Committee. I would hope the Chairman would choose to pick up my bill and mark it up, but should he fail to do so and bring another bill—

Mr. RANGEL. Is it within your legislative plans that we will take any bill, preferably, as you said, yours, to mark it up, for getting it out of the Committee this year? Is that a part of your plan?

Mr. ARMEY. I don't believe that is expected to be done this year, but I would think that the Chairman would be quite correct in saying that insofar as we plan to be prepared to do so next year, we ought to start holding hearings this year.

Mr. RANGEL. But he won't be the Chairman next year. That is why I am asking why we are doing this.

Let me move on, though.

Mr. ARMEY. We always proceed on the basis of great expectations.

Mr. SHAW. If want-to-be Chairman Rangel will yield to me for—

Mr. RANGEL. No, no. That is going-to-be Chairman Rangel.

Mr. SHAW [continuing]. One quick observation, Chairman Archer does not intend to mark up a tax bill as comprehensive as the one we are discussing today until next year, but he wants to continue a series of hearings to examine the existing code and to look at possible alternatives.

I thank the gentleman for yielding.

Mr. RANGEL. You said not this major bill. Could you share with me whether the Chairman intends to mark up any bill or to have any legislation?

Mr. SHAW. I don't know the answer to that.

Mr. RANGEL. Let's get back to this flat tax here. There has been some controversy as to the cost of this. I think Treasury would indicate that it is not revenue neutral. You have dealt with that before at some other forum.

Mr. ARMEY. We have had some studies that have been done about the scoring of the flat tax. Treasury has had a couple of false starts. There have been a couple of other organizations.

It is our assessment of the flat tax that I have written, as I have written it, that it would come within \$33 billion of revenue neutrality.

I would argue, and will argue at the appropriate time, that when it is officially scored for consideration that the way you make up that difference in order to be deficit neutral is to cut government spending.

Mr. RANGEL. We don't do it that way on this Committee. We have to balance it out beforehand. You are saying that even though it appears as though it is costly, you just cut government spending and we balance it that way?

Mr. ARMEY. Mr. Rangel, for me to have a goal of revenue neutrality, it would presume that I would endorse the current levels of spending and taxation of the Federal Government, and I endorse neither.

Mr. RANGEL. We don't have jurisdiction over the other Committees, but you are the leader. So I know you would work out that package.

Let me ask about this earned income tax credit. You leave in the Social Security, but you take out the earned income tax credit. Is that supposed to be compensated for by the removal of the lower income people from the tax structure?

Mr. ARMEY. The earned income tax credit is a form of income supplement to low-income people.

I happen to have a very strong approval of extending the supplement to low-income people. I don't agree that the best and most effective way to do that is through the Tax Code. If you have a Tax Code that is already as cumbersome and confusing as the one we have, it is probably acceptable to use the Tax Code for that purpose, but if you are going to achieve the ideal of a flat tax, which is fair, it is better to move the supplementation of low incomes to the expenditure side of the ledger, which is what I propose.

Mr. RANGEL. Is the expenditure side of the ledger in your proposal? How would you bring up people below the poverty line to living decently?

Mr. ARMEY. As you know, now we have a very large number of programs designed to do that, none of which are typically counted in the lives of these people as we measure the extent to which they are not able to achieve the poverty line.

I think there needs to be a fairly comprehensive reform. We have talked about welfare reform as one part of that aspect, but as we move forward, I think we have to have a more realistic measure of the real income of the American people at different levels and then have a more realistic assessment of the kind of supplements to American low-income families as we go forward on the expenditure side. There should be some coordination on that.

Mr. RANGEL. You are really clear and articulate when you are talking about cutting taxes, but, boy, when it comes to what you are going to use to make up for the removal of the earned income tax credit, all I got was that you are going to cut back government spending and try to work out something and determine how we are going to do it. Right now these people are going to be in deep trouble until we figure out what we are going to do. Is that a fair understanding of your testimony?

Mr. ARMEY. Not altogether fair. Obviously, folks that are currently without work would be the first beneficiaries of a growing economy where more jobs were made available to them in the growing economy.

Mr. RANGEL. You mean those without work would be the people that would benefit the best under your proposal, right?

Mr. ARMEY. Absolutely.

Mr. RANGEL. Mr. Leader, you are making more and more sense. So the more people we have unemployed, the more beneficiaries we would have.

Mr. ARMEY. There seems to be a very general consensus that the primary cause of poverty is separation from the world of work. In a growing economy, you have the first opportunity to reunite people with the world of work experience.

Mr. RANGEL. And the flat tax is the best key to open up that door of opportunity?

Mr. ARMEY. I believe a flat tax is the best thing this government can do to allow the economy to achieve its more natural growth rates that are substantially higher than what we have today.

Mr. RANGEL. As long as it is coupled with a cut in Federal spending.

Mr. ARMEY. I agree.

Mr. SHAW. Mr. Collins is recognized.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. ArmeY, I appreciate the fact that you have led the battle in this ongoing effort to change the Tax Codes. There are a lot of people in the Third District of Georgia who I have the honor of representing who really like the idea of a flat tax. There are also many people in the Third District of Georgia who favor the national sales tax. You can almost find unanimous agreement among the people of the Third District of Georgia that they would like to do away with the IRS.

In your proposal of the flat tax, how do you treat estate taxes?

Mr. ARMEY. In my proposal, estate taxes are eliminated under the principle of no double taxation of the same income. So there are no estate taxes in the flat tax.

Mr. COLLINS. That is good.

Did I understand you right on the earned income tax credit that you would eliminate the EITC?

Mr. ARMEY. Absolutely.

Mr. COLLINS. Is the basis for establishing poverty levels based on earned income or income?

Mr. ARMEY. As I understand it, the official measurement of the poverty level precludes an awful lot of the benefits that are being received currently by lower income persons. So that, with an incomplete measure of their real income, we have more people that are declared to be in poverty, given a level that is set, than what actually are because we do not count their full income. I think we ought to have a full and comprehensive accounting for that.

Mr. COLLINS. If I understand you right, you are saying in the judgment of how we determine poverty, we base it on earned income. Then, someone who has enough assets to live on for 1 or 2 years, from the interest on those assets, would not have any earned income as such and would not be eligible for the EITC under that type of setting. Is that what I understand you to be saying?

Mr. ARMEY. I am not quite sure about under the current system, but I do think that a lot of the benefits that they receive from the government are omitted from the accounting. To the extent to which they credit it against their income, income that is derived from sources of earning other than their own labor, is not something that I am technically qualified to answer.

Mr. COLLINS. Your flat tax would tax all income?

Mr. ARMEY. My flat tax taxes all income one time at the same rate as all other income at its source.

Mr. COLLINS. That is earned and unearned income?

Mr. ARMEY. I make no distinction between earned and unearned income. I believe what you are referring to is income that is earned by wages through labor as opposed to income that is earned by the provision of capital to the production process.

Mr. COLLINS. That is right.

Poverty is determined under the current system by earned income, not unearned income.

Mr. ARMEY. That may be the case. I am not sure.

Mr. COLLINS. Thank you, sir.

Mr. SHAW. Mr. Houghton.

Mr. HOUGHTON. No questions.

Mr. SHAW. Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

I will try not to quiz you too tough today.

Mr. ARMEY. All right. I am still mulling over the last question you asked.

Mr. JOHNSON. I will have to tell you, I was disappointed at my interpretation of my colleague Mr. Rangel's statement that apparently your side doesn't think the IRS is intrusive and doesn't want to make any changes in our Tax Code. That disappointed me a little bit. I would have hoped you would have been a little more observant of how the IRS has responded.

Mr. RANGEL. The gentleman misunderstood me, but it is OK with me.

Mr. JOHNSON. I misunderstood you?

Mr. RANGEL. I think so.

Mr. JOHNSON. Bless you.

I would like to ask you this. You mentioned income here. How are you addressing dividends and interest, per se? Forbes got questioned pretty heavily on that.

Mr. ARMEY. Yes. This is a very difficult thing for some folks to grasp.

When you own stock or bonds in a productive enterprise, a business, that enterprise has its gross earnings, and those earnings are taxed with a corporate income tax. In my Tax Code, it is a 17-percent corporate income tax on gross earnings.

Dividends are the distribution of aftertax earnings to the owners of the corporation. They would not be taxed a second time in the flat tax.

It bothers a lot of people that the person who actually receives the income doesn't file the forms and pay the tax, that the forms are filed on their behalf by the corporation, but you get naturally drawn that way if you want to get the compliance savings that you get by collecting at the source.

There is a tax form. I make reference to it, the 1099 form. There are 1 billion 1099 forms that are sent out that will not be sent out under my proposal.

I am a little amazed that people find that difficult, and I will give you an illustration of why. I have filed my taxes every year of my life since I was 16 years old. I have paid my taxes every year of my life since I was 16 years old.

It just occurred to me last February when I filed my taxes, I have not once in my life written a check to the IRS. Why? Because my taxes are collected at their source, by my employer who withholds them, remits them on my behalf, and sends me a notification to that effect.

When I first wrote the flat tax, I wanted to end the withholding, but it was scored by the Joint Tax Committee as a \$10 billion loss for all the cost it would be to process all this process over.

By the same token that I now say let's save the compliance cost that we now have associated with the double taxation of capital earnings by taxing again, a second time, at the point of distribution, I conceded that we should have to continue suffering withholding tax for wage earners because it reduces that compliance cost.

The basic fundamental question one has to ask, if I provide labor to production and you provide the capital, is it fair for your income to be taxed twice and mine to be taxed only one time? My answer is no, that is not fair.

If you think we ought to double tax the income earned by those who provide capital, then an alternative way to make it fair is to have the business withhold my taxes, send me my aftertax income, and have me pay tax a second time on that. I think most people would find that considerably unacceptable.

Mr. JOHNSON. Let me ask you another question. The three people who testified this morning before you indicated that a flat tax was

a consumption tax. You keep referring to it as income. What do you consider it as?

Mr. ARMEY. I think they are talking about the base on which the tax is built, and I believe that I would accept that. It is a rather esoteric thing.

Mr. JOHNSON. It is not esoteric in the fact that if we have a flat tax and we call it a consumption tax, how do we prevent having a second tax, an income tax laid on top of it.

Mr. ARMEY. My own view is we have very little danger of enacting a flat tax and then having a second tax.

Mr. JOHNSON. What is to keep it from expanding the way it has already under the current system?

Mr. ARMEY. I am sorry?

Mr. JOHNSON. What is to keep it from expanding the way the current system has?

Mr. ARMEY. If you enacted the flat tax as I have written it, you would put in a three-fifths vote requirement for both the House and the Senate to either raise the rate, lower the family exemption, add a second rate, or restore any of the personal deductions. That is the best way I know of to protect the Nation from a future Congress.

Mr. JOHNSON. Thank you.

Mr. SHAW. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

I appreciate the testimony from our distinguished Majority Leader on behalf of the flat tax.

Let me ask you a question, though, Dick. You don't tax interest, dividends, or capital gains at all, right?

Mr. ARMEY. No. I don't tax them twice. They are all taxed at their source. That is 17 percent.

Mr. CRANE. How about estate taxes?

Mr. ARMEY. No estate taxes.

Mr. CRANE. No estate taxes.

Let me ask you a question, though, on one provision that I have spoken to you about in your proposal, and that is taxing business. Doesn't that end up as double taxation of the individual consumer?

Mr. ARMEY. Are you talking about small business?

Mr. CRANE. Any business. Businesses don't pay taxes. They gather taxes, and they have got to pass them through to you and me but still show a fair return on their investment or they are out of business.

Mr. ARMEY. Surely.

Again, irrespective of your structure, whether you are corporate, individual, or partnership, you would pay taxes on the gross earnings of the business as a business tax, and you would pay at 17 percent.

Mr. CRANE. Yes, but that is a cost of doing business.

Mr. ARMEY. Absolutely right.

Mr. CRANE. Who ultimately picks up that cost?

Mr. ARMEY. People do.

Mr. CRANE. Right. So it is only individuals who pay all of the taxes, even though you are affecting some of them indirectly through business operations.

Mr. ARMEY. The guiding principle of the flat tax is the recognition that all taxes are paid by people and all taxes are paid out of current income flows, but the fact of the matter is I can earn my income in one of two ways. I can either provide capital to the production process or I can provide labor to the production process, and both are essential to the process of production, and the earnings received from both should be taxed, but only one time. So the providers of capital are treated exactly the same as the providers of labor.

By the same token, if you say, All right, Armeey provided labor to my production and that went into my cost of production not only what I paid him in his net pay, but the taxes I remitted on his behalf, that, too, must be covered in the end. So, this, I think, is going back to Mr. Johnson's point that you do have, then, in the end a consumption base to your Tax Code.

Mr. CRANE. That capital input was taxed already at the time you acquired it.

Mr. ARMEY. Again, in the flat tax, at the time you acquire capital or inventory, you expense it.

Mr. CRANE. My only concern with your proposal, and it is the concern I have with the consumption tax approach, too, is that there are hidden taxes, hidden directly from the consumer. It is a little bit like going to the gas pump and filling your tank, and I have always argued they should only indicate there the cost of your gasoline. Then when you go in to settle up, they will tell you what your tax bill is on top of that. Taxes, I think, should always be levied in the most simplified, easiest-to-understand, and, I might say, painful possible way, so people are acutely aware of what they are paying in taxes.

That same principle, kind of indirectly, applies, it seems to me, when businesses are paying taxes and, yet, you don't see that in terms of the purchase price of the commodity you are buying.

Mr. ARMEY. I agree with you on that. Taxes should be as visible as possible to people who pay the taxes.

Mr. CRANE. I commend you for your efforts in this, and I think it is a major educational battle to get people to fully understand.

I am sure you have probably seen the figures with regard to the home purchase mortgage deduction if you eliminate that. We have 64 percent home ownership here in the United States with that provision in our Tax Code. Canada has 63 percent home ownership without any such provision. Japan has 62 percent without any such provision. Australia is pushing 75 percent without any such provision. People buy homes not because of the motivation of that deduction. There are other compelling reasons to own a home.

I salute you for your efforts. Keep up the faith, and keep up the good fight.

Mr. ARMEY. Thank you.

If I could just comment, I am not eliminating the home mortgage from the Tax Code. I am eliminating the Tax Code in which you find it today.

Thank you.

Mr. SHAW. Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman.

Mr. Armev, I think one of your statements in your presentation was that if you were a home seller, you would pray that your proposal is adopted. The realtors and homebuilders I have talked to from my district are praying that it is not adopted, and their fears, as well as those of the people I represent, are about the issues of home mortgage interest deduction, property tax, and many, many people have written over the last few months since the Forbes proposal was out there about the charitable contribution deduction. So, know full well, there are people praying against you, also.

Mr. ARMEY. Would you like me to respond to that?

Mr. KLECZKA. Certainly.

Mr. ARMEY. If I may, as I wrote the bill, and I spent from January 1994 to June writing the bill, we studied these two because they were, obviously, important areas.

What did we discover about the home ownership? It was, frankly, quite surprising. Only 25 percent of tax filers take the home mortgage deduction. If you were to reinstate that in the new Tax Code, you would have to raise the rate on all tax filers.

Even more surprisingly, only 43 percent of homeowners take the deduction. That surprised me.

We also discovered in a recent poll that was commissioned by Citizens for a Sound Economy that 66 percent of new home buyers said that given the other benefits of a flat tax, they would be more than happy to give up their mortgage in order to have that.

We have had a lot of people try that. You heard the statistics cited by Mr. Crane.

Now we find a recent study by the Heritage Foundation, which I understand will be supported by a couple of other studies soon to come out, that home values are projected to go up anywhere from 7 to 14 percent over the next 5 years in a flat tax world because of the economic growth and falling interest rates.

A Kansas City Fed economist wrote an article in which he argued interest rates would fall by as much as 25 percent. So, if your income is going up and your interest rates are coming down, the two principal components of the home purchase decision are working in favor of home purchases.

On charitable contributions, as we studied that, we discovered that only one-half of charitable contributions are deducted by people under the current Tax Code, and during the eighties when we cut the tax value of a charitable contribution by more than one-half, charitable contributions more than doubled, and in fact, charitable contributions to religious organizations tripled during the eighties.

We deduce from that, that the reason people give is because they have, and when they have more, they will give more. I believe charitable organizations will thrive in a flat tax world because of the economic growth and increased incomes.

Mr. KLECZKA. The other major concern I have is the effects that a flat tax might have on employer-provided pension and health care benefits, and also, what I would like to ask you is to explain more fully for me the 20-percent tax on State and local governments who offer health care benefits to their employees.

As far as the employer-sponsored deductions for health care and pension, do you not believe that once that deduction is taken away

that the incentive to provide a decent health care benefit to employees and/or pensions would also be taken away?

Mr. ARMEY. I believe the incentive for employer-provided insurance would be taken away, but I believe it would be supplanted with a much more beneficial incentive, and that would be the incentive for the employee to say to the employer, Give me instead an increase in my salary that is equal to what you are now paying to give me more insurance than I want or need and can use, and I will go out and wisely buy insurance for myself.

Mr. KLECZKA. That might sound well, but I as an individual going to the market to buy a policy will not get the same rate as a group plan would, and so my employer gives me a couple more bucks and I have to shop around for my own plan and know full well I am going to pay a heck of a lot more than the 2,000 other employees that he is buying for in a group-type situation that is part of the benefit provided by the employer.

Mr. ARMEY. There is no doubt about it, it is a fascinating question, and I will give you a couple of points.

Mr. KLECZKA. The effects are scary, though.

Mr. ARMEY. First of all, in employer-provided group plans, we typically have people that are overinsured, and I will give you a quick example.

You won't believe this, but I am 55 years old.

Mr. KLECZKA. Oh, I believe it.

Mr. ARMEY. My wife is younger than I. We have both raised five children and put them all through college. We are 100 percent dedicated to the proposition that we will never again in our life use maternity benefits, but we get them because we are in a group.

Were we to buy our own insurance, we would not be buying benefits such as that, that we know we will never use. It is, like I say, a tricky proposition.

The fact of the matter is, that employer-provided insurance is such an institutionalized part of labor contracts these days that I dare say it would never be substantially changed by employers except by the initiative of the employees which I believe you would find expressed in a flat tax world where they found that I could get—let's say, give me the \$5,000 you are now laying out for my insurance. I will pay the 17-percent income tax on that, and I will go out and buy me the kind of insurance I need for me and my family, and I will be better off.

Mr. KLECZKA. Would you address quickly the 20-percent tax on State and local governments?

Mr. ARMEY. That would be to make it uniform that all income that is received by an employee be taxed.

The health insurance that you currently receive from a private employer is part of your real income, and we would say to the private employer, You pay the tax on that. So we would say to the State and local government, You do the same.

Mr. KLECZKA. The effect of that would be for the local governments and State governments to reduce or eliminate that employee benefit?

Mr. ARMEY. I have to say, I don't share your concern about that.

Mr. KLECZKA. My realtors don't like it because of the loss of the mortgage interest deduction. Consumers who are in need of health care should be very, very fearful of this proposal.

Thank you very much.

Mr. ARMEY. Thank you.

Mr. SHAW. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman.

To the distinguished leader, it is always good to see you, and I appreciate your leadership in this area of tax reform.

I just want to focus a bit on the issue of economic expansion and job growth. I was quoting some statistics in the morning session of projected population growth for our country. People who study population trends and so forth are predicting that by the year 2040, this Nation will be comprised of about 400 million people. So, obviously, we have to grow the economy.

The projections of economic growth as far as economists project currently show for nothing more than 1 to 2 percent growth rate indefinitely. So, obviously, this is a big part of tax reform in addition to providing simplicity and fairness and all the other desirable elements of any tax system.

This morning, we heard from three distinguished professors who advocated a broad-based national sales or value-added tax, and it was their judgment that output could be increased by 9 percent in the long run.

Let me ask you with respect to the flat tax, and we have heard from the Chairman of the Commission, Jack Kemp, and Jude Wininski that at least in their judgment a flat tax would double the output in the long term. In other words, we could grow from a \$7 trillion economy to a \$14 trillion economy in their considered opinion.

Where do you see the growth rate, given a flat tax?

Mr. ARMEY. It is always hard to pin these things down exactly, but we cite in my testimony a good different many scholars. My favorite citation is Dale Jorgenson, the chairman of the Harvard Economics Department, who says that the growth rate could go as high as 5 percent per annum for 5 years.

There is no doubt, though, that everybody agrees that it will be growing.

Auerbach who, for example, is not particularly a friend of conservatives says the economy would be 5.9 percent larger within 5 years. So there is no doubt that everybody, even DRI/McGraw-Hill, says there will be economic growth.

I don't know. I believe that it is possible for this country to reach and sustain a growth rate of 4.5 to 5 percent for an indefinite period of time, but that can only be done with the vitality of the investment cycle, and if you are double taxing investment income, you are always going to have that working against you.

Savings and investment, for as long as we have had the discipline of economics, was identified even by Adam Smith in 1776 as a principal cause of economic growth, and the flat tax does that. I think a national sales tax would do that.

I don't know the extent to which a value-added tax might do that. My own view of the value-added tax is that it is such an insidious tax, it shouldn't be studied in the first place.

Mr. RAMSTAD. But you wouldn't argue, then, that a flat tax would necessarily promote more economic growth than a national sales tax. The key, you think, is not taxing investment income.

Mr. ARMEY. I think that is the key.

My own view is a flat tax has a higher degree of neutrality than the national sales tax. The national sales tax actually seeks to promote savings and investment by directly taxing consumption, and my own view is that if you leave people with a neutral Tax Code, you will probably get better activity than you will with any Tax Code that has any government bias built into it, but that is more predilection than an empirical observation.

Mr. RAMSTAD. Thank you, Mr. Chairman.

Mr. SHAW. Mr. Houghton.

Mr. HOUGHTON. Yes.

I would like to follow up on this concept of growth because it bothers me. When you take a look at a company, there are three ways the company can grow, one through its earnings, two through its borrowing capacity, and three through its net worth.

If you apply that to this country, we are not earning any money, we are borrowing to the point where our capacity is going to run out, and our net worth, who knows what that is.

When you take a look at the statistics as far as growth is concerned, in the eighties, really, we had about a 3.9-percent growth rate. In the fifties and sixties, which were really very good economic years, we had less than 4.5 percent. So you are saying that now this will unleash something that we have never seen, even with the postwar boom, and it will increase our growth rate to over 4.5 percent?

Mr. ARMEY. Yes, I am, and I will tell you why. I know of no time in my lifetime when we did not double tax savings and investment. So this would be the first time since, Lord knows when, that we treated savings and investment in a nonprejudicial manner in the Tax Code.

So we should be able to achieve better growth rates than we did even in the fifties with all of the dynamics of the fifties and the sixties.

Mr. HOUGHTON. What difference does it make, Dick, from an economic standpoint whether the savings comes from this country or abroad? Clearly, our savings are low. So we don't have enough money to borrow from ourselves, but the point is that the cash is always available, and the cash has been available.

So, although we borrow it from Mr. X who lives in Japan versus Mr. Y who lives in the United States, economically, why does that make any difference?

Mr. ARMEY. It is not just a quantitative problem. It is a qualitative problem, too. For too much of our economic experience, the Tax Code has actually steered the investment of capital into second-best alternatives, alternatives that didn't get the best financial or economic score, but got a tax score that was high enough to put it over the top.

If you have neutrality, the quality of your investment, the investment decision will be based solely on economic or financial criteria and not at all on tax criteria.

So you have a greater availability of savings and investment, a greater incentive to pursue income through these two sources, and no tax bias that would cause you to direct your investment toward some option that would be an economic or financial second-best option.

Mr. HOUGHTON. Coming back to the original point, I am interested in transitions, and if you put in your flat tax or a flat tax was put in, whether it was the Forbes or the Kemp or yours or whatever it is, continuing your line of reasoning, with our borrowing now at the moment, we are not going to be able to generate any earnings until we get within reasonable destination of no borrowing. So I just don't understand how we can move from where we are with the present economic conditions to where you want to be without some tremendous intermediate upheavals.

Mr. ARMEY. First of all, I would argue that, immediately, there is an incentive for increased saving, and there is a decreased incentive for debt. You would probably find businesses expanding more on equity ownership and less on debt for example. So the interest rates will go down, and there is a generalized consensus on that.

Second, in your transition rules, you probably would have to be most mindful of current long-term capital investments under depreciation schedules that would have to be worked out, but you could begin immediately expensing inventory and capital, and particularly, in the high-growth sector of electronics and computers where obsolescence is almost an immediate phenomena, you would have a greater incentive to make the investments because you could have that expensing phenomena.

So I think the growth would show up more quickly than it would under a system where you left the structure of the current Tax Code in place and just lowered the rates because the changing structure has an enormous impact on the behavioral response of the people.

Mr. HOUGHTON. Suppose you just adjusted the capital gains, eliminate it, and at the same time took savings off the taxation roles, similar to the Nunn-Domenici plan. Wouldn't that do what you want?

Mr. ARMEY. If you did it the way the Nunn-Domenici plan has done it, you would have some beneficial effects on that side, but remember, the marginal tax rates went up incredibly under the Nunn-Domenici plan, and that was a major bother.

In the flat tax, you get the neutrality. You get the single taxation of capital and savings. You get the expensing of inventory and capital, and you get the lower marginal rates. So you have everything working in the same direction.

