National Retail Federation®
The Voice of Retail Worldwide

Submission of the National Retail Federation

to the

House Ways and Means Committee

Hearing on Tax Reform and Consumption-Based Tax Systems

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As the world's largest retail trade association and the voice of retail worldwide, NRF's global membership includes retailers of all sizes, formats and channels of distribution as well as chain restaurants and industry partners from the United States and more than 45 countries abroad. In the U.S., NRF represents an industry that includes more than 3.6 million establishments and which directly and indirectly accounts for 42 million jobs – one in four U.S. jobs. The total U.S. GDP impact of retail is $2.5 trillion annually, and retail is a daily barometer of the health of the nation's economy. www.nrf.com.

<u>Summary of Comments</u>

Members of the National Retail Federation believe that the most important aspect of any tax reform measure is its impact on the economy and jobs. Consumer spending represents two-thirds of GDP. The NRF believes that replacing our current tax system with a consumption tax, or adding a consumption tax to our current tax system, will present an unnecessary risk to our economy. The NRF believes that a reform of the income tax, by providing a broad base and low rates, will bring the greatest economic efficiency and will stimulate economic growth without causing the economic dislocations inherent in the transition to a new tax system.

According to a study of major consumption tax reform proposals performed for the NRF Foundation, transitioning to a consumption tax system will lead to a decline in the economy for several years and a loss of jobs, without stimulating much additional economic growth for a ten-year period.[1] The United States should not experiment with a brand new tax system that will put our economic future at risk.

The NRF also opposes enacting a value added tax (VAT) in addition to the federal income tax. A recent study performed for NRF by Ernst & Young and Tax Policy Advisors found that if a VAT were added to the federal income tax, it would result in a substantial decline in jobs for decades.[2]

In addition to the overall impact of consumption taxes on the economy, retailers are particularly concerned with the impact of consumption taxes on our customers. Consumption taxes are highly regressive and will raise the tax burden on lower and middle-income Americans. This occurs because lower-income households tend to spend a higher portion of their incomes, so they will pay a higher tax relative to income level under a consumption tax than will upper income households.

<u>Proposals to Replace the Income Tax with a National Retail Sales Tax</u>

Replacing the federal income tax with a national retail sales tax would result in harmful short-term and mid-term results to our economy. A 2000 study performed for the NRF Foundation by PricewaterhouseCoopers found that following replacement of the federal income

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[1] PricewaterhouseCoopers LLP, *Fundamental Tax Reform: Implications for Retailers, Consumers, and the Economy*, April 2000. A copy of the study can be found at: http://www.nrf.com/modules.php?name=Documents&viewlive&sp_id=6755

[2] Carroll, Cline, Neubig, Diamond and Zodrow, *The Macroeconomic Effects of an Add-on Value Added Tax*, October 2010. The Executive Summary for this study is included in the Appendix to this testimony. A copy of the compete study can be found at: http://www.nrf.com/modules.php?name=Documents&op=showlivedoc&sp_id=5564

tax, estate and gift taxes and most federal excise taxes with a national retail sales tax, employment would decline for four years, GDP would decline for three years, and consumer spending would decline for eight years.

In 2005, President George W. Bush's Advisory Panel on Federal Tax Reform studied a national retail sales tax and rejected it because they found that replacing the income tax with a national retail sales tax would place too great a tax burden on lower and middle income Americans, who must consume most of what they earn. Their analysis showed that even if a cash grant were provided to lower income families to offset the regressive nature of the tax, as proposed in the FairTax legislation (H.R. 25), a married couple earning $39,300 a year would still have a tax increase of 42%. A January 2005 study[3] of the distributional impact of H.R. 25 found that if that bill were enacted, families with income less than $18,000 a year would get a tax cut, and families with income over $100,000 would get a tax cut. However, families with incomes between $18,000 and $100,000 a year would have a tax increase. Families earning between $18,000 and $35,000 a year would have the largest percentage increase in taxes.

The Advisory Panel was also concerned that the establishment of a new federal entitlement program to administer the cash grants in the FairTax proposal would cost between $600 billion and $780 billion a year, making it the largest entitlement program in American history and causing most American families to be dependent on monthly checks from the federal government for a substantial portion of their income.[4]

Finally, the Advisory Panel concluded a national retail sales tax would be difficult to administer and enforce at the high tax rate necessary to be revenue neutral. The Treasury Department's analysis performed for the Advisory Panel concluded that a federal sales tax rate of at least 34% would be needed for a national sales tax to replace the federal income tax system.

