AN EXAMINATION OF THE FLAT TAX, NATIONAL SALES TAX, AND OTHER TAX REFORM MEASURES BEING CONSIDERED AS PART OF DEFICIT REDUCTION OPTIONS BY LAWMAKERS: A COMPARATIVE POLICY ANALYSIS

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ABSTRACT
Recent events in Washington, D.C., including the findings published in December 2010 by the National Commission on Fiscal Responsibility and Reform, the debate to temporary raise of the debt ceiling in August 2011, and the recent Congressional super committee's efforts are all actions and measures that focus the national need to eliminate both the federal budget deficit and the national debt. Part of the discussion involves reducing or eliminating federal spending, while other proposals include reforming the federal tax code by introducing alternatives to the existing taxing structure. Such proposals include: introducing a federal flat tax with very few tax expenditures; a national sales tax, attaching part of the federal tax collections to personal consumption, and reforming the existing tax structure by allowing very few tax expenditures (the National Commission's proposal). The purpose of this paper is to examine some of the recent alternative tax proposal policies on a comparative basis in order to glean an understanding of the similarities and differences in the varying proposals.

Introduction
Since 2001, there have existed two statutory baselines for individual income taxation in the United States. With the passage of the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) and the *Jobs and Growth Tax Relief Reconciliation Act of 2003* (JGTRRA), the federal individual tax rates have been held temporarily at lower rates. These have become known as the Bush tax cuts. Additionally, President Obama signed the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, which extended all the Bush cuts to December 31, 2012. On January 1, 2013, if no Congressional action, all the individual tax rates will adjust back to the pre-2001 levels. These statutory marginal tax rates on income can be described as two baselines: *Current Law Baseline* and *Current Policy Baseline* (Toder, 2011). Under the *Current Law Baseline*, statutory tax rates (on ordinary income) are 15, 28, 31, 36, and 39.6 percent, with the maximum rates on capital gains at 20 percent (10 percent if the gain were otherwise taxed at 15 percent) and 18 percent (8 percent if the gain were otherwise taxed at 15 percent) for property held more than five years; and dividends are taxed at ordinary income rates of 26, 27. Under the *Current Policy Baseline*, statutory tax rates (on ordinary income) are 10, 15, 25, 28, 33 and 35 percent, and the maximum rates on capital gains (and qualified dividends) are 15 percent (0 percent if gain were otherwise taxed at 10 percent or 15 percent). In addition to these differences in rates, there are variations in some corresponding taxable income bracket thresholds. Further, exemption levels for the AMT are at pre-2001 law levels and not indexed for inflation in the *Current Law Baseline*, whereas they

are at much higher levels and indexed in the *Current Policy Baseline*. These differences significantly affect the revenue raised by any given change in regular tax rates. Further, the *Current Policy Baseline* rates contribute to the federal budget deficit and add to the national debt.

In a recently issued report, "Using a VAT for Deficit Reduction," by Eric Toder, Jim Nunns, and Joseph Rosenberg, the authors argue that the current federal budget policies in the United States are clearly unsustainable (Toder, 2011, p. 3). The long-run projections made by the Congressional Budget Office (CBO) in June 20111 reveal the ratio of debt held by the public to gross domestic product (GDP) rising from 69 percent in 2011 to 187 percent in 2035 under their Alternative Fiscal Scenario, a budget baseline that assumes that 2011 federal spending and revenue policies will largely continue. Even under CBO's Extended-Baseline Scenario, where a budget baseline that assumes all the 2001-2003 tax cuts expire as scheduled by the end of 2012, and the individual alternative minimum tax (AMT) is no longer "patched," and that Medicare and other health-related spending is held to modest growth rates, CBO projects the publicly held debt will rise to 84 percent of GDP by 2035 (Toder, 2011, p. 3). At some (unknown) point of the debt-to-GDP level, purchasers of U.S. debt could decide that they face a significant risk of loss through inflationary policies or outright default, and accordingly demand much higher interest rates to hold U.S. government debt as compensation for that risk. If this were to occur, the spike in interest rates would require even higher spending, resulting in more debt and possibly sparking a significant crisis.

Moreover, while Congress has recently proven to be incapable of reaching consensus on measures intended to reduce the federal budget deficit and eliminate the national debt burden, the aforementioned fiscal challenges await resolution. The "super committee's" failure to issue a report in late November 2011, or at least move the debate forward sent a chill to the nation. Elected officials are not incapable of finding resolution, but both parties have let partisan politics prevent them from reaching consensus on these fiscal challenges.

The purpose of this paper is to examine some of the recent alternative tax proposal policies on a comparative basis in order to glean an understanding of the similarities and differences in the varying proposals. Specifically, we will examine the pros and cons of adopting a national retail sales tax, value-added tax (VAT), and a zero-based tax system (as recommended by the 2010 Federal Debt Commission). We will examine each proposal separately.

A National Retail Sales Tax
The President's 2005 Advisory Panel examined a variety of scenarios and simulations if a national retail sales tax were to be adopted. The Panel ultimately rejected the idea of a national retail sales tax, but their findings and analysis were instructive for this paper. Many of the Advisory Panel's findings are included in our analysis.

Retail Sales Tax with No Grants. Forty-five states and the District of Columbia currently assess a retail sales tax. Many states use multiple sales tax rates and exempt many goods and services from the tax. The 2005 Advisory Panel on Tax Reform examined the pros and cons of a national sales tax. The Panel considered a single-rate tax that would be imposed on a broad tax base because such a tax would be simpler to administer and create fewer economic distortions. The Panel's broad tax base would apply to sales of goods and services to consumers, but, to prevent multiple taxation or "cascading," it would not apply to purchases of goods or services by business that are used to produce other goods or services for sale to households. The Panel initially evaluated the federal retail sales tax using the broad tax base described by advocates of the "FairTax" retail sales tax proposal. That tax base (the "Extended Base") would exempt only educational services, expenditures abroad by U.S. residents, food produced and consumed on farms, and existing housing (or what economists refer to as the imputed rent on owner-occupied and farm housing).