Mr. HOUGHTON. Thanks very much.

Mr. SHAW. Mr. Laughlin.

Mr. LAUGHLIN. Thank you.

Mr. Leader, as I travel around the 14th District of Texas, there is a great deal of interest in your flat tax, but at the same time, people generally express concern in two areas, and while they may sound simplistic, they are valid concerns.

First is their observation that the current Tax Code, that they consider an absolute mess, started out as a flat tax. How do you approach in your flat tax proposal the creep or the growth of the

tax increase and all of the deductions, exemptions, and the problems that create the mess that you are trying to correct with your flat tax?

Second, and probably of greater concern, how do you deal with the IRS in your flat tax? One of the things that appeals to most of the people I talked to about the consumption tax is their idea that you are going to abolish the Internal Revenue Service, and there is great concern about the flat tax retaining the IRS, which in the lives of the people I represent, it is intrusive and abusive, and we heard a lot of testimony on that last week before this Committee.

How do you address those two concerns of the people I represent?

Mr. ARMEY. The first thing, obviously, once you put in the flat tax, and my own view is you stay flat or die, it has got to be 100 percent, and it is no policy for the timid. So take it straight out.

Then you put in the safeguards in terms of the future vote requirement to either raise the rate, add back itemized deductions, add a second rate, or lower the family exemption. That is the only way I know. There is no 100-percent safe way to protect America from a future Congress. So we do the best we can, and I think that will be very useful.

Plus, the fact that you have got a single rate for the entire population, you can't hit one segment of the population this year and survive the reelection and come back and hit another section next year. You are going to have to hit everybody at the same time. I think people are going to be reluctant to do that.

The way I deal with the existence of the IRS is as I said before. I think we need to understand that as long as there is a government, a government will have to raise revenue, and no matter how they levy taxes, there is going to have to be an enforcement agency. Quite frankly, if somebody said to me, You take my plan and I promise you there will be no Federal tax enforcement agency, I would consider this to be a rather doubtful thing that would fall under the category, I'm from the government, I'm here to help you.

The realistic thing is, understand there will be an enforcement agency, so write a civil code. I get an awful lot of cards and letters from people who work in the IRS who say keep on with your flat tax, you guys have given us a Tax Code that you can't understand, we can't understand, and the taxpayers can't understand, and now you have said go out and enforce it.

People say IRS people are cranky. Every time I am given a job that is impossible, I get cranky in trying to do it, and they are saying we would like to be civil and we would like to get along with folks and we would like not to get up every morning with a headache trying to figure out this Tax Code you guys have written, so give us a simple Tax Code and we will be civil in the enforcement of it.

I believe that. I believe that the flat tax bets on the goodness of the American people, not the guile of the Federal Government.

Mr. LAUGHLIN. It is your viewpoint, then, under your flat tax proposal that you would operate with a substantially smaller IRS?

Mr. ARMEY. It would be much smaller. It would be much more civil.

It is my belief that a flat tax will give you a smaller and more civil enforcement agency than what you can get with a national sales tax.

I understand the attractiveness of the national sales tax, and I think it is a great idea compared to the existing Tax Code, but I think just about every objective you would try to achieve with a national sales tax can be more fully achieved with a flat tax.

Mr. LAUGHLIN. Is it your viewpoint that under your proposal, with a smaller and more civil Internal Revenue Service, the American citizens, when they deal with the IRS, would feel that the IRS starts the whole proceeding as if the individual American citizen is already guilty. How do you change that mentality?

Mr. ARMEY. I think you can change that mentality, but I think you could do that better with something like a taxpayer's bill of rights that we will try to bring forward even this year, which we can do.

Mr. LAUGHLIN. Thank you, Mr. Leader.

Mr. ARMEY. Thank you.

Mr. SHAW. Mr. McNulty.

Mr. McNULTY. No questions.

Mr. SHAW. I just have a few, and Mr. Gephardt is supposed to be here, I believe, at any moment.

I have just one question. I noticed in reply to one of the earlier questioners, you mentioned that inventory would be written off when it is purchased, which I assume means that you put your merchant strictly on a cash basis and not on an accrual basis.

What do you do about depreciation of plant and equipment?

Mr. ARMEY. Obviously, we would have to have a transition period for existing depreciation schedules, but any new plant and equipment that would be purchased after the flat tax, you would have an immediate expensing of that.

If, in fact, you had an expensing that was great enough to give you a loss for the year, you would have a carryover. So you would be maintaining no depreciation and no inventory records.

Mr. SHAW. Do you think, though, that corporations should probably have two sets of books, one to account to their stockholders and the other to account to the Federal Government? You should set up some sort of depreciation. Quite frankly, just as I think the Federal Government should do, we are on the cash basis right now, and we should go to some type of budgeting where we depreciate buildings rather than just write them off immediately.

We are making a lot of bad business decisions as a Federal Government in renting these buildings—when we should be actually owning these buildings—because of the way that our budget process operates. It is capital budgeting that I think we ought to be going toward.

So I would anticipate that you would account to stockholders differently than you would account to the Federal Government.

Mr. ARMEY. My own view is that in a flat tax world, if I were running a corporation, I would keep my books in such a manner as to make my best decisionmaking information available to myself and for reporting to my stockholders.

My accounting department would be spending most of their time providing me with the information I need along the lines of mana-

gerial accounting and cost accounting, and they would be more productive contributors to the efficiency of my operation with the information analysis they could give me.

From that, which I desire to maintain my own records for my own purpose, I could easily garner any information I need to substantiate my tax filings.

Mr. SHAW. Would there be anything that would be detected? Somebody asked me just a few hours ago about how one would treat alimony where the wife now declares it. It used to be just the wife, but now the recipient of the alimony declares that as income, and the donor of the alimony takes that as a deduction. Would you change that, or have you thought that through?

Mr. ARMEY. It would be taxable to one or the other. I am not quite sure how we ought to tax it. Do you have any suggestions?

Mr. SHAW. I think there will be some. If we do get into a flat tax, I am sure there will be a lot of things such as that, which this Committee will have to look into, in depth, and make some decisions on.

Mr. ARMEY. I would hope that the question would not be something that I would have to deal with intimately at any time in my lifetime, but we will try to look after it. It would definitely be taxable income to either the payer or the payee.

Mr. SHAW. Dick, as always, it is a pleasure to have you before our Committee, and thank you for a very thoughtful testimony.

Mr. ARMEY. Thank you.

Mr. SHAW. We are ready now for Mr. Gephardt, the distinguished gentleman from Missouri, who is the Minority Leader in the U.S. House of Representatives.

Richard Gephardt, we have your prepared statement, which we have made a part of the record, and you may proceed as you see fit.

Welcome back, by the way, as a former Member of the Ways and Means Committee.

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. GEPHARDT. Thank you, Mr. Chairman. You are very kind to have me here. I always appreciate the opportunity to come back to my Committee and have looked forward to entering into this debate on elemental tax reform which I think is very important for our country.

I will have a written statement that I will send over to the Committee. It wasn't quite prepared and enough copies, but we will have it here for your perusal. I will just talk for a few minutes off the top of my head about this, and then, if we could have any questions you would have, I would be happy to try to respond.

Let me first say that I think it is important to know that there is a good deal of agreement on a bipartisan basis about the need for tax reform. I agree with Dick Armeey and Steve Forbes and Jack Kemp and lots of other people who have talked about the need for fundamental tax reform. I think the Code is too complicated. I think we have tried to engineer the economy too much from Washington. I think it is time that we had elemental tax reform, and I have felt that for a long time.

I guess where we all begin to differ is on exactly how to accomplish this tax reform, and the plan that we have put together is one that does get to a lower tax rate for all Americans. It does get rid of all of the deductions except for the home mortgage interest deduction, and it gets to a 10-percent rate for 75 percent of America's taxpayers, something that I think is very important in order to make the Code as simple and as fair for as many people as possible.

I do maintain four rates in addition to the 10-percent rate because, as you might expect, I believe in a progressive Tax Code. Since it has been progressive since 1912, I think it ought to remain that, and our rate system winds up with a top rate of 34 percent. We have a rate of 20, 26, 32, and then 34 percent. The 34-percent rate applies to dollars above \$265,000 a year, which is a high amount, but, indeed, it would apply to those amounts.

The final thing I would say is that I think it is important as you review these proposals that we try to put all of the proposals on a level playingfield. That is, we can argue at a different time about how much money the government should take. That, to me, is really a different set of ideas, but we ought to make sure that all of these proposals do not increase the deficit.

I know we have complaints and disagreements over how to judge all of that, but just as we have pretty well put behind us for the budget a discussion whether it should be CBO or not, I think we have all agreed CBO should be the judge. I think we ought to decide at the outset that CBO or OMB or the Joint Tax Committee or somebody is going to make this decision about how much money these proposals bring in, and then judge all of them by that standard.

I think if that is done, the flat tax proposals at 17 percent will have to be adjusted.

I know that Mr. Armev adjusted his proposal. I just think we need to be on a level playingfield as we look at all of these proposals.

Finally, let me say that whether we get to this, this year or next year, I hope that we will seriously go about this. It is very hard to get tax reform done.

Some of you on the Committee did this in 1986. You will remember the difficulties we had. It is hard to do, but I think it can be done.

I do think we have got to try to reach some agreement on some common goals, like whether it will bring in as much revenue as we do today or not or whatever that number should be. I think we should try to agree on whether or not we want progressivity in the Code or not. That is an important issue. I think we have got to come to some agreement on investment income as opposed to so-called earned income. That may be an unfair term, but investment income versus income earned as a salary.

We have got to decide, obviously, if we want to take most of the deductions out. I get a little alarmed by some who say they are for tax reform and then they say they are for keeping this deduction and that deduction and the other deduction. Before long, you are back to the present code, and tax reform is really not, in my view, about trying to put everything back in, but it is about how much

we can get out of the Code in terms of deductions and exemptions, so that we can get to a real discussion of what this should look like.

I am very, very much for the idea that we can get a great majority of taxpayers on a 10-percent rate. I think that is an important goal to try to hit. It would mean to most Americans that if they did their withholding right, they would not even have to file a tax return, and I can't think of a better thing to say to people that the Federal Government needs 10 percent of your income, your gross income, and we will get out of your life. If we could reach for that, I think that would be a great goal to hit, and I urge you to take a strong look at that.

With that, Mr. Chairman, I am happy to be here and would be happy to try to respond to any questions.

[Mr. Gephardt's statement was not available at the time of printing.]

Mr. SHAW. Thank you, Mr. Gephardt.

Mr. Houghton.

Mr. HOUGHTON. Yes.

Mr. Gephardt, there has been quite a bit of talk about the reactions to a tax system and the impact on growth, the implication being that the only way we will get sufficient income into the Federal coffers to take care of our expenses is to count on a much higher growth rate.

How do you feel about that, either in regards to the Armeys flat tax or to your own tax?

Mr. GEPHARDT. I think that while tax reform could have a positive impact on growth, I don't feel we should overstate the effect.

I think there are a lot of other issues that are probably more important to that issue than simply tax reform, and I think many people overstate its impact.

I think there are a lot of gains here in terms of people's faith and confidence in the government and their feeling about the country and their future.

I do think that we have gotten too sophisticated in trying to direct investment or direct activity in a particular way through what we do in the Tax Code. I think we wind up overcomplicating life and overdoing incentives to the detriment of other things that should be done.

I think the more we could leave investors on a level playingfield, workers on a level playingfield, and let them make their own decisions about things, the better off we will be.

I happen to believe that education and infrastructure and trade and scientific research and research and development are probably more important issues in the long haul to our long-term economic growth than simply fooling with the Tax Code.

Mr. HOUGHTON. Mr. Gephardt, how would you encourage increased scientific and technical activity? How would you increase, through this particular approach on taxation, productivity? Those are the critical issues that are going to determine whether we can grow and whether we can compete in the outside world.

Mr. GEPHARDT. In my plan, I don't affect the corporate side. I do try to take away some of what is known as corporate welfare and try to lower the rate with the use of that money for small corporations because I think we have got to encourage people to start their

own businesses in the world that we are in today, but I don't change the depreciation schedules, and I don't change the R&D credit for corporations. I leave all of that in place, and I think that is probably the best way to handle it.

Mr. HOUGHTON. Thank you very much, Mr. Chairman.

Mr. SHAW. Mr. Rangel may inquire.

Mr. RANGEL. Mr. Leader, let me thank you for attempting to bring something before us that simplifies the Code, which every American would want to do, but really doesn't pull up at the roots the existing system without having the slightest idea as to what impact it is going to have on the economy.

I think that, perhaps, in the next session, we will have much more time to discuss and work out something that is workable rather than merely having a vehicle for political comments.

I want to thank you very much for your contribution.

Mr. GEPHARDT. Thank you, sir.

Mr. SHAW. Mr. Laughlin.

Mr. LAUGHLIN. Mr. Gephardt, I wasn't here when you testified. So I apologize. I didn't hear what your approach is, but let me just share this with you. As I listened to the constituents that I represent in the 14th district, they have two very basic concerns that probably are shared by Americans nationwide.

One is the system is so complicated. They say it is unfair to them whether they are in the agricultural industry or small business or even big business. They want a more simplified system which would translate to being fair to them.

The second part that I hear a great concern about is the intrusiveness and the abusive nature of the Internal Revenue Service.

How does your proposal address those two concerns?

Mr. GEPHARDT. In my proposal, which is, again, a 10-percent proposal, I try to get to a 10-percent rate for 75 percent of the people. I do maintain progressivity. I have five rates. I throw out all of the deductions and exemptions, except for the home mortgage interest, and am able, therefore, to get rates down for everybody, but probably more for the so-called middle class than the rest.

I think that is where we ought to go. Again, if people withhold correctly, a lot of that 75 percent at a 10-percent rate could do away with a return at all. They wouldn't need a return at all, and that, to me, would really build confidence.

I think we add insult to injury with what we put people through in paying their taxes. It is enough to take the revenue we take away from them to run the government, but then when you put them through the torture of trying to file one of these returns, we really add insult to injury, and I am trying to figure out a way to get most people out of that bind, and I think my plan does that.

Other plans would undoubtedly do that as well. I think you are looking for simplicity and fairness, and we ought to go for the plan that gives us the most of both.

Mr. LAUGHLIN. We have constantly heard that savings by Americans is embarrassingly low. What is it about your plan that would stimulate or motivate us to save more to be available for capital investment?

Mr. GEPHARDT. I think if you put people on a level playingfield, and I try to do that—I don't discriminate between investment in-

come and salary income—I think people will make their own judgment about where to invest and how much to save.

Again, if you could get ordinary Americans, people under \$65,000 a year at a 10-percent rate, I think they would feel like they, maybe, had a few more dollars of the income to put into savings. We do lower rates and lower taxes under my plan by some amount for most of those people under, say, \$65,000 a year.

Mr. LAUGHLIN. In the first part of my first question, I asked you about the Internal Revenue Service and their impact.

Mr. GEPHARDT. Right.

Mr. LAUGHLIN. As I appreciate what you have told us, we will still, under your plan, retain the Internal Revenue Service as we know it.

Mr. GEPHARDT. I don't know of any plan that would do away with it. I think you would have to have a lot less of it because there would be a lot less trouble for the IRS in reviewing and auditing returns because the return would be vastly simplified.

Mr. LAUGHLIN. Thank you very much.

Mr. GEPHARDT. Thank you.

Mr. SHAW. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

I wanted to ask you how would your proposal address the issue of the life insurance industry, and how would your bumpy flat tax address the proposed inside buildup and the tax ramifications of life insurance?

Mr. GEPHARDT. We don't affect that.

Mr. CHRISTENSEN. You don't affect it?

Mr. GEPHARDT. No.

Mr. CHRISTENSEN. That is all I have.

Mr. GEPHARDT. Thank you.

Mr. SHAW. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. I am sorry I couldn't have been here earlier. All of our schedules are so crazy.

I did have one question I wanted to ask. I hope it hasn't already come up, and that has to do with the mortgage interest deduction. I note you kept it in your plan, at least the previous versions that I had seen, and I wondered if you could give us an explanation why you think that is important to keep, given the fact that it will result in rates being higher at probably all the levels.

Mr. GEPHARDT. Right. That is a real good question, and I think I wrestled longer and harder over that than anything I had to decide in putting the plan together.

I came to the conclusion that we needed to keep it for a couple of reasons. First, I really believe that owning a piece of property is part of the American dream. I think people are more responsible when they own a piece of the rock, to be corny about it, and I think that that one incentive is very, very important, and focusing people on trying to buy a piece of property rather than renting.

Second, I became concerned about a number of studies that had been published that indicate if we took the deduction away, that the value of all real property in the United States would diminish rather quickly and for a long period of time.

I don't know whether those studies are right, but that worried me that we would take an action here that would diminish the value of what to most families is their most important asset.

Third, I believe that the home building industry and all that goes in a home is probably the most important part of our economy, and I got concerned that if we, again, diminished that activity in any substantial way that it would really diminish our economy.

Now that it has been in the Code for the period of time that it has been in the Code, it is a powerful incentive, as you know. It really is the deciding factor for a lot of people on whether to buy or rent, and I just got worried about what that would do to our economy.

This is an issue on which reasonable minds can come to different conclusions. There is a very good argument you could make that this ought to be simple and elegant. We should not allow anything.

I wrestled over whether or not to allow the exemption of health care premiums, and I didn't; whether to allow the exception for pension payments, and I didn't. You can make a lot of the arguments I have made here about that. This is not an easy question and one that this Committee will wrestle with and all of us will wrestle with when we get down to trying to do this.

Mr. CHRISTENSEN. Would the gentleman yield?

Mr. PORTMAN. Absolutely.

Mr. CHRISTENSEN. Congressman Gephardt, this morning, we heard testimony that Canada has no home mortgage interest deduction, but, yet, they have 63 percent home ownership in their country. Australia has no such interest deduction, and they have home ownership at 62 percent. We are at 64 percent. Do you really believe that the home interest deduction, if taken away, would stall home ownership and the first-time home buyer?

Mr. GEPHARDT. I don't know the answer. I don't think any of us know the answer, but I worry about it. I worry about its impact on property values over the near term, and I worry about whether people—especially in our economy where we have had trouble with savings, this is one area where we have been able to get ordinary people to really save. I just worry about its impact. I don't know that I am right.

Mr. CHRISTENSEN. I yield back.

Mr. SHAW. Mr. Gephardt, in questioning Dick Armeey a few minutes ago on the deductibility of business expenses, he said that inventory, even buildings, plant investment, all of these deductions, would be taken at the time of the expenditure. Do you address that in your plan?

Mr. GEPHARDT. I don't change, again, on the corporate side anything but trying to close up a few loopholes to lower the tax rate of small corporations, even further than it already has been. I don't change depreciation schedules.

I must tell you that I have for a long time felt that we needed to quicken depreciation schedules, and I would love to figure out how we could get immediate expensing. I think it is a powerful incentive for investment in plant and equipment, and in today's competitive world, one of the things we desperately need is the most up-to-date technology and equipment in our plants and our businesses.

I also think the life of equipment has shortened, even in some cases below the schedules we got. So moving in that direction is a good idea.

Mr. SHAW. How about the 10-percent surcharge on alternative minimum taxes? Do you eliminate that and just go for the straight percentage?

Mr. GEPHARDT. We maintain the alternative minimum tax, and we don't have the surtax, as I remember. I may be wrong on that.

We keep the same progressivity that you have today. We just built it into the way we structured the rates.

Mr. SHAW. How would you handle something as a traveling salesman, for instance, the deduction of his lodging, the deduction of his automobile?

Mr. GEPHARDT. That is all capped, the cost of doing business.

Mr. SHAW. All of those are retained.

Mr. Johnson, do you have any questions?

Mr. JOHNSON. No.

Mr. SHAW. Mr. Gephardt, we have a few minutes before our next panel testifies. Do you have anything else you would like to bring up?

Mr. GEPHARDT. I can tap dance.

Mr. SHAW. We will take a pass on that one.

Mr. GEPHARDT. You are smart.

Mr. SHAW. I am afraid we all tap dance too much here.

Mr. GEPHARDT. I appreciate being here. I wish you well in this effort. I am glad your doing this seriously. I think this is a very important subject for our country, and I look forward to working with you.

I said I debated Jack Kemp on this at the American Enterprise Institute a few weeks ago, and one of the things I said there, and I really believe it, is that if this is to happen, Republicans and Democrats, liberals, moderates, and conservatives have got to come together at least on the goal of getting fundamental tax reform.

If we can come together on that, then I think it is possible to get to a bipartisan plan that can pass.

Mr. SHAW. Interestingly enough, I think the word "reform" is probably the buzz word of the 1996 election cycle. Everybody is for reform, but everybody has got a different definition of what reform is.

I agree with you. I agree with Mr. Arney and many of the other people that have appeared before us this morning or are about to appear. Our present Tax Code is absolutely ridiculous. It is far too complicated. The American people should not have to, in most instances, get professional help to figure out what they owe in taxes, and it is a terrible imposition on the American people.

You are so right in saying we do need reform. Now we have to figure out what reform is.

Mr. GEPHARDT. Right. The devils and the details.

Mr. SHAW. You got it.

Mr. GEPHARDT. Thank you.

Mr. SHAW. Thank you, Mr. Gephardt.

The Committee will now stand in recess for approximately 15 minutes or until the next panel arrives.

[Recess.]

Mr. SHAW. The witnesses are now here, and it is our pleasure to welcome Dan Schaefer of Colorado, Billy Tauzin of Louisiana, and Dick Chrysler of Michigan.

We will incorporate any written statement that you may have or may submit to the record, and please feel free to proceed as you see fit.

Mr. Schaefer.

STATEMENT OF HON. DAN SCHAEFER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. SCHAEFER. Thank you, Mr. Chairman and Members of the Committee, for inviting us to testify on what we think is one of the most ambitious plans on reforming our tax system that has ever been presented. We commend the Committee for delving into real comprehensive tax reform testimony.

Since we have a limited amount of time, I will outline the details of the Schaefer-Tauzin-Chrysler national retail sales tax, and my colleagues will address the important benefits of implementing a sales tax and the critical need to replace the current system of income tax.

Our legislation, H.R. 3039, completely replaces the current tax system with a national retail sales tax on the gross payments for the use, consumption, or enjoyment in the United States of any retail good or service. A number of strongly held principles guided our drafting of this bill.

My testimony today will highlight the most important of these principles. I would like to submit additional materials for the record that go into much more detail about the mechanics of our bill, including a forthcoming Cato paper written by David Burton.

The first principle of our bill is that the income tax should be "pulled out by the roots," to use the words of the Chairman.

The Schaefer-Tauzin-Chrysler legislation repeals the Federal, personal, and corporate income taxes, the estate taxes and gift taxes, and all nontrust fund excise taxes. The IRS is deauthorized after the 1999 tax year.

The States, who have 60 years of experience in collecting and enforcing the sales tax and already have all the necessary mechanisms in place, would largely administer the national retail sales tax. States choosing to administer the Federal sales tax would be permitted to keep 1 percent of the Federal tax collection to cover their costs. This amounts to an \$8.5 billion payment to the States, roughly what the IRS costs to run today.

Texas, for example, would receive an estimated \$300 million a year for the collection of the national sales tax.

The second principle is that no income, regardless of its source, should be taxed until it is consumed. The national retail tax ends the multiple taxation of economically productive savings and investment by imposing a single 15-percent consumption tax on the final retail sale of all goods and services.

Regardless of whether income is derived from wages, dividends, capital gains, or any other source, it is not taxed or withheld until it is used to consume a retail good or service. All income is ultimately taxed, but only one time.

The third principle of the bill is that the tax base should be as broad as possible. We believe that it is unwise to exempt any class of goods or services such as food from the sales tax in the pursuit of fairness.

First, we must recognize that Americans pay income tax on the purchase of the food. It is a hidden tax today since all consumer purchases are made in aftertax dollars.

Second, exempting broad classes of goods or services will only shrink the tax base and raise the sales tax rate, ironically, making the tax even more regressive.

Mr. Chairman, my light is on, and I would just ask that the remainder of this statement be put in the record, as well as other materials that I have, and I would now turn it over to Mr. Tauzin.

[The prepared statement and attachments follow:]

Testimony of
Representative Dan Schaefer (R-CO)

before the

House Ways and Means Committee

Hearing on the Replacing the Federal Income Tax

March 27, 1996

Mr. Chairman, thank you for inviting us to testify about the need to replace the current federal income tax.

We commend you for holding this series of hearings. The issue of comprehensive tax reform will dominate this nation's agenda in the coming years. You have shown great foresight in leading the debate.

Since we have a limited amount of time for verbal testimony, we thought we would split up our testimony among the three primary sponsors of our legislation. I will first outline the details of the Schaefer-Tauzin-Chrysler National Retail Sales Tax Act. My colleagues will then address the important virtues of implementing a sales tax and the critical need to replace the income tax.

Our legislation, H.R. 3039, completely replaces the current income tax system with a National Retail Sales Tax on the gross payments for the use, consumption or enjoyment in the United States of any retail good or service. Our bill is based on a number of strongly held principles that guided its drafting. My testimony today will highlight the most important of these principles and explain how our bill meets them. I have submitted additional materials for the record that goes into much greater detail about the mechanics of our bill.

