Statement of Michael J. Graetz
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on Tax Reform and Consumption-Based Tax Systems
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Mr. Chairman and Members of the Committee---

It is a great pleasure for me to have this opportunity to testify again before this committee, especially on such an important subject[1].

Our nation's tax system is badly broken. No one quarrels with that. The economic distortions due to our income tax law are numerous and substantial. The only area of the economy where the tax system creates jobs is tax return preparation and software, tax planning, tax controversies and tax compliance. Astounding income tax complexities confront taxpayers at every income level. They sow confusion and create the perception that the well-advised escape paying their fair share of taxes. All of this, in turn, makes a tax system that depends as heavily as ours on the goodwill and honesty of the American people ever more vulnerable to deliberate noncompliance.

In a recent report, the National Taxpayer Advocate, Nina Olson, estimated that individuals and businesses spend 6.1 billion hours a year—full-time work for more than 3 million employees—on tax compliance alone. I am surprised the number is that small. The Form 1040 instruction booklet spans more than 100 pages and the form itself has more than 10 schedules and 20 worksheets. No wonder more than 60 percent of income tax filers hire tax preparers and so many of the rest rely on computer programs to tell them what to do. The tax profession is not inventing new drugs or medical devices, streamlining manufacturing or creating useful new products. They are not, to borrow the President's phrase, helping this nation to "win the future." Even low and moderate income Americans waste enormous amounts of time and dollars complying with the income tax, time that could be much better spent with one's family, dollars that might pay for rent, utilities, gasoline, or groceries.

Although the income tax now affects nearly everyone, that hasn't always been so. It wasn't until World War II that the federal government expanded the income tax beyond wealthy individuals to tax nearly all middle and moderate income Americans. Seventy years later, this system is badly broken and unable to produce adequate revenues for the future without threatening economic growth. Relying as heavily as we do on income tax revenues to fund our government has become a liability in the current international marketplace.

[1] I am appearing here today on my own behalf, expressing solely my own views, not those of any institution or group with which I am or have been affiliated as an employee, counsel, or academic advisor.

In a world now immeasurably more interdependent than the mid-twentieth century, when our current system of taxation took shape, a vital question for any reform proposal is: Will it make American workers and businesses more competitive in the global economy, while maintaining the progressive structure that fits with our nation's historical insistence on fairness?

When it comes to meeting its funding requirements, a government has four basic choices as to what it can tax: income, wages, consumption or wealth. From these four basic categories of revenue, we in the United States have since World War II chosen two—income and wages—as our primary forms of government funding. While it is true that our Federal government has at one time or another imposed more than fifty kinds of taxes on everything from filled cheese to cotton futures, from telegraph messages to the manufacture of tires, none of these revenue streams could ever suffice to fund today's government budget. Put together, our individual and corporate income taxes along with our payroll tax on wages account for more than 90 percent of federal revenues annually. State and local governments rely on their own versions of these taxes in addition to taxes on sales and property. And while the federal government imposes a handful of excise taxes—on alcohol, tobacco and gasoline, for example—unlike the rest of the world, we do not have a national tax on the third category, consumption.

U.S. Reliance on the Income Tax

Overall, the U.S. is a relatively low tax country. But we are not a low income tax country. Looking at total taxes including federal, state and local taxes, as a percentage of total economic output (GDP) the U.S. at about 25 percent (including state taxes) has considerably lower taxes than the EU, which averaged about 40 percent before the recent addition of 10 new lower-tax members, mostly from eastern Europe. Our taxes are also lower than the approximately 36 percent of GDP average of the thirty countries of the Organization for Economic Cooperation and Development (OECD).

Our income tax level is comparable, however. We typically collect about 12 percent of our GDP in corporate and individual income taxes, while the OECD nations average about 13 percent. The biggest difference in our tax structure is that most other nations rely much more heavily on consumption taxes than we do: 11 percent of GDP in the OECD compared to less than 5 percent in the U.S. Indeed, we are the only OECD nation that does not impose a national level tax on sales of goods and services.

Although an income tax was used to help finance the Civil War, it did not become a permanent part of our nation's financial picture until World War I. The corporate income tax dates from 1909, but it was not until after the 16th Amendment was ratified in 1913 that a tax on individual incomes was enacted.

From the end of the Civil War until 1913, the federal government raised its revenue almost exclusively from tariffs on imported goods and excise taxes on this or that. By the beginning of the 20th Century, however, there was great dissatisfaction with this system. Tariffs and excise taxes raised the costs of goods for everyone, while large fortunes accumulating in real estate, corporate stock and other investments were left untaxed. The income tax was adopted--with the extraordinary public support necessary to amend our constitution--to fund a reduction in tariffs and to counterbalance the effect of taxes on consumption with a tax more closely linked to people's ability to pay. When first enacted, the income tax was expected to contribute only a small portion of ordinary government revenues and to supplement other revenue sources in times of emergency.

So the income tax was not originally supposed to play the central role in financing the federal government that it now does. Until World War II our income tax had exemptions that shielded most Americans from having to pay it. The income tax played a crucial role in financing World War I, but after that war ended, the tax was rolled back to its original limited scope. From 1918 to 1932 only 5.6 percent of the population filed taxable income tax returns, and from 1933 to 1939 that number dropped so that on average only 3.7 percent of the total population filed taxable returns. Public opinion polls in 1938 and 1939 showed large majorities of Americans favored an exemption level that would exclude at least 75% of the population from income taxes. Thus, through the economic shocks of the Great Depression and the creation and expansion of the New Deal, the reach of the income tax remained quite limited: true to its original conception, it was a low-rate tax on a relatively small group of higher-income Americans. But World War II changed that.

Legislation in 1940 and 1941 increased the number of Americans subject to the income tax by 400 percent, from 7.4 million to 27.6 million. After the U.S. entered the war, the number of income tax payers expanded dramatically. By 1943, taking into account both the regular income tax and a so-called "Victory Tax" (a 5 percent tax on incomes over $624) 50 million Americans—nearly 70 percent of the population—were required to file income tax returns.