This rate would be in addition to existing state and local sales taxes. This rate assumes that the national retail sales tax would apply to *all* goods and services. Thus, the base would include many goods and services that have never been taxed under any state retail sales tax. The base would include health care services, prescription drugs, new home sales, apartment rents, insurance, and purchases by state and local governments. The Treasury Department estimated that if a tax base were used that more closely approximated a typical state sales tax base, a rate of between 64% and 89% would be needed.

From a retail industry perspective the impact of a national retail sales tax would be particularly severe. Consumer spending would decline for eight years, causing a great contraction of the industry and employment. The impact would be particularly severe for small retailers, who are not as able to respond to what would become a competitive need to reduce prices because of the increased pressure on consumers. In addition, retailers would have the administrative burden of collecting and remitting the tax. Studies have shown that the compliance burden for collecting the tax is disproportionately higher on smaller retailers.[5]

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[3] The study was performed for the National Retail Federation by the Barcroft Consulting Group.
[4] President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, p. 208.
[5] The Advisory Panel cites a 1998 study by the State of Washington to illustrate this point. That study found that the cost of collecting sales tax was 6.5% of the tax collected for retailers with annual gross sales of $150,000 -

Proposals to Replace the Income Tax with a Value Added Tax

Economists agree that the economic impact of various forms of consumption taxes is similar, although the application of the taxes may differ. The President's Advisory Panel on Federal Tax Reform's objections to replacement of the federal income tax with a VAT are similar to their objections to replacement of the federal income tax with a national retail sales tax. "(T)he increased tax burden on the middle class and increased size of government resulting from the full replacement retail sales tax apply equally to a full replacement VAT."[6]

The 2000 PricewaterhouseCoopers study did not model the macroeconomic impact of replacing the income tax with a European style VAT, but it did analyze the impact of replacing the income tax with a Flat Tax, which is a form of VAT. The study found that following the enactment of a Flat Tax, the economy would decline for five years, employment would decline for five years and consumer spending would decline for six years.

Proposals to Add a Value Added Tax to the Federal Income Tax

Recently, some policymakers have suggested that a VAT be added to the federal income tax to help reduce the federal deficit. This model is similar to that used in many European countries. The 2010 study of The Macroeconomic Effects of an Add-on Value Added Tax, performed for the National Retail Federation by Ernst & Young and Tax Policy Advisors, found that an add-on VAT enacted to reduce the deficit would result in a loss of 850,000 jobs in the year of enactment, a loss of $260 billion in retail spending in the year of enactment, and a .2% drop in GDP in the year of enactment. The study found that even ten years after enactment, the impact of the VAT would still cause a decline of 700,000 jobs, $288 billion in retail spending, and GDP would be up a modest .3% because of *deficit reduction* (not specifically because of the VAT).

The 2010 study also found that an add-on VAT would have more adverse macroeconomic effects than a comparable deficit reduction through a reduction in government spending. The study found that deficit reduction through spending cuts would add 250,000 jobs in the year of enactment, whereas raising a similar amount of money through a VAT would cost 850,000 jobs in the year of enactment. Similarly, deficit reduction through spending cuts would cause GDP to rise by .1% in the year of enactment, whereas raising a similar amount of money through a VAT would cause GDP to decline by .2% in the year of enactment.

A VAT is a highly regressive tax, hitting lower and middle income taxpayers much harder than wealthier individuals. Even if exemptions were provided to alleviate the impact of a VAT on lower income households, most families with household income over $40,000 a year would have a lower standard of living if a VAT were enacted. A family of four at the U.S. median income level would have a 100% increase of the federal income taxes currently paid by that family.

$400,000. For retailers with annual gross sales greater than $1.5 million, collection costs were less than 1% of sales tax collected. *Ibid.* at 221.

[6] *Ibid.* at 222.