The first principle of our bill is that the income tax should be pulled out by its roots, to use your words, Mr. Chairman.

The Schaefer-Tauzin-Chrysler legislation repeals the federal personal and corporate income taxes, the estate and gift taxes and all non-trust fund excise taxes. For individuals, this means no more hidden income tax withholding or complicated tax forms to file every year. For businesses, this means no more burdensome Alternative Minimum Tax, multiple depreciation schedules, international tax rules or deferred compensation rules. According to the Tax Foundation, switching to a National Retail Sales Tax would eliminate 95 percent of the \$150 billion this country spends each year on tax compliance.

The IRS is de-authorized after the 1999 tax year. The Social Security payroll tax will continue to be collected as it is today, but by the Social Security Administration.

The states, who have 60 years of experience in collecting and enforcing a sales tax and already have all the necessary mechanisms in place, would largely administer the National Retail Sales Tax. This is not an unfunded mandate. States have a choice of collecting the federal tax or not. States choosing not to administer the federal tax could contract with a third state or allow the Secretary of Treasury to collect it. Administering states would be permitted to keep one percent of the federal tax collections to cover their costs. This amounts to a \$8.5 billion payment to the states -- roughly what the IRS costs to run today. Texas, for instance, would receive an estimated \$300 million a year for collecting the national sales tax.

The second principle is that no income -- regardless of its source -- should be taxed until it is consumed.

The National Retail Sales Tax ends the multiple taxation of economically productive savings and investment by imposing a single 15 percent consumption tax on the final retail sale of all goods or services. Regardless of whether income is derived from wages, dividends, capital gains or any other source, it is not taxed or withheld until it is used to consume a retail good or service. For example, the purchase of stock would not be taxed, but the brokerage fee would be, since it represents a service. Likewise, the proceeds from the sale of a stock would not be taxed as long as that money stayed invested in the economy. On the other hand, if those proceeds were consumed for personal enjoyment, they would be taxed.

The third principle of our bill is that the tax base should be as broad as possible.

We believe it is unwise to exempt any class of goods or services, such as food, from the sales tax in the pursuit of fairness. First, we must recognize that we pay income taxes on the purchase of food today, since all consumer purchases are made in after-tax dollars. Second, exempting broad classes of goods or services will only shrink the tax base and raise the sales tax rate -- ironically making the tax even more regressive.

The proper way to address fairness is to ensure that the basic necessities of all Americans remain untaxed. Our legislation accomplishes this by providing an automatic "Personal Consumption Refund" in the paycheck of every wage-earner each pay period. This refund, provided as a credit against the payroll tax, returns to taxpayers the sales tax they have paid on the basic necessities of life, calculated as consumption up to the poverty rate, adjusted for family size. The same mechanism can be applied to those receiving government benefits.

I have attached to my written testimony a chart showing the effective tax rate of the National Retail Sales Tax on different income categories and an estimate of how much each families' take home pay will increase after withholding is eliminated and the Personal Consumption Refund is made.

As a fourth principle, we believe that no taxes should be hidden from consumers.

We believe that, as a matter of economic reality, businesses do not pay taxes. Corporations cannot pay taxes because corporations do not exist, except on paper. Income taxes and compliance burdens are simply costs of doing business that must be passed along to consumers, hidden in the prices of every final good or service.

Our legislation eliminates these hidden taxes by eliminating the corporate income tax. To prevent sales taxes paid by businesses from being hidden in prices -- known as "cascading" -- sales at each intermediate stage of production are exempt (thereby avoiding the attributes of a value added tax [VAT]). In other words, any good or service that is purchased for resale, or for the production of another good or service for resale, is exempt.

In addition, we avoid hiding the compliance costs of retailers in the final prices of their goods or service by permitting them to keep one-half of one percent of the sales tax they receive to cover their administrative costs. This credit would provide nearly \$4 billion to the retail industry to offset their tax compliance costs. We also provide a 50 percent credit to retailers for the costs of any new equipment such as cash registers needed to charge the federal sales tax.

In summary, no one at this table will say our bill is perfect as it stands today. We have, however, provided an initial answer for every problem we could foresee. We believe that our National Retail Sales Tax plan has all the advantages of any other plan on the table today. At the same time, it has fewer disadvantages than any other plan -- and what disadvantages exist are easier to deal with.

Again, thank you for this opportunity to testify.

THE WALL STREET JOURNAL MONDAY, MARCH 11, 1986

THE WALL STREET JOURNAL

The Case for a National Sales Tax

By DAN SCHAFER

Despite the exploding number of comprehensive tax reform plans now on the table (19 at last count), a clear bipartisan consensus is emerging about the current tax system's fundamental weaknesses. Every major reform plan to date uses consumption, rather than income, as its tax base, ending the economically ruinous bias in the current code against savings and investment. The flat tax, for instance, applies only to income that has been taxed or invested. Likewise, the Unlimited Savings Account (USA) tax is a "consumption/income" tax. Even Vice President Al Gore has mused about the need to replace the income tax with a consumption-based tax.

Round Hole, Square Peg

Policymakers and economists increasingly seem to acknowledge that moving to a consumption-based tax will, in the long run, raise our productivity savings rate, lower inflation rates, increase economic growth and boost the standard of living for all Americans.

Each of these plans, while no doubt better than today's system, suffers from the same fundamental weakness. In vain, each attempts to hammer a square peg (the income tax) into a round hole (a consumption-based tax). The result is that as income must still be defined, deductions must still be sought and a taxpayer's every financial move must still be reported to the Internal Revenue Service, the promise of a consumption-based tax will never be fully realized.

Rather than simply simulating a consumption-based tax, why not replace it with a pure consumption tax that is simpler, fairer and fairer? Last week, Rep. Billy Tauzin (R., La.) and I unveiled the first detailed proposal to eliminate the income tax in its entirety and replace it with a National Retail Sales Tax. Our plan is modeled on the state sales taxes that most Americans and business are already familiar with. It is a point-of-sale levy on the final retail sale of every good or service. It can be collected by the

states using the same mechanisms they have in place today. Under our bill, both states and retail businesses will be able to simply opt out of the plan if they prefer to fully offset administrative costs.

The National Retail Sales Tax reverses the relationship between taxpayers and the government. Taxpayers—not the IRS—get the first crack at their paychecks. With no income tax withholding, workers have more money in their pockets. The government gets its cut only when the taxpayer chooses to consume.

No matter how we structure an income tax system or by what name we call it, the economic reality is that all income taxes are hidden consumption taxes in the end.

Our plan meets each of the six principles laid out by the Kemp Commission on Economic Growth and Tax Reform at least as well as, if not better than, the flat tax or any other reform proposal.

Every dollar paid in personal income tax, for instance, is one less after-tax dollar that can be consumed. Because of income tax withholding, however, that fact is hidden from consumers.

What is more, the hidden tax burden caused by the price of every consumer good or service, businesses do not pay taxes—they collect them from consumers. Corporate taxes and compliance expenses are simply costs of doing business that must be passed on to consumers in the form of higher prices. Only the final consumer, who ultimately pays all personal and corporate taxes and compliance burdens.

The National Retail Sales Tax expends these hidden consumer taxes, making the true burden of the federal government plain for all to see in a single, flat, 15% rate with no exemptions.

Our plan meets each of the six principles laid out by the Kemp Commission on Economic Growth and Tax Reform at least

as well as, if not better than, the flat tax or any other reform proposal. The Kemp Commission's plan for a flat tax must meet the following tests:

- Economic Growth. The National Retail Sales Tax eliminates every disincentive to hard work, saving and investment that exists in the current income tax code. Economists estimate that replacing the IRS with the National Retail Sales Tax will lower interest rates and increase family income. In addition, reduced compliance costs from a simplified tax system will allow the estimated \$30 billion we spend annually on compliance costs—an amount equal to a full year's economic growth—to be put to productive use.

- Simplicity. On a simplified basis, the National Retail Sales Tax is the 62% of individual taxpayers who have no income tax liability, file the 1040 EZ form or do not itemize, the greatest promise of a flat tax—simplicity—has already been realized. Under the National Retail Sales Tax there would be absolutely no compliance burden for any individual and net zero compliance costs for retail businesses (after they take their credit for record-keeping expenses).

• Stability. As our experience with the 1986 Tax Reform Act has proved, the notion that we can have a flat income tax over a long period is a pipe dream. Since the 1986 tax reform—which started as a flat tax—the federal income tax code has been amended by 40 different acts of Congress. As long as the income tax exists in any form, it can and will grow back.

The National Retail Sales Tax "leaves the income tax out by its roots," to use House Ways and Means Committee Chairman Dan Rostenkowski's words. It is a simple, wide income-reporting apparatus and an IRS, it would be very hard to recreate the complex mess that our tax code is today.

The consensus that the income tax should be replaced with a consumption-based tax system continues to grow. Once that decision has been made, the only relevant question becomes what is the most efficient, simplest and fairest way to do it. The National Retail Sales Tax wins, hands down.

Mr. Schaffer is a Republican congressman from Colorado.

Rocky Mountain News

March 18, 1996
27A

SPEAKOUT

Income tax has plagued us long enough

By Rep. Dan Schaefer

This coming April 15 could be the last time you ever face a tax deadline or a 1040 income tax form — if legislation I recently introduced is enacted by Congress.

America has suffered under the inequities and mind-boggling complexity of the income tax system for more than 80 years. Enough is enough. We need a new tax system that does not penalize hard work or double-tax savings and investment, does not need 480 different tax forms and 8,000 pages of IRS code and regulations to explain it, and does not allow special tax breaks for the rich or loopholes for corporations.

In short, America needs a national retail sales tax to completely replace the current income tax system. I have introduced legislation to do just that.

My plan would eliminate the current personal and corporate income tax, income tax withholding, estate and gift taxes, and most excise taxes. As a result, every taxpayer's take-home pay would increase by the amount in income tax that is currently being withheld from his paycheck.

In place of the income tax, the national retail sales tax imposes a levy modeled on the state sales tax with which every Colorado taxpayer and business is already familiar. It is a point-of-sale levy on the retail sale of every good or service. It can be collected by the state using the same mechanisms in place today. Under our bill, both states and retail businesses will be able to keep a percentage of the taxes they receive to offset administrative costs.

To protect the working poor, the income of every wage-earner up to the poverty level will be tax-free through a personal consumption rebate, ensuring that the basic

necessities of life remain untaxed.

The powerful appeal of the national retail sales tax lies in the fact that it reverses the relationship between taxpayers and the government. Taxpayers — not the IRS — get first crack at their paychecks. With no income tax withholding, workers take home every penny they earn that formerly went to pay the income tax. The government only gets its cut when the taxpayer chooses to consume.

The fact is that every consumer already is paying taxes on every good or service he consumes today. Under the current system, however, those taxes, and the true

The national retail sales tax would expose those hidden consumer taxes, making the true burden of the federal government plain for all to see . . .

burden of the government, is hidden. No matter how we structure an income tax system, or by what name we call it, the economic reality is that all income taxes are hidden consumption taxes in the end. Every dollar paid in personal income tax, for instance, is one less after-tax dollar that can be consumed. Because of income tax withholding, however, that fact is hidden from consumers.

Even more covert is the hidden tax burden carried in the price of every consumer good or service. Businesses do not pay income taxes — they can only collect them from consumers. Corporate taxes and compliance expenses are simply costs of doing business that

must be passed on to consumers in the form of higher prices.

The national retail sales tax would expose those hidden consumer taxes, making the true burden of the federal government plain for all to see in a single, flat 15% rate with no exemptions. We would eliminate two hidden consumption taxes and replace them with a single, visible tax. Taxing our consumption once is enough!

Moving away from an income tax and to a consumption-based tax, the national retail sales tax, would increase our paltry savings rate, lower interest rates and boost economic growth. It would ultimately increase the typical middle-class family's income between \$4,000 to \$6,000 annually, according to Harvard University economist Dale Jorgenson. As a result, most Americans would actually have more to both consume and save.

The national retail sales tax would also finally create a level playing field for American-made products around the world. Every exported good that leaves our shores carries with it the high burden of U.S. taxes and compliance costs hidden in its price. Because the national retail sales tax only applies to imports, not exports, our goods will finally be able to compete fairly in the world market, creating jobs here in the U.S.

As long as we retain an income tax system — flat or otherwise — we can never truly eliminate the potential for the income tax to grow back into the monstrosity it is today. As House Ways and Means Committee Chairman Bill Archer has said, we must "tear the income tax out by its roots." It is time to replace the income tax with a national retail sales tax.

Dan Schaefer represents Colorado's 6th Congressional District in the U.S. House of Representatives.

Take-Home Pay and Effective Tax Rates Under the National Retail Sales Tax

Take a look at your paycheck. How much does the government take each month in income taxes? Without an income tax, you would get all of that in your pocket every month. Plus, under the National Retail Sales Tax (NRST), wage earners would get a "Personal Consumption Refund" automatically in each paycheck, designed to rebate the sales tax they have paid on the basic necessities of life.

To see an estimate of how much your take-home pay could increase under the National Retail Sales Tax, find your income level and the size of your family on the following chart. The effective sales tax rate for each family is also shown.

		Annual Family Income											
		\$2,000	16,000	20,000	24,000	28,000	32,000	36,000	40,000	48,000	52,000	56,000	60,000
F 2	Take-Home Pay Increase (%)	17.2	17.7	18.0	18.2	18.4	18.5	18.6	18.7	18.7	18.8	18.8	18.9
A	Effective NRST Rate (%)	0	3.6	5.9	7.4	8.5	9.3	9.9	10.4	10.8	11.2	11.5	11.7
M													
I 3	Take-Home Pay Increase (%)	17.4	17.8	18.1	18.3	18.4	18.6	18.6	18.7	18.8	18.8	18.9	18.9
L	Effective NRST Rate (%)	0	0.7	3.5	5.5	6.8	7.8	8.6	9.3	9.8	10.2	10.6	10.9
Y													
4	Take-Home Pay Increase (%)	17.6	18.0	18.2	18.4	18.5	18.6	18.7	18.8	18.8	18.9	18.9	19.0
S	Effective NRST Rate (%)	0	0	1.2	3.5	5.2	6.4	7.4	8.1	8.7	9.3	9.7	10.1
I 5	Take-Home Pay Increase (%)	17.8	18.1	18.3	18.5	18.6	18.7	18.8	18.8	18.9	18.9	19.0	19.0
Z	Effective NRST Rate (%)	0	0	0	1.6	3.5	5.0	6.1	7.0	7.7	8.3	8.8	9.3
E													

The take-home pay increase estimate assumes: 1) The "married filing jointly" standard deduction is taken, with no itemized deductions; 2) Income tax withholding is calculated correctly, with no refund due or tax owed at the end of the year; and 3) no credits are claimed. Results will obviously differ in other situations. The effective NRST rate estimate assumes that all income is consumed. Savings or investment will lower effective rate.

THE NATIONAL SALES TAX: MOVING BEYOND THE IDEA¹

Discussion about alternative tax systems have centered around three major proposals: The Arney-Shelby flat tax, the Domenici-Nunn USA Tax (which combines a consumed income tax and a business transfer tax) and the national sales tax. Although much has been said about a national sales tax, to date critics and supporters alike have had to settle for a theoretical discussion of its merits and flaws.

On March 6, the national retail sales tax moved from an abstract idea to a concrete proposal with the introduction by Reps. Dan Schaefer (CO), Billy Tauzin (LA) and Dick Chrysler (MI) of H.R. 3039 (the STC plan). As the only national sales tax plan on the table, H.R. 3039 serves as the basis for analyzing how a national sales tax might actually function. In summary, the STC plan would impose a non-cascading, single 15 percent flat rate tax on the final purchase of goods and services at the retail level. Intermediate purchases would be exempt. The STC plan is similar in many respects to the sales and use taxes in place in 45 states and the District of Columbia. The individual and corporate income tax, the estate and gift tax and most non-trust-fund excise taxes would be repealed.

In this article, the authors briefly describe how the STC plan would work and present the rationale for replacing much of the current tax system with a national sales tax. The article discusses the sales tax base, the provision for low income families, mixed-use property, used property (including homes), non-profit organizations, government services, financial intermediation services and transition considerations.

H.R. 3039 provides a useful vehicle for the tax policy community and the American public to begin analyzing how a national sales tax could be structured. A national sales tax along the lines of the STC plan would, in the authors' judgment, have a salutary impact on the U.S. economy, the standard of living of the American public, the compliance costs borne by our economy and on the degree of intrusiveness of the tax system in our lives.

By David R. Burton and Dan R. Mastromarco*

Although much has been said about a national sales tax, to date critics and supporters alike have had to settle for a theoretical discussion of its merits and flaws. Replacing the Federal income tax with a national retail sales tax was merely an idea. On March 6, 1996, Reps. Dan Schaefer (CO), Billy Tauzin (LA) and Dick Chrysler (MI)

¹ Oliver Wendell Holmes once said that taxes are what we pay for a civilized society; he did not say there is a rule against seeking to collect them in the most civilized way.

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introduced H.R. 3039 (hereinafter the "Schaefer-Tauzin-Chrysler or STC plan"), which provides a detailed framework for how a national sales tax could actually be done.² Senator Richard Lugar (IN), who has been a long-time advocate of replacing the Federal income tax with a national sales tax, is likely to lead a parallel effort in the Senate. Ways and Means Committee Archer remains committed to "pulling the income tax out by its roots" and replacing it with a consumption tax.³ Although Chairman Archer has commended the authors of H.R. 3039⁴ and is widely viewed as sympathetic to a national sales tax, he remains officially uncommitted about which form of a consumption tax he will include in his plan (tentatively expected this fall).

The STC plan is the only national sales tax plan on the table provides a very useful vehicle for the tax policy community to begin analyzing how a national sales tax could best be structured. The STC plan is similar in many respects to sales and use taxes in place in 45 states and the District of Columbia.⁵ In summary, the STC plan would repeal the individual and corporate income tax, transfer taxes and most non-trust funds excise taxes and replace them with a single 15 percent flat rate tax on the purchase of final goods and services at the retail level. It would accomplish this result by exemptions for sales at each intermediate stage of production.

In order to achieve certain social objectives, the STC plan would also effectively exempt purchases by taxpayers below the poverty level. It would accomplish this by administering a sales tax rebate through the payroll tax system so that workers may consume up to the poverty level sales tax free. As a necessary consequence of the destination-based approach, the tax imposed by the STC plan is border-adjusted. Since a sales tax is indisputably an indirect tax, this border adjustment should pose no difficulty under the General Agreement for Tariffs and Trade. The sponsors expect that, in most instances, the national sales tax would be administered by the states.

This article will briefly discuss the rationale for replacing the current income tax with a national sales tax. In addition, the article will discuss the mechanics of the legislation. What will be the tax base? How will the tax be administered? How will the tax be enforced? The article also highlights how the STC proposal disposes of several problems commonly associated with alternative taxing schemes, and some problems peculiar to the sales tax. For example, how does the tax treat used property or "old capital" that was purchased with after-income tax earnings profits? How does the tax treat financial intermediation services? Government services? Not-for-profit organizations? Finally, this article discusses some of the standards of transitional equity

² Other original cosponsors included Reps. Bono (CA), Hefley (CO), Linder (GA) and Stump (AZ). Rep. Hall (TX) has since become a cosponsor.

³ See "Archer Outlines Ways and Means Agenda", Bureau of National Affairs, Daily Report for Executives, March 7, 1996, p. GQ-1.

⁴ See, e.g. "Schaefer, Tauzin Offer Retail Sales Tax; Ways and Means Chairman Salutes Sponsors", Bureau of National Affairs, Daily Report for Executives, March 8, 1996, p. G-5.

⁵ The states without general sales taxes are Alaska, Delaware, Montana, New Hampshire and Oregon.

that occur when a tax system based on income is replaced with one based on consumption, and some of the means by which the STC plan addresses the transitional problems.⁶

I. Why a National Sales Tax?

A national sales tax would promote higher rates of economic growth by dramatically reducing the tax bias against work, savings and investment. Moreover, economically inefficient distortions in the pattern of investments would decline as well. Although the magnitude of the impact on economic growth will undoubtedly generate much debate among economists, the large marginal tax rate reductions in the STC plan, combined with the complete elimination of savings and investment from the taxing net, will have powerful positive effects on the economy.⁷ In fact, it would be difficult to conceptualize a proposal that raises an equal amount of revenue as the current tax system, reduces adverse economic impact, and still exempts the working poor from tax.⁸

One of the immediate consequences of a national sales tax scheme is that interest rates would drop toward the current tax-free interest rate as the tax wedge between the pre-tax and after-tax rate of return is removed.⁹ The result would be to reduce Federal borrowing costs by more than \$100 billion annually.¹⁰ Industries and individuals that are sensitive to interest rates would also benefit. Moreover, as disincentives for savings and investment are removed, the supply of investment capital can be expected to increase further reducing interest rates. Finally, international capital is likely to flow to the U.S. Although the portfolio interest exception¹¹ and numerous treaties have reduced or eliminated the withholding on passive income on foreign investment, the complete removal of all taxation of non-consumed income would increase the attractiveness of the U.S. for foreign investors. Expatriated U.S. investment dollars can also be expected to find their way home. Indeed, given the proposed tax treatment and political stability of the U.S., the U.S. would become the ultimate global tax haven -- to the benefit of U.S. industry, U.S. workers and U.S. consumers.

⁶ Section references, unless otherwise indicated, are to the new Internal Revenue Code sections as if the bill were enacted. Page numbers are references to H.R. 3039 as introduced.

⁷ Other flat rate consumption taxes in their pure form, including the Armer-Shelby flat tax, are likely to have similar positive economic effects.

⁸ See, e.g., "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax", Laurence J. Kotlikoff, April 15, 1993, Cato Institute Policy Analysis, "The Economic Impact of Fundamental Tax Reform, Dale W. Jorgenson, Testimony before the House Ways and Means Committee, June 6, 1995.

⁹ This, of course, is the same result that occurs with tax free bonds under Section 103, which are advantaged in after-tax return to taxable bonds. The market is unlikely to clear at the present tax-exempt rate because such a high proportion of existing capital providers are tax-exempt or tax-deferred (most notably, governments, pension funds, retirement savings accounts and, in selected circumstances, foreigners).

¹⁰ Assuming roughly five trillion dollars in debt and a two point average reduction in interest rates.

¹¹ Current Internal Revenue Code Section 871(b).

Another consequence would be an expected windfall from the liberating capital unproductively spent on the costs of complying with the current, complex system.¹² Currently, the United States spends \$140 billion to \$250 billion complying with the Federal income tax system.¹³ Thus, in 1995 alone, compliance costs averaged an estimated 19 to 33 percent of the total revenue raised by the tax system and 2.0 to 3.5 percent of the Gross Domestic Product (GDP). These compliance costs have greater insidious effects for existing small firms and potential start-ups, which disproportionately bear their burden. As noted in the Kemp Commission report, small corporations endure compliance costs 3.8 times the tax actually collected.¹⁴ These high compliance costs are a pronounced drag on our standard of living and the international competitiveness of all U.S.-based firms. The STC plan would reduce tax compliance costs substantially, perhaps by more than 90 percent.¹⁵ This is roughly the equivalent of adding one additional good year of economic growth in the year of implementation.

Monetary savings from the costs of complexity is but one means of measuring the advantages of simplicity. Another -- elimination of the tax hassle factor -- would be more viscerally felt, especially around this time of year, by most Americans. As a consequence of moving to a national sales tax, individuals who are not engaged in business would no longer file tax returns. The number of tax returns filed may fall as much as 80 percent.¹⁶

Businesses would experience a dramatic decline in compliance costs. Business-to-business purchases would be exempt from tax and therefore contribute little to the cost of compliance. Vendors would simply need to maintain a copy of the purchasers exemption certificate on file. Retailers would be required to determine the sales that they made to consumers. This, however, would be a much simpler task than complying with the existing income tax system. Among business compliance cost savings: there would be no more alternative minimum tax, no more multiple depreciation schedules, no more complex international tax provisions, no more complex pension and deferred compensation rules and no more uniform capitalization rules.

Moreover, if the plan works as the sponsors believe, the advantages in lower compliance costs and a more productive economy would be amplified as states conform their own sales taxes. To the extent that states did conform, retailers would no longer be

¹² Although duly included in the national income and product accounts, and a source of employ to lawyers, accountants, IRS agents and other tax professionals, the payments extracted from the economy from the complexity of our system do not improve our collective standard of living.

¹³ See, e.g. "The High Cost of Tax Compliance for U.S. Business", Arthur Hall, Tax Foundation Special Report, November, 1993. See also note 15. In March 20, 1996 testimony before the Ways and Means Committee, Dr. Hall presented his updated 1996 findings: \$157 billion per year.

¹⁴ "Unleashing America's Potential", The National Commission on Economic Growth and Tax Reform, January 1996, p. 9.

¹⁵ See, e.g. "Compliance Costs of Alternative Tax Systems", Arthur Hall, Tax Foundation Special Report, June, 1995. See, also testimony of Arthur Hall, before the Ways and Means Committee, March 20, 1996 on "Replacing the Federal Income Tax" wherein he estimates that under the STC plan compliance costs would decline by 95 percent to \$8.2 billion.

