How Could We Improve the Federal Tax System?

Q. What is comprehensive tax reform?

A. The term refers to broad, sweeping changes to the tax system. What qualifies as "comprehensive" is a judgment call.

Rather than taking a piecemeal approach, making small changes to provisions of the tax code, comprehensive reform would address the inequities, complexities, and inefficiencies of the entire tax system. The last comprehensive reform to the US tax system took place in 1986, when the Tax Reform Act lowered income tax rates and broadened the tax base.

Some contemporary proposals are more of the same, broadening the tax base to lower tax rates without lowering revenue. Some proposals would scrap the current system entirely, replacing the income tax with a consumption-based tax system. But the broad goals of greater fairness, efficiency, and simplicity remain the same.

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How Could We Improve the Federal Tax System?

Q. What are the major options for comprehensive tax reform?

A. In a nutshell, broaden the income base while lowering tax rates, tax consumption instead of income, or do a bit of both.

BROADENING THE INCOME TAX BASE

Base broadening involves increasing the portion of income subject to taxation. It is often accompanied by proposals to decrease tax rates. The Bowles-Simpson plan, the Tax Reform Act of 2014, and a proposal from the Domenici-Rivlin Debt Reduction Task Force all fit this category.

In calculating tax liability, taxpayers have the right to exclude portions of their income through deductions, credits, exclusions, and the preferential treatment of income from certain sources. This, of course, lowers the revenues that could be collected if all income were taxed at the given rate. More than 150 such “expenditures” appear in the tax code; the 10 largest currently cost the government about $900 billion per year and account for approximately two-thirds of the budget impact.

SWITCHING TO A CONSUMPTION TAX

A consumption levy taxes the purchase of goods or services rather than income. A move to such a system was proposed by the 2005 President’s Advisory Panel on Federal Tax Reform, forms the basis of Columbia Law School professor Michael Graetz’s Competitive Tax Plan, and features in several other plans usually labeled as national retail sales taxes and flat taxes.

Retail Sales Tax

A national retail sales tax would levy a flat tax on all retail sales. In most proposals, the tax would have a broad base, exempting only expenditures for education, existing housing, purchases abroad by US residents, and food produced and consumed on farms. Proponents argue that the tax would be simpler to administer and create fewer economic distortions than the income tax. However, in most forms it would be regressive, disproportionately taxing low- and middle-income earners.

Value-Added Tax

Value-added taxes are collected from businesses at each stage of the production process. Under the “credit-invoice method,” all sales by businesses are taxable, while firms claim credits for all taxes paid on purchases from other businesses. The result is that the tax base is equal to the full value of the final sale to the consumer. The United States is the only developed country that does not have a value-added tax, which tend to have lower administrative and compliance costs than income taxes.

How Could We Improve the Federal Tax System?

What are the major options for comprehensive tax reform?

Flat Tax

A flat tax is really a value-added tax divided into two parts. It was first proposed in 1983 by economists Robert Hall and Alvin Rabushka of Stanford University's Hoover Institution. Their proposal called for a 19 percent tax at the business level on all value added other than wages. Households, for their part, would pay a 19 percent flat tax on all wages and pension benefits above a specified exemption level. The family exemption increases the progressivity of the tax. But the tax structure is regressive relative to the current system, as it lowers taxes for higher-income households.

X-Tax

The X-tax, proposed by the late David Bradford, is a variant of the flat tax. Businesses would still pay a single-rate value-added tax on all their nonwage value added. But unlike the flat tax, the wage tax would be set at progressive rates, beginning at zero and increasing until the business rate were reached. The plan would retain the earned income tax credit and the deduction for charitable contributions and would provide a credit for payroll taxes paid. A modified version of the X-tax was proposed in the 2005 reports of the President's Advisory Panel on Federal Tax Reform, in which the income tax would be replaced with a 30 percent tax on firms and top wage earners. (The panel would have supplemented the X-tax with a 15 percent tax on capital income earned by individuals.)

Consumed Income Tax

In general, all income can either be spent immediately or saved to be spent later. A consumed income tax would tax only current consumption, exempting all savings until it is spent. Proponents argue that the exemption of savings would encourage investment, which would increase economic growth.

A variation of the consumed income tax, the Unlimited Savings Allowance Tax, was offered by Senators Sam Nunn and Pete Domenici in 1995 as a replacement for the income tax. Under their plan, households would pay a progressive consumed income tax with deductions for some education costs, mortgage interest, and charitable contributions. Businesses, for their part, would be taxed with a subtraction-method value-added tax with a flat rate of approximately 11 percent. Both households and businesses would be able to claim a payroll tax credit.

How Could We Improve the Federal Tax System?

What are the major options for comprehensive tax reform?

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Q. What is a broad-based income tax?

A. One that minimizes tax preferences with the goal of increasing revenue at a given rate of taxation.

Expanding the definition of taxable income by removing or restructuring tax preferences could significantly increase revenue. In fact, the President's Advisory Panel on Federal Tax Reform estimated that converting the current preference-riddled tax to a comprehensive income tax system would nearly double the tax base.

In truth, virtually all tax analysts reach similar conclusions. Holding other factors constant, a broader tax base means that a lower tax rate will raise the same revenue. Hence, base broadening can offset the revenue effects of lowering the tax rate.

The National Commission on Fiscal Responsibility and Reform (Bowles-Simpson, for short) aimed to broaden the tax base by eliminating up to $1.1 trillion worth of tax expenditures, with the revenue gains used to reduce both tax rates and the budget deficit. The Domenici-Rivlin tax reform proposal also features base broadening and would reduce the deficit with a mix of eliminating, reducing, and simplifying various tax expenditures.

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How Could We Improve the Federal Tax System?

Q. What would and would not be taxed under a broad-based income tax?

A. Generally, all forms of income, but there are as many options as there are proposals.

Base broadening could include all forms of income, such as wages and "anything that allows you to spend more, either now or in the future" (President's Advisory Panel 2005, 20). These sources include retirement account income, capital gains, dividends, rental income, employer-provided health insurance, unrealized increases in the value of real estate, and securities.

The President's Advisory Panel looked closely at a somewhat less comprehensive broad-based income tax that would eliminate credits, "above the line" deductions, and itemized deductions. The individual alternative minimum tax would go; tax filers would get to keep the standard deduction and personal exemptions.

The Bowles-Simpson Commission's "zero-base budgeting" plan would modify the income tax to lower rates and deficits by cutting tax expenditures. This tax would eliminate all tax expenditures (an estimated $1.1 trillion per year) but would not modify the payroll tax base.

The Domenici-Rivlin plan, for its part, eliminates the standard deduction and personal exemption, taxes capital gains and dividends as ordinary income, simplifies the earned income tax credit, shortens the list of itemized deductions, and caps deductions for medical expenses.

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Q. What would the tax rate be under a broad-based income tax?

A. That depends on what exclusions, credits, and deductions are left in and whether revenue neutrality is a must.

The President's Advisory Panel on Federal Tax Reform estimated how much marginal tax rates could be reduced under a broad-based income tax that generated the same revenue as the current system. As table 1 shows, the switch would permit across-the-board cuts of about one-third. This sort of reform would not be an easy political pill to swallow, however. The panel's version, for example, would preserve only the standard deduction and personal exemptions, and would eliminate credits, "above-the-line" deductions, and itemized deductions. On the plus side, a broad-based tax would eliminate the much-despised individual alternative minimum tax.

TABLE 1

Marginal Tax Rates for Married, Filing Jointly Households

Under current law and a broad-based system, 2006

Tax bracket	Current law system	Broad-based system
$15,050 and under	10.0%	6.6%
$15,051 – $61,100	15.0%	9.9%
$61,101 – $123,250	25.0%	16.4%
$123,251 – $187,800	28.0%	18.4%
$187,801 – $335,400	33.0%	21.7%
$335,401 and over	35.0%	23.0%

Source: President's Advisory Panel (2005).

The Bowles-Simpson alternative provides similar estimates but argues that its zero-base budgeting methodology would allow the system to reduce rates and the deficit simultaneously (table 2).

Note, however, that after the 2017 Tax Cuts and Jobs Act, these estimates are dated and both the projected revenues and tax base have changed.

How Could We Improve the Federal Tax System?

What would the tax rate be under a broad-based income tax?

TABLE 2

Marginal Tax Rates in 2011 under Current Law and Broad-based Systems

Bowles-Simpson plan

	Current law system	Broad-based system	Illustrative plan[a]
Bottom rate	15.0%	8.0%	12.0%
Middle rate	28.0 – 31.0%	14.0%	22.0%
Top rate	36.0 – 39.6%	23.0%	28.0%

Source: National Commission (2010).

(a) The illustrative plan eliminates all tax expenditures except for the Child Tax Credit and Earned Income Tax Credit. It also taxes capital gains and dividends as ordinary income.

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How Could We Improve the Federal Tax System?

Q. What is a national retail sales tax?

A. A national retail sales tax is a consumption tax collected as a flat-rate tax on all sales from businesses to households.

Retail sales are business sales to households; neither business-to-business nor household-to-household transactions qualify. For example, the sale of a newly constructed home to a family that will occupy it is a retail sale. But the sale of that same home to a business that intends to rent it to others is not a retail sale, nor is the sale of an existing home by one occupant to another.

A pure national retail sales tax would represent a sharp break from the current tax system, shifting the tax base from income to consumption. Rates would be flat; no goods or services would be exempted or favored; and tax administration, enforcement, and points of collection would be radically altered.

No country in the history of the world has enacted a retail sales tax rate anywhere near as high as what would be required to replace the US tax system. Whether such a tax could be implemented effectively remains an open question.

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How Could We Improve the Federal Tax System?

Q. What would and would not be taxed under a national retail sales tax?

A. In theory, all consumption would be taxed. In practice, there would be great pressure to narrow the base.

Under a pure national retail sales tax, all consumption expenditures by individuals and by federal, state, and local government agencies would be subject to the tax. (Purchases by businesses are, by definition, not retail sales and would not be subject to tax.) However, no sales tax in history has come close to this ideal. Some items, such as imputed financial services, are quite difficult to tax. Taxing others, such as child care, rent, food, housing, and health care, might undermine popular (and arguably desirable) social policies.

State experiences demonstrate that interest groups often succeed in carving out preferences, just as they do from the income tax. As a result, few state sales levies tax many of the items listed above, and none tax all of them. Hence, a pure broad-based national retail sales tax has no precedent.

However, the path of least political resistance—exempting selected sectors—would be problematic. The broader the tax base, the lower the tax rate can be and still reach the revenue target. But health, food, and housing make up more than 40 percent of all personal consumption; exempting even one of these sectors would cut deeply into the sales tax base, forcing the required rate higher. Moreover, even with a broad base, the required tax rate would have to be very high to replace existing federal taxes.

Consider, too, that a national retail sales tax would need to tax all purchases by state and local governments. Exempting them would narrow the base substantially, which in turn would raise the tax rate needed to generate a given amount of revenue. Taxation of government transactions would also be necessary to ensure that private industry is not placed at a disadvantage when competing with public suppliers of goods and services.

Although the various national retail sales tax proposals differ in details, they generally maintain similar tax-base characteristics. Business purchases and education, both of which are considered investments, would be exempt. Domestic purchases by foreigners would be taxed; foreign purchases by US residents would not.

Employer-provided health insurance would be taxed, but economists Jonathan Gruber and James Poterba estimate that this tax change would boost the price of health insurance by an average of 21 percent. This price increase would reduce both the number of people insured (by 6 million) and the amount of insurance each remaining insured person would choose to carry.

The existing deductions for mortgage interest and property taxes would disappear along with the income tax. This would reduce the value of all residential housing. Newly constructed houses sold to occupants

How Could We Improve the Federal Tax System?

What would and would not be taxed under a national retail sales tax?

would be subject to the sales tax, but existing houses would generally not because such transactions would not constitute retail (business-to-household) sales. This change would lower the market value of new houses relative to old ones.

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How Could We Improve the Federal Tax System?

Q. What would the tax rate be under a national retail sales tax?

A. It depends on assumptions about the breadth of the tax base, tax evasion and avoidance, and the effects on economic growth. It also depends on how the tax rate is measured. Estimates for a tax that would replace revenues from the current federal tax system range from 31 percent to 65 percent. However, these estimates are dated, since revenue levels have recently changed, in part due to the 2017 Tax Cuts and Jobs Act.

Perhaps the most controversial aspect of the national retail sales tax has been how high the tax rate would need to be to replace all revenue from the current tax system. The answer depends on four things: (1) whether the quoted rate is in tax-exclusive or tax-inclusive terms; (2) the rates of tax evasion and tax avoidance; (3) the extent to which deductions, exemptions, and credits would be retained in the tax base; and (4) the impact on economic growth.

