Comments for the Record

House Committee on Ways and Means

Hearing on Tax Reform and Consumption-Based Tax Systems
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Chairman Camp and Ranking Member Levin, thank you for the opportunity to submit my comments on the advantages and disadvantages of a Value Added Tax (VAT), whether as a supplement to or full replacement for existing taxes and the policy arguments for and against adopting the FairTax as a replacement for existing federal taxes. These comments will start with consideration of the FairTax, move to the VAT and then expand upon the VAT-like Net Business Receipts Tax and the need to retain some level of income taxation. In describing each tax, we will address their economic impact and administration and compliance issues.

The FairTax

The main advantage of the FairTax is that it ends the requirement for individuals to report their personal financial information to the government on an annual basis in order to either pay additional taxes or claim a refund due to scheduled overpayment, with the attendant possibility of their return being audited and, in the case of unresolved disputes, having their property subject to seizure and their wages subject to garnishment if taxes have been under-reported or unpaid. It is no accident that a key feature of this proposal is the symbolic abolition of the Internal Revenue Service. (Students of reorganization know that no agency is really abolished, its mission is adjusted and it gets a new name, but it never really goes away).

Many FairTax critics point to the taxation of government purchases as a flaw it its methodology, however this is simply the method used to recover revenues lost from government employees and contractors not paying income and payroll taxes individually. The other purpose in such taxation is to not suddenly give added purchasing power to government employees and contractors who would not otherwise receive wage cuts, which FairTax sponsors insist private sector employers will do in an effort to keep product prices at current levels.

This attempt comes from an apparent unwillingness to simply mandate wage cuts rather than relying on employers to do the right thing. Whether they would cut wages to such levels depends upon the tax elasticity of demand for their industry. Less competitive industries can raise prices a fair bit without loss of sales volume, in which case taxes are simply added to the cost of a product. Others are highly price sensitive and will absorb any tax increase, decreasing either costs or profit to compensate. Likewise, industries which rely heavily on tax subsidies will be impacted, although their prices may not be.

The main flaw in the FairTax comes from its baseline. Proposed FairTax rates are based on current policy rather than permanent law. Many, including the President and a large proportion of the population believe that current tax rates favor the wealthy at the expense of future generations. Enacting a FairTax using these rates as a baseline would lock in those gains, and this is not acceptable. Additionally, while there is progress on a "Grand Bargain" to preserve current middle class tax rates through spending cuts, its success is by no means assured.

A balanced budget FairTax would require a much higher rate, as President Bush's Tax Reform Task Force found. At this rate, and even at the proposed rate, attempts would be made to game the system by claiming wholesale use for retail goods. The need to police such attempts will require an enforcement structure that will be seen as onerous to taxpayers as the Internal Revenue Service is now.

Another problem with the Fair Tax is that it complicates the possibility of Personal Accounts for Social Security. Creation of such accounts assumes a payroll tax to be diverted. If the payroll tax is abolished Social Security is an entirely governmental affair. While such accounts could, of course, be created using the information provided by employers to the Social Security Administration using FairTax revenue, this adds complexity to a system designed to be simple and largely leaves governmental sharing of financial information in place (as does the mechanism for funding the proposed Prebate).

A main strength of the FairTax is its cancelation of all tax subsidies. This is also its main weakness. While many tax subsidies can be considered the abusive results of campaign finance and the putting of local interest ahead of the national interest, others serve a social good and could conceivably lessen the impact of government on the lives of citizens while still providing much needed benefits, like support for families through the Child Tax Credit. Under the Fair Tax, and to a lesser extent the VAT, all such subsidies and services must be either foregone or provided by the government. While ending the exclusion for health insurance may well level the playing field for purchasing insurance, it could as easily lead to a demand for single-payer health care or even a National Health Service on the British model.

Some claim that the Fair Tax would close the Tax Gap by forcing everyone to pay. We marvel at strength of the myth that if only the Tax Gap were eliminated, all would be right with the world of federal finance. Indeed, part of the mythos behind the Fair Tax is that finally prostitutes and drug dealers would be paying their fair share of taxes under this plan.