¹⁶ Corporation, partnership and sole proprietor returns compared to all returns (1992) using IRS Statistics of Income.

required to cope with variegated exemptions and local rates. In jurisdictions that conformed and which already collect a sales tax, the marginal cost of complying with the Federal sales tax system would be quite low, conceivably producing net savings compared to complying with multiple state systems (particularly once the administration credit provided under the bill is considered).

The STC plan would also spread the hidden costs of compliance more equitably among all taxpayers. In an unprecedented step, the STC plan would pay firms for their compliance burden. The legislation provides an administration credit to retailers equal to one half of one percent of the revenue collected and remitted.¹⁷ In 1995, this credit would have provided a credit of nearly \$4 billion to the retailing community toward their compliance costs. The STC plan would also provide a compliance equipment cost credit equal to 50 percent of the cost that vendors incurred if they needed to purchase new equipment to comply with the receipt requirements.¹⁸ This credit would ease considerably the costs of transition by retailers with less capable point-of-sale systems.

This is not to say that all complexity would disappear or that the STC plan is the administrative equivalent of nirvana. As discussed below, complex issues still arise in the context of mixed-use property, financial intermediation services, financing leases¹⁹ and other transactions. Moreover, some of the problems regarding the underground economy that are problematic under the income tax would remain, particularly those involving cash transactions. Nevertheless, the costs of compliance will shrink and the benefit from lawful tax avoidance or illegal tax evasion will be much less at the margin relative to either the present system or competing alternative tax systems. Greater compliance from greater simplicity and lower temptation translates into additional revenue that will not be captured under current law.

Another benefit of the national sales tax is that it would be the most clearly visible tax to the consumer. The STC plan would require vendors to separately state and charge the tax imposed.²⁰ In this way, the consumer will see the full cost of government every time taxable property or services are purchased. Under the sales tax, hidden taxes and hidden tax compliance costs present in the income tax and existing value added tax systems would be exposed and quantified.

A sales tax that replaces the income tax has another important advantage (or flaw, depending on one's view) over consumption taxes that are collected through an income tax-based system. Once enacted, a sales tax will be much harder to reverse than either the flat tax or the USA Tax. While the STC plan would eliminate the Federal income tax infrastructure, other plans would not. Indeed, the flat tax could be *largely* converted into a graduated income tax by imposing a graduated rate structure, reinstating depreciation

¹⁷ §11(e), p. 18. This credit is subject to a minimum of \$100 per month provided that the credit does not exceed 20 percent of the tax due.

¹⁸ §11(f), p. 18.

¹⁹ §22(d), p. 34.

²⁰ §34, pp. 55-56.

rather than expensing for capital investment, taxing interest and dividends and restoring the deduction for interest expense.

Similarly, under the USA Tax, restricting the universal IRA, making wages and interest deductible (and interest taxable) to business and reinstating depreciation rather than allowing in expensing of capital investment would *largely* convert the USA Tax into a graduated income tax. The national sales tax best eliminates the need to think in terms of income. In all other options, the income tax infrastructure would remain in place, and the income tax would be constantly in the wings begging re-enactment. Because the income tax infrastructure would remain and because of the Congress' historical penchant for altering the tax code on a regular basis, these sorts of developments are likely. The developments following the enactment of the Tax Reform Act of 1986 are instructive on this score. With history as our guide, the outcome is nearly certain.

II. The Tax Base: Final Consumption of Goods and Services

The STC plan is imposed on the gross payments for the use, consumption or enjoyment in the United States of any taxable property or service.²¹ Taxable property or services include any property (including rents and leaseholds)²² other than intangible property and services (including financial intermediation services).²³ Interest, dividends, capital gains or other investment income is not taxable until used to purchase taxable property or services.²⁴ Exemptions are provided for purchases for resale, purchases to produce taxable property or services and for exports.²⁵ Property (or services) produced or rendered outside of the U.S. are taxed upon entry into the U.S. unless an exemption is available.²⁶

'Purchased for resale' means purchased by a person in an active trade or business for the purpose of reselling the property in the ordinary course of that active trade or business.²⁷ 'Purchased to produce taxable property or services' is a general exemption meant to exempt business inputs generally. The exemption is available if the property or service is purchased for the purpose of employing or using property or services in the production or sale of other taxable property or services.²⁸ Property or services purchased in connection with research, experimentation or development in an active trade or business are included in this category, as are property or services purchased by an insurance company on behalf of an insured individual if the underlying premium has been taxed. Education and training services are also treated as falling in this category. Wages paid by

²¹ §1, pp. 6-8. Most states pair a sales tax with a use tax. The STC plan is, in effect, structured as a use tax with the seller collecting and remitting the tax if the sale is made in the United States.

²² Rules for the disaggregation of interest and principal in connection with financing leases are provided. See §22(d), p. 34.

²³ §21(n), pp. 32-33.

²⁴ See §21(a)(2), p. 25 and §21(n), pp. 32-33.

²⁵ §2, pp. 8-10.

²⁶ §1(a) and (b), pp. 6-7.

²⁷ §21(d), pp. 28-29.

²⁸ §21(e), pp. 29-30.

an employer engaged in an active trade or business are not treated as taxable services. Wages paid by a household to a maid would be taxable services, however.²⁹

These exemptions are designed with one overriding purpose in mind: to prevent any cascading of tax. The STC plan avoids cascading to ensure an equal effective tax rate across all types of property and services (horizontal equality), irrespective of the number of companies or stages of production that were necessary to bring the good or service to market (vertical equality). Avoidance of cascading also ensures that the final price paid by the consumer excludes hidden taxes. The exemption framework serves the same purpose as deductions in a flat tax, business transfer tax or subtraction method value added tax framework, or the credit for previously paid taxes in a credit-invoice method value added tax.

The bill would also modify the self-employment tax.³⁰ This is necessary because the self-employment tax base is currently in large measure determined by the income tax. The revised self employment base is gross payments received from the sale of taxable property and services (without regard to exemption) less all purchases of taxable property and services and any wages paid in furtherance of a business purpose. Loss carry-forwards are allowed. Self-employment tax transition rules are provided.

As discussed more fully below, financial intermediation services, government services, gaming services and the unrelated business activities of not-for-profit organizations are also included in the tax base.

III. Administration of the National Sales Tax

A. The Tax is to be Administered by the States

States would be the primary administrators of the Federal tax system as envisaged under the STC plan, with the Federal government acting as the administrator of second resort. As an inducement to function as administrators, states would be provided with a fee of one percent of the revenues collected and remitted to the Federal government.³¹ Since the marginal cost to a state of collecting the Federal tax in addition to their own sales tax (for which they already incur costs) would be quite small, the one percent fee should constitute a strong incentive to become a conforming and administering state. In addition, the information sharing, allocation and destination rules would, for the first time, provide the states with a practical means of taxing mail order and other sales of goods shipped into their state from out of state vendors -- but only if they became conforming and administering states. Finally, the broader federal tax base would enable states to increase the breadth of their own tax base (and, presumably, lower the state sales tax rate).

²⁹ §21(n)(2), pp. 32-33.

³⁰ §8 of the legislation.

³¹ §31(e)(2), p. 40.

The combination of these three strong incentives, plus the certainty that the Federal government would administer the tax in their state if they choose not to do so, would probably lead most states to adopt conforming state sales taxes.³² By the same token, a state could choose to become a conforming state but not an administering state because the bill allows one state (presumably a small one) to contract with another state (presumably a large one) to administer their state sales tax. States that currently do not collect sales taxes may also find this option attractive.

Of course, in the event the state does not conform or administer the tax, the Federal government will still function as the tax administrator. The bill also provides for Federal administration of the tax in the case of electing multistate vendors that maintain retail establishments in five or more conforming states.³³ For these electing vendors, the Federal government would serve in the place of the state tax administrator and allocate and remit conforming state sales tax revenues to the respective state governments.

Appropriations for the Internal Revenue Service would not be authorized after fiscal year 2000.³⁴ A new Excise Tax Bureau would be established within the Treasury Department to collect the remaining excise taxes.³⁵ The Social Security Administration would collect the Social Security and Medicare payroll taxes.³⁶

B. Vendors Would Collect and Remit Taxes to State Authorities

The responsibility to collect and remit taxes would fall upon the vendor. Reports and payment of tax collected would be due on the 25th of each month.³⁷ Businesses collecting and remitting taxes or purchasing goods exempt from tax would be required to keep records for a period of three years after filing a report or asserting an exemption.³⁸ These records would allow audits of businesses, including, when appropriate, cross-firm audits such as occur in a value added tax regime or at the state level in connection with existing sales taxes. The state administrator would have subpoena power, the power to audit and the power to levy.³⁹ The state administrator is responsible for issuing exemption certificates and registering vendors,⁴⁰ and states must give full faith and credit to honor exemption certificates issued by other conforming states.⁴¹

At the same time, the proposal anticipates that some vendors would choose to collect sales tax even on otherwise exempt sales, rather than bother with an exemption

³² A similar system is presently employed by Canada in the province of Quebec where Quebec administers both the Federal and provincial goods and services tax (GST) and employs a single stage (retail) method.

³³ §33, pp. 42-43.

³⁴ §5 of the legislation, p. 57.

³⁵ §6 of the legislation, p. 57.

³⁶ §7 of the legislation, p. 57.

³⁷ §41(a) and (b), p. 44.

³⁸ §42, pp. 47-48.

³⁹ See §31, §49, and §51.

⁴⁰ §§43-44, pp. 48-49.

⁴¹ §31(i)(1), p. 41.

certificate for its sales.⁴² In this case, the buyer would then be eligible for a refund on the tax paid on the exempt sale.⁴³ Authority is provided to the U.S. Secretary of Treasury to require that certain industries or vendors selling certain services or products collect the tax if in the Secretary's judgment, 25 percent or more of sales in question were to consumers. Buyers would remain eligible for the credit due on exempt purchases.

To ensure maximum visibility, the legislation would require that the sales tax be separately stated and charged on each sale.⁴⁴ Specifically, each receipt would be required to show the price of the property or service exclusive of tax paid, the tax paid, the tax rate, the price of the property or service including tax paid, the name of the vendor, the registration number of the vendor and the date of sale. An exception is provided for certain vending machine sales.

De Minimus rules are provided to exempt gross payments received in connection with casual or isolated sales by persons not engaged in an active trade or business and small purchases of property imported into the U.S. by persons not engaged in an active trade or business.⁴⁵ These provisions would prevent us from becoming a nation of small-time law-breakers merely due to the sale of a lawn mower to a neighbor or some used clothing at a garage sale.

C. A Modified System of Taxpayer Rights and Penalties Would be Incorporated into the Proposal

The STC plan, unlike other alternative tax system plans, provides a series of enhanced taxpayer rights provision. Under these enhancements, the burden of persuasion would rest with the government, but the burden of production of documents and records would rest with the taxpayer.⁴⁶ Each state administrator is required to establish a Problem Resolution Office and problem resolution officers would be provided authority to enjoin collection activity. This administrative injunction could only be lifted by the highest officer in that tax authority.⁴⁷ Taxpayers would be entitled to reimbursement for professional fees incurred in disputes unless the government's position was substantially justified.⁴⁸

The STC plan establishes a series of civil and criminal penalties for non-compliance, including failure to register, failure to pay and failure to file. The penalties are structured so that there is a continuing incentive to comply with the law. This is in keeping with important reforms to the civil penalty structure that were added to the Code

⁴² §3(b), pp. 12-13.

⁴³ §11(a)(3), p. 14.

⁴⁴ §54, pp. 55-56.

⁴⁵ §2(b), pp. 8-9.

⁴⁶ §46, p. 50.

⁴⁷ §50, p. 51.

⁴⁸ §47, p. 50.

after extensive hearings before the House Ways and Means Committee, Subcommittee on Oversight in 1989.⁴⁹

D. Destination and Allocation Rules

In the current international tax system, two primary questions must always be raised. First, which state has the primary taxing jurisdiction? Second, if the U.S. can exercise jurisdiction to tax, what is the source of the income, foreign or U.S.? Both the income sourcing and expense allocation rules and the rules of juridical taxation in the international context can be quite complex, as international tax practitioners recognize. They can hinge upon questions of residency, where property is located, sold, or used, where services are performed, even where the property used to produce the goods is located. In the case of interest or research and development expenses, it can be determined under specific formulae.

Similar to jurisdictional notions under principles of international taxation, the destination rules under the STC plan seek to clarify the issue of primary taxing jurisdiction. However, the sales tax rules are far simpler. Allocation of taxable property and services (and therefore revenue) among the various states is based on the destination of the taxable property or service.⁵⁰ As the tax applies only to consumption, questions of how to source business-to-business transactions are irrelevant, as are determinations for the allocation of interest, research and development and other expenses.

The rules under the STC plan are as follows. The destination of tangible personal property (including property sold by "mail order") is the state in which the property was first delivered to the purchaser. The destination of real property is the state where the property is located. The destination of services is the state where the use, consumption or enjoyment of the services occurred. The destination of telecommunications services (including telephone, cable television and satellite services) is the residence of the purchaser. The destination of domestic transportation services is the destination of the trip (in the case of round-trips, the services are equally divided). International transportation services are deemed 50 percent attributable to the U.S. destination or origin. The destination of financial intermediation services is the residence of the purchaser. Gross payment for financial intermediation services purchased by a U.S. resident from a financial intermediation service provider that has a permanent establishment in the U.S. would be subject to tax.⁵¹ The destination of rents and leaseholds are generally the location of the rented or leased property. In the case of vehicle rentals of one month or less, the destination is the location where the vehicle was

⁴⁹ See §45, p. 49 and §41(c)-(f), pp. 44-47. See also, "Review of the Civil Penalty Provisions Contained in the Internal Revenue Code", Hearings before the Subcommittee on Oversight of the Committee on Ways and Means, February 21 and June 6, 1989, Serial 101-46.

⁵⁰ §53, pp. 52-55.

⁵¹ §22(c), p. 34.

originally delivered to the lessee. In the case of vehicle rentals of more than one month, the destination of the lease is the residence of the lessee.⁵²

While the taxpayer may remain relatively indifferent about which state imposes the Federal tax, the outcome of Federal jurisdictional questions will, as a matter of practicality, influence the outcome of state decisions concerning taxing jurisdiction. Of course, at the state level, rates can differ. Moreover, states may vie for taxing jurisdiction to enjoy the collection of administrative fees or to establish residency for other state tax bases. Consequently, a Federal Office of Revenue Allocation is provided to arbitrate any disputes that may arise among the states. This office is expected to serve the role in the role of Competent Authority.

Under the STC plan, the Federal government will facilitate information sharing, provide administrative support and regulatory guidance and, to the extent necessary, resolve destination/allocation disputes among the states.⁵³

IV. Dominant Issues: How the STC Addresses Commonly Raised Problems

A. The Family Consumption Refund

1. Some Thoughts About Progressivity

A common assumption about the sales tax is that it is naturally regressive, since lower "income" individuals spend a greater percentage of their income on consumption of necessities. However, a sales tax is an altogether different paradigm of taxation, and any judgment on the equity of the tax must be accompanied by a different analysis of regressivity.

This article is not meant to provide a complete treatment of the many issues raised when examining distributional equities. Nevertheless, to examine how the STC plan addresses these concerns, a number of issues should be broached. First and foremost, taxing *income* at a graduated rate has always been a surrogate index of progressivity. A tax on income, no matter how steeply accelerated, does not necessarily make an income tax progressive. Moreover, taxable income may not be the best index by which progressivity or regressivity is measured. Even if progressivity is measured by the "ability to pay", taxation of an income stream only denotes taxation on a return to capital or productive labor, not necessarily wealth, or more equitably, consumption. Equally important, using taxable income as a surrogate to determine progressivity is necessarily based on a year-to-year analysis, where the ability to pay is measured as a function of income per unit time. An income tax does not capture consumption of older accumulated capital.

⁵² §33(i), p. 53.

⁵³ §§31-33, pp. 38-43.

Consumption over the life of a taxpayer is in many respects a better measurement of the ability to pay taxes. Under the sales tax, the more the taxpayer is able to consume for personal enjoyment, as opposed to savings or investing which generates benefits to the community beyond personal enjoyment, the more taxes he will incur. The greater the level of individual consumption, the greater the tax.

The "progressivity" of a sales tax therefore cannot be judged on the basis of whether or not those with larger income streams over a particular period are taxed more or less than those with lower income streams. The issue should not be defined by tax burden versus income, but rather by the sales tax burden over consumption. The level of consumption over the course of one's life, maybe a more important measure of equity in the world of consumption taxes.

The STC plan strives to make the tax less compulsory by making it inapplicable to the level of consumption required for necessities. One manner in which the tax could have sought to accomplish this objective would have been by delineating specific categories of goods or services as exempt, food and clothing for example. A better, less intrusive, less costly way is to simply provide each family a level of consumption free of tax by providing a rebate of the tax up to the poverty level. This is the device chosen in the legislation.⁵⁴

Under the STC plan, the family consumption refund effectively exempts purchases of necessities by workers. Wage-earners would be entitled to a rebate equal to the sales tax rate times the lower of their wages or the poverty level. The poverty level is defined as the Department of Health and Human Services guidelines level grossed up by the sales tax rate.⁵⁵ For a family of the four, the HHS poverty level for 1996 is \$15,600 so the sales tax poverty level would be \$18,588. The annualized rebate amount would therefore be \$2,788. Assuming the head of household was paid 26 times per year, the rebate amount included in each paycheck would be \$107.23. Employers would pay less payroll tax and the Treasury would reimburse the Social Security Administration for the rebate amounts provided to families in order to ensure the balance of trust funds are unchanged.⁵⁶ Only the source of the payments into the trust funds would change. The rebate would then be administered at the family unit level (as the poverty level is defined by reference to the family unit).

⁵⁴ The legislation actually provides the rebate only against wage income. Although rules are provided that would effectively exempt consumption from the sale of homes, those with wage income less than the poverty level whose consumption was financed by the sale of financial assets or passive income would not be fully protected. Those that receive government benefits can be protected to the extent necessary by adjusting benefit levels. The level of benefit adjustment is uncertain since the repeal of the income tax should reduce pre-sales tax prices to some degree. Finally, if the view commonly held among economists is correct that the actual incidence of a consumption tax is on the factors of production (labor and capital) it is not clear that any relief is appropriate.

⁵⁵ §15(c), p. 21-22. The HHS poverty level is divided by the quantity one minus the tax rate.

⁵⁶ An explicit provision to reimburse the Treasury for payroll taxes not remitted by employers, although included in earlier drafts of the legislation (as §6(b)), certainly intended by the sponsors and referred to in cross references in H.R. 3039, was omitted from H.R. 3039. The legislation's sponsors believe that other existing statutory provisions ensure that the trust fund will be fully funded under current law.

The chart below indicates the applicable poverty thresholds and maximum rebates for 1996.³⁷

Family Size	Applicable Poverty Level	Max. Rebate Amount
One	\$ 9,106	\$1,366
Two	\$12,188	\$1,828
Three	\$15,271	\$2,291
Four	\$18,588	\$2,788
Five	\$21,435	\$3,215

All workers would receive a rebate up to the maximum rebate amount shown in the table. Thus, the effective tax rate for a family of four earning and spending \$37,176 would be 7.5 percent. The effective tax rate for a family of four earning and spending \$74,352 would be 11.25 percent. This assumes that the incidence of the sales tax is on the consumer. The view that incidence falls on the factors of production is commonly, though by no means universally, held among economists.

The family consumption allowance approach seeks to accomplish several objectives. First, it makes the sales tax applicable only to consumption beyond the necessities of life. Second, it make the tax progressive, not only because it is based on consumption, a better index of true ability to pay, but because -- if one wants to continue to view progressivity through an income tax lens -- it exempts entirely lower income workers from tax. Third, it does not commence down the road, as most state taxes do, of determining what to tax and what to exempt, thereby minimizing administrative and compliance questions and costs and economic distortions.

B. Used Property (Including Homes)

The legislation provides a credit for tax previously paid on used property that is subsequently resold.³⁸ The basic idea is that the government should only tax an item once and that the sales tax should not cascade every time the same property is subsequently sold (as is the case under many state statutes).

The rules operate differently with respect to depreciating and appreciating used property. As more fully discussed below, transition rules are provided for property owned on the date of enactment. These rules are designed to ensure that property purchased from after-income-tax dollars is not then also subjected to a sales tax.

Let us take two examples to illustrate the application of the rules. In the first example, the consumer has purchased an automobile after enactment of the law, which is resold at a substantially lower amount to another consumer, similar to our example above.

³⁷ See Federal Register, Vol. 61, no. 43, March 4, 1996, p. 8286 for 1996 HHS poverty level.

³⁸ §11(c), pp. 15-17.

<i>Automobile</i>	Purchased New	Subsequently Sold
Total Price	\$23,529	\$ 5,882
Tax	\$ 3,529	\$ 882
Net of Tax Price	\$20,000	\$ 5,000

In this example of a depreciating asset, the seller would be entitled to a credit of \$882, which equals the amount of tax the buyer would pay.

In our second example, the asset appreciates in value. Let us assume that the reverse of our first example holds true.

<i>Collectible</i>	Purchased New	Subsequently Sold
Total Price	\$ 5,882	\$23,529
Tax	\$ 882	\$ 3,529
Net of Tax Price	\$ 5,000	\$20,000

Here, the seller would be entitled to a credit of \$882, on tax liability of \$3,529.⁵⁹ The seller would have to remit \$2,647 to the tax authority, which is the difference between the tax paid by the subsequent purchaser on resale and the tax paid when the product was first purchased. In this way, the full value of the collectible, or \$23,529, was ultimately taxed in two components: (1) consumption to the extent consumed by the original purchaser, and (2) consumption when resold. This mechanism can continue on from consumer to consumer without limitation if need be.

The general used property credit rules, including the transition rules, apply to primary residences. However, in the case of the primary residence, special rules may be elected which allow the purchaser of a primary residence to elect to pay the tax due ratably over thirty years with interest. In the event this election is made, the responsibility for remitting the tax rests with the buyer. If the primary residence is subsequently sold, then the entire tax is due (but any used property credit due would be allowed as well).

In summary, these rules operate to provide a tax credit on the equity in existing property, and compensate for increases or decreases in fair market value. Homeowners are allowed to pay any additional tax on subsequent purchases over thirty years. They are thus in a situation comparable to having to pay the principal payments on their mortgage from after-income-tax dollars. The sales tax rate of 15 percent will be lower than the marginal income tax rate most homeowners faced, especially when one considers the typical one-time spike of income from conversion of long-held capital assets. Moreover, under a sales tax, mortgage interest rates will drop considerably. Thus, while homes are in the sales tax base, given the general structure of the tax, the transition rules provided and the effect on interest rates, it would seem that homeowners can be expected to fare better under a national sales tax than under the present system.

⁵⁹ unless an exemption or de minimus rule applied.

C. Financial Intermediation Services

The taxation of financial intermediation services poses a difficult problem for all consumption tax proposals. Interest rates may be viewed as having three components. The normal (risk-free) return to capital, the premium for the risk that the capital provided will not be repaid and the payment for financial intermediation services. Although some financial intermediation services are separately charged, in practice they are usually incorporated into the interest paid. Similarly, insurance premiums have a financial intermediation services component. Under the proposal, financial intermediation services (FIS) purchased by consumers are taxable services,⁶⁰ while FIS purchased by businesses are exempt as business inputs.

The legislation seeks to resolve the issue by defining FIS to include both explicit and implicit services. Explicit financial intermediation services include brokerage, banking, safe deposit box, trustees' and mutual fund management and exit fees as well as sales loads and insurance premiums to the extent that the premium is not allocable to the underlying investment account.⁶¹ If the services are explicit, they are taxable.

The proposal then undertakes to define implicit FIS in order to tax the intermediation fees imbedded in interest rates. The implicit fee is the difference between the applicable interest rate and the interest rate provided or charged times the debt balance. In the case of deposits, it is measured as the excess of the applicable rate over the rate provided. In the case of borrowers, it is measured as the excess of the rate charged over the applicable rate. The applicable rate is defined as two percent plus the rate that the Federal government pays when it issues securities of like term and like issuance date to the transaction for which an amount is being imputed. The two percent rate is designed to be an arbitrary risk premium.⁶²

Rules are provided allowing financial institutions to collect and remit the tax with the same frequency that statements are issued, provided the statements are issued at least quarterly. The option to account for financial intermediation services on other than an account-by-account basis is also provided.⁶³

⁶⁰ §21(n), p. 32 and §21(a), pp. 25-28.

⁶¹ If an health or property and casualty insurer makes a purchase on behalf of an insured (e.g. medical services or automobile body work) and the premium giving rise to the obligation was taxed, then, as discussed above, the insurer's purchase is exempt. Thus a hospital invoicing an insurance company would collect no tax but if it were invoicing a consumer it would collect the tax. However, a mechanism should be provided to credit the insured for taxes paid if the insurance company reimburses the insured rather than making the purchase directly (again, assuming the premium was taxed). Similarly, a provision should probably be made to provide a credit to life insurance proceeds recipients if the life insurance policy were taxed.

⁶² The netting rule in section 21(a)(4)(A), which provides that implicit fees are reduced to the extent of explicit fees, is probably wrong. The tax effect should not vary depending on whether the fees are implicit or explicit and this netting allows the effective tax burden to decline in certain circumstances if explicitly stated.

⁶³ §22(a)-(b), pp. 33-34.