Our nation's basic tax structure—with its reliance on income taxation of the masses—came into place, therefore, in the World War II era, when the United States essentially had all the money there was. Even a horrid tax system – with income tax rates up to 91% – could not then stall our economic progress. From 1946 through 1973, when OPEC quadrupled the price of oil, the economy grew by an average of 3.8% a year and unemployment averaged 4.5 percent. Since 1973, our economy has grown more slowly and so have the wages of middle income Americans. Now, the United States' economy must compete for the investment capital essential for economic growth – capital necessary to produce a rising standard of living for the American people – with many countries throughout the world, including not only Europe and Japan, but also countries such as Brazil, Russia, China, and India. Now, the venerable New York Stock Exchange can be transformed virtually overnight into an enterprise with a majority ownership in Germany and headquartered in the Netherlands. This was unthinkable when our nation's tax system was designed.

As we now know, the imposition of the income tax on nearly the entire population has led to perverse results in terms of complexity. It has also badly distorted presidential and congressional policy making.

One reason that our current individual income tax is such a mess is because our elected officials ask it to do too much. Presidents and members of Congress from both political parties have come to believe that an income tax credit or deduction is the best prescription for virtually every economic and social problem our nation faces. In the process, we have turned the Internal Revenue Service from a tax collector into the administrator of many of the nation's most important spending programs.

To keep track of all the tax benefits, the federal budget each year is required to contain a list of "tax expenditures," defined as all tax credits, deductions or exclusions that deviate from a "normal" income tax. The basic idea is that many tax benefits are substitutes for and the equivalent of direct government spending. According to a February 2011 report of the Staff of the Joint Committee on Taxation, the number of these tax expenditures has grown enormously since 1986, from 128 to 202. The JCT staff also points out that, once enacted, no matter how ineffective or distortive, tax expenditures "tend to stay in place." Their total cost in lost revenues is estimated to exceed $1 trillion a year.[2]

When we talk about tax expenditures, we are not talking here about narrow special-interest tax loopholes. Mostly, these are tax breaks widely available to broad segments of the general public—tax cuts for the large population of middle and upper income folks. The largest tax expenditures are very popular: tax advantages for employees' payments for health insurance and retirement savings, deductions for home mortgage interest, state and local taxes, and charitable contributions, and low or zero rates on capital gains.

And yet we know that trying to solve the nation's problems through "targeted tax breaks" typically does not work. Take health insurance, for example. Our nation, contrary to others throughout the world, has long relied on a tax benefit for employers and employees as its main mechanism for covering Americans who are neither poor nor aged. What has been the result? Our health-care costs are the highest in the world and about 50 million Americans have been uninsured. Moreover, these costs make American businesses and products less competitive in the world economy and gobble up wage increases of

[2] Staff of the Joint Committee on Taxation, "Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates, JCX-15-11, February 28, 2011.

American workers. Nor have our tax-based energy tax breaks produced better results. Nor do tax credits for working parents produce affordable childcare. I could go on and on, but I shall not.

Historically when competing policy ideas aimed at a common goal emerged in Congress, the leaders of the tax writing committees would fashion a compromise provision. Now, Congress often compromises by enacting *all* of the ideas, leaving unsophisticated taxpayers bewildered about how to cope. For a vivid illustration, consider the income tax incentives for paying for higher education. There are eight tax breaks for current year education expenses: two tax credits, three deductions and three exclusions from income. Five other provisions promote savings for college expenses. In 1987, there were only three provisions encouraging college expenditures or savings. The 1997 Act alone added five provisions that were estimated to cost $41 billion over five years; together they represented the largest increase in federal funding for higher education since the GI Bill.

Comprehending the tax savings provided by these provisions, their various eligibility requirements, how they interact, and their recordkeeping and reporting requirements is mind-boggling. Each of the provisions has its own eligibility criteria and definition of qualified expenses. For example, they do not provide consistent treatment of room and board, books and supplies, sports equipment and related expenses, other nonacademic fees, or the class of relatives whose expenses may be taken into account. A student convicted of a felony for possession or distribution of a controlled substance is not eligible for one of the education credits, but such a conviction is no bar to another one. And this is just the tip of the iceberg.

Relying, as we do, on income tax deductions and credits is about as successful a solution to our national needs as handing out more gunpowder at the Alamo. We must be weaned away from using tax deductions or credits as a cure-all for our nation's ills. But the largest tax expenditures are very popular with the public. To be sure, they may be trimmed: a floor on deductions here, a ceiling or haircut there, but I am convinced that the only path to real tax reform success is to remove most Americans from the income tax altogether.

Proposals for Income Tax Reform

The tax reform proposals most prominent today would reprise the 1986 Tax Reform Act and attempt only to improve the income tax. To be sure, the 1986 Act was a major improvement. It substantially increased the permissible amount of tax-free income; lowered and flattened income tax rates; shut down mass-marketed tax shelters for high income individuals; and curtailed the ability to shift income to lower-income family members subject to lower tax rates. However, an increase in corporate tax revenues was used to finance an overall reduction in individual income taxes (even though, by cutting back on deductions for plant and equipment, Congress found enough money to reduce the corporate tax rate from 46 to 34 percent). Hundreds of scatter-shot "transition" rules were enacted to give special tax breaks to particular companies or individuals.

Since 1986, Congress has amended the code annually, adding thousands of pages of new legislation. In retrospect, the inherent weaknesses of the 1986 Tax Reform Act have become easy to identify. First, despite the tremendous leadership and ingenuity of President Reagan along with the chairmen of this committee and the Senate Finance Committee, the fragile political coalition that enacted the law left in place a variety of ongoing complexities, inequities, and inefficiencies. Second, the 1986 Act had little public support even when it was passed. Third, and most importantly, the 1986 tax act was based on retaining and strengthening the income tax itself, rather than heeding the calls of many economists and politicians to replace all or part of it with some form of consumption tax on purchases of goods and services.