Finally, in OECD countries that have VATs in addition to income taxes, the VAT rates have risen greatly as the size of government has grown. The Ernst & Young/ Tax Policy Advisors study examined the experience of ten of the largest countries that have adopted a VAT. The average VAT rate rose in these countries from 10.7 percent at the inception of the VATs to 16 percent, a nearly 50 percent increase. The United Kingdom has doubled its initial VAT rate.

Compliance costs associated with VATs are also significant. A World Bank study found that the hours needed to comply with a VAT exceeded the hours needed to comply with the corporate income tax by 26%.[7] The dual tax system may be particularly, burdensome for small businesses, which have enough trouble meeting the burdens of collecting and remitting payroll and income tax withholdings.

Conclusion

We urge the Committee to enact income tax reform that will broaden the tax base and lower the tax rates. This type of tax reform will simplify administration of the tax system and encourage economic growth. We urge the Committee to oppose enactment of a consumption tax, which would hurt jobs and economic growth and shift the tax burden to those who can least afford to pay.

[7] World Bank, *Paying Taxes 2010* (November 2009). The compliance hours are presented in Appendix 1.3.

Executive Summary

As U.S. policymakers consider ways to address unsustainably high projected future federal government deficits and debt, significant policy changes to both spending and revenues will be debated. The President's National Commission on Fiscal Responsibility and Reform is charged with making recommendations by December 1, 2010 on how to address near-term as well as long-term projected deficits. The Commission is expected to consider significant changes to federal entitlement programs, defense and non-defense discretionary spending, and the tax system, including the possibility of a new federal value-added tax (VAT).

The National Retail Federation (NRF) engaged Ernst & Young LLP and Tax Policy Advisers LLC to analyze the macroeconomic effects of implementing a VAT to reduce projected federal deficits. Although there have been economic analyses of various policies to reform the existing tax system, a macroeconomic analysis of an "add-on" VAT as a means of reducing the deficit and government debt has not been undertaken.

This report examines the macroeconomic effects of reducing future deficits by two percent of GDP. The report focuses on a narrow-based VAT that is similar to VATs in most other countries. To achieve deficit reduction of two percent of GDP with a narrow-based VAT, a 10.3 percent tax rate would be needed. The report also analyzes the effects of a broad-based VAT with a rebate for tax paid by low-income households, as well as a narrow-based VAT with a rebate. All of the add-on VATs analyzed in this report are similar to those used in other countries or recommended in various proposals currently under discussion. For purposes of the analysis, it is assumed that the VAT is effective January 1, 2012.

The three principal findings of the report are:

1. An add-on VAT would reduce retail spending by $2.5 trillion over the next decade. Retail spending would decline by almost $260 billion or 5.0 percent in the first year after enactment of the VAT.

2. An add-on VAT would cause GDP to fall for several years. The economy would lose 850,000 jobs in the first year, and there would be 700,000 fewer jobs ten years later. By comparison, a comparable reduction in the deficit through reduced government spending would have less adverse effects on the economy, and could have positive effects for economic growth.

3. Although lower deficits and debt would have positive long-run effects for the economy, most Americans over 21 years of age when the VAT is enacted would be worse off due to

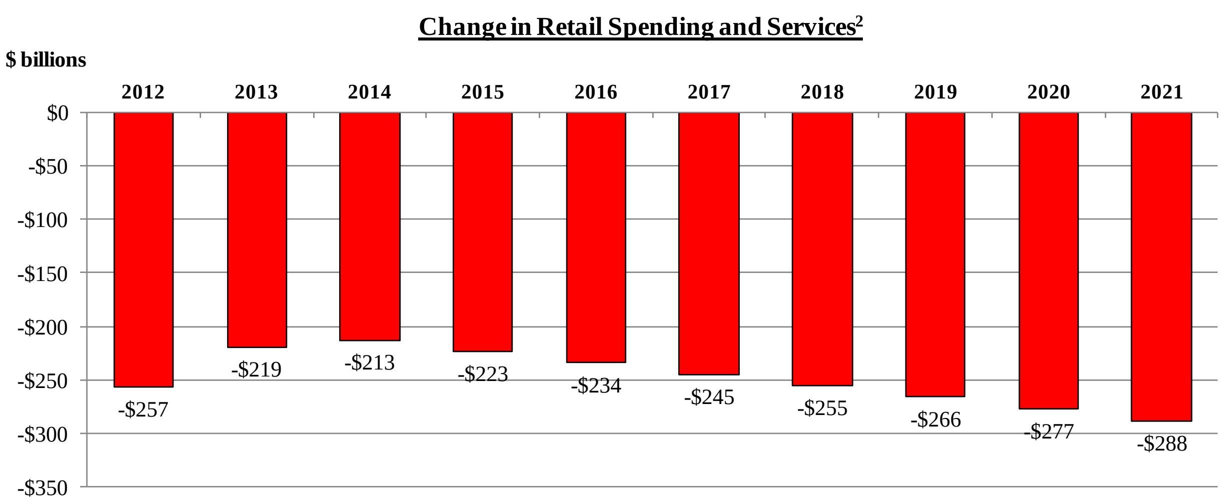
enactment of an add-on VAT. A VAT would have significant redistributional effects across generations, reducing real incomes and employment for current workers.