Using the "Extended Base," and assuming low rates of evasion, the Treasury Department calculated that the tax rate required to replace the federal income tax with a retail sales tax would be 22 percent on a tax-exclusive basis. This tax rate, however, does not include a program designed to ease the burden of the tax on lower-income Americans. Moreover, unless the states repealed their existing sales taxes, most consumers would pay both federal and state sales tax on many goods. The weighted average state and local sales tax rate is approximately 6.5 percent on a tax-exclusive basis. Thus, for sales subject to both federal retail sales tax and state and local sales taxes, the weighted average combined tax-exclusive sales tax rate would be approximately 28.5 percent (President's, p. 228). In high tax states like New York and California, the rates would be even higher.

The Advisory Panel notes that adopting a retail sales tax would impose a larger tax burden on lower-income households than the current system because a retail sales tax is imposed directly on consumption and does not provide deductions, exemptions, or credits to reduce the tax burden on lower-income Americans. Replacing the current income tax with a stand-alone retail sales tax would increase the tax burden on the lower 80 percent of American families, as ranked by cash income, by approximately $250 billion per year. Such families would pay 34.9 percent of all federal retail sales taxes, more than double the 15.8 percent of federal income taxes they currently pay (in 2005 dollars). The top 20 percent of American taxpayers would see their tax burden fall by approximately $250 billion per year. Such families would pay 65.1 percent of all federal retail sales taxes, compared to the 84.2 percent of federal income taxes they currently pay (in 2005 dollars).

Lower- and middle-income families would be especially hard hit by a stand-alone retail sales tax. According to the Advisory Panel, the Treasury Department estimates that a hypothetical single mother with one child making $20,000 per year currently pays $723 in total federal taxes (including both the employee and employer shares of the Social Security and Medicare taxes). In the 2005 report, under the stand-alone retail sales tax, her tax burden would go up to $6,186 – a tax increase of over 750 percent. A hypothetical married couple with two children making $40,000 per year would pay an additional $6,553 in taxes, an increase of more than 110 percent of total federal tax liability. In contrast, a hypothetical married couple with two children and $300,000 of income currently pays about $89,000 in total federal taxes. Under the stand-alone retail sales tax, this hypothetical family would pay about $72,000, a tax cut of 19 percent (President's, p. 229). The Panel then adjusted their analysis to reflect a cash grant to ease the burden on lower- and middle-income taxpayers.

Retail Sales Tax with a Universal Cash Grant Program. The Advisory Panel Report states that retail sales tax proposals generally recognize the distributional effects of a stand-alone retail sales tax. For this reason, such proposals usually include a cash grant program to relieve the burden of the retail sales tax on lower and middle-income families. The Panel considered the cash grant program advocated by proponents of the FairTax. This program (sometimes called a "Prebate") would provide a monthly monetary grant to all U.S. citizens and residents. The goal of the program would be to provide families with cash sufficient to pay retail sales tax on all their spending up to the poverty level. In addition, the program would not be income-based, eliminating the need of a federal agency to keep track of personal income. However, it would require a federal agency to keep track of family characteristics, such as family size, on which the cash grant would be based. The cash grant program would be expensive, and would require raising the retail sales tax rate. To pay for the cash grant program and remain revenue-neutral, the required tax rate, assuming evasion rates somewhat lower than those under the income tax, would be 34 percent. Using a higher evasion rate assumption, discussed further below, the tax rate would be 49 percent. The Panel cites that if a narrower tax base were used instead of the Extended Base, the tax rate would be even higher (President's, p. 212).

How would a universal cash grant program work? The federal government would be required to send monthly checks to every family in America, regardless of their income level. If the tax rate was 34

percent and the before-tax poverty level for an individual was $10,000, all single individuals would receive $3,400 a year from the government. The cash grant would also be adjusted for marital status and family size. For married couples with two children, the cash grant amount in 2006 would be $6,694 per year. The Prebate-type program would cost approximately $600 billion in 2006 alone (the Advisory Panel Report was issued in 2005, so no evidence of the estimated cost for 2012 or beyond was provided). Based on 2005 data, this amount is equivalent to 23 percent of projected total federal government spending and 42 percent of projected total federal entitlement program spending, exceeding the size of Social Security, Medicare, and Medicaid. The Prebate program would cost more than all budgeted spending in 2006 on the Departments of Agriculture, Commerce, Defense, Education, Energy, Homeland Security, Housing and Urban Development, and Interior combined.

The Advisory Panel Report showed how low-income and high-income Americans would benefit from the retail sales tax with a Prebate, while middle-income Americans would pay a larger share of the federal tax burden. American families with the lowest 20 percent of cash incomes in 2005 paid negative 0.5 percent of total federal income taxes because the tax credits they claim exceed their total positive tax liability. Under the retail sales tax with a Prebate, this group would pay negative 5.6 percent of the federal sales tax burden because the amount they would receive in monthly checks from the government would exceed what they would pay in retail sales tax when buying goods and services. In total, the bottom quintile would be assessed 5.1 percentage points less of the tax burden. Families with the top 10 percent of cash incomes would also benefit substantially from the retail sales tax. Their share of the tax burden would fall by 5.3 percentage points – from 70.8 percent to 65.5 percent.