Given the internationalization of economic activity during the past twenty-five years and the increased competition from abroad, the 1986 Act's reliance on increased taxation of income from capital and of corporate income now seems inapt. We need to attract capital to create better conditions for American workers and businesses. In order to do that, the United States must be an attractive place for both foreign and domestic investments, and American companies need to be positioned to take full advantage of the global market for goods and services, labor and capital. But our tax system does not advance the well being of American workers and businesses; it stifles it.

Our system of taxing international business income is truly archaic. The structure for taxing international business income came into the tax law in 1918 and 1921.[3] It was substantially modified in 1962 and again in 1986, and there has been quite a lot of tinkering since then. But we are in a very different world economy today. Corporations and other investors, including sovereign wealth funds investing on behalf of other nations, now move money quickly and easily around the world, making it much more difficult for any nation—including the United States—to tax their income.

How to tax multinational business enterprises has long been controversial. Recent disputes over the Obama Administration international tax proposals, dealing, for example, with cross-crediting of foreign taxes, the treatment of domestic expenditures that help produce foreign income, the treatment of U.S.-owned foreign entities, and transfer pricing, alongside the recent trend of countries with foreign tax credit systems to move to international business tax regimes that exempt foreign dividends, amply illustrate differences in policy preferences. The thrust of the 1986 Tax Reform Act was to limit the ability of U.S. companies to offset U.S. taxes on unrelated income and to restrict

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[3] See Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke Law Journal* 1021 (1997).

somewhat deductions for companies that invest abroad. Elsewhere around the world, however, nations have embraced low corporate income tax rates, both to attract investments and to reduce the temptations of their domestic companies to shift income abroad through intercompany pricing or other techniques.

The difficulties we face in taxing international income are even more fundamental. As I have observed elsewhere, the basic building blocks of international income taxation—the concepts of residence and source—are now foundations built on quicksand.[4] They may have drawn reasonable lines when they first became the basis for international income taxation early in the 20th Century, but in today's global economy, with all of its technology and innovative financial transactions, both corporate residence and the source of income and deductions are easily manipulated. And there is only a little the United States can do unilaterally to address this problem.

Businesses now not only have the ability to elect *whether* to be taxed as corporations, they also can elect *where* to be taxed. If you ask a law student in an international tax class where to incorporate a new business enterprise and he or she answers, "the United States," the student deserves a failing grade. As one savvy tax lawyer recently put it: deductions flock to high tax-rate countries and income flocks to those with low rates.

I have come to believe that, absent broad international agreement and cooperation foregoing tax competition to attract capital—a transformation that is certainly not on the horizon—a low statutory corporate tax rate is essential. This year we will have the highest statutory corporate tax rate in the developed world.

Economists and many government officials often tell us not to pay any attention to the statutory tax rate, that we should look instead at the lower "effective" tax rates. But, of course, average tax rates are meaningless when one is being asked about where to borrow or invest the next dollars. And the more relevant "marginal effective tax rates" are subject to debate and often difficult to calculate. Corporations respond to their knowledge that we tax corporate income at a 35 percent rate, while another country imposes tax at a much lower rate, say 15 to 20 percent. They do not need a computer to tell them where to locate their deductions and where to locate their income. Foreign-owned multinationals understand this as well as the U.S. companies.

To be sure, businesses often shift their income and deductions around the world without necessarily also shifting their employees or real investments in plant and equipment. But not always. Other governments may require that real economic activity actually take place there. In such cases, and whenever

[4] See Michael J. Graetz, "The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 *Tax Law Review* 261, 320 (2001) and Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expense," *Bulletin for International Taxation*, November, 2008.

business activity is located abroad for business rather than tax reasons, there may be incentives for companies to shift their foreign income to even lower tax countries—to so-called tax havens. Complicating matters further, it may well be in the U.S. national interest for our multinational corporations to engage in tax planning strategies that reduce their foreign income taxes and increase their cash flow. But when such strategies are turned on the U.S. tax system by either domestic or foreign-owned enterprises, our fisc and our economy is the loser.

As if the substantive difficulties of designing sound corporate income tax policies for today's global economy were not hard enough, taking political considerations into account—as you must—makes the task positively herculean. Corporate income taxes are popular with the public despite the virtually unanimous view among economists and other tax policy analysts that the corporate tax is a bad tax, if the goal is to enhance our nation's economic wellbeing. People believe that taxes remitted by corporations, especially large multinational companies, are paid by someone other than themselves. Years ago, this committee's chairman Dan Rostenkowski suggested adding a second verse to the tax reform classic coined by Senate Finance Committee chairman Russell Long: "Don't tax you; don't tax me; tax the fellow behind the tree." Congressman Rostenkowski added: "Don't tax you; don't tax me, tax the corporations across the sea." Not long ago, Treasury Secretary Geithner contributed to the confusion when he insisted that Americans should not have to pay one additional cent of taxes to reduce taxes on businesses. But as Paul H. O'Neill, George W. Bush's first Treasury secretary, observed, "Corporations don't pay taxes, they collect them."

The question of who actually bears the economic burden of corporate income taxes—who ultimately pays them—has tormented public-finance economists since the tax first came into existence. Three candidates come instantly to the fore: people who own the companies, people who work for the companies, or people who buy the companies' products. Since the tax may affect wages, prices, and/or returns to capital, economists believe that workers, consumers, and or owners of capital generally may bear the economic costs of the tax. For many years, the conventional wisdom among economists was that the tax principally reduced returns to capital, at least in the short run, and thus the tax was considered to be progressive, even if economically distortional. Government distributional tables have therefore tended to allocate the corporate tax burden to owners of capital. Even so, ultimately, however, any reduction in capital due to the tax might result in lower wages, so in the long run, workers may pay.