Under the optimistic assumption of a very broad base and extremely conservative assumptions about evasion and avoidance, the tax rate would have to be 44 percent on a tax-exclusive basis, or 31 percent on a tax-inclusive basis.

TABLE 1

Range of Average Tax Rates under a Retail Sales Tax
2006–15

Avoidance, evasion, and legislative erosion rate	Tax-exclusive rate	Tax-inclusive rate
None	44%	31%
10%	53%	34%
20%	65%	39%

Source: Gale (2005).
Note: Estimates assume a baseline of current law revenue projections.

How Could We Improve the Federal Tax System?

What would the tax rate be under a national retail sales tax?

Estimates from the President's Advisory Panel on Federal Tax Reform span an even wider range. Using reasonable assumptions about tax evasion and the breadth of the tax base, the Advisory Panel estimated the required tax-exclusive rate to be between 34 and 89 percent. Their highest estimate assumes (1) an evasion rate consistent with the current income tax for income on which taxes are not withheld and there is no third-party reporting and (2) a federal tax base equivalent to the median state sales tax base.

Note, however, that these estimates are dated. Revenue levels have changed since the 2005 report, partly from the 2017 Tax Cuts and Jobs Act.

TABLE 2

Range of Tax Rates under a Retail Sales Tax

Evasion rate	Extended base[a]	Median state sales tax base
Lower evasion (15%)	34%	64%
Higher evasion (30%)	49%	89%

Source: President's Advisory Panel on Federal Tax Reform (2005).
Note: Tax exclusive rates.
(a) The extended base refers to the tax base described by advocates of the FairTax proposal, which includes all sales of goods and services to consumers except educational services, expenditures by US residents abroad, food produced and consumed on farms, and existing housing.

TAX EXCLUSIVE OR TAX INCLUSIVE

A key issue in determining the required tax rate is how to define the tax rate. Suppose a product costs $100 before tax and has a $30 sales tax. The "tax-exclusive" tax rate would be 30 percent, because the tax is 30 percent of the pre-tax selling price. The "tax-inclusive" rate would be about 23 percent, which is obtained by dividing the $30 tax by the total cost to the consumer ($100 + $30). Sales tax rates are typically quoted in tax-exclusive terms, but income tax rates are typically quoted as tax-inclusive rates. For example, a household that earns $130 and pays $30 in income taxes would normally think of itself as facing roughly a 23 percent ($30 ÷ $130) income tax rate.

Although there is no single correct way to report the sales tax rate, it is crucial to understand which approach is being used. The tax-inclusive rate will always be lower than the tax-exclusive rate, and the difference grows as the rate rises. At a rate of 1 percent, the difference is negligible, but a 50 percent tax-exclusive rate corresponds to a 33 percent tax-inclusive rate, a 17 percentage-point difference.

How Could We Improve the Federal Tax System?

What would the tax rate be under a national retail sales tax?

OTHER FACTORS WOULD RAISE THE RATE EVEN HIGHER

Households' total sales tax rate would be significantly higher than the federal rates indicated above, after existing state sales tax were added. In addition, most or all state income taxes would probably be abolished in the absence of a federal income tax system because state income tax systems depend on the federal system for reporting income and other information. Today's state income taxes would likely be converted to sales taxes, adding considerably to the combined sales tax rate.

Other reforms would further raise the required rate. Transition relief for households would reduce the tax base and raise the required rate even higher. And if major consumption items such as food, housing, or health care were exempted from the base (the assumptions above do not allow for such large exemptions), the rate on the remaining goods and services would rise still higher.

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Q. What is the difference between a tax-exclusive and tax-inclusive sales tax rate?

A. It depends on whether the tax is reported relative to the pre-tax or post-tax price.

Suppose an item costs $100 before tax and is subject to a $30 sales tax. The tax-exclusive tax rate would be 30 percent, as the tax is 30 percent of the pre-tax selling price. The tax-inclusive rate would be about 23 percent, which is obtained by dividing the $30 tax by the total cost to the consumer ($100 + $30). Thus, the difference between the two definitions is whether or not the tax paid is included in the denominator when calculating the tax rate.

Although there is no single correct way to report a sales tax rate, it is crucial to understand which approach is being used. The tax-inclusive rate will always be lower than the tax-exclusive rate, and the difference increases as the rates rise. At a rate of 1 percent, the difference is negligible, but a 50 percent tax-exclusive rate corresponds to a 33 percent tax-inclusive rate, which is a big difference.

Sales tax rates are typically quoted in tax-exclusive terms, but income tax rates are typically quoted as tax inclusive. For example, a household that earns $130 and pays $30 in income taxes would normally think of itself as facing roughly a 23 percent ($30 ÷ $130) income tax rate.

Further Reading

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Q. Who bears the burden of a national retail sales tax?

A. A revenue-neutral national retail sales tax would be more regressive than the income tax it replaces.

A national retail sales tax would create a wedge between the prices consumers pay and the amount sellers receive. Theory and evidence suggest that the tax would be passed along to consumers via higher prices.

Because lower-income households spend a greater share of their income than higher-income households do, the burden of a retail sales tax is regressive when measured as a share of current income: the tax burden as a share of income is highest for low-income households and falls sharply as household income rises. The burden of a sales tax is more proportional to income when measured as a share of income over a lifetime. Even by a lifetime income measure, however, the burden of a sales tax as a share of income is lower for high-income households than for other households: a sales tax (like any consumption tax) does not tax the returns (such as dividends and capital gains) from new capital investment and income from capital makes up a larger portion of the total income of high-income households.

In contrast, federal income taxes are progressive. The individual income tax is progressive thanks to refundable credits for lower-income households (average tax rates are negative for the two lowest income quintiles), the standard deduction (which exempts a minimum income from the tax), and a graduated rate structure (rates on ordinary income rise from 10 to 37 percent, with an additional 3.8 percent marginal tax on certain investment income of high-income households).

The President's Advisory Panel (2005) concluded that replacing the income tax system with a national retail sales tax would heavily favor high-income households. A sales tax rate of 22 percent (the rate necessary to replace the revenue from the federal income tax at that time) would increase tax burdens on the lower 80 percent of the income distribution by approximately $250 billion a year (in 2006 dollars), if the sales tax were not modified to return some revenue to lower-income households.

Put another way, the lower 80 percent of the income distribution would go from paying 15.8 percent of federal income taxes to paying 34.9 percent of federal retail sales taxes. Conversely, the top 20 percent of the income distribution would go from paying 84.2 percent of federal income taxes to 65.1 percent of federal retail sales taxes (figure 1).

The Advisory Panel also found that offsetting the regressivity by per capita rebates to disadvantaged households would require a 34 percent sales tax rate to sustain revenue.

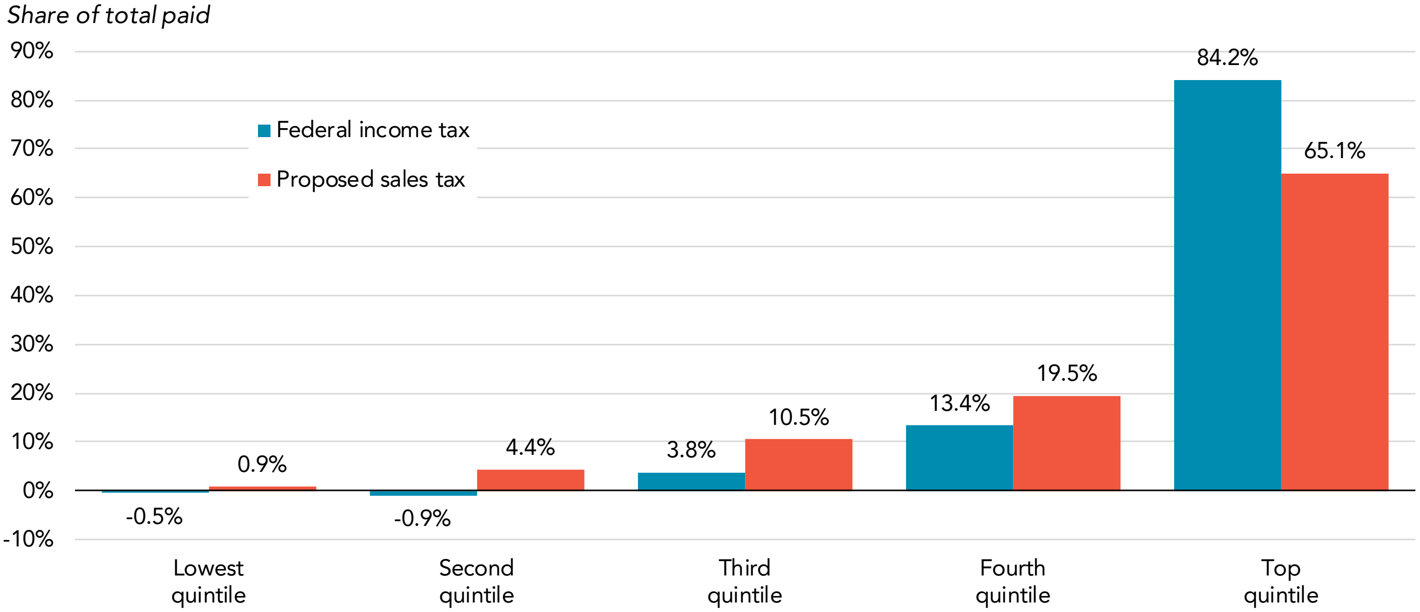
How Could We Improve the Federal Tax System?

Who bears the burden of a national retail sales tax?

FIGURE 1

Share of Current Federal Income Tax or Proposed Retail Sales Tax Paid

By income level under 2006 law



Source: President's Advisory Panel on Federal Tax Reform (2005).
Note: Assumes a 22 percent national retail sales tax without demogrant.

Some claim that a properly modified national retail sales tax would be "pro-family." Advocates usually point to the proposed demogrant—the per capita cash rebates—as proof of this assertion. On the other side of the ledger, though, families with children would likely be hurt by the elimination of both current deductions for health insurance, mortgage interest, and state and local income and property taxes (which finance schools and other government services) and by the elimination of various tax credits (the EITC, child care credits, education credits, and child tax credits). Consider, too, that at any given income level, families with children have higher consumption requirements than those without, so switching to a consumption tax would present an inherent disadvantage for families with kids.

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Q. Would tax evasion and avoidance be a significant problem for a national retail sales tax?

A. A national retail sales tax would certainly not eliminate tax evasion and avoidance, and might increase it.

Advocates of the national retail sales tax claim that tax avoidance and outright evasion would decline, and that tax revenue collected from the underground economy would rise significantly. But critics view these claims as somewhere between overly optimistic and nonsensical. The President's Advisory Council on Federal Tax Reform (2005, 218) noted in its final report that "a federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide a substantial inducement for evasion."

By eliminating the current tax system, the national retail sales tax would indeed eliminate current avoidance and evasion schemes. But that does not mean it would eliminate avoidance and evasion. It would simply change their locus and nature.

The overall rate of evasion of the US income tax is estimated at around 16 percent, with the net percentage of misreported income equaling 22 percent. But these figures mask great differences in behavior that depend on the source of the income. At one extreme, where taxes are withheld and reported to government by a third party (predominantly wages), the misreporting rate is just 1 percent. At the other, where taxes are not withheld and there is no cross-reporting among government agencies, the misreporting rate averages 63 percent. If the income is subject to reporting but no withholding, about 7 percent is misreported. (Think interest, dividends, unemployment compensation, etc.) A national retail sales tax would feature no withholding and no cross-reporting, and so the potential for evasion needs to be taken seriously.

Individuals might avoid or evade a national retail sales tax in several ways. They might misreport personal consumption as business activity (e.g., using a company car for personal use). Treating property that involves mixed consumer and business use would also be a problem, as would verifying that retail goods were not purchased for personal use by business representatives (e.g., a bar owner purchasing a flat-screen for his or her home).

Previous studies have found a 13 percent "delinquency" rate for state sales taxes. This rate of evasion is lower than the likely rate under a national retail tax, though, since the tax rate under a national plan would be significantly higher than the rates applied by the states, increasing the incentive to cheat. Underreported sales would almost certainly be much higher with a national retail tax for two reasons: (1) enforcing the income tax currently relies on cross-verification between federal and state income taxes, and (2) the effective sales tax rates are currently low. With a tax-regime change, both conditions would change.

How Could We Improve the Federal Tax System?

Would tax evasion and avoidance be a significant problem for a national retail sales tax?

Then there's the question of taxing the underground economy. The example frequently offered is that of a drug dealer who does not pay income tax on his earnings today but would be forced to pay the sales tax if he took the funds and bought, say, an expensive car. The flaw in this argument was laid out years ago by former congressman Richard "Dick" Armey: "If there is an income tax in place, he [the drug dealer] won't report his income. If there is a sales tax in place, he won't collect taxes from his customers and send them to the government. In the end, neither system taxes the [illegal] drug trade."