Middle-income Americans, however, would bear more of the federal tax burden under the retail sales tax with a Prebate. The Treasury Department's analysis of hypothetical taxpayers shows that married couples at the bottom 25th percentile, 50th percentile, and 75th percentile of the income distribution for married taxpayers would see substantial tax increases under a full replacement retail sales tax. A typical married couple at the bottom 25th percentile of the income distribution earns $39,300 per year and would pay $5,625 dollars in federal taxes in 2006. Under the retail sales tax with a Prebate, the same family would pay $7,997 in net federal taxes after subtracting the Prebate of $6,694, resulting in a tax increase of $2,372, or 42 percent. A typical married couple at the 50th percentile of the income distribution making $66,200 would pay an additional $4,791, a tax increase of 36 percent, and a typical married couple in the 75th percentile, making $99,600 would pay an additional $6,789, a 29 percent tax increase. A typical single mother at the bottom 25th percentile of the income distribution for head of household taxpayers has $23,100 of income per year and, compared to current law, would pay $5,866 more under the retail sales tax with a Prebate.

Administrative Complexities to a National Retail Sales Tax. According to the Advisory Panel, the cash grant program would require all eligible American families to file paperwork with the IRS or another federal government agency in order to claim their benefits under this new entitlement program. A federal agency would need to manage the program, verify individuals' marital status and number of eligible children, and write checks to every family in the United States. Eligibility rules would be necessary, for example, to ensure that a child claimed as a dependent could not also file for his or her own separate cash grant. Moreover, substantial additional complexity would be imposed by a targeted cash grant program because determining eligibility would require additional information. For example, a program based on annual income would require the IRS or another federal government agency to make many of the same determinations now made under the current income tax.

The next issue would be the appropriate national sale tax rate necessary to replace the revenues from the current individual and corporate income taxes. The Advisory Panel discussed two major

factors that determine the tax rate are the size of the tax base and the level of evasion. The tax rates and rebate program cost estimates in the Advisory Panel's report was based on relatively optimistic assumptions about the breadth of the tax base and the evasion rate. As explained earlier, even under these optimistic assumptions, the Panel did not recommend a full replacement sales tax at the resulting 34 percent tax rate.

The Advisory Panel discussed substantial concerns that a base as broad as assumed above would not be viable and that evasion rates could be higher than under the present income tax. Further, the Advisory Panel believed that in evaluating the retail sales tax it was important to consider the tax rate required under less favorable assumptions regarding the tax base and evasion. Existing state sales tax bases are substantially narrower than either of the broad bases studied by the Advisory Panel. In addition, there is great variation in tax rates and items considered exempt from the tax (food, clothes, etc.). Most states exempt a variety of specific products and many services from their sales taxes. For example, every state sales tax exempts prescription drugs, most states do not tax health care, approximately 30 states exempt food for home consumption or tax it at a preferential rate, and many states exempt clothing. These exemptions are often justified as a means to ease the burden of a sales tax on basic necessities, but are not well targeted because they often decrease the tax burden on higher-income taxpayers as much or more than they decrease the tax burden on lower or middle-income taxpayers. To illustrate the impact of extensive base erosion on a retail sales tax, the Advisory Panel requested that the U.S. Treasury Department estimate the tax rate using the average state sales tax base. The Advisory Panel acknowledged that there are structural differences between state tax systems and a federal tax system that would rely on a retail sales tax instead of an individual and corporate income tax, and that these differences would affect the nature of any base erosion.

Tax Evasion Issues. Tax evasion occurs when taxpayers do not pay taxes that are legally due. Analysts agree that some evasion is inevitable in any tax, and that evasion rates for any tax tend to rise as the tax rate rises. At the request of the Advisory Panel, the Treasury Department estimated the revenue neutral retail sales tax rate assuming evasion rates of 15 and 30 percent of personal consumption spending (President's, p. 217). The Treasury Department assumed no evasion by state and local governments. In comparison, for 2001 the IRS estimated that the evasion rate for the individual income tax was between 18 and 20 percent and the evasion rate of the entire U.S. tax system was about 15 percent. A national retail sales tax would rely on retail businesses to collect all federal tax revenue and eliminate federal individual income tax filing. Therefore, the number of federal tax return filers would fall significantly under the national retail sales tax proposal. The Advisory Panel concluded that the complexity of filing a business tax return would decline dramatically as compared to corporate income tax returns. Retail sales tax returns would indicate only total sales, exempt sales (sales to businesses with exemption certificates plus export sales) and tax liability. From an enforcement perspective, both the reduced number of tax return filings and the simple nature of the retail sales tax return represent substantial advantages. However, the Advisory Panel concluded that a number of features of the national retail sales tax would make it difficult to administer and enforce at the high tax rate necessary to be revenue-neutral. A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, might provide a substantial inducement for evasion at the retail level. Retailers and shoppers could use a number of techniques to evade a retail sales tax.

The Advisory Panel report cited the following potential evasion examples: Unregistered cash sales to a consumer would allow a transaction to escape taxation. Retailers facing a high retail sales tax might also misapply exemption criteria, whether intentionally or unintentionally, and fail to tax goods that are required to be taxed. In another example, the retailer might collect the tax from customers, but keep the money rather than remit it to the government. At high tax rates, the gain to retailers from evasion is high.