This assertion is patently false and misunderstands the relationship between consumption taxes and income taxes. Income taxes are essentially a hidden consumption tax, especially when one is purchasing from a business with federal and state tax identification numbers. Most employees in these cases never see that portion of their earnings which go to pay Federal Income, State Income, FICA, and Hospital Insurance payroll taxes. These monies essentially go from sales or other revenues right to federal and state governments, along with any sales taxes collected.

Unless prostitutes and drug dealers obtain tax ID numbers and report taxes as businesses under a Fair Tax, a VAT or a VAT-like NBRT, their payment of such taxes as consumers will likely be no different than their current indirect payment of the income and payroll taxes of those from whom they purchase goods and services.

Waiters, bartenders and the self-employed are also no more likely to pay more under tax reforms designed to eliminate the tax gap. Rather, these reforms can best close the tax gap by simply trying to collect taxes from them if their income falls under a certain threshold. This allows the government to set appropriate rates without the expectation that better enforcement might lead to a balanced budget.

The question of taxing waiters raises the question of who is an employee and who is an independent contractor. Waiters are often considered semi-independents, especially when tips are left in cash rather than added to the bill and paid with credit cards. In many more advanced companies, part time contractors and even essentially full time employees are hired as contractors or independent brokers, even though all of their efforts are dedicated to a single wholesaler or customer. The insurance and home cosmetic industries are prime examples of workers who are essentially employees operating and reporting as if they were independents. This is done to minimize benefits paid and to force the burden of tax reporting onto these employees, thus fueling the problem of low compliance.

Limits on revenue could be used to essentially keep these vendors outside the tax collection system. It could be called an Avon Lady exemption. In a VAT system, enacting such an exemption would lead to little tax loss, as the entire supply chain leading up to these vendors would still pay tax. This would not be the case under a Fair Tax system. Indeed, in a Fair Tax system, Congress would likely be required to consider such vendors employees of the supplying firm in order to realize all potential tax revenue from these industries.

Value Added Tax (VAT)

The question of whether a Value Added Tax (VAT) will be part of the solution comes up with more frequency that what was expected even a year ago. It is among the main solutions offered by the Bipartisan Policy Commission in its debt reduction plan, among others. As this discussion goes forward, we need to raise the question of whether the VAT will provide enough value added for this to be a good idea.

One key advantage a VAT shares with the FairTax is that it makes everyone conscious of being taxed. This is especially important given conservative objections to the fact that 51% of families pay no income tax at all. While most pay payroll taxes, at the lower end, the Earned Income Tax Credit essentially cancels out that payment provided the primary wage earner actually files taxes. Instituting a VAT makes everyone conscious of paying taxes, especially if the tax is made visible on the receipt, as if it were a retail sales tax, like the proposed Fair Tax.

The key objection to both the Fair Tax and a VAT is that it forces the poor to pay taxes, to which advocates for both plans counter with a proposed "prebate" to give a direct subsidy to some or all families an amount equal to what they would pay in taxes at a subsistence level. Of course, making households file for a prebate may defeat another purpose of the VAT – the desire to spare families, especially poor, less literate, families from having to file any kind of disclosure – which often requires that they pay a preparer to help them – with preparers often offering refund anticipation loans at rates that more savvy borrowers would not pay. Indeed, if a prebate were enacted, would prebate anticipation loans be far behind?

One reason many are for a VAT is the hope that it will increase revenues. This can be done much easier by literally doing nothing and letting the Clinton era tax rates return for everyone on January 1, 2013. Most forecasters predict that would bring the budget into primary balance (where we merely borrow to cover the interest but not operations). I suspect that, because forecasters tend to estimate conservatively, going back to Clinton era rates may even balance the budget and allow the country to begin paying down the debt (and repatriating American jobs, since without a debt to buy, our trading partners would have to start buying American products).