The STC plan's treatment of FIS represents a very substantial simplification compared to other consumption tax proposals, including the USA Tax and the flat tax, which must provide rules for valuing financial intermediation service in relatively complex, and more numerous, business-to-business transactions.

D. Government Services and Purchases

The question of the proper treatment of government services presents special problems. Excluding government from the tax base would provide a tax advantage when government is competing with private providers of services. Also, as government services are a substantial portion of the GDP and are taxed by both the income tax and the flat tax, excluding them would require a substantially higher tax rate (since spending is unlikely to decline to compensate for the lower tax on government).

As it would be administratively impossible to tax government provided services as they were received, the proposal seeks to reach parity between government services and private services through the imposition of an excise tax on the receipt of government wages.⁶⁴ Government purchases from the private sector would be subject to tax as would the purchase by private persons of government goods or services (e.g. transit, publications).⁶⁵ However, exemptions otherwise available to business would be available to government. For example, government purchases used for resale or for the production of taxable property and services would be exempt. Thus, Amtrak's purchase of locomotives or sandwiches for resale would be exempt. The Government Printing Office's purchase of paper for printing books produced and sold to the public (and therefore taxed) would be exempt.

E. Not-For-Profit Organizations

The tax system ought not to discourage provision of goods or services that serve a public need or good, which cannot be provided by the for-profit sector and which can more effectively be provided by private not-for-profit organizations than government. Likewise, the system ought to encourage volunteerism and contributions to charitable purposes. On the other hand, not-for-profits' commercial activities should not be allowed an unfair competitive advantage vis a vis the business activities of the for-profit sector.

Under the legislation, as in current law, a balance is struck between permitting some commercial activity and preventing such activity from competing against the for-profit sector. Primarily, not-for-profit organizations, which roughly correspond to present law 501(c)(3)-(6) and 501(c)(8) organizations, are accorded special treatment under the legislation.⁶⁶ Dues, contributions and payments to qualified not-for-profit organizations are not taxable gross payments for services.

⁶⁴ §22(f), p. 38.

⁶⁵ §3(a), p. 10.

⁶⁶ §3(a)(2), pp. 10-12.

However, if a qualified not-for profit organization provides property or personal services in exchange for dues or contributions, then the fair market value of the property or personal services provided are taxable. This is intended to replicate current law treatment, which denies a deduction for contributions to the extent of the fair market value of goods or services received in return. Moreover, gross payments to qualified not-for profit organizations for property or services that are not substantially related to the exempt purposes of the organization or that are commercially available would be taxable. This latter point is meant to incorporate the principles of an improved unrelated business income tax (which has been frequently criticized by small businesses as unworkable).

The organizations which fall within the rubric of the special rules are those organized and operated exclusively for religious, charitable, scientific, testing for the public safety, literary or education purposes; as civic leagues or social welfare organizations; as labor, agricultural or horticultural organization; as chambers of commerce, business leagues or trade associations; or as fraternal beneficiary societies, orders or associations.

F. Mixed Use Property

Mixed use property, i.e. property serving both business and personal consumption needs, presents problems in virtually all tax systems, including the income tax and the flat tax systems. The sales tax is no exception. Purchases of property and services may give rise to taxation or exemption depending on the use to which the property is put. The essential question presented is as follows: is the property used essentially for consumption or for production?⁶⁷

The STC plan seeks to resolve this issue by providing that, in order for mixed use property to be exempt, it must be used more than 95 percent for exempt purposes. Otherwise, the person purchasing the property (or service) is entitled to a business conversion credit equal to the product of the tax rate, the business use ratio and the mixed use property amount. The business use ratio is determined by the ratio of business use to total use using mileage for vehicles, floor space for real property, time for machinery and equipment and a reasonable method for other items. Records substantiating the use must be maintained. The mixed property amount for any given year is one thirtieth of the purchase price for thirty years for real property, one seventh of the purchase price for seven years for machinery and equipment, one-fifth of the purchase price for five years for vehicles.⁶⁸ To illustrate, a \$5,000 vehicle would give rise to a mixed property amount each year of \$1,000. If the business use ratio were 50 percent, then the annual credit would be \$75 (15 percent of \$500).

⁶⁷ §22(f), pp. 35-37.

⁶⁸ §22(g) provides rules preventing the assertion of a business exemption in the case of hobby activities made to appear as businesses.

Special rules are provided to tax property converted from business to personal use, and conversely, to provide a credit for property converted from personal to business use.⁶⁹

V. Transitional Considerations

The questions about how best to structure appropriate transition rules, and the standards by which the fairness of these rules should be judged, pose difficult issues for policy-makers in any major change to the tax system. These questions are of enhanced importance when we contemplate the complete replacement of the income tax system with one based upon consumption. Questions of equity, economic impact, revenue loss or gain and administrability must be balanced.

Possible standards for determining whether transition relief is appropriate might include: "Is a taxpayer's tax liability comparable to what it would have been under the law when an investment was made?" or "Is a taxpayer's after-tax rate of return comparable to what it would have been under the law when an investment was made?" These standards would rest on the equitable proposition that it is not fair to "change the rules after the game has been played" or, stated differently, that taxpayers' reasonable expectations about the future tax law with respect to existing investments should be respected. Another possible approach would try to ensure that neither new and old investments receive competitive advantage due to tax changes. These issues require greater analysis and discussion.

With these concerns in mind, the STC plan provides a number of transition rules, some of which have already been mentioned in the context of the structure of the plan. Owners of existing property (e.g. homes and automobiles) are deemed to have previously paid sales tax to the extent of their equity in the property for purposes of the used property credit rules.⁷⁰ Equity is defined as the ratio of (a) the income tax basis in property as of the effective date less debt secured by the property divided by (b) the income tax basis in property times (c) the original purchase price. This rule means that a homeowner would receive a tax credit towards his or her next purchase in amount equal to their deemed paid credit. Thus, to the extent the taxpayer had made equity payments out of after-income-tax dollars, he or she would not incur additional sales tax liability.

Also, self-employed persons, for purposes of the self-employment tax, are allowed to deduct remaining basis in depreciable property and inventory (including amounts capitalized by virtue of present law section 263A) ratably over 10 years.

Gains and losses attributable to enactment of the STC plan or any other alternative tax plan would clearly be quite large for some individuals or businesses. Nevertheless, in the STC plan, income tax transition rules are not provided. It is questionable whether

⁶⁹ §11(d), pp. 17-18.

⁷⁰ §11(c)(3), p. 16.

transition rules for remaining income tax basis, unused credits and the like are appropriate since the future income tax rate on individuals and corporations would be zero.

A scheme where a special refund equal to the income tax rate times the present discounted value of the stream of deductions plus any unused credits is conceivable. Were such an approach pursued, however, it would also seem appropriate to impose a corresponding tax on built-in capital gains and presumably even the capitalized value of future income streams. This revenue, in turn, could be used to fund the transition relief. Although it is clear that such an approach would be highly complex, it is far from certain whether the result would improve equity or economic efficiency. It would certainly do little to improve simplicity.

It may be appropriate to avoid a form of double taxation by providing some relief to persons consuming out of savings that were previously subject to the income tax. This relief may be particularly desirable since the STC plan family consumption refund benefits only wage-earners. Such relief is not appropriate for savings distributed from pension plans, Individual Retirement Accounts and other qualified plans because neither the original contribution nor the earnings on the plan would have been subjected to income tax. The STC deemed paid transition rule with respect to existing tangible property protects wealth or savings from double taxation. The problem primarily relates to financial instruments purchased with after-income-tax dollars. Qualified transition accounts could be established prior to implementation of the sales tax and spending out of those accounts (subject perhaps to an annual maximum) would result in a credit equal to the sales tax rate times the distribution amount. Some sort of debt netting requirement would have to be paired with such an approach to avoid heavy borrowing to fund the transition accounts.

Another transitional issue, probably best handled through the authorizing and appropriations process, relates to government benefits programs. Those making their consumption purchases out of social security, veterans, AFDC, food stamp or similar benefits will pay tax on their purchases. However, it is not clear what the appropriate level of relief is to hold benefit recipients harmless. All other things being equal, the market should clear pre-sales-tax goods and services prices lower after the income tax is repealed since income taxes are costs that will no longer be imposed on suppliers of capital and labor.

Conclusion

The introduction of a practical national sales tax plan into the current political dialogue has far reaching implications. The plan represents a fundamental challenge to the current federal graduated tax on income. A national sales tax along the lines of the STC plan would, in our judgment, have a highly beneficial impact on the U.S. economy, the standard of living of the American public, the compliance costs borne by our economy and on the degree of intrusiveness of the tax system in our lives. Such a tax system is more compatible with the principles of a free society than our current tax system.

Mr. SHAW. Mr. Tauzin.

STATEMENT OF HON. W.J. "BILLY" TAUZIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. TAUZIN. Thank you, Mr. Chairman.

As my colleague, Mr. Schaefer, has said, we have put on the table now the second of two very important proposals to dramatically reform the current, outdated, complex, most hated tax structure in American history, the American income tax system.

The first proposal, of course, on the table is Mr. Armev's flat tax, which I know this Committee is giving very serious examination to. This proposal, unlike the flat tax, which we think, by the way, would be a vast improvement over the current system, actually eliminates the income tax completely, eliminates not only the income tax on personal and corporate income, but also the inheritance and gift taxes as well.

The value we think of doing that, if we are going to do national tax reform, is in ending and eliminating the business of constantly simplifying and flattening the tax rates, only to see them constantly raised again and made complex again over time.

For example, the last time tax rates were flattened was in the mideighties with Ronald Reagan's tax plan that lowered the rates from 14 different rates down to 2. We are now back up to 5 effective rates, 4,000 changes in the Tax Code later. We think it is time to eliminate and pull that Tax Code up by its roots, as Chairman Archer has said.

The second point I want to make is that the current Tax Code, as hated as it is, would be hated even more if Americans fully appreciated the fact that their income is being taxed twice under that Tax Code, once when they make it, whether from salary, investments, dividends, or capital gains, and then second, again, when they spend that income, because every product made in America carries the full burden of the income tax system on its back.

Every company, every employee, every person who contributes to the manufacture of American products pays income taxes. In the course of extracting raw material in America and eventually turning it into a retail product, so many hands have paid income taxes and so much cost of the current system is passed along to the consumer that some economists tell us somewhere between 10 and 15 percent of the price of every product made in America is the cost of the American income tax system.

In fact, small businesses spend \$4 complying with the Code for every \$1 they send the Federal Government, and all of that tax is passed on to the American consumer in the price of American-made products.

Coincidentally, foreign-made products brought into America don't carry that tax burden, and so you wonder why we have economic insecurity in this land, you wonder why we have a disadvantage in world trade. Our tax system double taxes our income and favors foreign-made products, and that is wrong.

What we say is that it is time to end the double taxation. Once ought to be enough. Hidden taxes ought to go away. We ought to have a simple, up front national retail sales tax to take the place of both the income taxes and the hidden taxes on American-made

products, and we ought to apply that national sales tax to products made in America and brought into America on an equal basis.

When you do that, you create tax fairness, simplicity. You create for the first time a real pro where American manufacturers can compete in world trade fairly without the disadvantage of the American tax structure riding on the backs of American products.

I suggest to this Committee, we have offered the second of two very good proposals. We think this one is superior. We have included in the 15 percent a rebate for sales taxes paid for the income made under poverty levels to take care of regressivity arguments. Please look at that carefully. It is a good proposal.

We include in that 15-percent rate enough to make sure that we treat the purchase of a home as good or better than the current Tax Code. Please examine that in our proposal, and when you get through evaluating these two good proposals, we hope this Committee will recommend to the next Congress and to the American public not just a rehaul, not just a flattening of the American Tax Code, but a complete repeal of the American income tax system, inheritance tax system, gift tax system, and a system that rewards work, income, and investment, and taxes only consumption in a very simple national sales tax.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

**STATEMENT OF HON. W.J. "BILLY" TAUZIN
A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA**

Mr. Chairman,

We just heard Dick Chrysler eloquently address some of the multitude of reasons why the present income tax is a disaster for our country and our people. Dan Schaefer has clearly explained the details of a national retail sales tax and how it will actually work in our country. It is my honor to address the Committee about the benefits of a national retail sales tax, a tax levied not on income as it is received before we have an opportunity to consume, but at the time of actual consumption.

Mr. Chairman, all taxes reduce our ability to consume and are really "consumption taxes." Everyone I know intends to consume all the money they make, now or in the future. Some of us want to defer the consumption until we retire or until our kids are ready to go to college. Others want to consume a part of their earnings by donating it to a church or other organization. Others just use their earnings to consume today. However, anything ~~we~~ decide to do with the money we earn is consumption.

Now, anytime government taxes away part of my money, it is reducing my ability to consume. Therefore, a 15% tax withheld from my income at 15% reduces the money I have with which to consume foods and services. For example, to purchase a \$10 item of clothing with an income tax of 15%, I would actually have to make \$11.80, pay 15% of this amount or \$1.80 of income tax, and then use the remaining \$10.00 to purchase the clothing.

With a 15% national retail sales tax, I would have to earn \$11.50 in order to pay the \$1.50 in national retail sales tax and net the \$10.00 needed to buy the article of clothing. In the case of an income tax or of a national retail sales tax, the taxes reduced my ability to consume because I have fewer dollars to use for consumption.

My question to the Committee is this, if all taxes are really consumption taxes, shouldn't we replace the present failed income tax system with a national retail tax that accomplishes the following:

1. Frees individuals from filing any type of federal tax returns.
2. Requires only simple returns from retail business.
3. Abolishes the IRS and tears the income tax out by the roots.
4. Increases our competitiveness in the world economy.
5. Ensures that the members of the underground economy pay their share.
6. Eliminates the taxes on production, investment and savings.
7. Requires illegal immigrants and importers to pay taxes in the U. S.
8. Empowers all Americans by giving them the choice as to how much tax they pay.

I will now address each of these points.

1. **Frees individuals from filing any type of federal tax returns.** In 1994, there were 107,291,000 1040 individual income tax returns filed. 107,291,000 Americans were forced to spend in excess of 2 billion fours trying to calculate the amount of income taxes owed to the federal government. This is absurd.

The national retail sales tax requires no federal individual tax returns of any kind. Individual Americans will pay their taxes when we make purchases of retail goods and services. No receipts, no tax returns, no audits, no hassle. What a concept!

2. **Requires only simple returns from retail businesses.** Does anyone believe that businesses pay taxes? A businesses taxes are passed through to the consumer through higher prices and then paid to the government. All taxes are ultimately paid by consumers. In fact, many

economists believe that prices of consumer goods and services are between 12% to 20% higher than they otherwise would be because of our ridiculous income tax system.

A study released by the Tax Foundation revealed that corporations with assets of \$1 million or less (more than 90 percent of all corporations and the ones that create the most jobs), paid a minimum of \$382 in compliance costs for every \$100 they paid in income taxes (\$14 billion in compliance costs for \$3.7 billion in income taxes.) Does anyone believe that these costs are not passed on to us in the form of higher prices? Not anyone in the 3rd district of Louisiana. 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.

With a national retail sales tax all this changes. Because the national sales tax will be collected by businesses selling retail goods or services, these are the only businesses which will file simple sales tax returns. In addition, in our bill, retail businesses are entitled to be reimbursed a 1/2 of 1% of the national retail sales tax they collect. No longer will the compliance costs and the actual income tax itself have to be passed on to you and me in the form of higher prices. Through competition, the savings to business will be passed on to us and we can expect retail prices to actually decrease.

3. Abolishes the IRS and tears the income tax out by the roots. My constituents regularly complain about how Washington has got messed up priorities. We have 24,000 employees in the FBI to fight crime and terrorism. There are 6,700 employees in the Drug Enforcement Agency to combat the polluting of our children and country by drug dealers. The Border Patrol has 5,800 employees who are supposed to protect our borders. How in the world do we justify the IRS having 111,000 employees? Is it to keep in line the terrorist taxpayers?

Unlike the other income tax based alternatives to the income tax, the national retail sales tax is the only proposal that will abolish the IRS and tear the income tax out by the roots. As my colleague Dan Schaefer explained, the national retail sales tax will be collected by the states who already collect state sales taxes at a fraction of the cost for collection of our present income tax or of any of the other proposals.

We can shift our emphasis from terrorizing taxpayers to terrorizing criminals and drug dealers. Finally, does anyone believe that once freed from the income tax, the American people will allow it to come back?

4. Increases our competitiveness in the world economy. 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.)

Our income tax system has caused us to be a nation of exporter 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 pay any of the cost of our government. Therefore, the income tax penalizes American products and exports and subsidizes imports.

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 hundred of thousands of the type of high-wage jobs that our country desperately needs.

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. 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 expand at a much more rapid rate.

5. **Ensures that the members of the underground economy pay their share.** 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.

Using IRS estimates, the underground economy has grown at a rate of almost 8% per year since 1965 and is the fastest growing segment of our economy. The IRS estimates that \$127 billion of taxes went uncollected in 1992 but 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.

Will there be people who try to evade 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 an 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.

Finally, people who try to evade the national retail sales tax by obtaining a resale permit and purchasing all of their personal goods without paying sales taxes will be in for a big surprise. The states are now starting to enter into the computer the amount purchased with resale permits and the amount sold at retail. Unlike with the income tax, the cheats will be obvious.

6. **Eliminates the taxes on work, investment and savings.** Legislators understand that taxing something will produce less of it. By eliminating the income tax which penalizes work, investment and savings, we will get more work, investment and savings. Dr. Lawrence Kotlikoff and Dr. John Qualls both conducted detailed studies about the impact of replacing the present income tax with the national retail sales tax. They both 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 US 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 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 interest payments. In short, the United States will experience the greatest economic boom in our history.

7. **Requires illegal immigrants and importers to pay taxes in the US.** Not only do we fail to enforce the laws with respect to our borders, we also allow illegal immigrants to work in our country and because they work for cash, to pay no taxes to our federal government. If we adopt a national retail sales tax then each time illegal aliens make purchases they will pay a federal tax. This will not cure our illegal immigration problem but it will ensure that everyone living in our country contributes to paying our government's expenses.

8. **Empowers all Americans by giving them the choice as to how much tax they pay.** Our present income tax system takes our money through withholding before we receive it. Most of us now consider that our wages are really the "take-home pay" that we get net of all the deductions. Under the present system, it doesn't matter if one of us is more frugal than the other because we all pay the same amount of tax. In fact, if we are more frugal than our neighbor we are actually going to pay more and more tax because our earnings on our savings will be taxed each year.

With the national retail sales tax we receive all of the money we earn. Our checks are increased by the amount previously deducted for federal income tax. With this money in hand, we have the power to determine the amount of federal tax we pay based on how much we choose to spend. We, not some bureaucrat or lawmaker in Congress, will have the power.

Also because of the way that the present income tax system hides the amount of taxes we pay in the price of goods and through withholding, I don't think any of us can really tell how much tax we are paying to the federal government. By eliminating the individual and corporate income tax, the estate and gift tax and all non-trust fund excise taxes and replacing them with a simple national retail sales tax, all of us will see the amount of federal tax we pay each time we make a purchase.

To each of us who really wants to make the government more accountable this is a compelling difference between the present income tax and the other income tax proposals and the national retail sales tax. When our citizens see how much they are paying in federal taxes they will demand that we become more efficient and deliver better services to them.

Mr. Chairman, in closing, I believe that we should re-examine the basic ideas on which this government was founded. Our Founding Fathers insisted on the use of indirect taxes on individuals and specifically forbade direct taxes like the income tax. They did this because they were students of history and they knew that every despotic country had one thing in common--direct taxation which helped enslave the people. We have an opportunity to eliminate the income tax, the IRS, tax returns, audits and the penalties on our exports, work, savings and investments and replace them with an indirect national retail sales tax. For us, our children and grandchildren we must free America from the income tax.

I leave you with these words from Federalist Paper XXI by Alexander Hamilton writing under the name Publius.

"Imposts, excises, and, in general, all duties upon articles of consumption, 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 at his own option, and can be regulated by an attention to his 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 cannot be exceeded without defeating the end proposed--that is, an extension of the revenue. When applied to this object, the saying is as just as it is witty that, "in political arithmetic, two and two do not always make four." If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them."

Mr. SHAW. Thank you, Mr. Tauzin.
Mr. Chrysler.

**STATEMENT OF HON. DICK CHRYSLER, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF MICHIGAN**

Mr. CHRYSLER. Good afternoon. First, I would like to express my appreciation to the Chairman and to the Committee for taking time to discuss the tax reform our Nation desperately needs and the steps this Congress should take in terms of making reform a reality.

Simply put, our present income tax system has failed us miserably. It is time to rip the income tax system out by its roots and replace it with a national retail sales tax, while in the process eliminating the IRS, the inheritance tax, the estate tax, the capital gains tax, and the personal and corporate income tax.

The National Bureau of Economic Research issued a November report showing the massive 1993 tax increase resulting in decreased taxable income being reported, causing the Treasury to lose more than one-half of the extra revenues that had been projected. Indeed, taxpayer behavior was altered more than anticipated or desired.

Last year, we passed an immigration bill. It was interesting to note that we have 26,000 INS agents, while at the same time, we have 115,000 IRS agents. Are we more concerned about keeping illegal immigrants out of our country or squeezing taxes out of legal residents?

The American income tax system discriminates against savings and investment. Our income tax system increases the price of savings relative to consumption, directly opposite the economic message we should be promoting.

With an income tax, we initially tax income when it is earned, and then a second time on any return on investment or savings. On the other hand, the money spent on consumption, unlike the money going to savings, is not taxed again.

We have, in fact, a Tax Code that is systematically biased against savings, and as such, is detrimental to economic growth. Not only is our income tax biased against savings, it is a major impediment to productivity and business efficiency. Nationwide, individual taxpayers and businesses spend an estimated 5.4 billion man-hours complying with the Tax Code, more time than it takes to build every car, truck, and plane that we build in this country.

It is estimated that the compliance cost alone costs Americans \$250 billion a year. The current Internal Revenue code is 90 times longer than its first edition and has more pages than the Bible.

As a small businessowner, I know that the statistic is true, if not conservative, that small businessowners spend over \$4 in compliance cost for every \$1 paid in taxes. The Internal Revenue Service is itself a bureaucratic monster with a license to intimidate. It is one of the most intimidating bureaucracies that we have in the Federal Government, and it has no place in a free country.

Fred Goldberg, a former IRS Commissioner, admitted the IRS has been a symbol of the most intrusive, oppressive, and nondemocratic institution in a democratic society. With a work

force of over 115,000, the agency is one of the Federal Government's fastest growing nonentitlement programs.

I speak for the majority of Americans who demand tax relief. I don't mean just lower tax rates. Our entire tax system needs an overhaul, and the Internal Revenue Service has become the grim reaper of the U.S. Government.

As Jack Kemp stated in the report of the National Commission on Economic Growth and Tax Reform, the problem in America today is that we are taxing work, savings, investment, and productivity, and we are subsidizing debt, welfare, consumption, leisure, and mediocracy.

Clearly, I side with Mr. Kemp in his analysis and willingly accept responsibility to change the tax system. Therefore, I urge the Committee to join my colleagues and I to move to a national retail sales tax.

Thank you for your time and effort to reform this badly broken system.

[The prepared statement follows:]

National Retail Sales Tax
 Testimony Before the Committee on Ways and Means
 March 27, 1996
 Representative Dick Chrysler

The Need for the National Retail Sales Tax

Good afternoon. First, I would like to express my appreciation to the Chairman and the Committee for taking the time to discuss the tax reform our nation desperately needs and the steps this Congress should take in terms of making reform a reality.

Simply put, our present income tax system has failed us miserably. The income tax has failed this Congress and other Congresses before it by providing tax evaders and corporate welfare hawks a steady stream of opportunity in gaining unfair tax advantages. Our income tax has failed our government by fostering a counter-intuitive system which inhibits economic growth and discourages savings and investment. Finally, and most importantly, the income tax has failed the American people by becoming a nightmare of distrust and invasion of privacy. It is time to rip the income tax system out by its roots and replace it with a national retail sales tax, while eliminating the IRS, the inheritance tax, the estate tax, the capital gains tax, and the personal and corporate income taxes in the process.

The present income tax system is, to be politically correct, "economically challenged." Along with discouraging economic growth, savings, and investment, the income tax system is too complex and time-consuming. In fact, since the 1986 Tax Simplification Act, there has been 4,000 changes to the tax code. Congress has passively allowed the IRS to invade our privacy, and force the burden of proof on our citizens.

Mr. Chairman, this month the Joint Economic Committee laid out the persistent pattern of slow income growth plaguing the majority of middle class families, a situation described as the "Clinton Crunch." Without a doubt, much of this stagnation is attributable to bad government policies. Congressional history is full of our attempts to change or influence taxpayer behavior by giving special treatment to certain taxpayers or activities. However, with the incredible complexity of our income tax system, lawmakers have begun to baffle even themselves. The National Bureau of Economic Research issued a November report showing the massive 1993 Clinton tax increase resulted in decreased taxable income being reported, causing the Treasury to lose more than half of the extra revenue that had been projected. Indeed, taxpayer behavior was altered more than anticipated, or desired. I trust families to make decisions about how best to spend their money, not the federal government or the IRS. Last week, we passed an immigration bill. It was interesting to note that we have 26,000 INS agents, while at the same time we have 115,000 IRS agents. Are we more concerned about keeping illegal immigrants out of our country or squeezing taxes out of our legal residents?