The Advisory Panel report cited Empirical evidence suggesting third-party reporting substantially improves tax compliance, particularly when tax rates are high. For the portion of income from which taxes are not withheld and there is no third-party reporting, income tax evasion rates are estimated to be around 50 percent (President's, p. 218). There is no third-party reporting in a national retail sales tax. Retailers would add their retail sales tax to the pre-tax price for their goods and would remit that amount to the government, but shoppers would not separately report what they bought, and at what price, to the federal government. The federal government would rely on retailers alone to report their own taxable and exempt sales. In order to obtain exemption from tax, the Advisory Panel cited where retail purchasers might try to fabricate exemption certificates or otherwise masquerade as tax-free buyers of retail products. For example, individuals might create "paper" businesses solely to obtain business exemption certificates and avoid taxes on purchases for personal use. A related problem involves individuals with legitimate businesses using their business exemptions for personal purchases or for goods or services to give to employees in lieu of cash compensation. Using their business purchase exemption would provide a discount equal to the retail sales tax rate. With a retail sales tax, retailers would have the responsibility to determine whether the ultimate use of a good or service would be for a business purpose, and therefore would be deserving of the business purchase exemption. The Advisory Panel argues that retailers are often ill-equipped to carry out this role. Moreover, state tax experience suggests that abuse of exemptions is common, in part because distinguishing between business and individual consumer purchases of so-called "dual use" goods and services – goods and services that are commonly purchased by both businesses and final consumers, such as a plane ticket – can be difficult and costly.

According to the Advisory Panel, retail sales tax advocates often note that evasion rates with sales taxes are lower than evasion rates with the income tax. However, state sales tax evasion rates are not likely to be representative of the evasion rate of a full replacement retail sales tax for several reasons. First, state sales tax rates are a fraction of the tax rates required to replace the federal income tax. In 2005, among states that impose sales taxes, tax rates range from 3.5 percent in Virginia to 7.0 percent in Mississippi, Rhode Island, and Tennessee. When combined with local sales taxes, the highest sales taxes are found in Alabama (11.0 percent), Arkansas (10.625 percent), Oklahoma (10.5 percent) and Louisiana (10.5 percent). States with higher tax rates may provide greater incentives for taxpayer evasion and avoidance. As stressed by the Advisory Panel, those incentives also make administration and enforcement more expensive – and any failure to effectively administer the tax requires a higher tax rate to compensate for lost revenue. No state or country has ever levied a retail sales tax at a tax rate that even approaches the 34 percent required to replace the federal income tax system. This rate may need to be even higher in 2012, given the current state of the U.S.'s fiscal dilemma. According to the Advisory Panel report, state tax administrators reported they would expect significant compliance problems at the 34 percent rate.

State sales taxes also do not broadly tax service providers, often because they are difficult to tax. For example, all U.S. state sales taxes exempt most financial services. Other dual-use services, such as utilities, transportation, and communication services are also difficult to tax properly and often are exempt from state sales taxes. The Advisory Panel concluded that attempting to tax these services through a retail sales tax likely would result in more extensive evasion and higher compliance and administrative costs than existing state sales taxes. While the Panel found it difficult to know with any measure of certainty what the evasion rate would be under a national retail sales tax, it believes that it would likely be at least as high as evasion under the current income tax and that a 30 percent rate of evasion would not be an unreasonable assumption (President's, p. 219).

Other Compliance Realities. Although some national retail sales tax proposals claim the administration of the retail sales tax could be left to the states and the IRS could be eliminated, such a system would likely be unworkable. Existing state sales tax bases are both narrow and varied and it may be difficult to persuade the states to adopt the federal retail sales tax base. The Advisory Panel cited the experience of Canada, which tried to federalize its provincial sales taxes. Canada considered adopting a unified federal

and provincial sales tax base in 1987, but intergovernmental discussions failed to produce an agreement to standardize the existing provincial sales tax bases with the base for Canada's federal goods and services tax (President's, p. 220). Variation in local sales tax rates within the United States could further complicate any effort to standardize U.S. sales tax bases and rates. For example, Texas alone had 1,109 separate city tax rates, 119 county tax rates, and 67 other special tax jurisdictions. Texas is not atypical in having numerous local sales tax jurisdictions. Moreover, the Advisory Panel writes that while some states might bring their sales taxes into conformity with a federal retail sales tax, it is unlikely that all would adjust. Many states have not adopted identical definitions, standards, and rules in their own income tax regimes as those that exist for the federal income tax, even though there would be many administrative and compliance advantages to such an approach. In other words, their tax systems are not in conformity with the federal system. Given the tremendous variance in the current taxation of retail sales across the United States, the IRS or another federal agency with substantial personnel and resources would almost certainly have to define, administer, and enforce a federal retail sales tax. This would require codification at the federal level, which some lawmakers might resist. For example, detailed rules would be necessary to ensure that exemption certificates were issued uniformly and only provided to legitimate businesses for use in purchasing actual business tools, materials, and other inputs. Further, the IRS or another federal agency would likely need to administer the retail sales tax directly in the five states that do not currently impose a sales tax. The same might be true in those states that do not bring their sales tax bases into conformity with the federal retail sales tax base. Finally, because failure to effectively enforce the sales tax would lower federal revenues, Congress might decide that the IRS should maintain a significant enforcement function as a backup mechanism to state tax administration efforts. One might envision Treasury officials raiding warehouses and using enforcement efforts similar to the ones used to indict Al Capone.

Response from the States. The Advisory Panel cited at their public meetings, state and local tax officials suggested that a federal retail sales tax would encroach on a tax base that traditionally has been left exclusively to states and localities. In 2005, sales and gross receipts taxes account for about 37 percent of state general tax collections and about 17 percent of local revenues. However, if a federal retail sales tax were put in place at a rate of 34 percent or more, it could become unattractive for states to add their own rates on top of the federal retail sales tax. Moreover, if the federal government were to cease taxing income, states might choose to shift their revenue-raising to the income base from the sales base. State income taxes could rise, while state sales tax rates could fall. In any event, unless states found a substitute source of revenue, they likely would maintain their income taxes. For that reason, it is reasonable to expect that taxpayers would need to continue to keep track of income-related information and file income tax returns, regardless of whether the federal government eliminates the federal income tax. Furthermore, with an income-based cash grant program, tracking income at the federal level would remain a necessity.