Another major benefit of a VAT is that it functions as a tariff because it is fully collected on imports and zero-rated for exports. It is an implicit transfer to American workers, who could use a transfer right now – especially because many of our trading partners have a VAT which functions in this way, making our income tax based system a hidden tax which makes our products uncompetitive. Labor should be for this tax in a big way, but so far has not been – probably because organized labor has been converted to a movement for workers into an arm of the Democratic Party establishment. This brings us back to the question of why the left has not embraced it?

The reason tax reform with a VAT has not caught fire on the left is because it deals in half measures. It is not enough to simply increase visibility if the cost of doing so keeps the current paperwork burden largely in place, or to merely hold the poor and the middle class harmless, especially given the transition costs for doing comprehensive tax reform.

In Europe, which has a strong VAT and income tax system, families with children receive a sizeable subsidy that goes farther than offsetting tax liability for the VAT – as Bruce Bartlett reports in his New York Times Economix column of June 7, 2011, it offsets nearly all tax liability for the average family and essentially gives everyone a middle class life style. (http://economix.blogs.nytimes.com/2011/06/07/health-care-costs-and-the-tax-burden/). That level of subsidy is what it would take to make the effort of enacting a VAT worthwhile. It must, in effect, raise all families out of poverty or it is simply changing the tax system for the sake of change.

The Center for Fiscal Equity agrees with the Bipartisan Policy Center that a VAT should be part of the solution for our fiscal woes – both budgetary and economic. We propose a four pronged tax reform:

- a VAT that everyone pays, except exporters,

- a VAT-like Net Business Receipts Tax (NBRT) that is paid by employers but, because it has offsets for providing health care, education benefits and family support, does not show up on the receipt and is not avoidable at the border,
- a payroll tax to for Old Age and Survivors Insurance (OASI) (unless, of course, we move from an income based contribution to an equal contribution for all seniors), and
- an income and inheritance surtax on high income individuals so that in the short term they are not paying less of a tax burden because they are more likely to save than spend – and thus avoid the VAT and indirect payment of the NBRT.

The VAT would fund domestic military and civil discretionary spending, but not overseas deployments or strategic nuclear forces. Ideally, this spending would be considered regionally, with regionally specific VAT rates (which would require a constitutional amendment to enact) along with a balance requirement with automatic rate increases and sequestration should balance not be met (also requiring an amendment). Until regional excises are permitted, we estimate a national balanced budget VAT of 13%.

Before moving on, there are other objections to VAT that must be addressed. It is likely that for many, this unavoidability of payment is one of the reasons such taxes are opposed. This features is likely one of the main reasons that VAT is superior to the Fair Tax, which will likely increase the tax gap because many items which are in fact purchased for end use will be accounted for as wholesale in order to avoid taxation. If taxes are paid at each stage of production, this problem does not exist. Of course, analysis of how VAT systems are actually implemented suggests that the VAT is no panacea in stemming tax avoidance, especially if multiple rates and loopholes are present in the system.

Net Business Receipts Tax (NBRT)

The NBRT base is similar to a Value Added Tax (VAT), but not identical. Unlike a VAT, and NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

The NBRT would replace payroll taxes for Hospital Insurance, Disability Insurance, Survivors Insurance for spouses under 60, Unemployment Insurance, the Business Income Taxes, on corporations, business income taxes now collected under the personal income tax system, as well as most of the revenue collected under the personal income and inheritance taxes, less the amount collected under a VAT. The health insurance exclusion now included in the Business Income Tax and other subsidies under the Affordable Care Act. Most importantly, it would fund an expanded and refundable Child Tax Credit.

The expansion of the Child Tax Credit is what makes tax reform worthwhile. Adding it to the employer levy rather than retaining it under personal income taxes saves families the cost of going to a tax preparer to fully take advantage of the credit and allows the credit to be distributed throughout the year with payroll. The only tax reconciliation required would be for the employer to send each beneficiary a statement of how much tax was paid, which would be shared with the government. The government would then transmit this information to each recipient family with the instruction to notify the IRS if their employer short-changes them. This also helps prevent payments to non-existent payees.