It is ironic to watch lawmakers insist on the promotion of investment, job creation, and middle class family income growth, while at the same time adding to the matrix of tax provisions in the Internal Revenue Code. Such a tax system is itself a basic obstacle to economic growth.

An increasing consensus has emerged among tax experts and economists alike that moving to a consumption-based tax like the National Retail Sales Tax would provide incentives for savings and investment, lower interest rates, spur tremendous economic growth, and produce nearly a 14 percent increase in the standard of living for all Americans.

The American income tax system discriminates against savings and investment. Our income tax system increases the price of savings relative to consumption, directly opposite the economic message we should be promoting. With an income tax, we initially tax income when it is earned, and then a second time on any return on investment or savings. On the other hand, the money spent on consumption - unlike the money going to savings - is not taxed again. We have, in fact, a tax code that is systematically biased against savings, and as such, is a detriment to economic growth.

Not only is our income tax biased against savings, it is a major impediment to productivity and business efficiency. Nationwide, individual taxpayers and businesses spend an estimated 5.4 billion hours complying with the tax code. It is estimated that compliance alone costs Americans \$250 billion a year. The current Internal Revenue Code is 90 times longer than its first edition, and has more pages than the Bible. As a small business owner, I know that the statistic is true, if not conservative in its estimate, that small business owners spend over \$4 in compliance costs for every \$1 paid in taxes.

The compliance cost of our present income tax system is yet another level of taxation on the American people. The burden of our tax system is reflected in the inflated cost of every good and service we purchase. Economists estimate that 14 cents of every dollar we spend goes to pay hidden direct and indirect costs of our income tax system. Not only do Americans spend countless hours and dollars complying with our income tax system, but we are also punished with inflated prices. What a waste of productive time, money and resources!

The Internal Revenue Service is itself a bureaucratic monster with a license to intimidate. Imagine being involved in a tax conflict, where as a citizen up against the IRS and its five-foot Code and miles of rulings, you bear the burden of proof. There is no room for this intimidation in a civilized world. While a "flat tax" would be a vast improvement over the present system, it would still require us to report personal information and our income to the IRS, leaving us subject to audits and property seizure. Fred Goldberg, a former IRS Commissioner, admitted, "The IRS has become a symbol of the most intrusive, oppressive, and nondemocratic institution in a democratic society." With a workforce over 115,000, the agency is one of the federal government's fastest growing non-entitlement programs.

I speak for the majority of Americans who demand tax relief, and I don't mean just lower tax rates. The entire tax system needs an overhaul, and the Internal Revenue Service has become the grim reaper of the U.S. government. We need tax relief from our intrusive, complex and burdensome tax system through an entirely new way of collecting taxes. Ladies and gentlemen, I hope you will join me in supporting a retail sales tax system that fulfills the Kemp Commission's six principles.

As Jack Kemp stated in the report of the National Commission on Economic Growth and Tax Reform, "The problem in America today is that we are taxing work, saving, investment and productivity; and we're subsidizing debt, welfare, consumption, leisure and mediocrity." Clearly, I side with Mr. Kemp in his analysis, and willingly accept responsibility to change the tax system. Therefore, I urge the Committee to join my colleagues and I to move to a national retail sales tax. Thank you for your time and efforts to reform this badly broken system.

Mr. CAMP [presiding]. Thank you very much, and I want to thank all of you for coming to testify.

Mr. Christensen, any questions?

Mr. CHRISTENSEN. Thank you, Mr. Chairman. Yes, I do.

Mr. Chrysler, how do you see the national retail sales tax benefiting small business, labor, the consumers, in light of the fact that you would have a lot of retailers on Main Street say that the cost of their goods is going to go up and that you won't see as good of marketing, as good of sales at the cash register? Do you find that to be a true statement?

Mr. CHRYSLER. If you can lower the cost of doing business by eliminating the IRS by 10 to 14 percent, you will lower the cost of goods by 10 to 14 percent, and if you have a 14-percent sales tax, you are almost at a wash.

Then, if you are in a 15-percent tax bracket or a 25-percent tax bracket or a 40-percent tax bracket, that is like a 15-percent pay raise for every working American in America.

Businesses don't pay taxes, Jon. People pay taxes, and when you tax businesses, they add them into the cost of their product, and when you buy their product, you pay their taxes.

Mr. SCHAEFER. If I might intercede briefly, another thing besides the lowering of the price of the product is what it does for citizens' disposable income. You just have to ask people at town meetings how much they had withheld in their last paycheck in the Federal taxes, and you find that most of them don't remember. The NRST gives them a pay increase, because all of a sudden they are going to get that much money back, and if they have that much more money to spend—I think Billy mentioned something like \$8,000 a year on the average—more money in their pocket, they are going to buy more.

The third thing is that we were giving retailers one-half of 1 percent for collecting this in the first place, and we are giving a 50-percent writeoff on any cash registers or software or anything else in which they would have to purchase in order to comply with this.

So, as for the retailers, I think once they begin to understand some of these things more, they are going to find out this is going to be a great thing for them, and for the economy in the country.

Mr. TAUZIN. If I can jump in, you have touched on a very serious concern, as 15 percent is a big rate. We admit that that is one of the handicaps of our proposal, and adding 15 percent at the end of a product cost is something retailers are first going to be a bit concerned about. They should be.

What we are pointing out is that the consumer is already paying that basically in the cost of their products. We eliminate that cost. We put more money in each consumer's pockets because they no longer have withholding taken from their paychecks, and that extra income is disposable income, part of which will go into purchases, part of which will go into savings.

Let me give you the biggest reason why I think this is critically good for retailing in America. Retailers operate on about a 1.25-percent profit margin. It is that thin. Many of them are hurting right now in an economy that is not doing that well, where job security is not exactly what we would like it to be, where workers aren't earning as much in real terms as they did a few years ago.

What if you all of a sudden had an economic boom in this country because we start treating manufactured products in America as favorably as we treat products brought in from other countries? What if we took away that 14-percent disadvantage to manufacturing in America and we created a job market again for this country, manufacturing again? We put not only more money in each worker's paycheck, but we have more workers out there earning more money. The economy is growing more rapidly. We create an environment for retail sales, the likes of which we haven't seen in a long, long time. That economic analysis needs to be done, and when it is done, I think it will speak well of this proposal.

Mr. CHRYSLER. Billy, how do you think that the national retail sales tax would address the underground economy? Would it be the best approach of the proposals out there?

Mr. TAUZIN. Let's talk about the pros and the cons because we ought to talk about both.

On the pro side, the underground economy is not paying taxes right now. Maybe as much as \$100 billion is lost to your Committee's work. You have to raise taxes on somebody else to pick it up because somebody is not paying their taxes, maybe 100 billion dollars' worth, the legal underground economy.

The illegal underground economy may be another \$100 billion or so. We don't know.

This bill says everybody pays taxes. It doesn't matter where you make your money. You made it legally or illegally. When you spend it, you will be paying, along with the rest of us, part of the burden of this government. So it speaks to the underground economy problem and creates some tax fairness there.

Let me tell you about the con side if I have 1 second, the negative side. The negative side is a 15-percent tax is going to create some incentive for some people to avoid it, to create an underground economy in sales. The answer is that there are fewer retailers to watch in America than there are American taxpayers right now. You don't need 114,000 IRS agents to regulate and maintain tax avoidance problems in a retail sales tax collection system, as 45 States currently do a good job of it. We can incentivize them to do even better.

So, on the positive side, we tax the underground economy for the first time, tax fairness. On the negative side, I think we can address the problems of compliance cost.

Mr. CHRISTENSEN. Would the Chairman indulge me for one quick question?

Mr. CAMP. Absolutely.

Mr. CHRISTENSEN. How does your national retail sales tax, though, go after that remodeler that is doing a rough job and the homeowner says here is the \$500, let's just both work through this?

Mr. TAUZIN. Let's assume that happens. What happens when that guy goes to buy a boat with it or a new appliance with it? That money is going to eventually be taxed in this bill.

It doesn't matter, again, whether you earned it legally or illegally.

Mr. CHRISTENSEN. At some point, we are going to pick it up.

Mr. TAUZIN. Under current law, it is never taxed. You pay them in cash. No income tax is collected. There is no national sales tax today. So it is never collected.

Mr. CHRISTENSEN. I agree with you, but somebody said that the national retail sales tax would even drive more of a underground economy in terms of avoidance of taxes.

Mr. CHRYSLER. Can I address that really quickly, Jon, for you, and then we will go to Dan?

We have made a proposal in our plan to reward consumer informants. If that guy decided, hey, I am not going to charge a sales tax for putting the roof on your house, the person that didn't get charged could literally make a phone call to an 800 number. The person that didn't charge the tax would be fined and the informant would be rewarded.

Mr. CHRISTENSEN. There is going to have to be some enforcement mechanism.

Mr. CHRYSLER. So we wipe out most fraud by establishing a reward system.

Mr. SCHAEFER. If I might just add, no matter what kind of tax system that we put forth, there will always be some people trying to find loopholes somewhere. We know there are plenty of them in the one we have now, and the more affluent in this country are particularly able to figure out every loophole they can find.

In the surveys we have done, that has been done for us, the people who like this the most are the ones who are wage earners making between \$25,000 and \$50,000 a year, who do not have loopholes. These are the people that really like it because they know it will be more fair.

Mr. CHRISTENSEN. I applaud the Schaefer-Chrysler-Tauzin national retail sales tax. I think it may be the right approach. I think it could be good for this country. It allows people to save more money. It allows people to keep more of what they earn, and it takes us away from an egregious punitive tax system that is not going to take us anywhere in the 21st century.

So, Mr. Chairman, I want to thank this panel for testifying.

Mr. CAMP. Thank you, and I want to thank you all, too, for your work in this area.

I just have a question. What rate does your sales tax start out at, and does it stay that way or does it change as it is fully implemented?

Mr. SCHAEFER. Yes, Mr. Chairman. It is 15 percent. It started out at 12.9, and then we added in our personal consumption refund for everybody up at the poverty level, so that the working poor would virtually pay no taxes at all. So it is 15 percent.

I might add, it has woven into it a two-thirds vote of Congress in order to change it in any way, and you know how tough it is to get a two-thirds vote around here on anything.

Mr. CAMP. It is the majority, sometimes.

Mr. SCHAEFER. If somebody had proposed it, going from 15 to 16 percent, everybody in this country would know what you were doing. There wouldn't be any more of this hidden stuff being inserted here and there.

We are saying, in essence, we are going to give the right to pay taxes back to the American people, take it out of Congress' hands.

When they want to purchase something, they will know what they are paying in taxes.

Mr. TAUZIN. Let me add something quickly, Mr. Chairman. One of the biggest problems with tax systems around the world, including our own, is that so much of the taxes are hidden from the American public and from other citizens of other countries. That is the problem with the value-added tax, in my opinion. It is a hidden tax, much like the income tax cost is a hidden tax on products made in America.

The worst thing we do for our country is to hide what government costs. Our proposal says that our 15-percent rate is fixed and locked, cannot be changed without a two-thirds vote, and that 15-percent rate must be shown on the purchase price of the products purchased in America.

In short, we make sure it is not hidden anymore, that Americans know what the cost of government is, and that politicians who come to Washington to represent them are going to have a serious problem on their hands if they try to raise that 15 percent in the future.

So we try to avoid the business of hidden taxes that can be increased in the dead of night so easily, without the public ever knowing what hit them.

Mr. CAMP. Could you just elaborate a little bit, Dan, on the accommodation you make for the working poor?

Mr. SCHAEFER. Yes. Again, that is why we had to go to 15 percent outside of the 12.9. We felt we had to do this because of the regressivity of it.

Up to the poverty level, and it depends on the size of your family, you are going to get a personal consumption refund coming back on your FICA in your paycheck.

We feel this was very important to incorporate. It was important enough to raise this up to 15 percent. We can take away this argument and now say that the people who are the working poor up to that poverty line really aren't going to pay any taxes on anything because they get that refund in their check.

Mr. CHRYSLER. The other thing that is important is, that whatever the gross domestic product is on the day it is instituted is really what will set the rate, ultimately.

Also, I think it is important to add to what Dan said. Home mortgage deductions are treated, essentially, as they are today, and also charitable contributions. Charitable contributions are not consumption. Interest on your home mortgage is not consumption. So they would not be taxed.

Mr. TAUZIN. In fact, we have another vision for home purchases that I think is really, really excellent. What we provide in this is that if you have already purchased a home or already are purchasing a home, you are considered as having paid those taxes already. You did. You paid income taxes already.

If in the future you purchase a home, you will not pay taxes on the mortgage interest you pay. The taxes you do pay on the principal will be spread out over the life of your mortgage, whether it is 25, 30 years, whatever it is.

Whatever payments you make on that house over the years, when you sell it and repurchase another house, you will get a used

property credit for the taxes already paid. So you never will pay but once for the purchase of the value of the home.

What we have done is created a more favorable condition for home purchases in America than even the current Tax Code, and keep in mind, by eliminating the income tax, we are eliminating up to 14 percent of the cost of a home which is the cost of compliance with the IRS Code for all those people who manufacture things that go into home building in America.

Mr. CAMP. Thank you. Thank you all very much.

Mr. SCHAEFER. Thank you. We appreciate it, Mr. Chairman.

Mr. CAMP. Our next panel includes Hon. Nick Smith of Michigan and Hon. Sonny Bono of California. Mr. Smith is at the Rules Committee. Sonny Bono is detained.

So, without objection, we will permit those two Members to submit their testimony for the record.

[The prepared statements of Mr. Bono and Mr. Smith follow:]

**TESTIMONY OF CONGRESSMAN SONNY BONO (R-CA, 44th)
WAYS & MEANS TAX REFORM HEARINGS - MARCH 27, 1996**

Thank you Mr. Chairman, it is a pleasure to join today's distinguished witnesses and testify. Over the last year, there has been considerable talk and hype about tax reform. I commend you, Mr. Chairman, for scheduling the first of the many comprehensive hearings necessary to begin to comprehend this fundamental issue -- tax reform. In addition, I must congratulate Representatives Tauzin and Schaefer on their hard and smart work on a bold proposal for a National Retail Sales Tax.

Certainly, our country was born on the issue of tax reform. Every student knows the history behind the revolution that brought our Republic to life was, in large part, fought against a tyrannical and unjust tax collector, the British monarch. Essentially, this question is about fairness and independence.

Unfortunately, as the saying goes, people who forget history are doomed to repeat it. Today, many Americans find themselves subject to a similar plight, an undemocratic and intrusive federal bureaucracy called the Internal Revenue Service (IRS). While I applaud the IRS reforms that the House has begun, it is important to remind ourselves what they are -- a band-aid on a congenital wound. Beyond any procedural changes, there must be a fundamental change. Our economic survival and stability requires this.

The IRS administers our national income tax, an out-of-date idea that stifles personal savings and adds hidden costs to products and services. In addition, the IRS operates in a distinctly oppressive fashion, disregarding the rights of citizens and due process, and scrutinizing the taxpayer's every financial move.

This year, tax reform is certainly in vogue. The Presidential campaign brought the issue to the national spotlight once again. Millions in advertising dollars were spent promoting different plans. Although a number of tax reform alternatives have been proposed, in reality, none is as simple and fair as a National Retail Sales Tax.

Virtually all the other plans offered as replacements for the current tax system are consumption based. Unfortunately, they all share a common weakness. Each of these plans attempt to solve only a part of the problem. Under the flat tax, the Unlimited Savings Account Tax and an array of other proposals, income must still be defined, deductions must still be sought and taxpayers must still report to the IRS.

A National Retail Sales Tax is a genuine consumption based tax. It turns the current system upside-down and changes the relationship between the consumer and government. Under this plan, taxpayers, not the IRS, will get first crack at their paychecks. In fact, the IRS would be abolished under the National Retail Sales Tax legislation I have co-sponsored with Reps. Tauzin (R-LA) and Schaefer (R-CO). This proposal would eliminate income tax entirely and replace it with a National Retail Sales Tax of 15%.

The plan is simple. It is levied only at the final point of sale, on every product and service purchased. My experiences as a former businessman also confirm the soundness of the national sales tax. Many states already administer a sales tax, and businesses are familiar with the concept. Under the bill, both states and retail businesses would keep a percentage of the taxes they receive as a means to offset fully administrative costs. This is not an unfunded mandate. States would use their existing systems to collect the revenue generated from sales -- the government would only get its share when the taxpayer chooses to consume. Studies estimate that the national economic growth under this plan would be, conservatively, between 7 to 9%.

Under the existing income tax system, hidden taxes are passed on to the consumer in higher prices. Economists will tell you that corporations do not pay taxes, consumers do. Its simple, taxes and the reporting compliance are factored into the price of any item produced and then passed on to the consumer. No matter what we call it, any income tax becomes a hidden consumption tax in the end. Every dollar paid in personal income tax

is one less after-tax dollar that can be consumed. But, because of income tax withholding, that fact is hidden from consumers.

The Schaefer-Tauzin bill will repeal the income tax, abolish the IRS, install a National Retail Sales Tax, protect taxpayers, provide tax credits to those at or below the poverty level, and help make American products more competitive abroad. Home mortgage interest will not be taxed, and a used property tax credit is created to protect home buyers. Investors are also protected, since investment and savings are not consumption. Individuals will no longer have to itemize deductions or seek exemptions. To safeguard against future tax increases, the bill requires a 2/3 supermajority vote in both Houses of Congress to raise the sales tax rate and create any new exemptions.

The Kemp Commission on Economic Growth and Tax Reform laid out six principles that any tax reform plan should meet. The NRST qualifies on all counts. It will stimulate economic growth, it is fair, it is simple, it is revenue neutral, it is visible and it is stable. When the income tax was instituted in 1914 the tax code was 14 pages long. Today the code has been amended by 40 different acts of Congress, and comprises thousands of pages of law and rules, and hundreds of thousands of pages of rulings and interpretations. Tax preparers and income tax experts admit that they do not fully understand all the provisions and ramifications -- how can we expect the average consumer to deal with it. We can, and must, do better.

Join me in supporting the National Retail Sales Tax movement. For this type of radical change, the people must send a message to their representatives that the time has come for action. This should be a mandate from the people, for the people -- not a government mandate to the people.

Again, I thank you Mr. Chairman for this opportunity to address the Committee, and I yield the balance of my time.

Statement of Congressman Nick Smith

House Committee on Ways and Means
March 27, 1996

Mr. Chairman, members of the committee:

Thank you for the opportunity to provide the committee with some of my thoughts regarding tax reform. As I was Chairman of the Senate Finance Committee in Michigan, which is the only state in the nation to have a value added tax, and which also has a retail sales tax and a flat rate income tax on individuals, I have followed with great interest the debate on tax reform.

You are well aware of the problems with our current system of direct taxation. Economists Robert Hall and Alvin Rabushka estimate the cost of collecting the tax and taxpayer compliance at \$625 billion for the 1993 fiscal year. Economists have long known that the double taxation of dividends and capital gains that mark the current system creates a bias against capital. This bias leads to a distortion in the capital/labor ratio which leads to reduced wages. The intrusive nature of the system creates a concern about the diminution of our individual rights. Tax avoidance and evasion lead other taxpayers to feel that the system is unfair. The time has long past for a revamping of the entire system.

What I would like to talk about today is the similarities among the three basic options for a complete reform of the tax system--the flat tax, a consumption-based value added tax, and a national retail sales tax. What has not been emphasized in this debate is that all three of these taxes have essentially the same tax base, and thus will have nearly the same economic effects.

The sum of the value added of individual firms is the value of retail sales. Thus, a value added tax which allows for immediate expensing of capital, has the same tax base as a retail sales tax. To see this is true, consider the simple example of a farmer growing wheat, which is then sold to a miller, who then sells flour to a baker, who sells bread at retail. Value added is a firm's sales minus what it purchases from other firms. To simplify the example, suppose the farmer has his own seeds, fertilizer, etc., so he doesn't purchase anything from another firm. He then grows wheat and sells it for \$150 to the miller. The farmer's value-added would be \$150. The miller turns the wheat into \$200 of flour, which she sells to the baker. The miller's value added is \$50, the \$200 minus the \$150 she paid for the wheat. The baker then bakes the bread and sells it for \$300. The baker's value added is \$100, the \$300 of bread minus the \$200 of flour. Now, the total value added is the farmer's \$150, plus the miller's \$50, plus the baker's \$100, or \$300. This is the exact same value of the retail sale--\$300. Thus, a tax on value added will give you the same tax base as a true retail sales tax.

Now we will see that the flat tax gives the same tax base as a value added tax, except for the personal deduction. The flat tax taxes all business firms on their business profit. But business profit is defined as sales minus what is purchased from other firms minus expensing of capital minus wages. But, this is simply the firm's value added minus wages. The individual then pays his or her tax on wages. Since the tax rate is the same for businesses and individuals, if we ignore the personal exemption, the tax base of the value added tax and the tax base of the flat tax are the same. The only difference is that under the value added tax the tax is collected completely from businesses and under the flat tax the compensation part of value added is collected from the individual.

There are two differences between the flat tax and the value added tax. One is that under the flat tax individuals are allowed a personal exemption (around \$32,000 per family of four, depending upon whose plan is being discussed). Obviously, since a value added tax is collected from businesses, it is not possible to give individual exemptions. The second difference is the administration of the tax. Under a flat tax the individual taxpayer is aware of the amount of the tax on his compensation, since he pays the tax directly. Under the value added tax, the individual does not pay the tax directly and therefore is spared the burden of filing the tax and the intrusion of the IRS in finding out how much each individual is paid.

The difference between the retail sales tax and the value added tax is its administration. The value added tax would be collected from each firm, rather than only those that make retail sales. Thus, more firms are involved in a value added tax. Under a retail sales tax, it is possible for each individual to be made aware of the amount of the tax by separating the tax from the purchase price of the good. Under the value added tax, there is no direct information to the consumer of the amount of the tax, since it simply shows up in the price of the product.

The point of this discussion is two-fold. First, it is easy for the press to underestimate the degree of agreement among those who are seeking elimination of the current system. Those who advocate the national retail sales tax differ from those who advocate a consumption based value added tax primarily in one collection and administration of the tax. Those who offer a value added tax differ from flat tax advocates only in the administration of the tax and the personal exemption. It is even possible to mimic a personal exemption in the value added tax through a payment to individuals on an annual basis. The same can be done for a retail sales tax.

Second, I would like to offer some thoughts on the issues that need to be considered in deciding on reform. With regard to the retail sales tax: it will be necessary to ensure that the tax does not turn into a pyramiding turnover tax. As an example, if I hire an accountant to do the books for Nick Smith's farm, this should not be a taxable transaction, since it is a business to business transaction. However, if this accountant does my personal finances, then this will be a taxable transaction, since it is a retail sale. There are many lessons that can be learned from talking with those who currently administer retail sales taxes in the various states, especially those that have, as Michigan does, an exemption for goods-in-process.

With regard to the value added tax, will it be too easy to increase the rate? The experience in the industrialized countries has been that the rate has gradually increased. However, this was not the case in Michigan. The Single Business Tax was enacted in 1975 and the rate remained stable for 20 years at 2.35%. In Michigan, the SBT rate was actually decreased slightly to 2.3% in 1994. Increased consumer awareness that it is ultimately the consumer that pays this tax has been a factor in keeping the rate from rising.

With regard to both the value added tax and the retail sales tax, will they become a tax that is placed on top of the current income tax system, or will they be enacted in conjunction with a repeal of the 16th Amendment and complete elimination of the current system?

With regard to the flat tax for individuals: will it be possible to truly reform the tax without the eventual return of the complicated system that we now have? Already there is a debate about a deduction for home mortgage interest and charitable contributions. Also, the transition costs of the flat tax are a little more obvious than for a value added tax or the sales tax.

In particular, the remaining depreciation will be a major issue. Of course, as I pointed out, since the tax base of all three taxes is essentially the same, the existing depreciation is also lost under a VAT or retail sales tax, but it is not so obvious since it appears that the tax is very different.

In summary, each of the major proposals for tax reform would be a major improvement over the current system. Each would reduce the intrusion of the federal government into the personal lives of our citizens. Each would lead to a more efficient use of capital and labor in this country with an increase in the standard of living for all Americans. Mr. Chairman, your leadership in detailing the failings of our current system and the possibilities we have to set our economy on the right path and restore some of our individual liberty is to be commended. Thank you for allowing me to add my thought to the debate.

Mr. CAMP. The Committee stands adjourned.
[Whereupon, at 3:15 p.m., the hearing was adjourned.]
[Submissions for the record follow.]

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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

Topic: Replacing the Federal Income Tax

March 1996

Thank you Mr. Chairman and members of this committee for holding this second round of hearings to tear the income tax out by its roots, and examining alternative tax systems that would replace federal taxation calculated from profits, gains, interest, wages, salaries, tips, gross receipts, estates, gifts, or other, periodically or randomly received lawful monies.

The word "reform", found in Webster's Seventh New Collegiate Dictionary, tells us the idea of "reform" is "to put an end to (an evil) by enforcing or introducing a better method or course of action."

Chairman Archer unequivocally laid the ground rules for true reform when he declared his aims were "... the total elimination of the IRS from the individual lives of every single American Citizen...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."