As the economy has become more open internationally, a number of recent economic studies have concluded that the corporate income tax is less likely borne by capital generally, but rather—at least in some substantial part—by workers in the form of lower wages. Owners of capital today have the ability to move their money anywhere in the world, but workers and consumers are less mobile.

All the uncertainty in the economics profession contributes to the public view that the tax is probably paid by someone else. And it is child's play to characterize large corporations, especially large multinational corporations, as if they are villains. This is probably why the public seems to like a tax that economists hate. But high tax rates on corporate income in today's global economy are a very bad way to try to achieve economic growth or to obtain and maintain progressivity in the distribution of the tax burden. (Indeed, simply shifting the tax burden from corporations to shareholders and bondholders could increase progressivity.)

Tax experts now regard the 1986 Act as a promise failed. Surprisingly, many people continue to think that the best path for tax reform is simply to improve the income tax. But, while many income tax reform proposals might improve current law, they do not, in my view, go far enough. As we know, it doesn't take very long after a good cleansing of the income tax for things to get very dirty again. Even those who applauded the 1986 Act as a wildly successful tax reform must concede now that this legislation was not a stable solution. Over time, many of its reforms have been reversed: its broad base and low rates have been transformed into a narrower base with higher rates. How can anyone remain optimistic about fixing the income tax without radical surgery? What our nation needs is a new and better tax system, one that is far simpler, fair, and more conducive to economic growth.

It is the central contention of my book, and the centerpiece of my proposal, that the fundamental reform required to create an internationally competitive, administratively efficient, and viable long-term solution to our funding requirements is to make a different choice. We should eliminate the income tax for the overwhelming majority of Americans and replace it with a broad-based tax on sales of goods and services. We should return the income tax to its original, manageable purpose: the collection of a simpler tax on high-income earners who tend to have multiple income sources. And we should dramatically lower our corporate income tax rate. In order to do that, we need to tax consumption, sales of goods and services.

A Plan for the Future

Mr. Chairman, a tax reform following the income tax base-broadening and rate-lowering precedent of the 1986 Tax Reform Act is not an adequate response to the tax policy challenges this nation faces in the 21st century. My main ideas about tax reform and my analysis and views about many alternative suggestions are described in my book *100 Million Unnecessary Returns: A Simple, Fair and Competitive Tax System for the United States* – the paperback edition of which was published last spring.

For those unfamiliar with my Competitive Tax plan, it has four key pieces:

- First, enact a value added tax – a broad based tax on sales of goods and services now used by more than 150 countries worldwide. We are the only OECD country that does not have a VAT or, as it is sometimes called, a goods and services tax.

- Second, use the revenues produced by that consumption tax to finance an income tax exemption of $100,000 of family income and to lower substantially the individual income tax rate on income above that amount.

- Third, lower the corporate income tax rate to 15%, or at most 20%.

- Fourth, replace the earned income tax credit and provide low and middle income families with tax relief from the VAT burden through payroll tax offsets and debit cards.

This plan has many significant advantages over current law and other tax reform alternatives:

- First, this competitive tax system would encourage saving and investment in the United States, stimulating economic growth and creating additional opportunities for American workers. This plan would take advantage of our status as a low-tax country by making us a *low-income tax* country.

- Second, a 15% corporate income tax rate would be among the lowest in the world and would solve the most vexing issues of international tax policy.

- Third, the plan would eliminate more than 100 million of the 140 million income tax returns and would free more than 150 million Americans from ever having to deal with the IRS.

- Fourth, with only a relatively few high-income Americans filing tax returns, there would be far less temptation for Congress to use income tax exclusions, deductions, and credits as if they offered adequate or appropriate solutions to the nation's most pressing social and economic problems. They do not.

- Fifth, a value-added tax would be border adjustable under WTO international trade rules, which means that we could tax imports and exempt exports. VATs can be imposed on such a "destination-basis," but business income taxes cannot. (As this Committee well knows from longstanding WTO disputes over the DISC, the FSC, and ETI, income taxes must be imposed on an "origin" basis which means that we must tax goods produced here, even for export, and we cannot tax imports.) Economic theory and most economists insist that border adjustments make no difference in international trade due to offsetting changes in exchange rates, but business owners do not accept that exchange-rate adjustments happen as readily in practice as theory suggests. China certainly seems to confirm the business view. In any event, destination-based consumption taxes do not depend on either the "residence" of multinational corporations or the "source" of income but rather on where consumption takes place. As a result, they have major advantages for tax compliance (for example, with regard to transfer pricing). Moreover, given the size of our nation's trade imbalances, border adjustments would likely result in hundreds of billions of dollars of additional revenues to the U.S. Treasury over the 10-year budget period and beyond.

- Sixth, this plan would avoid most of the difficult issues of transition to an entirely new system that have haunted other proposals to replace the income tax with consumption taxation.

- Finally, by combining taxes commonly used throughout the world, this system would facilitate international coordination and fit well with existing tax and trade agreements—something that most other consumption tax proposals fail to do.

Opponents of value-added taxes often complain that they are regressive, and if such a sales tax were to fully replace our income tax, as proponents of the so-called Fairtax urge, tax burdens would indeed be shifted down the income scale. So I designed my Competitive Tax Plan in a manner generally to change neither the progressivity of the tax system nor the amount of revenue produced under current law. This allows my proposal to be evaluated by comparing it directly to the current system, and it follows the important precedent of both distributional and revenue neutrality that facilitated enactment of the 1986 Tax Reform Act, our last major tax reform.