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How Could We Improve the Federal Tax System?

Q. What would be the effect of a national retail sales tax on economic growth?

A. The switch from an income tax to a consumption-based tax would probably make a positive difference, but it is far from certain.

A pure retail sales tax without exemptions or transition relief ought to have a positive impact on growth. First, switching from an income tax to a consumption-based tax would lead to greater savings and investment. And that should increase productivity and the pace of output growth.

There's a subtler route, too. The effective double taxation of existing capital during the transition to a national retail sales tax would generate windfall revenues and thus allow a tax-rate reduction that stimulated growth.

However, the world is not quite that simple. Many forms of saving—including pensions, 401(k) plans, and individual retirement accounts—already receive consumption tax treatment, and a significant share of corporate income is currently untaxed. Moreover, under a national retail sales tax, the likely provision of transition relief for existing assets could reduce the effect on saving further (it's hard to imagine that sophisticated lobbies would accept double taxation without a fight).

Several analysts have constructed models capable of generating realistic estimates of how tax reform would affect growth. The most complete model, developed by David Altig and colleagues (2001), simulates the effects of moving from the current system to a flat-rate consumption tax.

Their analysis—which assumes a less generous demogrant (cash rebate) than proposed by national retail sales tax advocates, some transition relief for existing assets, and no avoidance or evasion of the new tax—finds that the economy would be 0.6 percent larger than otherwise after two years, 1.8 percent larger after 10 years, and 3.6 percent larger in the very long run. But here, as almost everywhere, the devil is in the assumptions. Plausible allowances for avoidance, evasion, and erosion of the statutory tax base for political reasons, along with a more generous demogrant, would reduce these estimates.

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How Could We Improve the Federal Tax System?

Q. What transition rules would be needed for a national retail sales tax?

A. The answer depends more on politics than on economics.

Any fundamental tax reform that seeks to collect the same amount of revenue in a new way is almost certain to redistribute tax burdens, affect asset values, and change price levels. Those who stand to lose would try to prevent the reform or secure "transition relief" that delays or blunts the impact.

The national retail sales tax proposal illustrates these issues starkly. Could the proposal withstand the inevitable political pressures to provide some with preferential treatment or to introduce transition relief? The issue is pivotal because backsliding would undermine the logic of pressing the reform in the first place.

The transition to a national sales tax would open a can of worms. At one extreme, the sales tax could include no adjustments. At the other, policymakers could grant extensive relief by adjusting Social Security benefits to reflect higher retail prices, allowing consumption to be tax free if financed by existing wealth, and so forth. In practice, the transition relief that has accompanied much smaller tax reforms has tended to balloon.

The economic case for transition relief depends on how it affects the simplicity, efficiency, and equity of the new tax system. Providing no relief would be simpler, transition rules could prove complex, and the transition period could stretch out for years. However, there are wheels within wheels here. Not providing relief would also be problematic because it would create strong incentives for individuals to adjust their behavior before the tax takes effect.

Not providing transition relief would certainly be more efficient. A consumption tax that exempts old assets is just a tax on future wages. While a pure consumption tax (one that taxes all old capital) is usually found to be more efficient than a pure income tax, a wage tax (which exempts all old capital) is usually found to be less efficient than a pure income tax. Not taxing existing assets requires higher tax rates on the rest of the tax base to raise the same revenue, increasing the disincentives to work that plague any tax on wages.

Surely the strongest argument for transition relief is fairness. The assets that people own today were priced, purchased, and used under the current tax system. Is it fair to their owners to change the rules midstream?

The answer may not be as obvious as it seems. First, a one-time implicit tax on existing capital would be very progressive. The distribution of such capital is more skewed toward wealthy households than the overall distribution of wealth. And the overall distribution of wealth is, in turn, more skewed toward the wealthy than the distribution of income. Second, since wealthy households would benefit most from the switch to a consumption-based tax, it seems reasonable to ask them to pay some of the costs.

How Could We Improve the Federal Tax System?

What transition rules would be needed for a national retail sales tax?

Third, older households tend to have more assets than younger ones, so taxing existing capital places heavier burdens on older generations. But there's rough justice here: those older households, on average, have received transfers through Social Security and Medicare that far exceed what they have put in. And the vast majority of most elderly households' income and wealth is in earnings (which have not yet been taxed), housing (which receives extraordinarily preferential treatment under the current tax system), pension income (which already receives consumption-tax treatment), Social Security benefits (which everyone agrees would be indexed for inflation with tax reform), and Medicare benefits (which are not taxed). Few elderly households finance much of their living expenses from other assets, and those that do tend to be well off.

Ultimately, the political case for transition relief would determine whether it was part of the package. And history strongly suggests that it would be. Even in much smaller tax reforms, the losers—households and businesses made worse off by the reform—have been compensated. A big question, then, is whether imposing what might be called "sales tax lite" would be worth the economic dislocation.

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Q. Would a national retail sales tax simplify the tax code?

A. It would for individuals, but not as much for businesses and enforcement authorities.

Constructed as a flat-rate consumption tax with a universal demogrant (cash payment) for needy families, the proposed national retail sales tax contains many features that make taxation simpler. Most individuals would no longer need to keep tax records, learn the fundamentals of tax law, or even file returns. Only sole proprietorships, partnerships, and S or C corporations that make retail sales would have to file. And the complexity of filing a return would decline dramatically, even for these taxpayers.

But a national retail sales tax could create new areas of complexity, for example, in administering the proposed demogrant that returns part of the revenue to millions of households, and in enforcing the tax code to ensure that personal and business consumption are not mixed.

DEMOGRANTS

In many proposals, the demogrant that would accompany a national retail sales tax would likely be based on the existing federal poverty guidelines, which rise less than proportionally with the number of family members. For example, in 2016, single individuals fell beneath the federal poverty level if their annual incomes were less than $11,880. This number rose by $4,140 for each additional family member. Thus, the federal poverty level for a family of four in 2016 was $24,300, roughly twice the level for an individual. Basing the demogrant on the federal poverty level would thus create incentives to conceal family relationships to claim the demogrant for more than one individual in a family.

ADMINISTRATION

It is also unclear how the demogrants would be administered or even which agencies would be responsible for determining eligibility and monitoring claims. Thus, compliance and administrative costs could be significant.

TAX AVOIDANCE AND EVASION

Another area of complexity stems from the threat of tax avoidance and evasion. The most likely way that people would try to avoid the tax would be by disguising personal consumption as business activity, as business-to-business transactions would not be taxed.

For example, individuals might register as firms or purchase goods for personal use with a business certificate. Or employers might buy goods for their workers in lieu of wages. Ensuring that all business purchases are not taxed and that all consumer purchases are would require all businesses to record their transactions, even though only retailers would actually have to remit the tax. Some proposed tax plans

Would a national retail sales tax simplify the tax code?

deviate from a pure retail sales tax by requiring that taxes be paid on many input purchases and that vendors file explicit claims to receive rebates on their business purchases. Such requirements would raise compliance costs further.

EVIDENCE

Some related evidence on the potential extent of these problems comes from the experience with state-level "use" taxes, under which taxpayers are obliged to pay taxes on goods purchased in other states. One analyst described the current enforcement of such taxes as "dismal at best."

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How Could We Improve the Federal Tax System?

Q. What has been the state and local experience with retail sales taxes?

A. Most states and localities rely heavily on retail sales taxes. But their experiences suggest that administering a national tax would be daunting.

The first sales tax in the United States was a tax of last resort, established in Mississippi in the 1930s to raise revenue during the Depression. Sales taxes are now the rule rather than the exception in states and localities: 45 states, the District of Columbia, and several thousand localities impose them. Only Alaska, Delaware, Montana, New Hampshire, and Oregon abstain (although Alaska allows localities within the state to have them). Sales tax rates vary widely (from 3 percent to 8 percent), as do the goods and services that are exempt.

Nothing in the states' experience suggests that a broad-based, high-rate federal retail sales tax would survive attempts to create preferences or would be easy to administer. For example, states show little inclination to carefully differentiate between producers' and consumers' purchases. But without a uniform exemption of producer purchases in a national retail sales tax, cascading taxes and market distortions would present a significant problem.

Further, states make little effort to tax services, and they exempt broad categories of purchases for reasons relating to social and economic policy, tax administration, and plain old lobbying. The federal base would have to be much broader than the typical state base; otherwise, the rate needed to replace the revenue generated by today's income tax would be sky-high. The states offer only limited experience in taxing government entities. But proposals for a national retail sales tax envision taxing every dollar of government purchases and investment.

A uniform retail sales tax would cover consumption of all goods and services. State sales taxes, however, deviate from this norm in numerous ways. According to a 2010 Federation of Tax Administrators survey, 35 states exempted household water usage, 25 household electricity, 21 household natural gas, and 21 household telephone services. Another Federation of Tax Administrators survey in 2015 revealed that 33 states exempted food and almost all states exempted prescription medicines. Taxation of services under state sales taxes is spotty at best.

Product exemptions intended to make the tax more progressive would be deeply problematic. Demogrants (cash rebates for lower-income families) would be simpler to administer, would induce fewer distortions of household behavior, and—according to some studies—would be at least as progressive as specific product exemptions. Yet exemptions for "worthy" goods like prescription drugs and heating fuel are quite popular,

What has been the state and local experience with retail sales taxes?

pleasing policymakers because they appear progressive even as they serve the interests of producers looking for exemptions.

The state experience suggests that items difficult to tax are sooner or later excluded and, again, that political pressures can easily affect the form and substance of a retail sales tax.

The taxation of services is even more problematic. Although many states tax some services, only Hawaii and New Mexico include almost all services in the tax base. Enforcement of sales taxes on services has proved exceptionally difficult. These taxes are hard to administer and easy to evade because their paper trail is difficult to audit. This challenge raises red flags for a national retail sales tax.

Last, but not least, remember that an efficient retail sales tax should exempt all business purchases, but most state-level sales taxes do not come close to this ideal. Various estimates indicate that, on average, between 20 and 40 percent of state sales tax revenue comes from business-to-business sales. Estimates for individual states are as high as 70 percent.

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What is the experience of other countries with national retail sales taxes?

Q. What is the experience of other countries with national retail sales taxes?

A. No country has attempted a truly ambitious retail sales tax. Those that have tried more modest versions have abandoned them in favor of value-added taxes.

Many countries have attempted to implement national retail sales taxes or variants, such as wholesale-level taxes or "ring" taxes (retail sales taxes with exemptions for businesses "in the ring"). But not for long. In 1967, 19 Organisation for Economic Co-operation and Development countries had some form of wholesale, retail, or "turnover" tax (a tax paid when a good is manufactured, rather than when it is sold). By 1995, all had converted to value-added taxes (VATs) that collect revenue at each stage of production. Developing countries have also largely abandoned retail sales taxes in favor of VATs.

Retail sales tax rates are generally lower than VAT rates, running 4–6 percent as opposed to 14–25 percent. These sales tax rates are also much lower than the rate advocated by proponents of the national retail sales tax. Only a few countries (Iceland, Norway, South Africa, Sweden, and Zimbabwe) have ever instituted retail sales taxes with rates in excess of 10 percent. And none of these countries currently maintains such a tax, presumably because high-rate sales taxes invite evasion.

Retail sales taxes got replaced with VATs for good reasons—namely, evasion and "cascading." Cascading occurs when taxed inputs are used to produce taxed outputs, so that the total tax on goods compounds beyond what was intended. This effect can be avoided by exempting all business purchases from taxation. But separating business purchases from consumer purchases is difficult. Moving to a VAT solves the problem because businesses receive credits for the taxes paid on their input purchases.

Evasion is higher under a retail sales tax than under a VAT for several reasons. First, the retail level is the weakest link in the enforcement chain. Second, if a retailer evades a sales tax, the full tax on the sale is lost. But with a VAT, successful evasion by retailers only costs the government the tax on the retailer's value added. Third, sales taxes do not produce a paper trail enforcers can easily follow.

How Could We Improve the Federal Tax System?

What is the experience of other countries with national retail sales taxes?

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How Could We Improve the Federal Tax System?

Q. What did the President's Advisory Panel on Federal Tax Reform say about the national retail sales tax?

A. Put simply: a nonstarter.

The President's Advisory Panel on Federal Tax Reform's first objection to replacing the current tax system with a national retail sales tax hinges on the latter's effect on income distribution. The report (2005) noted that "lower and middle-income families would be especially hard hit by a stand-alone retail sales tax" (2005, 211).