Currently, 45 states and the District of Columbia have state income taxes. Most states use federal adjusted gross income as the starting point in determining the state individual income tax base. Eliminating the federal income tax would remove the common basis upon which most state income taxes are now structured. The Advisory Panel believes that state and local income tax returns would likely become much more complex if they could not be based on a pre-existing federal income tax return that includes a calculation of annual income. Greater disparities among state income tax systems and potential distortions would likely develop as state income tax structures diverge from each other over time in the absence of a common federal income tax base as a starting point. Another important point was made in the report: State income tax compliance initiatives currently rely in large measure on information that the states receive from the third-party reporting structure created by the federal income tax – such as W-2 and 1099 forms as well as other standard tax forms that report income. In the absence of the federal third-party reporting system, states would need to impose information reporting requirements on individuals, employers, financial institutions, and others in order to maintain their income tax systems. States might

bind together to coordinate enforcement of state income taxes and impose those reporting requirements. However, if states chose to impose reporting requirements independently, multi-state businesses might face many different sets of reporting obligations. The Advisory Panel stressed that simplification of the federal tax system through a national retail sales tax might be achieved at the expense of greater overall complexity in the combined system of state and federal taxation.

Compliance Burden on Small Business. A national retail sales tax might place a disproportionate burden on small retail businesses. Few statistical studies exist on the compliance costs for retailers of different sizes. However, a well-regarded study conducted by the State of Washington Department of Revenue in 1998 suggests that, although such costs are low overall, they are disproportionately high for small retailers. I n Washington, the cost of collecting sales tax for retailers with annual gross retail sales of between $150,000 and $400,000 was 6.5 percent of sales tax collected. By comparison, firms with annual gross retail sales greater than $1.5 million spent less than 1 percent of sales tax collected on compliance. Small vendors, particularly those operating on a cash basis, account for a significant share of the noncompliance in many state sales taxes as well as our current income tax. A national retail sales tax would include all retailers, including small service providers, such as dentists, car mechanics, or beauticians, as well as small retail stores. Small service providers would likely find retail sales tax compliance costly and would have noncompliance incentives that would be similar to those for small retail stores.

The Advisory Panel concluded that similar to other consumption taxes, the full replacement of a national retail sales tax has pro-growth features. Nevertheless, the Advisory Panel did not recommend a full replacement retail sales tax. Without a large cash grant program to ease the burden of the tax, a retail sales tax would not be appropriately progressive. A cash grant program to make the tax appropriately progressive would cost at least $600 billion per year – which would make it America’s largest entitlement program. The Advisory Panel concluded that it was inappropriate to recommend a tax reform proposal that required the federal government to collect and redistribute this amount in additional revenue from taxpayers. Moreover, the Advisory Panel was concerned with administrative and compliance issues associated with a retail sales tax, as well as difficulties involving coordination with existing state sales taxes.

The Value-Added Tax

The Value-Added Tax (VAT) can be structured in a variety of ways. Two approaches were derived in the Toder, Nunns, and Rosenberg report (2011), but only the add-on VAT proposal will be examined.

As the nation has moved into a difficult fiscal situation where expenditures need to be cut along with revenue increases, policy makers could choose to increase revenues as part of a plan to help avert an eventual fiscal crisis. Toder (2011) argues for two options to increase revenues. The first option is to adopt a value-added tax (VAT). Specifically, a VAT is a tax on households’ consumption of goods and services, equivalent to a retail sales tax, with the same broad base and same rate, but with a different administrative structure. Unlike a national retail sales tax, which is collected only at the final retail level on sales, a VAT is collected incrementally at each stage of the production and distribution of goods and services. More than 130 other nations around the world have a VAT, including every country in the Organization for Economic Co-operation and Development (OECD) except the United States. The VAT examined in Toder et report is considered an “add-on tax” (i.e., it raises revenue, rather than replacing funds from an existing federal tax). This form of a VAT has a broad base and includes a rebate to mitigate the distributional effects of the tax on lower-income households (Toder, p. 1).
The second option offered by Toder, Nunns, and Rosenberg would reduce the deficit by the same amount as the VAT, but in a very different way: by increasing all individual income tax rates, including those that apply to capital gains and dividends. For purposes of this paper, the authors decided to examine Toder (2011) option one since it was more a discussion of the Value-Added Tax.

Adopt an Add-on VAT. A VAT is a tax on households' consumption of goods and services, equivalent to a retail sales tax with the same broad base and same rate, but with a different administrative structure. Unlike a sales tax, which is collected only at the final retail level on sales, a VAT is collected incrementally at each stage of the production and distribution of goods and services. The two most common forms of VAT are the "credit-invoice" and the "subtraction-method". Credit invoice is used throughout Europe and in Canada, Australia, New Zealand and most other countries in the world. Under a credit-invoice VAT, every business pays VAT on its sales, but is allowed a credit for the VAT included on the invoice for its purchases from other businesses. The net amount of VAT paid by the business therefore is the tax on the difference between its sales and its purchases from other businesses. The difference between sales and purchases is "value added," the amount the business pays to labor and capital. The total value added by all businesses through the retail level is the value of the good or service sold to final consumers, i.e., its retail value.

The other common form of VAT is the subtraction-method, which is used in Japan and has been proposed in the United States. Under this system, every business pays tax on the difference between its sales and its purchases from other businesses, its value added. The subtraction method VAT base is identical to the credit-invoice VAT base, assuming there are no exemptions. The VAT option analyzed by Toder (2011) is credit-invoice, the structure used in most major countries. This also is "destination-based" like others in place, which means that export sales are not taxed, exporters receive a credit for VAT paid on their purchases, and imports are subject to VAT.