The Tax Policy Center, pursuant to a contract with Pew Charitable Trusts, is currently in the process of estimating the revenue and distributional consequences of my plan and has given me permission to describe their *preliminary* results. These estimates are for the year 2015. They suggest that my proposal is essentially revenue and distributionally neutral with a VAT rate under 12.5 percent, a 15 percent corporate income tax rate, and tax rates for married couples of 16 percent on income between the $100,000 family allowance and $200,000 and 25 or 26 percent for income above $200,000. Offsets are provided for low and moderate income families. The Tax Policy Center, under this contract, is now working on a paper that will provide more detailed final results.

Consumption Tax Alternatives[5]

Our federal government has previously considered imposing a national consumption tax. For example, in 1921, when the income tax was only eight years old and a fraction of its current size, Ogden Mills, then a Congressman from New York, who later served as Herbert Hoover's Secretary of the Treasury, argued that Congress should substitute a tax on "spendings" for the income tax. Mills' proposal for taxing consumption rather than income was not a new idea, even in the 1920s. John Stuart Mill had urged taxing consumption, and Alexander Hamilton had only praise for consumption taxes.

In 1942 Franklin Roosevelt's Treasury Secretary Henry Morgenthou advanced a progressive, graduated rate tax on spendings to finance the Second World War, but Congress rejected it. Instead, the Revenue Act of 1942 began the conversion of the income tax, which had applied only to high income people, into a tax on the masses. Had this episode turned out differently, the income tax might have remained narrowly targeted to high income people, and a consumption tax, rather than the income tax, might have become the federal government's main revenue raiser. After that, from time to time, presidents and many members of Congress have considered taxing consumption rather than income, but no national tax on consumption has been enacted.

The simplification advantages of a consumption tax depend on how it is implemented. Retail sales taxes and VATs are collected from businesses rather than families, greatly easing the compliance burdens of households and freeing them from having to deal with the tax collector. Other forms of consumption taxes such as the so-called "flat tax" (which is a consumption tax although the public may believe it to be an income tax) tax the wage element of value added to individuals and thus require households to file tax returns. Since under the "flat tax" only wages would be taxed to individuals, and all deductions, exclusions and credits would be eliminated, its proponents claim that the annual tax return would shrink to a postcard that everyone would be able to fill in quickly and easily. Adding more than one tax rate as, for example, President Bush's tax reform panel recommended, does not substantially complicate matters.

The fact is that the flat tax (along with its cousin, the "Growth and Investment Tax" proposed by President Bush's tax reform panel in 2005), economist Alan Auerbach's "Modern Corporate Tax" and Congressman Paul Ryan's Business Consumption Tax are all variations on a form of value-added tax that resembles an income tax. They are what is called "subtraction-method value-added taxes." This kind of VAT taxes the difference between the total receipts from a business's sales of goods or services and the total amount of the business's purchases of goods or services from other businesses. The difference between sales and purchases is the business's value added and the

[5] I discuss these issues in much greater detail in my book, *100 Million Unnecessary Returns*.

tax rate is applied to that amount. Variations on a subtraction-method VAT seem to enjoy great favor among some consumption tax advocates.

At the same tax rate and with no exceptions, a retail sales tax, a subtraction-method VAT and the much more common credit-method VAT should produce similar results. But exemptions for particular goods or services or for small businesses, for example, are far more troublesome under a subtraction-method VAT than in the more common credit-invoice method.

The flat tax (and President Bush's panel's GIT) proposals essentially split the collection of a single rate subtraction-method value-added tax between businesses and individuals. Rather than denying businesses any deduction for wages, as is usual under a subtraction-method value-added tax, the flat-tax allows businesses to deduct wages in addition to purchases from other businesses. This type of consumption tax is collected at each stage of production, as under a typical value-added tax, except that the tax on wages is directly remitted by individual wage-earners. In combination, the total of the business and individual tax bases should equal total sales, putting aside any exemptions.

The principal advantage of dividing a value-added tax between businesses and individuals is that it enables the exemption of a certain amount of wages from tax and may thereby eliminate, for wage earners, the regressivity at the bottom of the income scale of a standard flat-rate tax on consumption. The amount of the exemption or standard deduction will, of course, vary depending on the flat tax rate and the other exclusions, deductions or tax credits allowed. (As my proposal and my recent book detail, there are other methods of addressing this issue under a VAT or retail sales tax.) This division of the consumption tax base tax also allows the imposition of progressive rates on wages, although it is mysterious why only wages and not investment income should be subjected to progressive tax rates.

Three problems remain, however. First, the flat tax (and its variations) are consumption taxes invented by academics, which are untried and untested elsewhere in the world. They do not work well internationally. Second, all experience warns us that even if such a tax could be enacted in its pure form with all deductions, exclusions and credits eliminated—a real long shot—the tax would stay neither pure nor flat for very long. Tax breaks for homeownership, charitable gifts and education expenses, to name only a few, would soon make their way back into the tax code. Third, as the president's panel discovered, taxing only individuals' wages and not their income from investments offends our notions of tax justice. This is why the panel—hardly a bunch of liberals and none of whom, as John Breaux has reminded us, was standing for re-election—coupled their consumption tax proposal with a tax on interest, dividends and capital gains, albeit at a lower 15% rate. The panel concluded -- correctly in my view -- that the American public will not accept taxing families only on their wages and not on the income they receive from their investments or savings.

In the 1990s Senators Sam Nunn and Pete Dominici proposed coupling a VAT with a progressive rate tax on consumption—a so-called expenditure tax. The Senators called their tax a "Uniform Savings Allowance," or "USA" tax. The senators designed their proposal this way to avoid the substantial tax cut for high-income families which would occur under flat-rate consumption taxes that entirely replace the income tax. Again, unlike the VAT or retail sales tax, a progressive consumption tax is essentially untested, although it has long been discussed and often applauded in academic circles. Only India and Sri Lanka ever enacted an expenditure tax, and both repealed the tax shortly after it was enacted.[6]

Many of these consumption tax alternatives do not work well internationally. While my proposal would harmonize our tax system with international standards and thus open up the possibility of real cost-savings for companies doing business in more than one nation, the unusual nature of the methods used to collect subtraction-method VATs and their variations may create large difficulties under our international tax and trade treaties. Indeed, President Bush's tax reform panel admitted that their favorite consumption tax would require renegotiation of our trade and tax treaties. Value added taxes of the standard credit-invoice sort fit well with these international agreements. They can be –and always are—border adjusted: imposed only by the country where the consumption takes place. They therefore tax imports and exempt exports, so that the location where a good is produced is irrelevant. In contrast, income taxes are typically imposed on all domestic production and the tax on production abroad is generally ceded to the country where the production occurs.