Judging from last years' hearings on this topic and the public's subsequent focus on two primary alternatives to current income taxation, namely a flat tax or national sales tax, and a number of faults having been identified in each of these proposals, perhaps it is wise to address such faults and find remedies if possible in order to accomplish the stated aim of genuine tax reform.

The flat tax proposal does not even come close to accomplishing Chairman Archer's tax reform guidelines and will not end the following list of complaints associated with current taxation which were made known to this Committee during last years hearings:

* Businesses and self-employed individuals will still have to keep time consuming and costly records for the IRS.

* The IRS will still be allowed to exercise intrusive inquisitorial powers, including that of random audits of individuals and businesses.

* The IRS will still exercise an arbitrary power to impose fines and penalties upon those who may make an honest mistake in computing taxable income, which continues the need for businesses and individuals to retain expensive tax attorneys and accountants.

* The proposed flat tax "reform" will also preserve a government bureaucracy capable of reaching almost every adult and business in America, a bureaucracy known to be used by folks in government to harass and subjugate political opposition, including members of Congress, under the guise of collecting taxes!

In addition, the flat tax idea is based upon the same questionable principle as a progressive income tax. For example, those in our nation's labor force who find it necessary to work overtime and/or on weekends to pay for their children's college tuition, family medical bills which may arise, or other such necessities, and are thus more productive in their community during a calendar year than fellow employees working at the same job who do not work overtime and enjoy their weekends, will be singled out (based upon their annual earnings) and compelled to finance government, not through an equal contribution in harmony with "*equal protection under the law*", but forced to finance the federal government based upon law which penalizes these individuals for their superior production, i.e., work more, earn more . . . pay more.

There is no formula in the flat tax proposal to compensate our nations' most productive people for the overtime they work or their lost weekends . . . only a penalizing increase in their taxes for daring to be productive. Is this what the architects of the flat tax desire?

The suggestion that the flat rate tax is designed upon a principle of equality (every person bears the same burden by paying the same rate) is far from being true. If the object of the flat tax is to insure fairness by having every person contribute to financing government based upon a fixed percentage of their wealth, then the calculation for each taxpayer's share under the proposal would have to be computed from *actual wealth in real and personal property*, (total accumulated wealth) and not limited to a taxpayers' annual earnings which only represents a fragment of some peoples wealth.

The omittance of actual wealth in real and personal property from the flat tax formula, and its focus on annual earnings, seems to be an intentional attempt to place a disproportionate burden of the tax upon those with the least total accumulated wealth. In many instances a working person's total annual wages will almost equal the person's entire accumulated wealth, while the opposite is generally true for our nation's most successful citizens, i.e., their annual earnings generally represents a minuscule portion of their total accumulated wealth.

A taxpayer, under the flat tax proposal, may adjust his financial affairs so he may own millions, even billions of dollars in jewelry, luxury automobiles, marine and air vehicles, summer and winter homes and other real estate holdings, etc., and also have annual investment income in the millions of dollars, and wind up contributing less to the federal government under the flat tax proposal than a carpenter, plumber, doctor, or person engaged in a similar working type occupation.

And what is the stated principle for making income from monied investments tax free, while earned wages are not? Why is there a tax exempt status created for those who have money working as opposed to those who work for their money? Why are those who make monied types of investments, as contradistinguished from labor intensive investments, even if the monied investments do not benefit the community (investments in corporate stocks financing manufacturing facilities on foreign soil, or, investments in government securities, which is an investment in Congress' power to tax America's domestic labor, businesses and industries, and is nothing more than an investment in Congress' decision to increase the national debt), to be tax free upon such earnings? Surely the proponents of the flat tax must be eager to answer such questions and enlighten this Committee in their method of fairness.

Another glaring inequity in the flat tax proposal is immediately identified by its two different tax forms: one is for individuals and the other for businesses, as if our nations' laboring class citizen is not engaged in a business transaction

when marketing their time, labor, skills, personality, etc. The reason why two different forms are necessary is because of the dishonest method by which taxable income is calculated for wage earners.

Under the flat tax plan businesses are to subtract all expenses and outlays from gross receipts when computing the profit or gain from which their tax will be measured. For those unfamiliar with the definition of the word income as it appears in the Sixteenth Amendment, and to provide the reason why businesses under the flat tax proposal are to deduct all expenses and outlays when computing their "taxable income", the following quote from the United States Supreme Court decision, Eisner v. Macomber, 252 U.S. 189, (1920), is here given along with another tax case occurring eight years afterwards:

"Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets . . ."

In Sullenger v. Commissioner, 11 T.C. 1076 (1948), a case involving a tax imposed upon the income received from the sale of meat, the judge stated that Section 162 of the regulations of the Office of Price Administration, a World War II agency, made no provision for the deduction of the cost of goods sold:

"but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory. The income from a business which is wholly illegal was held subject to income tax in United States v. Sullivan, 274 U.S. 259. Nevertheless, it was necessary to determine what that income was, and the cost of an illegal purchase of liquor was subtracted from proceeds of the illegal sale of the liquor in order to arrive at the gain from the illegal transactions which were subjected to income tax in that case . . . No authority has been cited for denying to this taxpayer the cost of goods sold in computing his profit, *which profit alone is gross income for income tax purposes.*" [emphasis added]

So, now we see "income" is not all money which comes in, but refers only to that portion which constitutes a "profit", or "gain", and thus, even a person engaged in an illegal profit making operation is entitled (as stated by the Court), to certain deductions in order to compute the profit from which the tax is measured. Such deduction are not a matter of grace granted by Congress, they are constitutionally mandated!

The architects of the flat tax seem to obey the Supreme Court's definition of the word "income" when it comes to calculating a businesses income (profit or gain), but disregards the Court in reference to working people by promoting a system in which the necessary expenses and outlays of the working person such as transportation to and from work, the market value of eight hours of life given up and placed at the disposal of an employer, the food which fuels a working person's body during working hours, and other costs and outlays which makes a person's labor possible (especially the necessities of life) are not to be subtracted from annual wages in order to compute "*profit, which profit alone is gross income for income tax purposes.*"

The irrefutable fact is, wage earning people are not normally engaged in a profit or gain (income making) venture when employed by business, industry or otherwise. Their relationship with an employer amounts to nothing more than a *conversion of human capital* (labor, skill, time, etc.) into earned wages, while those who employ the wage earner do in fact seek to realize a profit by

purchasing and then utilizing and managing the wage earner's human capital.

With so many obvious inequities attached to the flat tax proposal, including the continuation of class warfare and its failure to fulfill the goals as stated by Chairman Archer in June of 1995 at the opening of last years session, the stated goal being to rip income taxation out by its roots, it appears this Committee has no choice but to acknowledge the countless irreconcilable deficiencies contained in the flat tax proposal, and move on to other alternatives in search for sincere tax reform.

One such alternative is the Founding Founder's original tax reform plan which taxes consumption. An outline of the Founder's plan appears on pages 687-692 of last years' Hearings book titled "REPLACING THE FEDERAL INCOME TAX" JUNE 6, 7, AND 8, 1995.

Not only does the Founder's plan contain Chairman Archer's stated goals, but it also contains an exact method to extinguish annual deficits should Congress continue to borrow money to meet annual expenses. Moreover, it has already proved to be a successful system. Was not America the economic marvel of the world when Congress abided by the Founder's original tax reform plan?

For the benefit of this Committee, I will now provide the text of the Founder's plan, as reported in last year's hearing book:

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 seaboard 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 the national sales tax proposals appear to be somewhat fairer than existing taxation, each would do ill to our nation as they are all based upon internal taxation, which would ultimately increase the cost of goods manufactured on American soil; burden 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 further study the Founder's plan and learn 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 not only filled our national treasury, but 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...an irrefutable sign of America's decline traceable to the 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 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 Framers' 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 Framers' 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.

April 5, 1996

Philip D. Mosely
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20516

Dear Mr. Mosely:

I would like to comment on the possibility of replacing the federal income tax system. I do not think that we should replace the federal income tax system. None of the alternatives to our tax system work with the framework that is in place. The framework of our income tax system has arisen as needs have arisen and should be repaired and kept in good working order in the same manner. None of the alternatives offered to our tax system have the ability to promote public policy, stimulate the public good and morals as does our current system. I think our tax system should have the ability to stimulate correct behavior in U.S. citizens.

I do think that certain changes are in order. Changes should be made to correct the framework of our taxes. My example is the area of Passive Losses. A small transaction can generate a string of forms and probably should be ridiculed. By the time you can record the activity of a Publicly Traded Partnership (my specific example) you have been through a decision-tree that few would ever understand. Areas such as these should be simplified. I could not see the point for having to create this type of format. I would probably try to simplify our system where a given point could never generate more than a certain number of forms. An item could never generate a string of forms greater than a certain length or a simpler treatment should be sought. The decision-tree should have only a certain number of branches.

I also think that the double-taxation of corporations should be eliminated. I think corporate growth would be stimulated. Investment in corporations would increase and possibly reverse our export deficit. I don't think we should even consider alternative ways to tax or exempt dividends. Simply tax the corporations, not the distributions and keep this in line with simplifying the tax system. From what I have heard this will give the United States parity with other tax systems anyway.

I would also take the stance that whenever a problem arises in regard to our tax laws when implementing future changes, the rules should lean toward favoring our basic three types of business organizations: the proprietorship, the partnership, and the corporation (not including the S-Corporation). I have noticed our tax laws work well with these organizations. All other business forms are hybrids and complicate our basic tax structure. They should not be favored.

These thoughts are not much but might help simplify our current tax system and help develop a clearer picture of where our taxes need more simplification in the future.

Please note my comment is limited only to our federal income tax and not to our Social Security and Medicare system which should probably be reformed separately and with separate comments.

Thank you so much.

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Mark Borsuk
Managing Director

March 22, 1996

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SUBJECT: INFOTECH's Impact on Tax Policy

Dear Chairman Archer and Committee Members:

Your consideration of tax code revision should incorporate the impact of information technology on the economy. Specifically, the Committee should examine the negative impact of tax policy and INFOTECH on commercial real estate values. INFOTECH refers to the integration of computer hardware, software and telecommunications.

INFOTECH severs place from activity: work no longer needs a workplace and shopping does not require a shop. This has profound implications for commercial real estate. First, INFOTECH already is a factor in the office building market. In three to five years on-line shopping will impact retail properties. Second, millions of individuals, by investing indirectly through public and private pension funds, insurance companies and other financial institutions, and directly through REITs, could suffer from an erosion in property values. Third, falling collateral values put lenders at risk. The cumulative impact on equity and debt investors could make the savings and loan crisis pale in comparison. However, unlike their imprudent investing, the impact of INFOTECH is unavoidable.

INFOTECH also challenges the industrial age assumptions underlying the tax code created in 1913 by the 16th Amendment. Falling commercial demand induced by INFOTECH combined with the present taxation scheme will exacerbate real property losses. One approach to stemming the fall in value is to modify the Code's provisions related to real property. Even the present policy is not economically neutral. In the information age the tax law is stacked against commercial property.

There is a serious discontinuity between an economy in the information age and a tax system rooted in the industrial era. The Code's rigidities influence all phases of the investment cycle: acquisition, ownership and disposition. One example of changing the Code to comport with the information age is to accept that INFOTECH creates "extraordinary obsolescence" for buildings. IRS Regulation Sec. 1.167(a)-9 permits this outcome, albeit not to the degree required. If the regulation incorporates INFOTECH's impact on commercial property, then taxpayers would have a deduction for the balance of their unamortized costs. Adding this safety valve could offset some of the problems created by INFOTECH, like the North American legacy office building. Many contemporary office buildings have floor layouts incompatible with the space needs of organizations. When buildings no longer serve a useful purpose, what happens to their value and the property tax base? Other examples of the mismatch between INFOTECH and the Code are:

- the very long, 39 year, depreciation period taken for improvements;
- the requirement to capitalize demolition costs;
- the six month limit on IRC 1031 exchanges; and
- the type of building eligible for rehabilitation credits.

Thus, the present tax policy distorts market efficiency and economic growth by hampering the reuse of existing properties.

The present tax law is a product of a bygone era. The Committee's efforts to reform the tax code should encourage the economy's transition to the information age. Acknowledging INFOTECH's impact on commercial property represents a positive step in tax reform. The Committee's challenge is to develop a responsive tax policy in an era of continuous discontinuity.

Thank you for considering my proposal for tax reform. If I may provide the Committee with additional information, please contact me.

Sincerely yours,



Mark Borsuk

Attachments:

-Real Estate Tax Policy for the Information Age, Real Estate Review, Vol. 25,
No. 4, Winter, 1996.

-Don't Be A Cyberputz, California Real Estate Journal, March, 1996.

-James Denn, High Tech Means Big Changes For Cities, Real Estate, Albany Times
Union, March 13, 1996.

cc: **Committee Members**
Philip Moseley, Chief of Staff
Stuart Brown, Chief Counsel, IRS
Alvin and Heidi Toffler

Message: 640

To: mborsuk@ix.netcom.com (Mark Borsuk)

Cc: tdurkin@vfr.net, gcrick@sqi.utexas.edu, kircher@bga.com

From: jgreen@friday.houston.net (Jonathan Green)

Subject: Real Estate Changes

Date: Mon, 18 Mar 1996 19:06:17 -0600

Here's a copy of the article, the original's URL is:

http://nytsyn.com/live/Features1/073_031396_070011_11404.html

HIGH TECH MEANS BIG CHANGE FOR CITIES, REAL ESTATE (03/13)

By JAMES DENN

Albany Times Union

ALBANY, N.Y. - The winds of change, stirred by the rapid emergence of technology, are blowing through America's skyscraper canyons and office parks. These changes eventually may have a dramatic and financially painful effect on the mammoth commercial real estate market, according to new research. Linked computers, high-speed faxes and powerful computers capable of digitizing documents by the roomful, are rewriting the rules of how business operates, studies say. Not only is technology reducing the need for workers in some fields, it is giving companies the option to house workers at less costly sites through interconnecting computer systems.

Historically, cities grew as centers of transactions and commerce largely because of the need for physical proximity among firms, suppliers and customers. Massive office buildings - the skyscraper - were built to meet this need. But companies may no longer have to house employees in a central location.

"The economics that drove the development of real estate for the past three decades aren't there in today's information age," said Barry Libert, managing director of Arthur Anderson & Co.'s real estate transformation group in Boston.

"In the old days, all business was done in buildings," he said. "But companies are expanding globally, using fewer people to do more work in less space with the help of electronic connections. Location - the proximity to customers - no longer drives the bottom line." By the turn of the century, the value of commercial real estate in the U.S. may plummet \$660 billion, or 20 percent, according to a new study by Anderson, a national consulting company.

Anderson reports there is 100 million square feet of unneeded retail space in the U.S., or about 20 percent of the total. There is 3 billion square feet of unneeded office space, or about 10 percent of the total. And there is 40 percent extra industrial space.

Anderson is only one group among many that has noted the pending changes in the U.S. commercial real estate market. Last year, the federal Office of Technology Assessment, just before it was disbanded, issued a stirring report on the technological reshaping of America. "The United States is in the midst of a technological revolution, driven in large part by rapid advances in microelectronics," wrote OTA's analysts. "These technologies will form the basis of a new technology system that is giving shape to the next wave in urbanization ... the post-industrial metropolis."

Many of the early applications of information technology improved internal operations and often created "islands of automation" with little interconnection between components. Only recently has technology been widely adopted that facilitates real-time connections and allows widespread linkages and communication among dispersed operations. Technology now connects economic activities, enabling these activities to be physically farther apart, reducing the once competitive advantage of high-cost, congested urban locations and allowing people and businesses more freedom to choose where they will live and work.

"There is no question technology is having an impact on real estate," said Hugh Johnson, chief investment officer with First Albany Corp. "The economy is becoming less labor intensive. There is going to be less need for commercial real estate."

Henry C. Lucas, a professor at Stern School of Business in New York, says managers can now remain in contact and supervise significantly more subordinates. Technology may also reduce the need for warehousing. Years ago, corporations leased huge warehouses to store paper documents. Today, most of those documents can be stored electronically, reducing both space needs and costs. Experts predict modern technology may also have an equally dramatic impact on retail space. If enough people grow used to "virtual shopping malls" it could eliminate the need for a substantial portion of existing retail space. The changes technology is having on the marketplace go far beyond the impact on owners of commercial real estate. Not only could it reduce property values for municipalities and school districts, it also may change commuting patterns.

The federal study suggested that urban centers will have trouble adapting and will face greater disinvestment, job loss and fiscal difficulties than suburban markets. "Businesses and people will be freer to choose where they will locate," said the OTA. "And many will choose to locate in lower-cost, higher-amenity areas."

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COMMENTARY

DON'T BE A CYBERPUTZ

TO UNDERSTAND INFOTECH'S IMPACT, DON'T PRETEND IT'S NOT HAPPENING

BY MARK BORSUK

A significant shift is coming for commercial real estate — a result of information technology. "Infotech," the widespread use and integration of computer hardware, software and telecommunications, severs place from activity and can reduce property values by lessening the premium paid for location. Infotech has already had an impact on the office market and in three to five years it will exert an impact on the retail market. Infotech's cumulative impact will profoundly shift the demand for commercial property.

Infotech changes how, when and where we work. It changes consumption, shopping and leisure time patterns. In the very near future, there will be a large and growing cadre of consumers banking and shopping on-line. In the real estate market, infotech will create new winners and losers.

Market participants need to understand the impact and challenges of infotech. The putz will dismiss infotech as a fad. However, others will seek to understand the shift and align themselves with the imperatives of the information age. They will benefit in this changing environment; while the cyberputz will be asking "what happened?"

WHAT IS HAPPENING: The transition from the industrial to the information age is upon us. In the information age knowledge and its manipulation become the engines of growth.

Infotech allows organizations to move from hierarchies (vertical) to networks (horizontal) for decision making. The network removes layers of management, permits work outside the office and promotes outsourcing of functions. It also reduces "monkey work": the review of work by ever higher levels of checkers.

Infotech is fueling the rapid expansion of home computers and Internet use. Today, approximately 9.6 million households are on-line. By 1999 that number will double or triple. The wired

consumer base necessary for on-line banking and shopping is fast approaching critical mass.

If organizations and governmental entities are more productive with less space, what does this portend for office space demand? If consumers can shift their purchases on-line, how does this impact the need for retail space?

NOW IT'S HAPPENING: In the private sector several factors are working to reduce commercial space require-

ments. In their drive to improve performance and shareholder value, companies are aligning their real estate holdings with their corporate goals. This thinking is revolutionary.

Corporate America knows there is a critical need to actively manage its real estate, for occupancy costs are the second largest expense. Two studies published in 1995 give organizations the impetus to substantially reduce their property holdings with less emphasis on Class A space while improving productivity, profitability and customer satisfaction.

The International Development Research Council study "Reinventing the Workplace" provides the academic justification. The Harvard Business Review article "Managing Real Estate to Build Value" (Nov.-Dec.) legitimizes the issue and offers methodologies for implementation. They add to other research demonstrating significant cost savings and productivity gains from infotech. For example, PacBell is reducing its administrative office space by 28 percent — from 9.5 million square feet to 6.8 million square feet over five

years with an expected 25 percent drop in occupancy costs.

If managers will not implement these strategies, then the cybersurgeons will. Cybersurgeons are a new class of corporate raiders using infotech to sharpen their valuation models. Cybersurgeons will seek companies with large holdings of space, amenable to downsizing. They will substitute software for staff to reduce headcount, impose telework programs on employees to cut back on space needs, sell corporate holdings and renegotiate leases, all to improve shareholder value. Cybersurgery will force landlords and lenders to become unwilling participants in corporate takeovers.

A similar restructuring could face government. How long before the private sector heuristics port over to the public sector? Will corporate successes whet the taxpayers' appetite for equal staff and space reductions? If a political mandate occurs, many will seek to implement these ideas. A government space retrenchment would place downward pressure on office rents.

The retail property market presents an analogous situation. However, instead of separating work from the workplace, shopping will require fewer shops. Cybersales require two prerequisites: the use of the new retail distribution channel, and consumers learning a new shopping pattern.

Retailers are not in the real estate business, although stores are their primary marketing channel. Rather, location is one of several distribution avenues. Retailers in the software, computer and name brand goods businesses are candidates for the transition to cyberelling. Retailers have a very compelling reason to generate sales in cyberspace: lowering their rent and overhead expense. Wal-Mart's intention to start selling on-line indicates "location, location, location" is losing its appeal.

In order to change their distribution channel, retailers will need to persuade consumers to get on-line and choose their cyberstore. Skeptics argue there are too many impediments to on-line shopping. See **CYBERPUTZ** Page 34

"In the information age, knowledge and its manipulation become the engines of growth."

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CYBERPUTZ

from page 4

like access, security and selection. Today, they are correct. Tomorrow? We forget destination shopping is a learned pattern. Thus, on-line banking may be the catalyst to convert consumers to on-line shoppers. Once consumers bank on-line, shopping will be natural.

Today, many goods and services are amenable for cybershopping. Commodity items like books, computers, software, electronics, car parts and recorded music are good candidates for on-line purchases. They are fungible and consumers for the most part are presold or just need information. Location based retailers add very little value to the transaction.

Similarly, restocking items may also be ripe for cybershopping. Why is it necessary to go to the grocery store or the warehouse club to buy aspirin, toilet paper and ketchup? They all can be ordered on line and shipped to the consumer's door. Again brand, quality and price are givens with the merchant adding no value.

From the retailer's standpoint, a growing volume of sales generated in cyberspace will quickly call into question the store as a distribution channel. Reaction may include going to a catalog format with no space devoted to inventory, eliminating locations or changing functions. Along with reconfiguring their space needs, retailers will fundamentally change lease terms. The use of a short term, pure gross lease

with multiple options is possible. All this spells trouble for retail property owners.

The tax law does not bless property made redundant by infotech. Taxation is economically not a neutral factor. The system reflects an industrial age bias of treating bricks and mortar as wealth without adjusting for a rapidly decreasing life span. In the information age, wealth will increasingly come from knowledge (Netscape) instead of goods (General Motors). Put another way, it will take less space to create wealth.

The tax code works against commercial property. It inhibits transition to the information age by stretching deductions over long periods, limiting rehabilitation credits to a small class of structures, not permitting the expensing of demolition costs, and not recognizing that infotech causes "extraordinary obsolescence" to buildings. Witness the North American office building legacy problem — the floor plate does not correspond to organizational needs.

A tax revision targeting existing commercial structures will protect them from the full price decline induced by oversupply. The existing policy requires investors to demand steep price concessions to justify the risk. This makes microeconomic sense but given the large number of public and private pension fund investors it may not make much macroeconomic and political sense.

WHAT HAPPENS TO YOU? The impact of infotech on commercial property is an emerging issue. Most market participants are likely to dismiss the phe-

nomemon. It's easy to believe the acceptance of infotech in the home and office will not change organizational needs or consumer habits. Besides, it's somewhat counter intuitive to think this when office vacancies are falling and developers are constructing spec buildings.

The abstract nature of infotech is another reason for the market to have a recognition lag. The abstraction masks a ubiquitous presence. Unfortunately, all the signposts point in the same direction: change is here and accelerating.

The market will adjust to infotech in a number of ways. For instance brokerage and investment strategies will undergo change. Commercial brokers need to provide greater service. Much of their proprietary information will become available on the Internet. For example, the Building Owners and Managers Association's Web page will have member building information. This is the harbinger of a public national MLS. In addition, deals will require more rigorous financial analysis. Brokers will have to understand the economic impact of lease clauses to properly advise their clients. Just introducing the parties is no longer enough.

Tenants benefit from infotech. It offers them flexibility and lowers their real estate costs. Owners and lenders are at risk. Their investment environment is more volatile. Infotech will likely cause a shorter real estate cycle with more frequent tenant turnover. However, new uses and users will appear to offer attractive investment opportunities for those following the trend. ■

R E A L E S T A T E

REVIEW

Winter 1996

Real Estate Tax Policy for the Information Age

with the compliments of

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**VG
&E**

REAL ESTATE TAX POLICY FOR THE INFORMATION AGE

The federal government should recognize the coming decline in demand for commercial properties.

MARK BORSUK

Cyberspace strikes at the heart of commercial real estate by radically diminishing the value of location. Presence and activity are no longer synonymous. "Information technology" (INFOTECH), the integration of computer hardware, software, and telecommunications, severs the link between work and the workplace and between shopping and retail stores. The impact of INFOTECH has changed the American economy fundamentally. The transition from an industry-based to a knowledge-based economy will be rough and painful, and it will significantly lower the values of many commercial real estate investments.

A significant factor preventing commercial real estate from adapting to the information age is the federal tax law. The static nature of federal tax policy make it a powerful negative influence on the market. Changing the tax law may not forestall the financial losses facing real estate developers, investors, and lenders as the information age takes hold, but the transition would be eased by a tax system that promotes development, investment, and disposition of property consistent with the new forces driving the economy.

This article, however, is not about tax law per se. It is about how tax policy influences economic decisions concerning developing, investing in, and disposing of commercial properties. Tax policy is never market neutral; present tax policy is a product of the rapidly disappearing industry era, it sends the wrong signal to the commercial real

estate market and inhibits the market's adjustment to the imperatives of the information age.

This article, therefore, suggests tax code revisions that would generate tax benefits for developers and investors. Because the suggested revisions apply only to existing commercial properties and not to new development, they are not an attempt to return to the "golden age" of real estate tax shelters.