The panel was also concerned that, although the proposed demogrant program (which would provide cash rebates to needy households) would make the retail tax system less regressive, it would be a bear to administer. And it would thus "inappropriately increase the size and scope of government" (208). Moreover, the panel concluded that, with the demogrant, the tax rate needed to sustain current federal revenues would exceed— perhaps far exceed—34 percent. Meanwhile, households would still be liable for state and local sales taxes, which currently average 6.5 percent.

Nor was the panel impressed with the tax's value as a tool to simplify the tax system. Taxpayers would still be required to complete state income tax returns unless states abolished their own income taxes. Moreover, a new government agency would be required to monitor both collection of the tax and allocation of demogrants.

The panel also expressed concern about likely evasion: "A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide substantial inducement for evasion at the retail level" (218). And with third-party reporting—such as W-2 and 1099 forms—notably absent from the proposal, "evasion rates are estimated to be around 50 percent" (218).

There's more glum news here. The panel noted that states would lack the ability to collect the tax and that an agency analogous to the IRS would be needed to enforce compliance. It also pointed out that states currently rely on taxpayers' fears of audits of federal income tax returns to deter state sales tax evasion. If the federal government abandoned income tax enforcement along with the income tax, states would be left hanging. Last, the report cited concern that the burden of collecting the national retail sales tax would disproportionately fall on small businesses and small service providers, raising their costs.

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Q. What is a VAT?

A. The value-added tax (VAT) is the world's most common form of consumption tax, in place in more than 160 countries, including every economically advanced nation except the United States.

"Value added" is the difference between business sales and purchase of goods and services from other businesses. It represents the sum of wages, other labor compensation (such as health insurance), interest payments, and the profits businesses earn.

For example, suppose a farmer grows wheat and sells it to a baker for $40. The baker turns the wheat into bread and sells it to consumers for $100. The baker's value added is $60—the difference between sales and purchases. Let's further assume that the farmer has no input costs so that his value added is $40. The sum of value added at each stage of production is equal to the retail sale price of the good, in this case, $100.

The VAT is popular because it raises significant revenue, is relatively easy to administer, and, unlike an income tax, does not impinge on household saving and business investment choices. In 2015, VAT revenues averaged 5.8 percent of gross domestic product in the Organisation for Economic Co-operation and Development, the third-largest revenue source after income and payroll taxes.

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Q. How would a VAT be collected?

A. Most countries with a value-added tax employ the credit-invoice method. Under this method, businesses are taxed on their sales at each stage of production but obtain credits for the taxes they paid on inputs.

CREDIT-INVOICE METHOD

Most countries with a value-added tax (VAT) employ the credit-invoice method. All sales by businesses are taxable, but sellers pass invoices on to the VAT-registered business taxpayers who purchase the sellers' goods and services. These purchasers, in turn, claim a credit for taxes paid but then pay VAT on the full value of their sales. The result is that there are no net taxes on sales between registered VAT businesses, while the full value of the final sale to the consumer bears tax (table 1).

TABLE 1

Prices with Different Types of 10 Percent Sales Taxes

Taxes paid in parentheses

Production stage	No tax	Retail sales tax	Credit-invoice VAT	Subtraction method VAT
Farmer	$300	$300 ($0)	$330 ($30)	$330 ($30)
Miller	$700	$700 ($0)	$770 ($70–$30)	$770 ($40)
Baker	$1,000	$1,100 ($100)	$1,100 ($100-$70)	$1,100 ($30)
Total tax	**$0**	**$100**	**$100**	**$100**

Source: Toder and Rosenberg, 2010.

SUBTRACTION METHOD

Under a subtraction-method VAT, sometimes called a business transfer tax, businesses pay tax on the difference between the value of their sales and the value of their purchases from other businesses. As with the credit-invoice VAT, the sum of all the amounts subject to tax, without exemptions, is equal to the value of final sales. Japan uses a subtraction-method VAT, but it contains all the invoice requirements and rules of the credit-invoice method, so in practice it is not that different from the VATs used in other countries.

How Could We Improve the Federal Tax System?

How would a VAT be collected?

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Q. What would be taxed under a VAT?

A. Typically, a value-added tax covers all or most forms of consumption.

In principle, the tax base of a value-added tax (VAT) is all consumption. Most VAT systems, however, exclude certain items from taxation. Some items (e.g., food and prescription drugs) are excluded to reduce the impact of the tax on low-income households. Others are excluded because defining their "value added" is difficult (e.g., financial services).

BROAD VERSUS NARROW BASES

Eric Toder and Joseph Rosenberg (2010, 12) provide examples of broad- and narrow- based VATs. The broad-based VAT they examine includes "all domestic consumption, except for education, government-financed health care (Medicare and Medicaid), services of charitable organizations, and services performed by subnational governments," capturing about 80 percent of consumption. Their narrow-based VAT excludes (in addition to the exemptions in the broad-based VAT) "housing consumption, food consumed at home, and private medical expenses (out-of-pocket expenses and insurance premiums)," capturing about 50 percent of consumption.

REVENUE RATIOS

A revenue ratio is a formal measure of how broad a tax base is. For a VAT, the revenue ratio is calculated by dividing VAT revenue by the product of the standard VAT rate and all consumption. If the standard tax rate applied to all consumption and to nothing else, and if there were no evasion, the ratio would be one. Goods that are exempt, preferentially taxed, or zero rated (the inputs are eligible for credits though the goods are not taxed upon sale) reduce the revenue ratio, as does tax evasion.

The unweighted average VAT revenue ratio was 0.55 across all OECD countries in 2014, suggesting significant erosion in VAT revenues. The ratio ranged from 0.31 (Mexico) to 1.13 (Luxembourg). The combination of Luxembourg's status as a center of financial services and e-commerce and the current tax treatment of those services may explain why its VAT revenue ratio is greater than 1.00.

The older VATs, mainly in European Union countries, have narrow tax bases, with many goods or services receiving preferential treatment. Newer VATs, such as in New Zealand and Japan, tend to apply a lower standard rate to a broader base of goods and services.

How Could We Improve the Federal Tax System?

What would be taxed under a VAT?

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How Could We Improve the Federal Tax System?

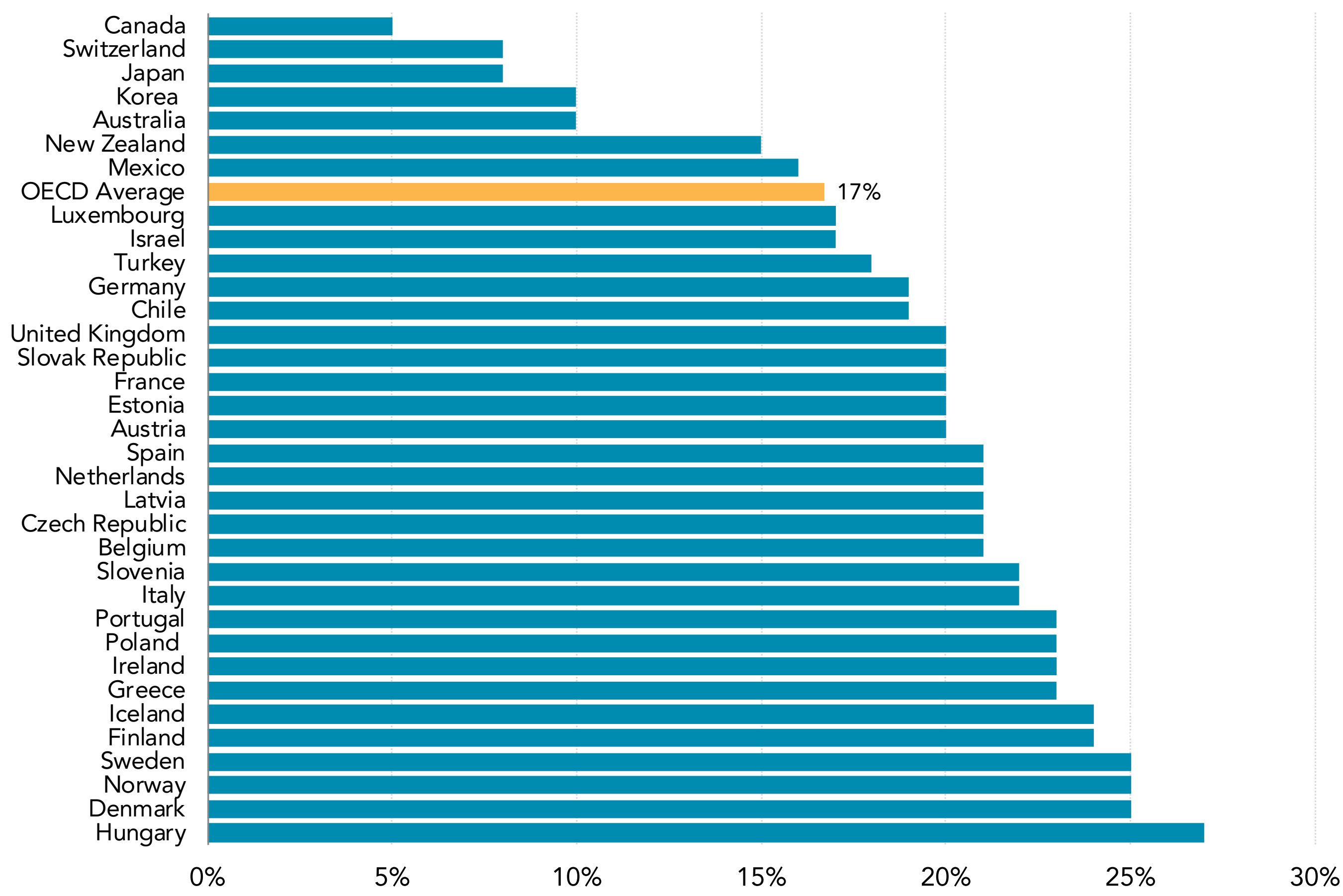
Q. What would the tax rate be under a VAT?

A. The rate of a value-added tax depends on how much revenue it is intended to raise and how broad the VAT base is. The lower the revenue target and the broader the base, the lower the tax rate will be.

FIGURE 1

Value-Added Tax Rates

Among select OECD countries, 2015



Source: OECD, 2016.

How Could We Improve the Federal Tax System?

What would the tax rate be under a VAT?

Value-added taxes (VATs) typically have a standard rate that applies to most goods and services. In 2018, the standard rate in the Organisation for Economic Co-operation and Development averaged 19.2 percent (unweighted) but varied widely—27 percent, its highest, in Hungary, 20 percent in the United Kingdom, 15 percent in New Zealand, 10 percent in Australia, 8 percent in Japan, and 5 percent, its lowest, in Canada (figure 1).

VATs typically provide preferential treatment for certain goods. Some goods are zero rated (the inputs are eligible for credits though the goods are not taxed upon sale), and some are exempt. Some are taxed at preferential rates. The VATs in European Union countries have narrow tax bases, with many goods or services receiving preferential treatment. Newer VATs, such as in New Zealand and Japan, tend to apply a lower standard rate to a broader base of goods and services. The broader the base, the lower the tax rate will be for a given revenue target.

Toder and Rosenberg (2010) estimated that the United States could have raised gross revenue of $356 billion in 2012 through a 5 percent VAT applied to a broad base that included all consumption except spending on education, Medicaid and Medicare, charitable organizations, and state and local government—capturing about 80 percent of consumption. That revenue would equal about 2.3 percent of GDP. If the same 5 percent rate applied to a narrow base that also excluded housing consumption, food consumed at home, and private medical expenses (out-of-pocket expenses and insurance premiums) —capturing about 50 percent of consumption—revenues would have been $221 billion, equal to about 1.4 percent of GDP.

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Q. What is the difference between zero-rating and exempting a good in the VAT?

A. For a "zero-rated good," the government doesn't tax its sale but allows credits for the value-added tax paid on inputs. If a good or business is "exempt," the government doesn't tax the sale of the good, but producers cannot claim a credit for the VAT they pay on inputs to produce it.

ZERO RATING

Almost all countries apply preferential rates to some goods and services, making them either "zero rated" or "exempt." For a "zero-rated good," the government doesn't tax its retail sale but allows credits for the value-added tax (VAT) paid on inputs. This reduces the price of a good. Governments commonly lower the tax burden on low-income households by zero rating essential goods, such as food and utilities or prescription drugs.

EXEMPTING

If, by contrast, a good or business is "exempt," the government doesn't tax the sale of the good, but producers cannot claim a credit for the VAT they pay on inputs to produce it. Because exempting breaks the VAT's chain of credits on input purchases, it can sometimes raise prices and revenues. Hence, governments generally only use exemptions when value added is hard to define, such as with financial and insurance services.

IN PRACTICE

Of the 34 Organisation for Economic Co-operation and Development countries with a VAT in 2016, 18 "zero rated" certain goods and all but Chile and Japan had at least one reduced VAT rate.

How Could We Improve the Federal Tax System?