In the face of an economy that continues to struggle, immediate enactment of an add-on VAT would pose serious risks. The drop in retail spending, jobs, and GDP under an add-on VAT has the potential to further weaken the economy in the near term, rather than strengthen it. Other countries have reduced, not increased, their VATs in the face of the recent economic downturn. Reducing the deficit through lower government spending would have much more favorable economic effects – more jobs, higher GDP, a better standard of living for Americans, and a less depressing effect on retail spending – in both the near term and in the longer term.

Retail Spending Would Fall Significantly Under a VAT

- A VAT would lower household consumption in the short- and long-runs, and would reduce GDP for the next several years followed by several years of negligible change.
  - Retail spending subject to the VAT would initially fall by 5.0 percent or almost $260 billion.
  - Retail spending would fall by $2.5 trillion over the next decade.

An Add-on Narrow-Based VAT Would Lower Retail Spending and Services Substantially[1]

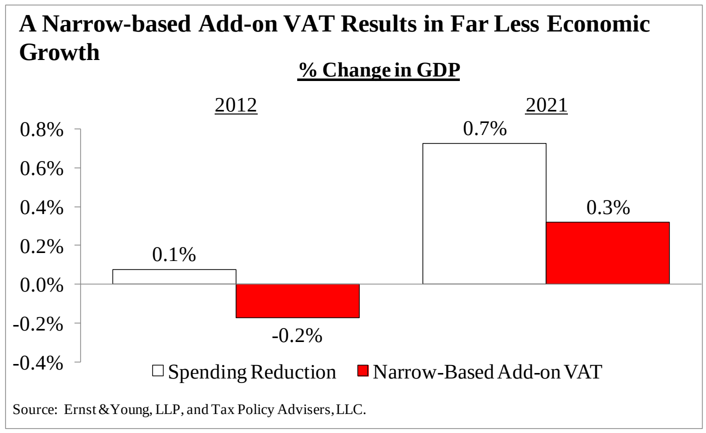


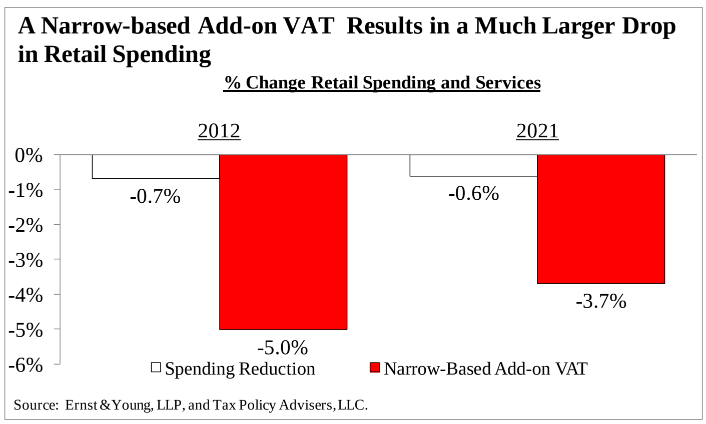
[1]Estimates are for narrow-based add-on VAT with no rebate that begins in 2012.
[2]Retail spending as used here includes the retail categories that would be subject to a VAT under a narrow-based VAT. That would include most retail categories, such as, clothing and footwear, furnishings, motor vehicles, personal items, recreation, food services, tobacco, fuel, personal services, hotel accommodations, transportation, etc. As discussed in detail in the report, certain consumer expenditures, such as health care, financial services, education, and certain food items (e.g., groceries), as well as business-to-business purchases, are excluded from the narrowly-defined VAT base. The exemption of these items follows the design prevalent among VATs in other countries.