The Base of the VAT. A VAT is a broad-based tax on consumption; the starting point for the base of a VAT is total consumption as defined in the National Income and Product Accounts (NIPA) prepared by the Bureau of Economic Analysis (BEA) in the U.S. Department of Commerce. Several items in NIPA consumption, however, are assumed to be excluded from the base of a VAT for policy reasons. The Urban Tax Policy Center assumes exemptions for government-reimbursed health expenditures (primarily Medicare and Medicaid), education spending, and expenditures on behalf of households by religious and nonprofit organizations. The VAT base also excludes some components of NIPA consumption for administrative reasons.

First, it excludes all housing rents – both imputed rent on owner-occupied housing (the net rental value of housing services that homeowners receive) and rents paid for tenant-occupied housing. Instead, the VAT base includes the full value of purchases of all new housing and improvements to all existing housing. Second, the VAT base excludes financial services that are provided without charge. A common example is when a bank's cost of maintaining a checking account is recouped by paying little or no interest on the customer's account balance, instead of charging the customer an explicit fee. In this situation, it is difficult to determine what the customer would be charged if the bank paid her the net amount of interest it earned on her balances and assessed a fee to cover the services' costs. Therefore, indirect charges in the form of reduced interest are typically excluded from the VAT base. However, Toder (2011) argues that direct charges by banks and other financial institutions, such as for blank checks and safe deposit boxes, are included in the VAT base. The VAT base also excludes state and local general sales taxes, so that the VAT applies to sales net of these taxes. If state and local governments in turn exclude the VAT from their bases for general sales taxes, it simplifies computation of the federal VAT and of state and local sales taxes by removing interactions among calculated liabilities. However, because federal, state and local excise taxes are generally collected from manufacturers and wholesalers instead of retailers and are simply embedded in prices retailers pay, this analysis assumes they remain in the VAT base.

Moreover, some taxpayers will not pay their VAT in full and on time. Such noncompliance has the same

effect on revenues as explicit exemptions from the VAT base. The size of this compliance gap for a U.S. VAT is difficult to predict. TPC's estimates of VAT revenues assume a 15 percent reduction in the VAT base from a combination of noncompliance and administrative exemptions for small businesses. This figure is roughly equal to the percentage of tax liability that IRS estimates is not paid in a timely manner under the current federal income tax, and similar to noncompliance estimates under the United Kingdom's VAT (Toder, 2011).

The Urban Tax Policy Center estimated the base size for the VAT option in 2015 by starting with NIPA consumption, which in 2015 was estimated to be $13 trillion, 70 percent of projected GDP of $18.6 trillion. The base is reduced by policy adjustments for government health expenditures (primarily Medicare and Medicaid) of $1.4 trillion, education spending of $0.3 trillion, and religious and nonprofit expenditures of $0.5 trillion. The net administrative adjustment for housing reduces the base by $1 trillion, and the adjustment for financial services provided without payment reduces the base by another $0.3 trillion. With some minor other adjustments, the consumption amount in the VAT base is $9.4 trillion, or 71.7 percent of total consumption and 50.2 percent of GDP (Toder, p. 7). Further reductions include removing state and local general sales taxes of $0.5 trillion, and the 15 percent adjustment for noncompliance and a small business exemption, which is $1.4 trillion. The effective VAT base therefore is $7.4 trillion in 2015, or 56.9 percent of total consumption and 39.8 percent of GDP (Toder, p. 8).

According to Toder (2011), both housing and food are included in the base, items many countries and states remove to reduce burdens on low-income families. The report does offer a rebate to reduce or remove the burden on lower-income households.

Rebate. As indicated, rather than excluding selected goods and services from the VAT base, Toder (2011) employs a rebate to remove its burden from low-income households. The rebate has two components: an earnings credit claimed on income tax returns and an adjustment in cash transfer payments. Neither component phases out with income. An alternative design would phase out the rebate for higher-income households. Toder writes that this phase-out would reduce the rebate's cost and, therefore, the required VAT rate, and there would be fewer claimants for the earnings component. However, an income phase-out has several drawbacks. It would complicate the administration of the rebate, and it would increase marginal tax rates for households in the phase-out range. Toder (2011) argues that due to these drawbacks, the VAT rebate described in their analysis does not include an income phase-out.

The first component of the rebate would be a refundable tax credit based on a measure of employment income. This measure would include amounts taxpayers report on income tax returns of wages, pensions, and other withdrawals from retirement accounts, plus 80 percent of self-employment income. The proposed rebate amount would phase in with the sum of this income for each tax unit. This phase-in would have a ceiling equal to an estimate of the weighted average federal poverty threshold for a one-person household in 2015 of $12,000 for a single and-head- of-household filer, and to double that level ($24,000) for a married couple filing a joint return (Toder, p. 8). The credit rate applied to this eligible income would be the effective rate of VAT as a percentage of income. The credit would be refundable and would not phase out at incomes above the ceiling.

The second portion of the rebate would go to recipients of cash transfer payments, mainly Social Security benefits. A new VAT would not burden current recipients of these benefits because after retirement, they are indexed to changes in the consumer price level and thus automatically

offset any effect of a VAT on the price level. Over time, Toder et al argues the reduction in real wages that a VAT produces would reduce initial Social Security benefits, which are tied to a worker's lifetime earnings. This portion of the rebate, therefore, consists of an annual adjustment in the government's computation of benefits for each form of cash transfer payment to maintain the benefit at the level that would have been computed using the pre-VAT level of wages. Beneficiaries of cash transfer payments would not need to claim this portion of the rebate on their tax return, as it would automatically be included in their benefits.