What is the difference between zero-rating and exempting a good in the VAT?

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Q. Who would bear the burden of a VAT?

A. A value-added tax (VAT) is a tax on consumption. Poorer households spend a larger proportion of their income. A VAT is therefore regressive if it is measured relative to current income and if it is introduced without other policy adjustments. A VAT is less regressive if measured relative to lifetime income.

Although a value-added tax (VAT) taxes goods and services at every stage of production and sale, the net economic burden is like that of a retail sales tax. Sales taxes create a wedge between the price paid by the final consumer and what the seller receives. Conceptually, the tax can either raise the total price (inclusive of the sales tax) paid by consumers or reduce the amount of business revenue available to compensate workers and investors. Theory and evidence suggest that the VAT is passed along to consumers via higher prices. Either way, the decline in real household income is the same regardless of whether prices rise (holding nominal incomes constant) or whether nominal incomes fall (holding the price level constant).

REGRESSIVITY

Because lower-income households spend a greater share of their income on consumption than higher-income households do, the burden of a VAT is regressive when measured as a share of current income: the tax burden as a share of income is highest for low-income households and falls sharply as household income rises. Because income saved today is generally spent in the future, the burden of a VAT is more proportional to income when measured as a share of income over a lifetime. Even by a lifetime income measure, however, the burden of the VAT as a share of income is lower for high-income households than for other households. A VAT (like any consumption tax) does not tax the returns (such as dividends and capital gains) from new capital investment, and income from capital makes up a larger portion of the total income of high-income households.

AVERAGE TAX BURDEN

Using a method more reflective of lifetime burdens, Eric Toder, Jim Nunns, and Joseph Rosenberg (2012) estimate that a 5 percent, broad-based VAT would be regressive at the bottom of the income distribution, roughly proportional in the middle, and then generally regressive at the top. The VAT would impose an average tax burden of 3.9 percent of after-tax income on households in the bottom quintile of the income distribution. (Each quintile contains 20 percent of the population ranked by income.) Yet, households in the top 1 percent of the income distribution would only have an average tax burden of 2.5 percent (table 1).

How Could We Improve the Federal Tax System?

Who would bear the burden of a VAT?

TABLE 1

Distribution of a Fully Phased-In VAT at 2015 Income Levels
(percentage change in after-tax income)

Cash Income Percentile	VAT Options		
	Broad base	Narrow base	Broad base with rebate
Lowest quintile	-3.9	-3.8	-0.6
Second quintile	-3.6	-3.5	-1.8
Middle quintile	-3.6	-3.6	-2.9
Fourth quintile	-3.6	-3.6	-3.5
Top quintile	-2.9	-2.9	-3.7
All	-3.3	-3.3	-3.2
Addendum			
80–90	-3.4	-3.4	-3.8
90–95	-3.2	-3.2	-3.8
95–99	-2.8	-2.8	-3.6
Top 1 percent	-2.5	-2.5	-3.6
Top 0.1 percent	-2.5	-2.6	-3.7

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-7).

DEMOGRANTS

Exempting, zero rating, or excluding certain essential consumption goods from the tax base (e.g., foodstuffs, medicine, health care) can reduce the regressivity of a VAT. Giving preferential treatment to particular goods, however, is an inefficient way to make the tax less regressive because high-income households consume more of the goods in question (though less as a share of income) than low-income households do. A better approach is to provide a limited cash payment—that is, a demogrant or a refundable tax credit. That way, everyone receives the same benefit, in dollars, which translates into a larger share of low-income households' income.

In the same study, Toder, Nunns, and Rosenberg simulate the effects of a 7.7 percent broad-based VAT with a refundable tax credit (the higher tax rate keeps the net revenues the same as the 5 percent, broad-based VAT with no tax credit). They find that the VAT in combination with the tax credit would impose an average tax burden of 0.6 percent on households in the bottom quintile of the income distribution. Households in the top 1 percent of the income distribution would face an average tax burden of 3.6 percent. Their results also show that the distribution of a narrow-based VAT that excludes spending on food, housing, and health care is much the same as the distribution of a broad-based tax (table 1).

How Could We Improve the Federal Tax System?

Who would bear the burden of a VAT?

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How Could We Improve the Federal Tax System?

Q. Is the VAT a money machine?

A. A common criticism of the value-added tax is that it is simply a "money machine" that will enlarge a federal government by supplying a steady source of revenue. The empirical evidence has largely shown that this has not been the case.

Critics provide various reasons a value-added tax (VAT) would enlarge government. First, they say that any increase in government revenues will lead to more spending. If we want to control government spending, they say, we should cut revenues and "starve the beast." Second, critics fear that because a VAT is a "hidden tax," buried in the price of a good, policymakers can raise the tax with minimal economic disruption and without people noticing.

VATs' accumulated track record, however, largely belies these concerns. For starters, VAT revenues and rates have not risen inexorably over time. In advanced countries, VATs were phased in during the 1960s and 1970s. But after that, as International Monetary Fund economist Michael Keen has shown, VAT revenues remained remarkably constant, hovering around 7 percent of gross domestic product (GDP) in the 1990s and 2000s (Keen 2013; Keen and Lockwood 2006). VAT revenue among high-income countries in 2015 was almost exactly the same share of GDP as in 1984.

Further, although revenues have risen significantly in European countries that have VATs, VATs don't seem to be the reason. A study of 16 Western European countries from 1965 to 2015 found that VAT revenue rose by 5.6 percent of GDP, but excise and other sales taxes' falling by 5.2 percent offset almost all of that change. Indeed policymakers in those countries often enacted a VAT with the explicit goal of replacing less efficient sales and other taxes. Total revenue in those countries rose substantially—by about 10 percent of GDP—so the 0.4 increase in revenue from VAT was a tiny fraction of the total tax increase. In addition, some evidence suggests that instead of a VAT fueling higher spending, the public's demand for higher spending fuels demand for a VAT (Lee, Kim, and Borcherding 2013).

How Could We Improve the Federal Tax System?

Is the VAT a money machine?

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Q. How would small businesses be treated under a VAT?

A. Most countries exempt small businesses from value-added tax, although many small businesses choose to voluntarily register for the VAT.

Most countries exempt small businesses from a value-added tax (VAT)—partly because small businesses are a powerful political constituency and partly because the administrative and compliance costs of taxing small businesses are high relative to the revenue raised.

The exemption is a mixed blessing, however. Many businesses prefer to buy their inputs from businesses in the VAT system so they can claim credits on the tax they pay. As a result, countries allow small businesses to register for the VAT even if they are not required to do so. For example, in Australia during the 2010–11 tax year, 37 percent of businesses had sales below the VAT threshold, yet 92 percent of all businesses registered for the VAT.

A higher exemption based on business sales saves on compliance costs but reduces revenue, with the revenue loss depending on the tax rate. A recent study by Treasury Department economists finds that if the United States had a 10 percent VAT, the optimal exemption based on sales would be about $200,000 and would cover about 43 million businesses (Brashares et al. 2014). That exemption would be higher than in most other countries, but the 10 percent rate would be lower than in most other countries. At a 20 percent rate, close to the average for Organisation for Economic Co-operation and Development countries, the optimal exemption would be $90,000, which is within the range of exemptions in other countries.

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Q. What is the Canadian experience with a VAT?

A. Concerns about regressivity, transparency, coordination with state sales taxes, and money machines can be assuaged by observing the Canadian value-added tax experience.

In 1991, Canada implemented a 7 percent national value-added tax (VAT) to replace a tax on sales by manufacturers. The VAT was introduced by the Conservative party, which had concerns about industry competitiveness and the country's fiscal situation.

Canada addressed distributional concerns by applying a zero rate to certain necessities—including groceries, drugs, and rent—and adding a refundable credit to the income tax. Transfer payments had been indexed for inflation and were highly progressive, further insulating against regressivity.

The Canadian VAT is completely transparent: it is listed separately on receipts and invoices just like sales taxes in the United States.

The Canadian experience also shows that a federal VAT can successfully coexist with either a VAT or a retail sales tax levied by subnational governments.

And the VAT in Canada has not been anything like a "money machine." The standard VAT rate declined over time to 6 percent in 2006 and 5 percent in 2008. In both revenues and expenditures, the size of the Canadian federal government as a share of the economy has shrunk significantly since introduction of the VAT. General government tax revenue and spending in Canada has actually fallen as a share of the economy since 1991.

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How Could We Improve the Federal Tax System?

Q. Why is the VAT administratively superior to a retail sales tax?

A. Retail sales taxes suffer from several enforcement problems. Most notably, the government has no record of transactions with which to verify retailers' tax payments. In a value-added tax, the chain of crediting creates a natural audit trail, and the seller has more incentive to report the transaction and pay tax.

If the value-added tax (VAT) replicates the effect of a well-functioning sales tax, why not just enact a retail sales tax?

Retail sales taxes suffer from several enforcement problems. Most notably, there's no cross-reporting; the government has no record of the transaction and the retailer responsible for sending the check to the government for the tax it collects knows this. As a result, compliance rates can be low. Most countries have found that, as a practical matter, retail sales tax rates of 10 percent or higher aren't enforceable—buyers have greater incentive to avoid the tax and retailers have greater incentive to keep the revenues. Not coincidentally, all state sales tax rates are below 10 percent.

For any tax, cross-reporting is essential to compliance. In the income tax, evasion rates on wage income are low: firms withhold income and payroll taxes on workers' behalf and send the money to the government. (The exception is tips, which proves the point.) In the VAT, the chain of crediting creates a natural audit trail. In a transaction between two businesses, the seller knows the buyer is reporting the transaction to claim a credit, so the seller has more incentive to report the transaction and pay tax. There's no similar incentive under a retail sales tax.

Also with a sales tax, the retailer can't always tell whether the buyer is a consumer who should pay the tax or a business which should not—and has little incentive to find out. If the retailer doesn't impose a sales tax on consumer purchases, that's tax evasion. If the retailer does impose a tax on business purchases, the tax "cascades," building up over successive stages of production, which raises and distorts prices. By providing a credit for taxes paid, the VAT prevents cascading.

Last, when retailers evade sales taxes, revenues are lost entirely. With a VAT, revenue would only be lost at the "value-added" retail stage. All these differences help explain why numerous countries replaced their sales and turnover taxes with VATs.

How Could We Improve the Federal Tax System?

Why is the VAT administratively superior to a retail sales tax?

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How Could We Improve the Federal Tax System?

Q. What is the history of the VAT?

A. The value-added tax is a relatively new tax. It was designed by two people, independently, in the early 20th century. Many European countries enacted a VAT in the 1960s and 1970s. Other countries followed in the 1980s and thereafter.

The value-added tax (VAT) is a relatively new tax. It was designed by two people, independently, in the early 20th century. To Wilhelm Von Siemens, a German businessman, the VAT was a way to resolve the cascading problems that arose in implementing gross turnover taxes and sales taxes. To Thomas S. Adams, an American, the VAT was a better version of the corporate income tax.

In practice, governments have implemented the VAT largely as an improved sales tax. European countries, for example, have largely used the VAT to reduce or eliminate other sales taxes. The countries continue to maintain separate corporate income taxes.

Many European countries enacted a VAT in the 1960s and 1970s. Other countries followed in the 1980s and thereafter. Sijbren Cnossen, a leading VAT expert from Maastricht University in the Netherlands, called its spread "the most important event in the evolution of tax structure in the last half of the 20th century" (1998, 399).

US policymakers have found it tempting to consider the VAT, but no one seems to be able to muster the courage to call it by its real name. The "destination-based cash flow" tax that House Speaker Paul Ryan and Ways and Means Committee Chair Kevin Brady proposed in the 2016 Republican "blueprint" is just a VAT with a wage deduction. VATs are embedded in Ryan's "business consumption tax," libertarian Kentucky Senator Rand Paul's "Fair and Flat Tax," 2012 Republican presidential candidate Herman Cain's "9-9-9" proposal, and Republican Senator Ted Cruz's "Business Flat Tax." VATs have also been proposed (and renamed) in Senate Finance Committee Democrat Ben Cardin's "progressive consumption tax" and the Bipartisan Policy Center's 2010 Domenici-Rivlin commission report, which called it a "deficit reduction sales tax."

Although these leading policymakers proposed to use the resulting revenues differently, they all viewed the VAT favorably for three reasons: it raises lots of money, it creates few negative economic incentives, and it's administratively feasible.

How Could We Improve the Federal Tax System?

What is the history of a VAT?

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Q. How are different consumption taxes related?

A. A retail sales tax, value-added tax, the flat tax, and the X-tax are closely related. These taxes are contrasted with wage taxes.

A retail sales tax is a flat-rate tax on all sales from businesses to households.