Mostly for compliance reasons, the president's panel decided—rightly in my view—that any U.S. consumption tax should be border adjusted and imposed in the standard manner: on a destination basis. Otherwise, imports

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[6] Senators Nunn and Domenici modified the standard form of expenditure tax in an effort to make their proposal more appealing politically. Their proposals would exempt, for example, much consumption financed out of sales of people's existing assets and would defer the tax on consumption from borrowed funds. These modifications required complex rules to track both borrowing-financed consumption and consumption from dispositions of pre-enactment assets. Indeed, the Nunn-Domenici plan floundered because of its inability to solve problems of transition from an income tax to this type of consumption tax and its failure to tax consumption financed with borrowing. In combination, these two problems allowed people with assets or the ability to borrow to avoid the tax. The personal tax was essentially a tax on wages, but by borrowing for consumption and reinvesting the proceeds of asset sales, people could have avoided even the wage tax. Senators Nunn and Domenici also concluded that it was necessary politically to retain a number of existing income tax preferences, including, for example, not taxing interest on state and local bonds. This created other opportunities to consume tax free. The Nunn-Domenici experiment suggests that enacting a coherent progressive tax on consumption is probably not politically viable. This is hardly surprising since no other nation relies on such a tax.

would not be taxed but exports would. The latter kind of tax is said to be imposed on an "origin" basis.[7]

Economists claim that we should be indifferent to the distinction between origin-based and border adjusted taxes because currency exchange rates — the value of the dollar relative to other currencies — will adjust to compensate for these tax differences. But U.S. manufacturers and other U.S. companies that compete with products from abroad will not readily accept the economists' assurances that exchange rates will adjust so perfectly. Especially when the country with whom we have the largest trade deficit, China, has yet to allow its currency to float freely against the dollar.[8] Moreover, President Bush's panel determined that imposing a consumption tax on an origin basis would raise major enforcement difficulties. In my view, border adjustments of a consumption tax will be an important -- perhaps even decisive -- issue.[9]

It is puzzling to me that U.S. economists and policy-makers have struggled to fashion novel consumption tax alternatives when there is a well-functioning consumption tax—the value-added tax—being used throughout the OECD and in more than 150 countries worldwide. Given the interconnectedness of the world economy, consumption tax design does not seem the right place to insist on American exceptionalism.

The So-Called FairTax

The retail sales tax, which is the form of consumption tax being advanced by the Fairtax proponents on today's other panel, is, of course, the type of consumption tax levied by our states and is therefore quite familiar. As the simple example attached to my statement demonstrates, a credit-method VAT

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[7] This occurs, for example, under the flat tax. Thus, if Ford sells cars manufactured in the United States to be used in the United States, their full retail sales value would be included in the flat tax base. Likewise, if Ford or any other U.S. automobile manufacturer sells automobiles in the U.S. to a foreign dealer for use abroad, the manufacturer's sales price would be subject to the U.S. flat tax. But a U.S. dealer of cars made in Japan, Germany or another foreign country would be taxed only on the excess of the dealer's total receipts from its sales over the costs of the cars from the foreign manufacturer. As a result, the costs of manufacturing cars abroad would not be included in the U.S. consumption tax base; only the foreign car dealer's markup would be subject to U.S. taxation.

[8] Domestic businesses undoubtedly will resist rules that impose a U.S. tax on the full retail price of products manufactured in the United States, but tax only the dealer markup of products manufactured abroad. They will view such a tax as fundamentally unfair to American businesses and, perhaps, as seriously disadvantaging U.S. manufacturers competitively.

[9] The president's panel acknowledged that its recommended consumption tax along with other consumption taxes such as the flat tax, which allow businesses to deduct wages and tax the wages to individuals, cannot be imposed on a destination basis without violating our major trade treaty (the GATT) and all of our existing bilateral income tax treaties. Tax reform proposals so out of sync with international trade and tax arrangements to require renegotiation of all our trade and tax treaties are essentially unrealistic.

and a retail sales tax at the same rate and with the same coverage are the same economically. A VAT is essentially a retail sales tax with withholding at earlier stages of the production, import, and sales process. Experience demonstrates that such a VAT works well. Since sellers of goods and services collect taxes and receive credits for VATs paid on their purchases, tax revenues are collected regularly throughout the year from companies at all levels of production, rather than just from retailers, thereby easing enforcement. A credit-method VAT also facilitates exemptions for small businesses (and for specific goods or services if such exemptions become necessary politically). The VAT's withholding feature improves tax compliance and limits the revenue cost of exceptions in the supply chain. This enables a VAT to exempt most businesses through a high registration threshold, such as $500,000 of gross receipts. (A similarly high exemption is used in Singapore's VAT, for example.)

While it is true that a retail sales tax might be simpler than a VAT, no country has a retail sales tax at a rate above 10 percent (compared to the more than 150 countries with VATs). At the 30 percent rate proposed by Fairtax advocates, the greater compliance risks of a retail sales tax are substantial.[10]

In addition, unlike VATs around the world, retail sales taxes often do not apply to services, so they are imposed on a much smaller consumption tax base. Moreover, retail sales taxes in the United States do apply to many purchases by businesses—which they should not—causing double or multiple taxation (known as "tax cascading"). While there are no reliable estimates of how much of this occurs, the only two extant estimates suggest that as much as 40 percent of U.S. retail sales tax revenues are from sales to businesses rather than final consumers. This causes significant economic costs and distortions. A credit-method VAT avoids any such cascading.