The expansion of the child tax credit to $520 per child per month is paid for by ending the tax exemption for children, the home mortgage interest deduction and the property tax deduction. This is more attractive to the housing industry than the alternative proposal, which is to end or limit the credit and use the proceeds to help bring the budget into primary balance. Shifting the benefit in this way holds the housing industry harmless, since studies show that the most expensive cost of adding a child is the need for additional housing.

Assistance at this level, especially if matched by state governments may very well trigger another baby boom, especially since adding children will add the additional income now added by buying a bigger house. Such a baby boom is the only real long term solution to the demographic problems facing Social Security, Medicare and Medicaid, which are more demographic than fiscal. Fixing that problem in the right way definitely adds value to tax reform.

This tax should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

This tax could also be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions. ***This is a feature that is impossible with the FairTax or a VAT alone.***

If cost savings under and NBRT, allow companies to offer services privately to both employees and retirees in exchange for a substantial tax benefit. Employers who fund catastrophic care would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but not so much that the free market is destroyed.

Enacting the NBRT is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

The Center calculates an NBRT rate of 27% before offsets for the Child Tax Credit and Health Insurance Exclusion, or 33% after the exclusions are included. This is a "balanced budget" rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

The last question is whether the income and inheritance surtax can be incorporated into the NBRT, as proposed by Lawrence B. Lindsey. While it is feasible, I reject it because it will either lead some to be overtaxed while others are under-taxed or will require a personal financial reporting system that many employees and investors would regard as intrusive if it came at the hands of employers or investments. While there is resistance to letting the government know all of one's financial details, I am quite certain letting your employer into all your business would be considered worse. What bartender wants to work for a lower wage (if he or she could even find a job) if part of being hired was the requirement to disclose family trust fund income to management, who would have to pay taxes on behalf of that employee at a higher rate? Better to leave the personal income tax in place so that only the government knows who is really rich.

Income and Inheritance Surtax

Retaining an income surtax could have few rates or many rates, although I suspect as rates go up, taxpayers of more modest means would prefer a more graduated rate structure. The need for some form of surtax at all is necessary both to preserve the progressivity of the system overall, especially if permanent tax law enacted before 2001 is considered the baseline (which it should be) and to take into account the fact that at the higher levels, income is less likely to be spent so that higher tax rates are necessary to ensure progressivity.

This tax would fund net interest on the debt, repayment of the Social Security Trust fund, any other debt reduction and overseas civilian, military, naval and marine activities, most especially international conflicts, which would otherwise require borrowing to fund. It would also fund transfers to discretionary and entitlement spending funds when tax revenue loss is due to economic recession or depression, as is currently the case. Unlike the other parts of the system, this fund would allow the running of deficits.

Explicitly identifying this tax with net interest payments highlights the need to raise these taxes as a means of dealing with our long term indebtedness, especially in regard to debt held by other nations. While consumers have benefited from the outsourcing of American jobs, it is ultimately high income investors which have reaped the lion's share of rewards.

The loss of American jobs has led to the need for foreign borrowing to offset our trade deficit. Without the tax cuts for the wealthiest Americans, such outsourcing would not have been possible. Indeed, there would have been any incentive to break unions and bargain down wages if income taxes were still at pre-1981 or pre-1961 levels. The middle class would have shared more fully in the gains from technical productivity and the artificial productivity of exploiting foreign labor would not have occurred at all. Increasing taxes will ultimately provide less of an incentive to outsource American jobs and will lead to lower interest costs overall. Additionally, as foreign labor markets mature, foreign workers will demand more of their own productive product as consumers, so depending on globalization for funding the deficit is not wise in the long term.

Identifying deficit reduction with this tax recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

Using an income tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.

Thank you for this opportunity to provide comments to the Committee.

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Hearing on Tax Reform and Consumption-Based Tax Systems

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