A value-added tax (VAT) is equivalent to a retail sales tax but it collects the tax in small pieces at each stage of production rather than entirely at the final sale.

The Hall-Rabushka flat tax is simply a two-part VAT, with all value added except wages taxed at the firm level and wages taxed at the individual level, after allowing for exemptions based on family size. Businesses and individuals face the same flat rate on all income.

The X-tax is simply a variant of the flat tax in which wages are taxed at graduated rates, and the business tax is set equal to the highest rate on wages.

A wage tax is quite different. It would tax wages directly, as would the flat tax or X-tax, but it would not contain the business component of such taxes.

How Could We Improve the Federal Tax System?

How are different consumption taxes related?

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How Could We Improve the Federal Tax System?

What is the flat tax?

Q. What is the flat tax?

A. While any tax system with flat rates could be called a flat tax, the name is usually reserved for a system developed by Robert Hall and Alvin Rabushka in 1985. Their flat tax is really a two-part VAT: All value added except wages is taxed at the business level and wages are taxed at the individual level at the same flat rate but with an exemption related to family size.

The Hall-Rabushka flat tax would replace the current income tax system with a consumption tax. Their system is a two-part value-added tax (VAT). All value added would be taxed at the business level except wages, which would be deductible. Wages would be taxed at the individual level, with an exemption based on family size. All taxable wages and all business non-wage value added would face the same flat rate. In Hall and Rabushka's original proposal (1985), that rate would be 19 percent.

In short, the flat tax is a consumption tax, even though it looks like a wage tax to households and a variant of a VAT to most businesses. Therefore, except for the exemptions, the economic effects of the flat tax are essentially the same as those of a VAT or a sales tax.

The flat tax can be split into two parts: the business tax and the individual tax. Firms would be responsible for paying taxes (at a flat rate) on sales after they have deducted wages, pensions, material costs, and capital investments. Individuals would be responsible for paying taxes (again, at a flat rate) on the wages that firms have deducted, but only on wages in excess of an exemption level.

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Q. What is the X-tax?

A. The X-tax is a variant of the flat tax developed by economist David Bradford. It is mechanically identical to the flat tax, except that it incorporates graduated tax rates on household wage income to improve progressivity.

The X-tax is a variant of the flat tax developed by Princeton economist David Bradford (1986). Like the flat tax, it is consumption based and incorporates two elements: a business tax and a personal tax.

On the business side, firms would be responsible for paying taxes on their sales, less material costs and wages; the business tax rate would be equal to the highest individual tax rate. On the individual side, individuals or households would be taxed on wages, less a deduction based on family size. The individual tax would have graduated rates up to a maximum equal to the business rate.

The major difference between the flat tax and the X-tax is the inclusion of a graduated individual rate structure on wages. This makes the X-tax more progressive than the flat tax.

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How Could We Improve the Federal Tax System?

Q. *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System,* Report of the President's Advisory Panel on Federal Tax Reform, November 2005.

A. The President's Advisory Panel on Federal Tax Reform recommended two simpler and fairer alternatives to the US income tax system, but both come with some big catches.

The President's Advisory Panel on Federal Tax Reform was created by President Bush in 2005 to recommend options to make the tax code simpler, fairer, and more conducive to economic growth. The panel developed two proposals, outlined below. Both contain features of income and consumption taxes, simplify taxes and streamline filing, eliminate the alternative minimum tax, eliminate most tax expenditures, and decrease the effective tax rate on capital income. As directed by President Bush, the panel designed the plans to be revenue neutral, though with the assumption that tax cuts proposed in President Bush's budget would be enacted.

The panel's report, *Simple, Fair, and Pro-Growth*, outlines the Simplified Income Tax Plan and the Growth and Investment Tax Plan (as well as how a value-added tax might be added to the former). The final chapter examines the possibility of replacing the income tax with a retail sales tax and finds that doing so would be deeply problematic.

SIMPLIFIED INCOME TAX PLAN

The Simplified Income Tax Plan would streamline the tax code by eliminating several exemptions. It would lower individual income tax rates to a range of 15–33 percent and set the top corporate rate at 31.5 percent. And it would encourage greater use of Roth-style savings accounts, such that a family of four could contribute up to $60,000 per year in plans for retirement, health, education, and housing.

Major Changes to Tax Expenditures

- Replace the standard deduction, personal exemption, and head-of-household family credit with a single family credit.
- Replace the earned income tax credit (aimed at the working poor) with a less generous version.
- Convert the mortgage interest deduction to a 15 percent credit and reduce the cap on eligible interest payments to increase the number of people qualifying for the credit by 60 percent.
- Allow any taxpayer to deduct charitable contributions in excess of 1 percent of income.
- Eliminate the state and local tax deduction.
- Allow taxpayers to deduct non-group health insurance up to the amount of the average premium. Employer-paid premiums in excess of caps would be taxable.

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Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, November 2005

Savings and Retirement

- Replace all current tax-preferred savings options with three savings vehicles and a refundable saver's credit that phases out with increases in income. Each account would have a Roth-like structure (no initial deductions) and would not have income eligibility limits.
- Implement Save at Work plans that would consolidate all employer-provided defined-contribution plans and 401(k) plans, encourage automatic contribution as a default, and maintain the current 401(k) contribution limits.
- Implement Save for Retirement plans that would replace all savings plans not provided by employers, such as individual retirement accounts. Save for Retirement plans would have a $10,000 annual contribution limit.
- Implement Save for Family plans that would replace education and health savings plans and could be used for education, medical care, home purchases, and retirement. Up to $1,000 could be withdrawn each year for any purpose and up to $10,000 could be contributed annually.

Corporate Taxation

- Divide businesses into small, medium, and large, with separate rules for each.
- Eliminate most deductions and credits.
- Move to a territorial system that taxes only domestic income.
- Eliminate the income tax on dividends received from US companies.
- Exclude 75 percent of corporate capital gains received from US companies from personal taxation.
- Tax interest received at regular individual income tax rates.

GROWTH AND INVESTMENT PLAN

The Growth and Investment Tax Plan alternative would move the system closer to a consumption tax. It would be composed of a hybrid X-tax (a tax that mixes a European-style value-added tax with an income tax on wages) plus an individual-level 15 percent surcharge on capital income. Most proposals in the Simplified Income Tax Plan regarding major credits and deductions, as well as individual savings and retirement, would also apply to the Growth and Investment Tax Plan.

Main Provisions

- The X-tax would be a flat 30 percent levy similar to a value-added tax, with deductions for wages and other compensation. Investments would be expensed, interest and other financial inflows would not be taxed, and interest payment deductions would be eliminated.
- Individuals' interest, dividends, and capital gains would be taxed at 15 percent.
- All front-loaded 401(k) plans would be converted to back-loaded Roth plans.
- Individual income tax rates would be consolidated into three brackets with rates of 15, 25, and 30 percent.

How Could We Improve the Federal Tax System?

Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, November 2005

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How Could We Improve the Federal Tax System?

Q. *The Moment of Truth*, Report of the National Commission on Fiscal Responsibility and Reform, December 2010.

A. The 2010 report of the National Commission on Fiscal Responsibility and Reform recommends policy reforms, collectively known as the Bowles-Simpson plan, intended to stabilize America's fiscal path.

President Obama tasked the National Commission on Fiscal Responsibility and Reform with recommending ways to bring the federal budget back into balance and to improve its long-run viability. The commission created a six-part plan outlining comprehensive tax reform, Social Security reform, cuts in discretionary spending, health care cost containment, mandatory personal savings, and changes to the budget process.

As a whole, the Bowles-Simpson plan would reduce the deficit to 2.3 percent of gross domestic product (GDP) by 2015, cap total tax revenue at 21 percent of GDP, and reduce spending to less than 22 percent of GDP. It would also stabilize the debt by 2014 and reduce the debt to 40 percent of GDP by 2035 (from about 60 percent when the report was written). The plan would cut the fiscal gap with an almost equal mix of revenue increases and spending cuts.

COMPREHENSIVE TAX REFORM

The commission's plan for tax reform set multiple goals: lower tax rates, broaden the base, cut tax expenditures, reduce the deficit, and maintain or increase tax progressivity.

Key Provisions

- Create three individual income tax brackets of 12, 22, and 28 percent, as well as a single 28 percent corporate rate.
- Eliminate the alternative minimum tax.
- Tax capital gains as normal income.
- Eliminate all tax expenditures except as follows:
  - Keep the child tax credit and earned income tax credit.
  - Replace the mortgage interest deduction with a 12 percent nonrefundable credit for all taxpayers for mortgages on principal residences only. Cap mortgage eligibility at $500,000.
  - Cap the exclusion for employer-sponsored health care at the 75th percentile of average premiums in 2014. Reduce the excise tax on high-cost health care plans (the Cadillac tax) to 12 percent.
  - Replace the charitable contribution deduction with a 12 percent nonrefundable credit for contributions over 2 percent of adjusted gross income.
  - Tax interest on newly issued state and municipal bonds.
  - Consolidate retirement accounts and cap tax-preferred contributions at the lower of $20,000 or 20

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The Moment of Truth, Report of the National Commission on Fiscal Responsibility and Reform, December 2010

percent of adjusted gross income, while expanding the saver's credit.
- Eliminate all tax expenditures benefiting corporations.
- Implement a territorial tax system for active foreign-source income.
- Increase the excise tax on gasoline by 15 cents between 2013 and 2022.

SOCIAL SECURITY REFORM

To reduce Social Security's projected funding shortfall, the commission would increase the taxable wage base by 2050 to include 90 percent of earnings, increase the full- and early-retirement ages to 69 and 64, respectively, by 2075, cover newly hired state and local workers after 2020, and create a hardship exemption allowing those who cannot work past age 62 to receive benefits early. In addition, a chained consumer price index (which is generally lower than the unchained consumer price index) would be used to index benefits. To aid the lowest earners, the proposal included provisions to make the benefit formula more progressive and to create a minimum benefit for low-wage workers and the long-term disabled.

CUTS IN DISCRETIONARY SPENDING

The commission recommended that discretionary spending be capped through 2020 to force a reckoning of priorities, and that security and non-security spending be reduced by equal percentages.

HEALTH CARE COST CONTAINMENT

The commission recommended changes to the Medicare Sustainable Growth Rate, a system designed to control Medicare payments to physicians. Other savings would come from changes in cost sharing, malpractice law, and prescription drug costs. Overall, the commission recommended that health care spending growth be held to GDP plus 1 percent.

MANDATORY PERSONAL SAVINGS

The commission recommended several reforms, including reforming civilian and military retirement programs, reducing agricultural program spending, eliminating in-school subsidies in federal student loan programs, and giving the Pension Benefit Guaranty Corporation the authority to increase premiums.

CHANGES TO THE BUDGET PROCESS

Finally, the commission proposed changes to the budgeting process, including switching to a chained consumer price index where cost-of-living indexes are used to set spending, establishing a debt-stabilization process to enforce deficit reduction targets, allowing budgetary cap adjustments for program integrity efforts, and reviewing budget-scoring practices.

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How Could We Improve the Federal Tax System?

Q. Debt Reduction Task Force proposal, "Restoring America's Future," Bipartisan Policy Center, November 2010.

A. The task force proposed changes to the tax system, federal spending, health care spending, and Social Security to improve America's fiscal condition.

The Debt Reduction Task Force, chaired by Senator Pete Domenici and Alice Rivlin, created a plan to recover from the 2008 recession in the near term and reduce the national debt in the long term. The task force provided recommendations to reduce and stabilize the debt, streamline the tax code, restrain health care costs, strengthen Social Security, and freeze defense and domestic discretionary spending. The plan would reduce the debt to 60 percent of gross domestic product (GDP) by 2020 and balance the primary budget (excluding interest payments) by 2020. Federal spending would shrink to 23 percent of GDP by 2020, with revenues at 21.4 percent of GDP.

REVIVE THE ECONOMY AND CREATE JOBS

The task force recommended a one-year payroll tax holiday to create between 2.7 and 7 million new jobs over two years.

TAX REFORM

The task force's plan would cut tax rates and broaden the base by eliminating tax expenditures and establishing a new debt reduction sales tax.

Major Reform Proposals

- Consolidate individual income tax rates into two brackets: 15 and 27 percent.
- Set the corporate income tax rate at 27 percent.
- Tax capital gains and dividends as ordinary income, while allowing a $1,000 exclusion for capital gains.
- Eliminate the standard deduction and personal exemptions, along with most tax expenditures.
- Replace the earned income tax credit and other family and child provisions with a $1,600 per child universal credit and a credit of 21.3 percent on the first $20,300 of earnings for each worker.
- Replace the mortgage interest deduction and deduction for charitable contributions with 15 percent credits available to everyone regardless of income (the 15 percent mortgage interest credit would only be available for expenses on a principal residence, and only up to $25,000).
- Eliminate deduction for state and local taxes.
- Allow individuals and employers to contribute up to 20 percent of annual earnings to qualified retirement plans, up to $20,000 per year.
- Introduce an expanded refundable savings credit for taxpayers in the 15 percent tax bracket.
- Repeal the alternative minimum tax.