The analysis in this article ignores any positive impact that INFOTECH may exert on commercial space demand. The dynamic nature of the American economy could offset the projected fall in demand for commercial space by creating new tenants.

THE CONSEQUENCES OF TECHNICAL ADVANCE

INFOTECH, by separating work from the workplace, enables office tenants to slash their space needs or to postpone expansion. Additionally, INFOTECH alters how retailers and service providers do business. It breaks the connection between retailers and property owners who until now have shared a common destiny based on location. Rapid advances in INFOTECH make home shopping not only possible but preferable for a growing number of consumers. Thus, for office and retail property owners, INFOTECH reduces the value of location.

THE ELEMENTS OF INFOTECH

Information technology is not new, but its recent advances will soon make it a significant competitor for retail and service tenants as well as for office

Mark Borsuk (mborsuk@ix.netcom.com) is a commercial real estate broker and attorney practicing in San Francisco. Copyright © 1995 by Mark Borsuk. All rights reserved.

space tenants. The most prominent of the new developments are the following:

- The development of powerful sub-notebook computers;
- The acceptance of easy Windows-based software;
- The availability of access to the Internet; and
- The popularization of cyberspace.

Hardware. The miniaturization of computer hardware has made generally available powerful, fully functional, modem-equipped, battery-operated computers weighing less than five pounds, and costing about \$5,000. Each unit is literally an "office in a box." It performs like a desktop machine but its portability makes it ideal for working outside the office.

Software. Windows-based software can perform most office functions, including telecommunications. The graphical user interface for word processing, financial analysis, accounting, and other tasks flattens the learning curve and makes the programs relatively easy to master.

Telecommunications. The opening of the Internet to the public for commerce is by far the most important development. Internet service providers offer users full access for about \$20 per month. Popularization of the Internet makes E-mail available to everyone. The development of World Wide Web (WFB) page format for displaying text and graphics is a phenomenal draw for goods and service providers. The Internet supplements the older on-line membership services like Prodigy, CompuServe, and America Online.

Cyberspace. Cyberspace is the world behind the monitor. Cyberspace enables individuals to communicate with others worldwide at little cost, reaching individuals through E-mail and groups via discussion circles. Cyberspace contains a vast amount of information on every imaginable subject provided by individuals, governments, universities, research institutes, private businesses, and policy groups. In cyberspace there are cybermalls and virtual storefronts in which computer users may shop. Cyberspace equalizes big and small companies, individual retailers and national chains. Many national retailers already have a WEB presence.

The Diffusion of INFOTECH. The diffusion of INFOTECH is extraordinary. Eighteen million households can now connect to cyberspace.¹ In 1993 and 1994, personal computer shipments for the home exceeded 10 million units.² Many more households will embrace the technology over the next several years, enticed by continually decreasing real prices, more powerful systems, easier software, and the allure of cyberspace. The more consumers

there are on-line, the greater the incentive for retailers and service providers to attract them to cyberspace instead of to the mall.

INFOTECH'S IMPACT ON SOCIETY AND BUSINESS

It is a frequently stated truism that society has entered a post-industrial era that observers call the "information age." The transition to a period in which knowledge has become the central economic resource is having as profound an impact on society as the invention of movable type and industrialization.³ What distinguishes the information age from earlier periods is the speed with which change is occurring. Centuries transpired before the impact of the printing press and literacy was diffused through European society. Industrialization evolved over 200 years; however, INFOTECH will change society within decades. Each generation of faster computer processing chips and telecommunications improvements speeds the flow of information for analysis and use.

The earlier innovations, mass literacy and industrialization, brought severe disruptions to medieval and agrarian societies and upset the established hierarchies. New skills and classes arose to create and acquire wealth. The transition to the information age is creating similar upheavals. New classes and skills are supplanting the older knowledge and techniques to exploit the opportunities inherent in the information age. Most importantly, wealth creation will take less space.

NOW INFOTECH CHANGED THE NATURE OF WORK

Advances in INFOTECH permit work outside of the office: "telework." Work that was previously confined to offices has become portable and may be done on the road, from the home, from

a customer's office, at a field office, or at a telecenter (satellite office). Developments like "telecommuting" (working from home or a telecenter) and "hoteling" and "nonterritorial offices" result in more employees' spending more worktime outside the office. "Virtual office" and "mobile office" describe other developments that enable employees to work anywhere. Taken collectively, these new concepts translate into less space demand.

Development of Telework

Conceived of in the 1970s, telework has only recently been implemented by business and government. The advent of personal computers in the 1980s made it feasible to move a substantial amount of work out of the office. Businesses sought increased employee productivity and reduced space costs through the wider use of personal computers.

In 1994, 9.1 million people regularly telecommuted from home. As a group they averaged 40 hours per month (almost one-quarter of their total work month) away from the office. Many telecommuters are professionals, executives, managers, teachers, sales, marketing, and customer support personnel. As would be expected, telecommuters have above-average incomes. One study reports that their average household income is \$53,000, that 75% belong to two-income households and 55% hold college and advanced degrees.⁴ However, another study found that three-quarters of telecommuters work for small businesses and only 5% work for large companies.⁵ This suggests that, as corporate America adopts telecommuting, the number of employees in this category will escalate dramatically.⁶

THE IMPACT OF INFOTECH ON REAL ESTATE

Every advance in computing power, mobility, and telecommunications network integration is an additional reason for office building tenants to reduce their space needs. INFOTECH will not empty offices overnight. The rate at which the decline in demand will occur is the subject of some debate, but the impact will be cumulative. In time, more buildings will have chronically high vacancy rates leading to negative cash flows. A similar

The impact of INFOTECH on the demand for commercial spaces potentially devastating.

pattern is likely to be repeated in the occupancy of retail and service space. Information technology provides many benefits to society, but its effect on commercial real estate is negative.

INFOTECH, environmental regulations, and the telecommunications industry are all factors that reduce the demand for commercial space. INFOTECH reduces the demand for space, environmental regulations promote telework, and telecommunications firms tell organizations that by substituting technology for space, they can save on rent and comply with the environmental laws.

The impact of INFOTECH on the demand for commercial space is potentially devastating. From 1992 through 1994, IBM, using a combination of technology and mobile employees, eliminated approximately 20 million square feet of office space worldwide.⁷ Verifone, a leading supplier of electronic credit card verification equipment, exists almost totally in cyberspace, minimizing a physical presence.⁸

Retailing Without Stores

On-line shopping breaks the connection between the consumer and store locations and will ultimately lead to a significant reduction in demand for retail and service space. Cyberspace has no use for the real estate mantra of "location, location, location." It invalidates the belief that goods and service providers need a physical location to conduct business. On-line retailing and the provision of services on-line are so new that they do not yet compete with retail property owners. But they will!

People shop on-line by joining an on-line membership service or connecting to the Internet. CUC International, Prodigy, CompuServe, and America Online are membership services. The user must be a member and provide credit card information. Numerous companies offer access to the Internet for a monthly fee.

Membership Services. About 100,000 of CUC International's nearly 34 million members shop on-line.⁹ The CUC database offers 250,000 products with guaranteed low prices. CUC carries no inventory; it merely takes the order and informs the manufacturer who ships directly to the customer. Profits come from membership fees

and a small mark-up on each transaction. The three other services mentioned above rent their cyberspace to those providing goods and services.

Bulletin Boards System (BBS). Members of a BBS (a forum for discussing specific topics or interests) are potential on-line shoppers. There are approximately 60,000 BBSs in operation with a combined membership of 17 million. Anyone with a computer may start a BBS. BBS participants may also subscribe to the commercial member services or access the Internet.

Internet. The Internet dwarfs the commercial membership services and dramatically expands the potential size of the on-line shopping market. In 1994, Internet users increased to an estimated 36 million worldwide. In the United States alone, 18 million households were able to connect to the Internet.¹⁰ The Internet is evolving into a secure payments medium that will permit anyone, anywhere, to purchase goods and services on-line with a credit card.

The Internet's merchandising vehicle of choice is the World Wide Web. Each WEB page has a unique address. The shopper goes to the site, browses and, possibly, purchases the merchandise. The shopper needs no special knowledge to use the software. The WEB is the Internet's "killer" application.

Many questions remain about consumer attitudes toward on-line shopping. Much will depend on making the technology accessible to more households and designing appealing virtual storefronts and cybermalls.

The Effect of Competition From Cyberspace on Traditional Stores

A recent study concluded that electronic shopping could shift 10%–20% of sales away from retail stores.¹¹ Another analysis translated the amount of redundant space from lost sales, obsolescence, and shifting demographics to the equivalent of over 100 regional shopping centers of one million square feet each by the end of the decade.¹²

The shopping center industry believes that it is already losing sales to catalog sellers, TV shopping channels, and on-line services. A recent survey done for the International Council of Shopping Centers disclosed that 60% of consumer respon-

dents stated their activities conflicted with store hours. The time conflict was greatest among younger shoppers; these consumers were considering the benefits of home shopping.¹³

Technology and the Sellers of Retail Services

Many other problems face retail property owners: technological change, improved space utilization by tenants, and excess space.

Technology. The ubiquitous one-hour photo shop is heading towards extinction. Digital (electronic) cameras may soon eliminate the development and finishing cycle. The camera can make a direct transfer to the computer without the need to develop film.

Reducing or Eliminating Tenant Presence. Technology is also likely to reduce or eliminate tenant space requirements for businesses like travel agents and retailers of software and recorded music. Consumers may obtain trip information and book the flight on-line. On-line shoppers can browse a far larger selection of software and music than is available at most stores.

Technology is assisting banks to reduce branches. On-line banking is one way for banks to meet customer needs and reduce costs. Wells Fargo's entry onto the Internet for banking transactions portends a massive shift from branch banking to home banking.

Other Problems. Excess retail space haunts property owners. A recent forecast estimated that up to 20% of the regional malls that were in business in 1990 will close by the end of the decade.¹⁴ An observer, writing in *Real Estate Review*, believes that up to 50% of retail space is unnecessary because of advances in marketing and inventory controls.¹⁵ The growth of on-line shopping merely exacerbates existing tendencies.

Implications for Warehouse and Distribution Space

Warehouses are at risk in any shift to on-line shopping. If the CUC International strategy of cyber-middlemen is accepted, then on-line retailers will not need either storage or distribution facilities. Customers will order on-line and manufacturers will ship. Advances in manufacturing and distribution are also eroding the demand for intermediate distribution and warehousing space.¹⁶

REAL ESTATE TAXATION FOR THE INFORMATION AGE

Current tax law does not favor the reuse of commercial space. It recognizes that property owners invest in change, but it stretches deductions over long periods, limits rehabilitation credits to a small group of structures, and does not permit expensing demolition costs.

The impact of INFOTECH on property uses and space demands invalidates many of the assumptions underlying the taxation of commercial property. Existing policy assumes a continuing demand for space so Congressional debates have been confined to the issue of raising revenue versus offering tax benefits. The prospect of long-term stagnant or falling demand shifts the debate. The current tax structure does not make available the financial incentives needed to convert the substantial quantities of office, retail, and warehouse space that are being made redundant by INFOTECH. But, tax policy has long been used to advance governmental objectives.

The Federal Tax Code applies to each phase of the real estate cycle: development; ownership; and disposition. Following are a number of suggested changes to each phase of the cycle that will help the market to adjust to the new conditions. (The proposals are not comprehensive, and there may be other ways to achieve the same goals.)

Change the Rules for Development

Offer Tax Credits for Rehabilitating Contemporary Structures. This benefit is already enjoyed by buildings of historic value, a laudable but limited purpose. Expanding the definition to include the upgrading and reuse of newer structures will ease the problems of commercial owners and their communities.

Make Demolition and Renovation Period Costs Deductible. The cost of demolition and renovation period expenses like interest and taxes should be expensed in the year taken and not added to the value of land or written off.

Change Ownership Rules

Reduce the Deduction Period for Commercial Property Improvements. The write-off period for residential property is 27 1/2 years, and for

INFOTECH
invalidates
many
assumptions
underlying
current tax law.

nonresidential property 39 years. Depreciable lives of such length effectively negate depreciation as an incentive to convert offices, shopping centers, factories, and warehouses. At this writing, Congress is considering adding to the Code a nonresidential leasehold improvement write-off period of ten years. Expanding the provision to benefit existing (not new) commercial properties that are unleased and making 10-year write-

offs applicable to commercial properties that are converted to residential use would ease the transition to the information age.

Eliminate the Passive Income Category for Properties That Are Being Readapted.

The passive activity rules were enacted in 1986 to curb abusive tax shelters. They prevent losses from certain real estate activities from offsetting other taxpayer income. Today these rules eliminate incentives for investors to readapt commercial property. These rules should be changed to allow passive activity losses and credits generated from existing readapted commercial property to offset ordinary income.

Change the Tax Rates for Dispositions

Extend the Period to Complete a Deferred Exchange. The present rule, which gives an exchanger a maximum of six months to acquire replacement property, is too short. The period should be lengthened considerably; for example, to two years, the same as for personal residences.

Defer Tax on the Discharge of Indebtedness. Under certain circumstances, relief from mortgage debt may create taxable income. Consideration should be given to deferring a seller's tax liability to assist the taxpayer to transfer the property for reuse.

Adjust the Capital Gains Tax to Promote Change. Real estate owners have little incentive to sell aging properties outright because a sale triggers large taxable gains created by inflation. A reduction in the inflationary component of the gain would revive the incentive to sell and give the market a better opportunity to convert older properties into productive use.

Sanction an Exit Strategy. A taxpayer may take an ordinary loss for the "extraordinary obsolescence" of a building. INFOTECH represents the "extraordinary obsolescence" of property.

CONCLUSION

INFOTECH is inducing widespread, fundamental changes in the economy and society that challenge the commercial real estate market. Market participants, developers, owners, and lenders will have to adapt their investments to the new conditions and will encounter financial loss. Unfortunately, the present tax policy impedes change; it recognizes neither commercial reality nor the radically changing economy and penalizes owners of commercial real estate who seek to convert their properties to more productive forms. Although the problem is not yet urgent and has received little public attention, perhaps this is the best time to start thinking about what changes are desirable. ■

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Sam Thompson, III
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Memo of March 18, 1996

To: Persons interested in tax reform

Attached is the typed version of my paper: "Qualities of Tax Plans". The original hand-written version was published (p. 1001-1027) in Replacing The Federal Income Tax, including hearings before the U.S. House Ways and Means Committee June 6, 7, 8, 1995, Serial 104-28, U.S. Government Printing Office, Washington, D.C., 1996 (ISBN 0-16-052327-3). The original hand-written version was as legible as I could write. The reproduction by the U.S. Government Printing Office was excellent, but the reduction in size made some parts barely legible. Thus this typed version is prepared to provide a more readable text. In the typed version, each page is the same as the hand-written version, but individual lines may be different. A few minor revisions were made.

A highlight of my paper is my proposal for a Unified Retail Sales Tax (p. 1012 ff), in which all Federal, State, and Local taxes on retail sales of goods and services are combined into one rate of say 10-20% and collected by the local business. The business retains a collection fee of say 1% and sends the remainder to the Local Tax Office; only the latter has the authority to audit the business. The Local Tax Office retains its portion of the revenue, say 40%, and sends the remainder to the State Tax Office. The State Tax Office retains its portion of the revenue, say 30%, and sends the remaining 30%, to the Federal Tax Office.

My Unified Retail Sales Tax is similar to the National Retail Sales Tax proposed by Senator Richard Lugar and others. However, some proponents of the latter have indicated that the business would send the tax directly to the Federal Tax Office (or even an unabolished IRS!), implying that it may directly audit the business. I strongly oppose such a policy. Other proponents have indicated that the business would send the tax to the State Tax Office, a system that already is established in 45 states. I now see that procedure could be implemented more readily, and would modify my proposal to allow each State that option. However, I dislike the term "National"; my dictionary defines it as "belonging to or mandated by the federal government." Even if the plan says otherwise, the term "National" connotes direct payment to and auditing by the federal government. I strongly recommend that the "National" term be dropped and that my term "Unified" (or perhaps a better one) be adopted so that those of use who support the basic concept of replacing the present income tax with a combined Federal-State-Local retail sales tax can join together and help convince others that our plan is the best for the country.

Some proponents of the National Retail Sales Tax have proposed exemptions for necessities such as food and medicine. I object to such exemptions (p. 1019) because they would open the door to endless complexities that would be promoted by social engineers. The only purpose of the tax code should be to raise revenue to cover legitimate government expenditures. Some have

proposed that a cash advance or rebate of say \$5,000 be sent to all citizens, so that the "regressive" impact of the sales tax on those with lower incomes be alleviated. I am opposed to such direct payments from the Federal government. They would be as wasteful and counterproductive as the current welfare program. I believe it is better to give money to the needy on the local level, either through a local government agency and/or a private charity, so that only individual needs are targeted. Money may be provided to the local agency or charity on a matching funds (or other) basis by the State and Federal governments.

In my paper, I presented a preliminary chart (Fig 1, p. 1008) showing the damage to the economy produced by increasing government revenue. In the same Ways and Means book (Serial 104-28), Dr. Richard W. Rahn presents a documented chart (p. 629) with a different shaped curve (more "bell" like) but with an optimum 25% of government revenue that would not seriously damage economic growth; this determination is not far from my intuitive estimate of 20%. This should be one of the basic tenets of any tax reform -- that government revenue should be kept below a maximum of say 30%, and at or below the optimum of 25%, in order to avoid serious damage to the economy.

Although I am still reading the Ways and Means book (received March 7), one of the best papers is by Steven L. Hayes, President, Citizens for an Alternative Tax System, (p. 646-655): "Replacing the Income Tax with a National Retail Sales Tax." I wish I had information from this and other good papers in the book when I was writing my paper. However, I offer some key points that I have not yet seen addressed in the others.

We all owe a deep debt of gratitude to Representative Bill Archer (R-TX), the Chairman of the House Ways and Means Committee, for beginning and continuing the current intensive debate on tax reform. No longer are we talking about tinkering with the present income tax system. Rather, we are on the verge of throwing the whole thing out and substituting a much more reasonable consumption tax, preferably a combined Federal-State-Local retail sales tax, that will greatly encourage economic growth and provide other benefits for our country.

Chairman Archer encourages input from the general public as well as from experts. He realizes that such a sweeping change in tax policy must have public acceptance if it is to be successful. I suggest that every interested citizen (and every citizen should be interested!) study the different tax reform proposals, then let your Congressman and the Ways and Means Committee know which one you prefer and why.

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 O.K., so I hope you can read my left-handed, arthritic handscrit! If you will give me some extra time, I'll be glad to have 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 \$40. 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
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El Paso, TX 79968-9991

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 bask 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, III
 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:

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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.

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) Liberating	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 (Ogden)	3	3	1	2	1	1	1	0	2	0	0	0	14
3) Consumed income tax (Nunn & Donenics)	3	3	3	2	1	1	1	2	4	0	0	0	20
4) Flat rate tax on wage income (Armer)	3	4	4	3	3	3	3	3	4	3	3	2	38
5) Flat income tax + VAT (Brown)	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 (Luger, 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

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 between No. 3 and No. 5 at 20; 7 No. 2-14 and 8 No. 1-13 appears reasonable.

(Maximum 60)

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. 2-4) 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.

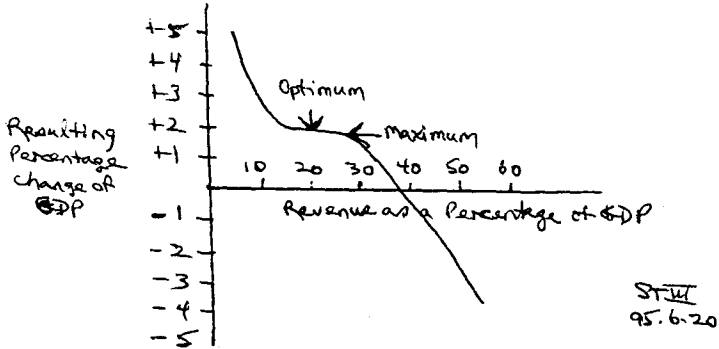
The reform plans that would change the tax base from income to consumption (Nos. 6-8) are also tentatively rated 3 because they too aim for low rates. Total retail sales in the U.S. during 1993 are reported to have been \$2.1 trillion. A consumption tax rate of 20% would have raised about \$420 billion 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) Undamaging - 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 impact. 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 result in maximum and optimum revenue percentages and compare them 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 present system as a 2-Poor regarding the quality of undamaging. 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 Arney (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 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 instigation of subsidies

for the needy may not offset 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 41%), 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 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 higher 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 their plan only a rating of 3-Fair. The much better Arney 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 and 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 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 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 Arney Plan (No. 4) is relatively simple, so enforcement by the IRS should be less involved; but the risk remains, 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 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 compliance 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 businessman 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 Armeij Plan (No. 4) appears to be the epitome of simplicity. But the worst feature of it is that the payments must be sent once per month with an annual return to make any adjustments. Sending even 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 Armeij 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 (No. 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 law and regulation (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 2008 (Pilla, 1995, p23). 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 (W. Kurt Hauser, Wall Street Journal, May 14, 1993). All that to collect \$800 billion in revenue (William Grace, 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 their 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 Arney (No. 3) and Lugar (No. 7) plans have less to do with the IRS and the cost of compliance should be reduced, so they are rated as 3 (maybe 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 1987 to 1991, Money magazine prepared 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 1040EZ 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 Arney 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 so 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 begin tinkering with one then the other. The unwary citizen would have a doubly hard time understanding what is being taxed, what the rate is, 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 entire 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 or sales)? 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 dollars

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". (Is 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, Ensign 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 increases standards of living, and that taxing capital or the gains from investment will slow or reverse this process. Regrettably, I must give the Nunn-Domenici Plan a 2 rating.

If the Arney 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 deduction, 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 exemption and their numbers in a never ending assault on the 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 incomes 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 headlines as each deduction is passed, they get only one large exemption in a lump sum. No doubt they will vote in favor of the initial plan, but 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.") Armeiy 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 these problems, I can give the Armeiy 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 neither 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 legitimately 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 Federal Sales tax of say 20% to a State/Local tax of 5% to 10% may scare away a lot of potential customers, at least initially. One suggestion under this type of plan is to send 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 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 roaming 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 IRS, 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% FICA 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 FICA 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 a 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 rate 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 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 their bill is considered the best tax reform we can get.

The Arney 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 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). Senator Richard Lugar (R-IN) has prepared a plan for 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, and 8) could be implemented quickly, but if they would have a high rate of 20% or more, they would raise everyone's 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. 1023), I proposed that retirees who depend on Social Security for most of their income may get a 20% (or whatever this 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 law.

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 Nunn-Domenici (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 Arney (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 wildly optimistic.

11) 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 amid 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 vulnerable 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 Armev Plan (No. 4) has at least a fair shot 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 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 replaced.

The National Retail Sales Tax (No. 7) is given 4 because it could last many years if the regulation of the retailers by the IRS does not get out of hand. The Unified Retail Sales Tax (No. 5) 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 in the short 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.

Wouldn't it be wonderful if we could make our financial 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 reinstate the gold standard?)

12) 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-Awful. The Arney 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 dependant 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 the 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!

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DEAR SIR:

PLEASE THANK YOUR CHAIRMAN FOR ADVOCATING A CONSUMPTION TAX. AS A TAX PREPARER FOR MOSTLY SMALL BUSINESS AND WORKING CLASS CITIZENS, I BELIEVE THAT THE FLAT TAX PROPOSALS ARE NOTHING BUT POLITICAL SNAKE OIL, AND THAT PAYROLL TAXES AND SELF EMPLOYMENT TAXES CREATE ALL THE WRONG INCENTIVES. BELOW IS A COPY OF A LETTER I WROTE TO THE LOCAL EDITOR THAT I OFFER BY WAY OF COMMENT:

Thursday, September 21, 1995

LETTER TO THE EDITOR
The Daily Tribune News
P.O. Box 70
Cartersville, GA 30120

SUBJECT: SOCIAL SECURITY

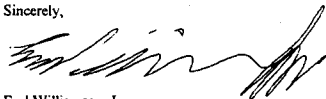
Social security is the most regressive tax we have and is largely responsible for our underground economy. It taxes the working poor first and the nonworking rich last. The low income, self employed can't afford to pay the tax and support themselves and their families so they don't. Some low income people simply decide that welfare is a better option—perhaps, supplemented by unreported and maybe even illegal income.

The Democrats sold us social security under the guise of an insurance fund when in fact it was welfare paid by the workers to retirees. This pyramid scheme worked (as they all do) as long as there were more workers than retirees. But now the retirees are about to outnumber the workers, and social security will break us if we do not do something about it. The Republicans are afraid to take up the fight because they know it will create a worse political fire storm than they have now with the Medicare debate.

Americans worthy of the name believe in helping those in need and letting those that don't fend for themselves. Our parents and grandparents have made many sacrifices for us and our country. They deserve a safe and secure retirement. However, the working poor do not need to be supplementing the retirement of the rich. Political posturing will not solve the problem, but calmly assessing all of the facts and working together will.

In my opinion, a consumption tax combined with a negative income tax (in place of income, social security and Medicare taxes) would go a long way toward solving our deficit, welfare and tax problems. What's yours?

Sincerely,



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