The "FairTax" proposal would reduce taxes on those at the top and make up the lost taxes from people with less income or wealth. This seems particularly inappropriate when gains in income and wealth have been so skewed toward the top.[11] To be sure, people move in and out of wealth and income classes over

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[10] Fairtax advocates claim that their tax rate is 23 percent, but unlike every retail sales tax we have ever paid, they are calculating the tax rate on a tax-inclusive, rather than the normal tax-exclusive basis. This is just a matter of disguising how high the rate is. For example, if one were to pay a total of $3.90 for a retail purchase where the amount of tax is 0.90, the standard way of describing the retail sales tax rate would be 30 percent, 90 cents on a $3.00 purchase. In the Fairtax world, however, this is described as a 23 percent rate, 90 cents of the total $3.90 paid. Generally, income tax rates are described on a tax-inclusive basis and VATs and retail sales tax rates are described on a tax-exclusive basis and that is the practice I am following here.

[11] For example, between 1979 and 2006 the income of the richest one percent of Americans nearly doubled, while the income of middle-class Americans increased by only about 11½ percent, according to the most reliable numbers. Over the same period, the wage at the 10th percentile, near the bottom of the wage distribution, rose just 4 percent, while the wage at the 90th percentile, near the top of the distribution, rose 34 percent. The share of after-tax income garnered by the top 1% of households increased from 8 percent in 1979 to 14 percent in 2004. Even within the top 1 percent the distribution of income has recently widened. And although the

time; some of the rich lose money and some poor people become rich over time. But, while Americans can debate forever what constitutes a fair distribution of taxes, surely it is not appropriate to shift the tax burden downwards now when those at the very top are doing so very much better than everyone else. This, however, is exactly what the FairTax proposal would do.

In addition, the promise of Fairtax advocates to eliminate the IRS and turn the assessment and collection of virtually all federal revenues over to the states is just a political ploy, a fanciful illusion. How can Americans believe that the federal government can collect trillions of dollars of taxes annually withour a tax collection agency? However, to the extent that the revenues from either a VAT or a retail sales tax are used to remove individuals and families from the income tax rolls –as my Competitive Tax Plan does for 150 million Americans—April 15 will become just another spring day.

FairTax advocates have claimed that under their plan workers would receive 100 percent of their paychecks with no taxes withheld *and* that the sales tax would not increase prices. Thus, they claim wages will not fall nor will prices go up. Now, while either of these claims might be true, they cannot both be true simultaneously. A sales tax either must be paid out of people's wages, like the income tax, or at the store when people buy goods and services. You can find economists who believe one or the other would happen, but no respectable economist believes that *neither* of these occur. Nevertheless, FairTax advocates claim to have discovered a pain-free tax reform.

Moreover, no independent analysis –whether from President Bush's tax reform panel or the Tax Policy Center – has confirmed that a 30% retail sales tax (or a VAT at that rate) would generate revenues adequate to fund repealing all of the taxes that FairTax advocates claim they would eliminate. (In fact, I wish the Fairtax advocates' revenue claims were correct; they would allow my Competitive Tax Plan to replace the bulk of payroll taxes as well as income taxes at the VAT rate I have suggested, or allow my plan to have a much lower VAT rate.) Given the wildly unrealistic claims of FairTax proponents (along with their insistence on diquising a 30% sales tax rate as 23%), it is hardly surprising that they have generated considerable enthusiasm for their plan, especially among higher-income folks who would enjoy a large tax cut. Unlike the FairTax, my Competitive

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nation's economy grew by 11.7% in the period 2001-2005, the income of the median household fell by 0.5% in that period.

Wealth is even more unevenly distributed than income, with the wealthiest one percent owning about one-third of all wealth in the United States. The bottom 50 percent hold just 2¼ percent of all wealth. As Austan Goolsbee has pointed out, "The average net worth of the top 10 percent of American families is almost 30 times greater than the average net worth of families in the middle 50 percent of the spectrum -- and these disparities in net worth have been growing even faster than the disparities in income."

Tax Plan is a realistic proposal that would neither reduce federal revenues nor shift the distribution of federal taxes down the income scale.

Conclusion

What all this history of attempts to enact a consumption tax teaches us is that in order for such a tax to become a politically viable alternative to our current income tax system it must produce a practical outcome that is better for businesses, better for savings and investment, feasible, and fair to moderate-income Americans. I believe that my proposal meets these criteria. Unfortunately, other plans currently popular in Washington don't.

Given its widespread application around the world, it is clear that the U.S. can readily administer and comply with a VAT. Since my book was published, I have worked closely with private-sector legal, accounting, and corporate VAT experts from around the world in an effort to determine what a model VAT might look like in the United States. Clearly, the best VAT practices are not to be found in Europe, but rather in the more modern VATs enacted in places such as Singapore, New Zealand, Canada, Australia and South Africa. These taxes are imposed on broad consumption tax bases at a single rate to minimize distortions. As in my proposal, regressivity is mitigated through measures directed at low and moderate income households, rather than through VAT exemptions for items such as food and clothing. These kinds of exemptions add complexity to VAT administration and compliance and are wasteful since they also apply to purchases by high-income households.

The Canadian experience, in particular, demonstrates that a national VAT and state retail sales taxes can live side-by-side, but it also demonstrates the efficiencies that can be achieved by encouraging states to replace their retail sales taxes with a harmonized VAT that minimizes compliance and administrative costs.

And, as I have said, any VAT should be border-adjusted to tax imports and exempt exports and should have quite a high registration threshold so that small businesses can avoid reporting VAT (although bona fide small businesses below the threshold should be allowed to register if they elect to do so). Experience shows that VATs are much less costly to administer and comply with than income taxes per dollar of revenue.