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Debt Reduction Task Force, "Restoring America's Future," November 2010

- Increase the excise tax on alcohol from about 21 cents per ounce to 25 cents.
- Phase in a 6.5 percent debt reduction sales tax over two years. The tax would be structured similarly to a broad-based value-added tax

DOMESTIC DISCRETIONARY AND DEFENSE SPENDING

The task force recommended that domestic discretionary spending be frozen for four years and defense spending be frozen for five years. After this time, spending growth would be allowed to increase at the rate of GDP growth. All spending limits would be enforced through statutory caps. If the caps were exceeded, spending would automatically be cut across the board. Cuts to domestic discretionary spending would save $1 trillion, and cuts to defense spending would save $1.1 trillion through 2020.

HEALTH CARE

The task force proposed short-term and long-term changes to all aspects of the health care system. As a whole, the reforms would save $756 billion through 2020.

Changes to Medicare

- Raise Part B premiums from 25 to 35 percent of program costs over five years.
- Use the government's bargaining power to increase rebates from pharmaceutical companies.
- Modernize benefits package and copayment structure.
- Bundle payments for post-acute care.
- Transition to a premium-support option to limit growth per beneficiary and increase competition among private plans.
- Eliminate barriers to enroll dual-eligible patients (Medicare beneficiaries who are also eligible for Medicaid) in managed care.

Other Major Changes

- Reduce excess cost growth in Medicaid by 1 percentage point per year.
- Require states to cap awards for non-economic and punitive damages for medical malpractice and test other reforms to the malpractice system.
- Impose an excise tax on beverages sweetened with sugar and high-fructose corn syrup.
- Reform the sustainable growth rate mechanism for physician payments.
- Cap the exclusion for employer-provided benefits in 2018 and phase it out over 10 years. This would replace the "Cadillac tax" that is part of the Affordable Care Act.

SOCIAL SECURITY

The task force proposed several changes to Social Security to ensure its long-run sustainability. Major reforms include increasing the portion of wages subject to the payroll tax to 90 percent, changing the cost-of-living calculation, indexing the benefit formula for increases in life expectancy, reducing benefit growth for the top 25 percent of beneficiaries, and covering newly hired state and local government workers. To aid the most at-risk populations, the task force proposed increasing the minimum benefit for long-term low-wage earners and the most vulnerable elderly.

OTHER SAVINGS

Cuts and reforms to smaller federal programs were projected to save $89 billion by 2020. The task force recommended reducing farm program spending by eliminating payments to producers with an adjusted

How Could We Improve the Federal Tax System?

Debt Reduction Task Force, “Restoring America’s Future,” November 2010

gross income over $250,000, consolidating and capping conservation programs, and reforming crop insurance. In addition, they proposed changing the benefit calculation for civilian government retirees and changing the age at which career military personnel can retire.

BUDGET PROCESS

To enforce the proposed reforms, the task force recommended that changes to the budget system be imposed to increase accountability. Examples of reforms included statutory spending caps, a pay-as-you-go requirement to prevent the fiscal situation from getting worse, and a fiscal accountability commission that would meet every five years to evaluate program growth and other budget issues.

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The Tax Reform Act of 2014, House Ways and Means Committee

Q. "The Tax Reform Act of 2014: Fixing Our Broken Tax Code So That It Works for American Families and Job Creators," proposed by the House Ways and Means Committee.

A. The Tax Reform Act of 2014, an ambitious plan for broadening the tax base and simplifying both the corporate and personal income taxes, was designed to be revenue neutral over the 10-year budget horizon.

The Tax Reform Act of 2014 was proposed by former chair of the House Ways and Means Committee Dave Camp as a point of reference for tax reform. The Camp plan would reduce tax rates and eliminate or limit most tax expenditures. It would be revenue neutral and income distribution neutral over the 10-year budget horizon but would lose revenue and become more regressive after then.

INDIVIDUAL INCOME TAX

- Consolidate individual tax rates into three brackets: 10, 25, and 35 percent. The 35 percent bracket would be composed of the 25 percent rate plus a 10 percent surtax that would only apply to modified adjusted gross incomes over $450,000 ($400,000 for single taxpayers).
- Increase the standard deduction for all taxpayers and add an additional deduction for single taxpayers with at least one dependent child.
- Eliminate the personal exemption, state and local tax deduction, deduction for medical expenses, and other smaller tax expenditures.
- Reduce the cap on the interest deduction over four years to mortgages of $500,000.
- Allow deductions for only those charitable contributions in excess of 2 percent of adjusted gross income.
- Increase and expand the child tax credit.
- Modify the earned income tax credit, index the parameters to the chained consumer price index, and reduce eligibility for children to those younger than 18. The earned income tax credit would thereby be reduced for almost all families.
- Consolidate higher education incentives into an American Opportunity Tax Credit.
- Modify the rules for individual retirement accounts (IRAs) and 401(k) plans by barring deductible contributions to traditional IRAs and removing income limits on contributions to Roth IRAs.
- Repeal the alternative minimum tax.
- Tax capital gains and dividends as ordinary income, with a 40 percent exclusion.

CORPORATE INCOME TAX

- Set the top corporate rate at 25 percent; phase in the reductions over five years.
- Shift to a territorial system (which would exempt the foreign income of US multinational firms from US

How Could We Improve the Federal Tax System?

The Tax Reform Act of 2014, House Ways and Means Committee

taxation).
- Institute a retroactive tax on foreign-earned income of 8.75 percent on cash assets and 3.5 percent on noncash assets, with the option to spread payments over eight years. All revenue would be allocated to the Highway Trust Fund.
- Institute a 0.035 percent excise tax on big banks that is levied quarterly on consolidated assets in excess of $500 billion.
- Repeal the corporate alternative minimum tax, along with the deduction for domestic production activities and most other business tax preferences.

ANALYSIS

The Joint Committee on Taxation predicted the Camp plan would be revenue neutral in the initial 10 years. However, when considering the macroeconomic effects, the committee found that the plan could boost GDP by between 0.1 and 1.6 percent in that 10 years, increasing federal revenue by between $50 billion and $700 billion.

Beyond the first 10 years, though, the fiscal impact would be uncertain. Many provisions that initially increased revenue would expire. In addition, the official estimates may have misstated the cost of making certain tax extenders permanent, thereby increasing long-term costs. These additional costs could have been partially offset by adopting the chained consumer price index to index tax rates, credits, and so on.

Tax burdens for heads of households would significantly increase in all quintiles of the income distribution except the lowest. Further, households in high-tax states that itemize their deductions, families with older children, and households that previously benefited from tax preferences that would diminish or expire would probably bear a higher tax burden in the long run.

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How Could We Improve the Federal Tax System?

Q. The Graetz Competitive Tax Plan: Update for 2015.

A. Graetz's proposal recommends cutting income and payroll taxes and making up the revenue with a value-added tax.

Columbia University law professor Michael Graetz introduced his "Competitive Tax Plan" more than a decade ago and has recently updated it. Broadly, the plan shifts the tax system, which is based on income, to one based on consumption. The plan is revenue neutral and would not change the overall income distribution.

The Competitive Tax Plan contains five components.

- A value-added tax (also called a goods and services tax) with a broad base and a single rate of 12.9 percent. Businesses with less than $1 million in gross receipts would be exempt. There would be 18 to 24 months between enactment and implementation, which Graetz expects would accelerate purchases of durable goods and provide a short-term boost to the economy. The tax would be modeled after modern value-added taxes in New Zealand, Australia, Canada, Singapore, and South Africa. States would be given incentives to harmonize their tax policies with the federal tax.

- An individual income tax in which the first $100,000 of income for married couples would be exempt from taxation ($50,000 for singles and $75,000 for heads of household). Above this threshold, tax rates would be 14, 27, and 31 percent. The alternative minimum tax and surtax on investment income would be repealed. With these reforms, less than one-fifth of the households now paying income tax would be required to file returns.

- A corporate income tax with a reduced rate of 15 percent. All credits except the foreign tax credit would be eliminated, and the corporate alternative minimum tax would be repealed. The plan may also subject large businesses (even if they are not corporations) to the corporate income tax while simplifying the taxation of small businesses.

- The current payroll tax, but with credits of 15.3 percent of wages for workers with earnings up to $10,000 and a credit of $1,530 for workers earning between $10,000 and $40,000. The credit phases out for incomes above $40,000.

- Refundable child credits would be established and distributed through debit cards. Each child would qualify for $1,500 per year, with a phaseout provision for higher-income earners. Low- and moderate-income earners, on the other hand, would receive an additional rebate of up to $3,500 for one child and $5,200 for two or more children.

How Could We Improve the Federal Tax System?

The Graetz "Competitive Tax Plan:" Update for 2015

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How Could We Improve the Federal Tax System?

Q. What is return-free filing and how would it work?

A. If an income tax system were simple enough, the government could withhold taxes owed and do its own accounting at the end of the year without much help from taxpayers.

EXACT-WITHHOLDING SYSTEM

In this variation, the tax agency attempts to withhold the exact amount of taxes due from paychecks and other income so that no end-of-year filing, payment, or refund is needed.

Two types of exact-withholding systems exist. Cumulative systems (used in the United Kingdom and Russia) aim to withhold exactly the right amount of tax at regular intervals across the year. Final-withholding systems (used in Germany and Japan) make adjustments by withholding more or less money from the final paycheck of the tax year.

TAX AGENCY RECONCILIATION SYSTEM

In a tax agency reconciliation system, taxpayers who choose to do so provide the tax authority with basic information. The tax authority then calculates tax liability from this information and from information it receives from employers, financial institutions, and other payers. The taxpayer then has a chance to review (and correct) these calculations and submits the return.

TAX AGENCY RECONCILIATION VERSUS EXACT WITHHOLDING

In both variations, taxpayers must report certain nonfinancial information to either their employers or the tax authority. In the United States, nonfinancial information would likely consist of the taxpayer’s name, address, Social Security number, and filing status, along with the names and Social Security numbers of spouses and dependents. The employer or the tax authority would use this information to calculate withholding allowances. Taxpayers might be required to report this information periodically or whenever there is a change in their circumstances that would affect tax liability.

Neither an exact-withholding nor a tax agency reconciliation system provides an easy way to handle capital gains, itemized deductions, business income, employee business expenses, moving expenses, or individual retirement accounts, although some accommodation is possible. A key issue in return-free systems is who bears responsibility for mistakes on the return prepared by the tax authority, and for mistakes in exact withholding made by either the tax authority, the employer, or another payer.

How Could We Improve the Federal Tax System?

What is return-free filing and how would it work?

RETURN-FREE ELIGIBILITY

A return-free system in the United States could include more taxpayers if the tax code were adjusted in several ways:

- having the vast majority of taxpayers face the same marginal ("basic") tax rate;
- making the unit of taxation the individual rather than the family;
- taxing interest and dividend income at a flat rate and withholding it at the source;
- largely exempting capital gains from taxation; and
- limiting the number of itemized deductions.

None of these conditions, however, is necessary to operate a return-free system for at least some taxpayers.

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Q. What are the benefits of return-free filing?

A. It eases the burden of tax compliance on individuals, and could make the tax code simpler and tax collection and enforcement more efficient.

The primary benefit of a return-free system is a reduced tax compliance burden. Depending on the changes made to the current US income tax structure and administration to accommodate return-free filing, the requirement to file a final tax return could be eliminated for somewhere between 8 million and 60 million households. Secondary benefits include simplification of the tax code, and perhaps a lower administrative burden on the Internal Revenue Service and lower federal expenditure for tax collection.

Filing tax returns can be a drain on taxpayers' time, emotions, and, for those who hire a tax preparer, wallets. Thus, even if most taxpayers can complete their returns with little effort, a return-free system could still provide them significant benefits. There is one important catch: state income tax systems piggyback on the federal system. If the states failed to shift to a return-free system, the reduction in costs would be modest.

Although taxpayers participating in the return-free system would be spared filing paperwork, the net administrative savings might not be great. Of the 62 million or so taxpayers potentially eligible, over two-thirds currently file the simpler 1040A and 1040EZ returns. Even under a return-free system, these taxpayers would still have to provide some of the same information (such as filing status and dependents' identification) that they do now. Further, some administrative costs would merely be shifted from the taxpayers to their employers, other payers, and the IRS.