Administrative Costs. A VAT would be a new tax for the United States. The VAT outlined by Toder et al would be significantly less complex than the current income tax system, and would not impose additional burdens on non-business taxpayers, aside from any additional costs of claiming the rebate. A new VAT would nonetheless be quite complex for businesses, nonprofits and governments, and would involve substantial startup costs. A VAT would require the IRS, or a new agency, to establish a new administrative apparatus, with its own forms, instructions, regulatory guidance, processing, taxpayer service, and collection and enforcement activities. While much of this apparatus might be similar to what exists in the IRS to administer taxes, it would still be a major addition to the tax administrative structure. These costs would be incurred regardless of whether the VAT is administered by the IRS or a new agency. A new VAT would require a significant appropriation in advance of startup to establish the VAT rules and procedures and to pay for initial taxpayer education programs. And it would require additional annual appropriations thereafter.

Toder (2011) argues that parallel to the federal government's administrative needs, businesses and other entities would have to establish internal processes to learn about and comply with the VAT. Small businesses would likely be exempt from the VAT, but even exempt businesses would have some compliance costs to learn about it and determine whether exemption was in their best interests. Large businesses would all be directly involved in collecting and remitting VAT, or, if excluded from it through zero-rating, at a minimum in determining their eligibility for VAT refunds and filing refund claims. The commercial activities of nonprofits and governments would be subject to VAT, entailing compliance costs similar to those of any other business subject to VAT. Further, the excluded activities of governments and nonprofits would entail compliance costs similar to those of businesses excluded from VAT. Toder (2011) argues that a national VAT could provide a template to help reform state and local retail sales taxes. It could be used to extend their bases to apply to services purchased by households, which would remove the cascading of tax that occurs from taxing sales between businesses, and would resolve the taxation of Internet and other remote sellers. These reforms would most easily be achieved if state and local sales taxes piggybacked on the national VAT. Combining administration of a national VAT and piggybacked state and local sales taxes would reduce compliance costs for businesses and total administrative costs for governments (Toder, p. 32).

The third type of alternative tax system in this paper dealing with a relative flat tax system will be discussed next.

The 2010 Fiscal Commission's Zero-Base Plan

In December 2010, the National Commission on Fiscal Responsibility and Reform ("Fiscal Commission") issued its report, titled "The Moment of Truth" (National, 2010). The Fiscal Commission was charged with examining the short-term and long-term economic effects of the federal budget deficit and level of national debt in the United States. The Commission argues that the tax code allows for $1.1 trillion annually in earmarks (tax expenditures), which are revenue losses due to allowances for income tax deductions and credits for taxpayers (both individual and corporate) to lower their income tax liability. The report suggests that the U.S. Tax Code "drives up health care costs and provides special treatment to special interests" (National, 2010, p. 28). In addition, the Fiscal Commission argues that the tax code is complex and requires high compliance costs in order to file a return, while some taxpayer's under-report

their income, evading their tax responsibility. With regard to corporate income taxes, the Fiscal Commission argues that the U.S. corporate income tax rate is much higher than other industrialized nations; areas unique to the U.S. are provisions requiring the taxation of active foreign-source income. The report claims that the tax code should be reformed to allow for only taxation of territorial income, reducing corporate tax rates, and in the process "leveling the playing field" with other industrialized nations (National, 2010, p. 28).

The Fiscal Commission's report recommends four (4) basic goals of comprehensive tax reform:

1. ***Lower rates, broaden the base, and cut spending in the tax code.*** The current tax code is riddled with $1.1 trillion of tax expenditures: backdoor spending hidden in the tax code. Tax reform must reduce the size and number of these tax expenditures and lower marginal tax rates for individuals and corporations – thereby simplifying the code, improving fairness, reducing the tax gap, and spurring economic growth. Simplifying the code will dramatically reduce the cost and burden of tax preparation and compliance for individuals and corporations.

2. ***Reduce the deficit.*** To escape our nation's crushing debt and deficit problem, we must have shared sacrifice – and that means a portion of the savings from cutting tax expenditures must be dedicated to deficit reduction. At the same time, revenue cannot constantly increase as a share of the economy. Deficit reduction from tax reform will be companied by deficit reduction from spending cuts—which will come first. Under our plan, revenue reaches 21 percent of GDP by 2022 and is then capped at that level.

3. ***Maintain or increase progressivity of the tax code.*** Though reducing the deficit will require shared sacrifice, those of us who are best off will need to contribute the most. Tax reform must continue to protect those who are most vulnerable, and eliminate tax loopholes favoring those who need help least.

4. ***Make America the best place to start a business and create jobs.*** The current tax code saps the competitiveness of U.S. companies. Tax reform should make the United States the best place for starting and building businesses. Additionally, the tax code should help U.S.-based multinationals compete abroad in active foreign operations and in acquiring foreign businesses (National, 2010, pp. 28-9).

These goals serve as a reference point for overall tax reform. In examining the second goal above, the Fiscal Commission recommended that the House Committee on Ways and Means and the Senate Committee on Finance craft proposals that rely on a "zero-based budgeting" model by "eliminating all tax expenditures" in order to derive three (3) individual rate structure (8%-14%-23%) and one (1) corporate rate (26%). This is known as the "Zero Plan" whereby the basis for tax reform is primarily all-inclusive income with no deduction or credit offsets, or exclusions and is the starting point for tax reform. The Fiscal Commission's report recommends that the increased revenues derived from repealing tax expenditures be used for three purposes: 1. Substantially lowering marginal tax rates; 2. Reducing the reduction (by "adding-back" to the tax base tax expenditures for targeted purposes); and 3. Supporting a small number of simpler, more targeted provisions that promote work, home ownership, health care, and savings (National, 2010, p. 29). After the zero plan base was derived, the Fiscal Commission recommended adding back targeted provisions, as mentioned in purpose no. 3 above, making it easier for lawmakers to craft bills for passage. This would, in effect, cause the individual rates to increase back up to (12%-22%-28%) and the corporate rate to increase to 28%. In the next section, individual tax reform recommendations will be examined.