Finally, while many countries do not publicize their VAT rates to consumers, Canada requires its VAT to be separately stated on sales receipts. This creates resistance to rate increases. In Canada, federal revenues and spending have fallen relative to GDP since a VAT was introduced in 1991.

Consumption taxes clearly have a role to play as a part of a modern tax system. They are used in the states and throughout the industrial world as a part of tax systems that typically also contain progressive income taxes. Enacting a VAT—a national sales tax with withholding by businesses other than retailers—would permit a major restructuring of our tax system into one that is vastly simpler and far more conducive to savings, investment and economic growth. And, as my competitive Tax Plan demonstrates, this can be accomplished in a way that is fair—a way that neither increases the tax burden of low and moderate-income taxpayers nor shifts taxes away from those at the top of the income scale.

As a result of the recent financial crisis, the most significant recession since the Great Depression (with unemployment reaching a 25-year high), and a vast amount of government spending aimed at combating these problems, our nation's short and long-term financial condition has deteriorated dramatically since I first advanced my Competitive Tax proposal. Now our nation's financial position is perilous. We have never in modern times faced such a dangerous ongoing imbalance between the levels of federal spending and revenues. Our federal debt as a percentage of our economic output is greater than it has been at any time since the end of World War II. And then Europe and Japan were in shambles and China was entering into a dark communist era. Our economy was poised to grow for decades at an unprecedented pace. And our government owed 98 percent of the money it had borrowed to finance the war to Americans. The Congressional Budget Office now projects that in a decade our national debt will exceed $20 trillion—roughly equal to our annual economic output (GDP)—with more than half owed to foreigners, many of whom we cannot count as friends. If we are able then to borrow at a 5% interest rate, interest on the federal debt alone would cost us a trillion dollars a year.

As you well know, our long term fiscal situation is even more dire. Our population is aging with fewer workers for each retiree, and we still have no credible plan to control excessive and rapidly rising health care costs. So the nation's financial situation is projected to get even gloomier in the longer term. If we fail to get control of the federal budget, rising interest costs will gobble up an ever-larger share of our economic output. Public debt growing to such levels will also decrease the value of the dollar and lead to challenges to its role as the world's reserve currency. Our growing national debt increases the risks of substantially higher interest rates, inflation, and another financial crisis. Over time, it will threaten the living standards of the American people. These are facts, not forecasts. We are currently heading toward a cliff, risking the economic wellbeing of our children and grandchildren.

Deficit finance increases our economic vulnerability when it is coupled with a substantial imbalance in trade. Because we import far more than we export, other nations accumulate dollars, which they use to purchase U.S. assets, including government debt. And they are accumulating many more dollars every day. If they were to dump those bonds or dollars on the market, it would cause a precipitous decline in the value of the dollar and might destabilize our economy.

Allowing foreign governments such control over our economic well being may ultimately prove harmful not only to our economic health but also our national interest and security. As Harvard economist Benjamin Friedman puts it: "Government deficits sustained year after year even when the economy is operating at full employment, reduce net capital formation and induce foreign borrowing. Both effects accumulate over time. Both are harmful."

A great advantage of my Competitive Tax plan is that, by introducing a border-adjustable value added tax on sales of goods and services and thereby decreasing our nation's need to rely so heavily on the income tax to finance our government's spending, we can have a tax system that is fair and yet substantially more favorable to economic growth than our current system.

There has been much talk lately, in connection with the debt ceiling, that Congress might enact a six-month deadline for major tax reform. Because most countries have taken 18 months or even two years after enactment to put a VAT into effect, this may suggest to some that my Competitive Tax Plan is not realistic in the short-term. This is wrong. Experience in other countries, such as Japan and New Zealand, shows that consumption rises in anticipation of a VAT coming into effect. Thus, enactment this year or next, with a VAT phased in slowly, could serve to spur consumption in the short-run. And, over the long-run, a VAT would be far more favorable to economic growth (and therefore increased consumption) than the corporate and individual income taxes it would be replacing.

Former Treasury Secretary Larry Summers once remarked that Republicans don't like value-added taxes because they are a revenue machine and Democrats don't like them because they are regressive. "We will get a VAT," he said, "when Democrats realize that they are a revenue machine and Republicans realize that they are regressive." To the contrary, I believe that we will only get a VAT when a VAT is included as part of a tax reform designed to ensure that it is *neither* regressive nor a money machine. That is what my Competitive Tax Plan does.

Despite the daunting challenges of our fiscal situation—challenges that a VAT can surely help to ease—I believe that it would be a mistake to enact a VAT without using a substantial portion of its revenues to help finance major reform and simplification of income taxes. That would indeed be an opportunity wasted.

Our nation's tax system is badly broken. No one quarrels with that. If we don't solve the problems of our grossly inefficient system of raising revenues, all the other challenges our government faces will eventually be overwhelmed by one over-arching reality: we will have too little money and will lack the means to raise it without damaging our economy. Doing nothing is no option.

Example of Retail Sales Tax and VAT

VAT vs. RST: Domestic Sale, No Exemptions

[Illustration with 10% tax-exclusive rate]

	Farmer	Miller	Baker	Total
Business transactions				
Sales	$300	$700	$1,000	
Purchases	$0	$300	$700	
Value added	$300	$400	$300	$1,000
1. RST calculation				
Tax base	$0	$0	$1,000	$1,000
Tax	**$0**	**$0**	**$100**	**$100**
2. VAT calculation				
Tax on sales	$30	$70	$100	
Credit for tax on inputs	$0	-$30	-$70	
Net tax	**$30**	**$40**	**$30**	**$100**

- A retail sales tax and a VAT with the same tax base and rate both collect the same amount of revenue on sales to final customers, but with a VAT much of the tax is withheld prior to the retail sale.

VAT Jurisdictions, 2010