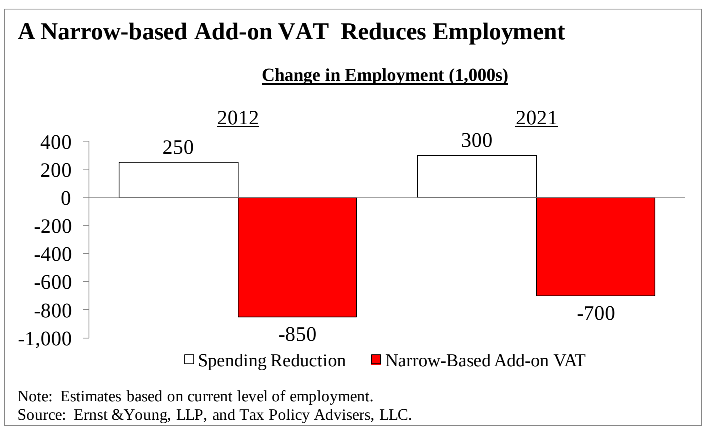
Source: Ernst &Young, LLP, and Tax Policy Advisers, LLC.

An Add-on VAT Would Have More Adverse Macroeconomic Effects than a Comparable Deficit Reduction through a Reduction in Government Spending

- An add-on VAT would result in less economic growth as compared to a reduction in government spending, when addressing the nation's long-term fiscal imbalance.
  - The level of GDP initially falls when future deficits are financed with a VAT, but would rise almost immediately when reduced through lower government spending on income transfers.
  - A VAT has more adverse effects after ten years as well – reducing the deficit through a VAT cuts the growth of GDP by more than half as much as a reduction in government spending after ten years.
  - The drop in taxable retail spending and services is initially 7.5 times as large under a VAT (-5.0 percent) than after a reduction in government spending (-0.7 percent). After ten years it remains 6 times as large.
  - A deficit-reducing VAT would result in an initial loss of about 850,000 jobs and a loss of 700,000 jobs for more than a decade. In contrast, reducing the deficit through lower government spending could add 250,000 jobs to the economy.
  - The two policies would have different distributional effects, depending on the distribution of the reduction in transfer payments.



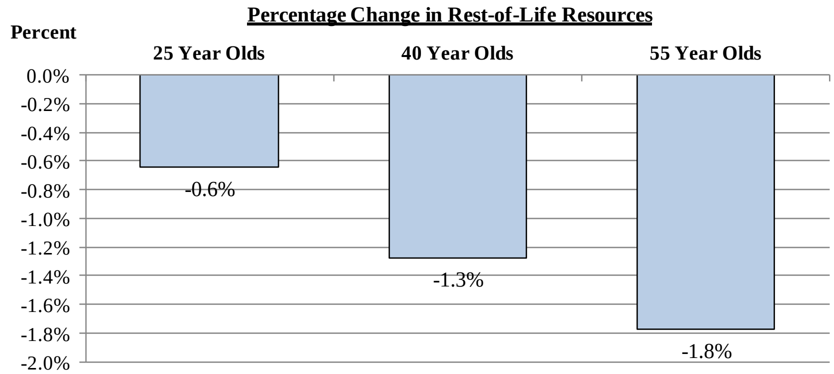




Most Americans Alive Today Would Be Worse Off Under an Add-on VAT

- Most Americans over 21 years of age when the VAT is enacted would be worse off due to a decline in their real wages and their inability to consume as much. Households with incomes above $40,000 and over the age of 21 at the time of enactment would be worse off.
- These losses reflect the costs current generations would bear from using a VAT to reduce the current unsustainable level of deficits and the debt in the United States.

A Narrow-based Add-on VAT Hurts Current Middle-Income ($40,000 to $80,000) Working Age Households



Note: Estimates are for narrow-based add-on VAT with no rebate. Ages indicate when the narrow-based add-on VAT is enacted. Middle income refers to households in the 4th through 8th deciles.
Source: Ernst & Young, LLP, and Tax Policy Advisers, LLC.