The Fiscal Commission's Individual Tax Reform Recommendations

Figure 1.1 below summarizes the effect of the impact on both individual and corporate rates. Individual tax reform will be examined first.

Figure 1.1: Tax Rates Under Various Scenarios

	Bottom Rate		***Middle Rate***		***Top Rate***		***Corporate Rate***
Current Rates for 2011	10%	15%	25%	28%	33%	35%	35%
Scheduled Rates for 2013		15%	28%	31%	36%	39.6%	35%
Eliminate all Tax Expenditures ("Zero Plan")		8%		14%		23%	26%
Keep Child Tax Credit + EITC		9%		15%		24%	26%
Enact Illustrative Tax Plan (Figure 1.2)		12%		22%		28%	28%

The add-backs to the zero plan are summarized in Figure 1.2 below. Some of the more prominent highlights of the Fiscal Commission's plan include stripping the Code of a majority of the existing tax expenditures, eliminating the need for itemized deductions. Note that the Fiscal Commission released its report in early December 2010, right before Congress passed and President Obama signed into law a two-year extension of the Bush tax cuts, known as the *Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010* (P.L. 111-312). Many of the provisions in the Fiscal Commission's report were based on prior law, the *Economic Growth and Tax Relief Reconciliation Act of 2001* (P.L. 107-16), or EGTRRA, which was scheduled to "sunset" on December 31, 2010. When the report was filed, there was no agreement moving to the President, so it reflects prior law. Therefore, Figure 1.2 was adjusted by these researchers to reflect these extensions in the "Current Law" column that were not contained in the Fiscal Commission's final report.

Figure 1.2: Illustrative Individual Tax Reform Plan

	Current Law	*Illustrative Proposal (Fully Phased In)*
Tax Rates for Individuals	In **2011-12**, six brackets: 10%, 15%, 25%, 28%, 33%, 35%. In **2013**, five brackets: 15%, 28%, 31%, 36%, 39.6%.	Three (3) brackets: 12%, 22%, 28%
Alternative Minimum Tax	Scheduled to impact middle-income individuals, but "patched" annually.	Permanently repealed
PEP and Pease	Repealed in 2011-12, resumes in 2013	Permanently repealed
EITC and Child Tax Credit	Partially refundable child tax credit over $1,000 per child. Refundable EITC of between $457 and $5,666.	Maintain current law or equivalent alternative.
Standard Deduction and Exemptions	Standard deduction of $5,700 ($11,400 for couples) for non-itemizers; personal and dependent exemptions of $3,650.	Maintain current law; itemized deductions eliminated, so all individuals take standard deductions
Capital Gains and Dividends	In 2011-12, top rate of 15% for capital gains and dividends. In 2013, top rate of 20% for capital gains, and ordinary dividends.	All capital gains and dividends taxed at ordinary income rates
Mortgage Interest	Deductible for itemizers; mortgage capped at $1 million for principal and second residences, plus up to $100,000 for home equity loans.	12% non-refundable tax credit available to all taxpayers; Mortgage capped at $500,000; No credit for interest from second residence and equity loans.
Employer Provided Health Insurance	Excluded from income. 40% excise tax on high cost plans (generally $27,500 for families) begins in 2018; threshold indexed to inflation.	Exclusion capped at 75th percentile of premium levels in 2014, with cap frozen in nominal terms through 2018 and phased out by 2038; Excise tax reduced to 12%
Charitable Giving	Deductible for itemizers	12% non-refundable tax credit available to all taxpayers; available above 2% of Adjusted Gross Income (AGI) floor
State and Municipal Bonds	Interest exempt from income	Interest taxable as income for newly-issued bonds
Retirement	Multiple retirement account options with different contribution limits; saver's credit up to $1,000	Consolidate retirement accounts; cap tax-preferred contributions to lower of $20,000 or 20% of income, expand saver's credit
Other Tax Expenditures	Over 150 additional tax expenditures	Nearly all other income tax expenditures are eliminated

Figure 1.2 has several noteworthy recommendations. Before examining each, one theme is consistent: Itemized deductions will be eliminated with the retention of specific tax expenditures that will either be converted into *before AGI* deductions or converted into a tax credit (as is the case with home mortgage interest and charitable contributions). If a deduction or credit is not indicated in Figure 1.2, it is most likely recommended by the Commission for repeal.

Individual Rates and the AMT. In examining Figure 1.2, the recommendations by the Fiscal Commission for the zero plan both raise revenues as well as reduce revenues. The Fiscal Commission recommendations to create three (3) individual tax brackets of 12-22-28% are contingent on the implementation of the proposals in the "Illustrative Proposal" column. If this zero plan were enacted, the alternative minimum tax (§55) would be permanently repealed. According to David Cay Johnston, if the alternative minimum tax (AMT) were repealed, it would cost over $70 billion in lost revenues (and most likely cost much more today) (Johnston, 2007). Therefore, a goal of the Fiscal Commission is to repeal this complex provision, even if it causes the federal government to lose revenues. The tax expenditures that would assist in paying down the cost of lost revenues associated with repeal of the AMT and lowering the individual and corporate tax rates.

Conclusion

Each of the three (3) types of alternative tax systems discussed in this paper have salient features for policy makers to consider in attempting to raise revenues fairly, equitably, and without increasing costs or compliance burdens to taxpayers. Each system, however, would be a significant paradigm shift for lawmakers, government officials, and all taxpayers. As the 2010 Fiscal Commission and the Toder, Nunns, and Rosenberg reports cite, if lawmakers do not act soon to device solutions to the fiscal status of the United States, there will be severe consequences to all Americans and to the world. While the authors of this paper do not advocate adopting a specific tax system above, the different systems can assist in gleaning an understanding of alternative ways to tax a nation.

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