In 1996, the US General Accounting Office estimated that a tax agency reconciliation system could reduce the time spent preparing tax returns by as much as 155 million hours a year for 51 million taxpayers and reduce the IRS's annual costs by up to $37 million. These estimates, however, do not take into account the ways in which such a system might increase the administrative burden on taxpayers and the IRS. For example, 1 billion information reports would have to be filed earlier and processed much sooner by the IRS in order to complete returns by April 15 (with refunds to follow later). State income tax authorities would also incur additional costs or delays.

How Could We Improve the Federal Tax System?

What are the benefits of return-free filing?

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Q. What are the drawbacks of return-free filing?

A. Potential drawbacks include a heavier administrative burden for those charged with withholding income tax and for government collection agencies, as well as added limits on taxpayer independence.

Drawbacks to a return-free system include a potentially heavier administrative burden on employers and other businesses charged with withholding income tax, as well as on state and federal tax collection agencies. In addition, taxpayers and opponents have expressed concern that a return-free plan would allow the government to decide how much tax was owed, limiting taxpayers' independence and constraining their ability to appeal tax agencies' decisions.

Taxpayers appear to like overpaying tax through withholding then receiving refunds, perhaps viewing this as a form of forced saving. Moving to a cumulative exact-withholding system would eliminate refunds. In a tax agency reconciliation system, however, refunds would still be possible.

Some argue a "visible" tax system (as we have now) is important, on the principle that citizens who know what they pay can make better economic and political choices. In a return-free system, taxpayers would presumably be less informed about how they are being taxed and thus less aware of the tax consequences of their actions. However, the link between filing and understanding may be overblown. Payroll taxes in the United States already operate under a return-free system for almost all taxpayers, yet interest in Social Security and Medicare does not appear to have suffered as a result.

The IRS concluded in 1987 that "there are serious timing and accuracy problems" in developing a tax agency reconciliation system. Even after almost a decade of technological improvements, the US General Accounting Office in 1996 agreed that the IRS would likely need significant investments in processing capability to implement such a system.

How Could We Improve the Federal Tax System?

What are the drawbacks of return-free filing?

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Q. How would the tax system need to change with return-free filing?

A. The simpler the system, the easier it would be to increase the number of return-free filers.

Although many countries have adopted return-free tax systems, most of them have simpler tax codes than the United States. Implementing a return-free system that most US taxpayers could participate in would require sweeping changes in the tax code to make it more like those countries'. Common elements of such codes include a "basic" rate for most taxpayers, the designation of individuals (rather than families) as the unit of taxation, taxation of interest and dividends at one rate (and at the source), exemption of some capital gains from taxation, and the paring of deductions, allowances, and credits.

Still, with just minor reforms, the current system could accommodate return-free filing for the substantial number of taxpayers who now file simple returns. A big stumbling block is that the current withholding formulas are not designed to be exact for dependent filers, dual-income couples, or taxpayers with more than one job during the year. Indeed, if dependent filers and filing units with income from more than one job were still required to file a return, only 8 million taxpayers with wage income could be exempted from filing. Even among these 8 million, changes in personal circumstances during the year could cause withholding errors.

Without any changes in the law, it might still be possible to fine-tune withholding formulas to meet most taxpayers' needs. But there's no free lunch here: attaining the additional precision would add significant complexity to Form W-4 and the computation of withholding allowances.

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US Department of the Treasury. 2003. *Return-Free Tax Systems: Tax Simplification Is a Prerequisite*. Washington, DC: US Department of the Treasury.

Q. Who would qualify for return-free filing?

A. As many as 50 million taxpayers would qualify, including most of those who take the standard deduction and rely on wages for most of their income.

The size and scope of a return-free system would depend on its administrative and structural features. At best, some 50 million would qualify. This group would consist mostly of earners whose incomes come from wages and who choose not to itemize their deductions. The system could be expanded to include taxpayers with income from dividends, interest, pensions, individual retirement account distributions, and unemployment insurance, as well as low-income earners qualifying for the earned income tax credit (EITC). Taxpayers with uncomplicated itemized deductions could also be brought into the system.

In 2003, the Treasury conducted a study on how return-free filing could be implemented; the report was later updated to reflect 2007 tax data. Tables 1 and 2 break down the numbers. Note that the information is dated, as the 2017 Tax Cuts and Jobs Act changed the system with respect to personal exemptions, itemized deductions, and the standard deduction.

ELIGIBILITY

The Treasury reports that approximately 20 million taxpayers in 1999 had income solely from wages and salaries, claimed no credits (including the EITC), did not itemize deductions, and were in either the zero or the 15 percent tax bracket. Since almost all wage income is subject to withholding already, these taxpayers could more easily be shifted into a return-free system than the rest of the filing population.

If withholding at the source were extended to interest, dividends, pensions, individual retirement account distributions, and unemployment insurance benefits, the number would rise by 21.6 million. To some extent, taxes are already withheld on these forms of income. Mandatory withholding would expand the scope of a return-free system and could improve compliance, but may also add to taxpayers' administrative burdens. To reduce these burdens, small payments and some payers—for example, those who hold debt (such as seller-financed mortgages), foreign banks, and other foreign-resident debt holders—could be exempted from withholding.

THE EARNED INCOME TAX CREDIT

The EITC could be retained under a return-free system, but its administration would work differently depending on how the system was designed. Administering the EITC under an exact-withholding system would be complex but feasible. Under a tax agency reconciliation system, the EITC could continue to be administered through the tax system. With the EITC included in the return-free model, an additional 13.5 million taxpayers would have been eligible to use a return-free system in 1999.

How Could We Improve the Federal Tax System?

Who would qualify for return-free filing?

ITEMIZED DEDUCTIONS

Some deductions could be accommodated within a return-free system. Three of the most common are for state and local taxes, mortgage interest, and charitable contributions. The Treasury predicted that incorporating these into a return-free system would raise the number of eligible taxpayers by 1.7 million in the zero and 15 percent brackets and another 1.9 million in higher brackets. But these numbers represented a modest fraction of the then-current 33 million itemizers, demonstrating that itemizers do not generally meet other restrictions needed to avoid filing.

TABLE 1

Filers Qualifying for Alternative Return-Free Systems

By type of income, 2007

Filing system	Type of filer by change in administrative practice	Total (millions)	Percentage of current law filers
Current law	Total filers	138.8	100.0
Exact withholding	With current withholding rules[a]	8.2	5.9
Exact withholding	Plus more precise withholding rules[b]	19.9	14.3
Exact withholding	Plus expanded mandatory withholding[c]	30.9	22.2
Exact withholding	Plus delivering EITC through means other than tax return	43.5	31.3
Agency reconciliation	Plus exempting two-earner couples from filing	46.7	33.6
Agency reconciliation	Plus exempting taxpayers in higher brackets from filing	50.0	36.0

Source: Holtzblatt, 2007.

(a) This category is limited to taxpayers whose income is derived solely from one job and who do not claim above-the-line or itemized deductions or credits other than the child tax credit. Dependent filers are excluded. The exact withholding system is assumed to be restricted to taxpayers in the 15% or lower rate brackets.

(b) The withholding rules would be made more precise, so that the correct amount of taxes could be collected from filers who are claimed as dependents by other taxpayers or who have more than one job. However, two-earner couples are excluded from this category.

(c) Mandatory withholding would be extended to income from pensions and individual retirement account distributions, unemployment compensation, interest and dividends.

How Could We Improve the Federal Tax System?

Who would qualify for return-free filing?

TABLE 2

Filers Qualifying for Alternative Return-Free Systems

By type of return under current law, 2007

Filing system	1040 (millions)	Percent of total	1040A (millions)	Percent of total	1040EZ (millions)	Percent of total	Total
Current law	87.1	62.8	30.0	21.6	21.7	15.6	138.8
Exact withholding	6.0	13.8	18.7	43.0	18.8	43.2	43.5
Agency reconciliation	7.5	15.0	21.4	42.9	21.0	42.0	50.0

Source: Holtzblatt, 2007.
Note: Amount may not add up to total because of rounding.

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How Could We Improve the Federal Tax System?

Q. Would return-free filing raise taxes?

A. Not for those who pay what they owe now.

While some antitax groups have suggested otherwise, a return-free system would not raise taxes for households already paying all the taxes they owe. Nor would anyone need to share more information with the IRS than they do now.

Some members of Congress, along with some antitax groups including Americans for Tax Reform and the American Conservative Union, oppose return-free filing on the grounds that it would shift the burden of contesting tax liability from the IRS to the taxpayer. They have other concerns, too. Americans for Tax Reform argues that implementing return-free filing would be dangerous because it "would create a conflict of interest where the Internal Revenue Service would become both tax preparer and enforcer." These groups further argue that return-free filing shields taxpayers from awareness of the costs of paying taxes and, consequently, is a means of implementing tax increases without taxpayers' knowledge.

These seem weak objections. Return-free filing should be viewed as a taxpayer tool, not a shield from information. Taxpayers could still file returns as they did before but would be given the option of filing "return free" if their taxes are simple enough to qualify. All taxpayers would retain the right to challenge their tax liability as calculated by the IRS.

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Americans for Tax Reform, "Senate Conservatives Speak Out against Return-Free Tax Filing Scheme." Press release, October 26. Washington, DC: Americans for Tax Reform.

Goolsbee, Austan. 2006. "The Simple Return: Reducing America's Tax Burden through Return-Free Filing." Washington, DC: Hamilton Project.

Q. What was the experience with return-free filing in California?

A. Generally positive.

California operated a pilot program for return-free tax filing in tax years 2005 and 2006. Some 50,000 prescreened Californians who had previously filed as single taxpayers with no dependents, no itemized deductions, and wage income only were invited to participate. These taxpayers were sent "ReadyReturns"—completed forms—and were given the option of either filing their ReadyReturns (on paper or online) or discarding them and filing conventional returns later. The pilot program was popular among taxpayers who used it, and California subsequently authorized the widespread availability of ReadyReturns for tax year 2007. The program has now been incorporated into CalFile, the state's free online tax-filing site.

PROGRAM PARTICIPATION

The ReadyReturn pilot program had a participation rate of about 21 percent. Of the 11,000 who chose to participate, approximately half filed a paper copy and half filed electronically. The California Franchise Tax Board, the state's tax administrator, reported that more than 88,000 people used the service in 2012. The board estimated that about 2 million taxpayers would be eligible for the ReadyReturn in 2013, indicating that the program could be expanded somewhat easily to much of the state's population.

THE PROGRAM'S SUCCESS

Reviews of the system have been positive. Of those filing an electronic ReadyReturn, 95 percent said that it saved time, as did 87 percent of participants filing a paper version. Almost all participants said that they would opt to use the service the following year. Tax preparation services strongly opposed ReadyReturn and have lobbied against its expansion.

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Q. What other countries use return-free filing?

A. At last count, 36 countries, including Germany, Japan, and the United Kingdom, permit return-free filing for some taxpayers.

Nearly all countries that offer return-free systems have "exact-withholding" systems, of which there are two types: "cumulative" systems (used in the United Kingdom and Russia) and "final-withholding" systems (used in Germany and Japan). Some countries combine one of these approaches with other requirements. In Chile, for example, taxpayers are not eligible if they wish to file for refunds of excess withholdings.

COUNTRIES WITH TAX AGENCY RECONCILIATION SYSTEMS

Denmark and Sweden, both small countries, operate tax agency reconciliation systems. About 87 percent of Denmark's taxpayers and 74 percent of Sweden's had their returns filled out by the tax authorities in 1999. Spain, Estonia, Finland, Norway, and Iceland have also implemented tax agency reconciliation systems.

THE BRITISH EXPERIENCE

Britain's Pay As You Earn system, which has incorporated exact withholding since the 1940s, has several features that facilitate return-free filing. One is that it treats the individual (rather than the family) as the unit of taxation. Another is that a large proportion of taxpayers (64 percent) are taxed at the same "basic" marginal rate. The system was reformed in April 2013 to require employers to report salary payments in real time, with the goal of decreasing withholding errors. The reform also linked revenue collection and benefit payments to the same database, increasing efficiency.

Despite the clear need for the changes, concern still exists as to whether real-time reporting places a disproportionate burden on small businesses. To minimize the problem, small employers have been temporarily allowed to file payments monthly. In 2014, about 90 percent of the United Kingdom's income tax revenue was collected through Pay As You Earn.

FILING RATES

The portion of taxpayers who still have to file returns varies widely by country. About 90 percent of taxpayers eligible for final withholding in the United Kingdom did not have to file in 2014. The figures for other countries are dated, but there's no reason to believe that they are unrepresentative. In Germany in 1986 and in Japan in 1988–90, the corresponding figures were 46 percent and 63 percent, respectively.

Many countries, it should be noted, maintain a filing requirement for taxpayers with more than one job. At least one, Kenya, requires taxpayers to file a return if their personal circumstances change during the year.

How Could We Improve the Federal Tax System?

What other countries use return-free filing?

Further Reading

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