An Add-on VAT Would Result in a Large Tax Increase for Middle-Income Families

The required tax rate for a narrow-based VAT would initially need to be at least 10.3 percent to reduce federal government debt by two percent of GDP. An add-on VAT would be in addition to all existing taxes, such as individual income taxes, corporate income taxes, and the payroll tax.

- Under a narrow-based 10.3 percent VAT, a middle income family-of-four with the U.S. median income of roughly $70,000 would pay $2,400 a year in value added taxes. This would be a 100 percent increase over the federal income taxes currently paid by this family.
- A family earning $40,000 would pay an additional $1,800 in VAT. A family at this income level has no federal income tax liability.
- A family earning $100,000 would pay $2,800 in value added taxes – a tax increase equal to more than 40 percent of their current federal income tax liability.

Moreover, the VAT rate would likely increase over time due to continued political pressure to further narrow the VAT base and/or add some type of rebate to offset VAT paid by lower-income households. This is in addition to the possible increase in rates that would be needed to finance any increase in government spending due to the availability of the VAT; such increased spending would be consistent with international experience.

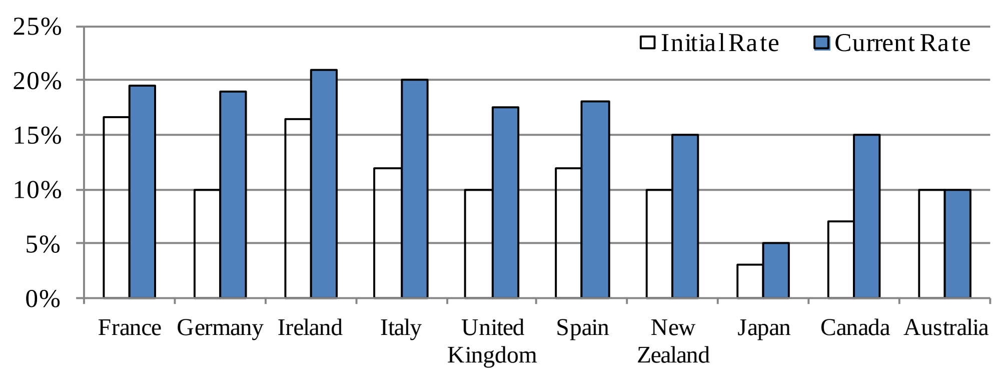
International Experience with VATs

The report examines the experience of ten of the largest countries that have adopted a VAT. All of these countries replaced existing, national consumption-type taxes, such as turnover taxes and manufacturing and wholesale sales taxes, with a VAT.

To address the distributional concerns that VATs are borne disproportionately by lower income households, these VATs have been designed with exemptions and multiple rates. Exemptions and multiple rates increase the administrative and compliance costs of these VATs. Of the ten VATs examined, only Japan imposes a VAT with a single tax rate.

VAT rates in these countries have also increased substantially over time. The average VAT rate has risen from 10.7 percent at the inception of the VATs across all ten countries to 16.0 percent today – a nearly 50 percent increase. The average VAT rate among the 30 member nations of the Organisation for Co-operation and Economic Development (OECD) is 18.0 percent. The United Kingdom will be the first of the ten largest countries analyzed to double its initial VAT rate with its scheduled increase from 17.5 percent to 20 percent in January 2011. Japan briefly considered raising its VAT rate from 5 percent to 10 percent earlier this year, but has not done so in the face of significant political opposition.

VAT Rates In Other Countries Have Risen Over Time



Source: OECD *Consumption Tax Trends 2008* (Nov 2008) and European Commission, *VAT Rates* (May 2010).

The narrow taxable base for VATs in other countries has resulted in some goods and services being favored relative to other goods and services. This has led to important and sizable sectoral effects favoring tax-preferred sectors. In addition, the enactment of a VAT can have temporary effects on consumption patterns. For example, Australia reduced its excise tax on automobiles and replaced its wholesale sales tax when it enacted its VAT in 2000. Before the effective date, automobile sales fell, but then rose sharply after their excise tax was reduced, while retail spending increased just before the VAT effective date, but fell sharply afterwards.