Cato Policy Analysis No. 272 April 15, 1997

Policy Analysis

Emancipating America from the Income Tax: How a National Sales Tax Would Work

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Executive Summary

This study demonstrates how the individual and corporate income tax, the capital gains tax, the estate and gift taxes, and non-trust-fund excise taxes all could be replaced with a national sales tax (NST). The NST would exempt low-income Americans from tax and raise the same amount of revenue currently collected. The ideal NST plan would include the following features:

- A 15 percent sales tax on the final purchase of goods and services at the retail level. The NST would be similar to state sales taxes. The rate should decline in future years to 10 to 12 percent as economic growth allows more revenue to be raised at a lower rate and government downsizing continues.
- A universal rebate for every household, exempting all consumption up to the poverty level. That would mean that the first $18,588 of consumption each year for a family of four would be tax-free. The rebate could be provided as a refundable credit against the payroll tax.
- Reimbursement to states and retailers of the cost of collecting the national sales tax.
- Abolition of the Internal Revenue Service. The states should bear the primary responsibility for administering the national sales tax. The IRS would be abolished, and a much smaller, less intrusive federal excise tax bureau would collect trust fund excise taxes such as the gasoline tax. The Social Security Administration would enforce and collect payroll taxes.

Introduction

Discussions about alternative tax reform initiatives center around three major proposals: the Armey-Shelby flat tax that would eliminate all tax deductions and lower the annual tax rate to 17 percent; the Domenici-Nunn USA (for unlimited savings allowance) tax, which combines a consumed-income tax and a business transfer tax; and the national sales tax (NST). In March 1996 the national sales tax picked up political momentum with the introduction of the first comprehensive NST legislation, H.R. 3039, sponsored by Reps. Dan Schaefer (R-Colo.) and Billy Tauzin (R-La.). [1] Sen. Richard Lugar (R-Ind.), a long-time advocate of replacing the federal income tax with a national sales tax, is likely to lead a parallel effort in the Senate.

Ways and Means Committee chairman Bill Archer (R-Tex.) remains committed to "pulling the income tax out by its roots" and replacing it with a consumption tax. [2] Although Archer has commended the authors of H.R. 3039 [3] and is widely viewed as sympathetic to a national sales tax, he remains officially uncommitted about which form of consumption tax his plan will include. What is clear is that the national sales tax has moved beyond the realm of theory and is now a formal policy proposal before Congress; and it is among the top three concrete proposals in the tax reform debate on Capitol Hill.

A national sales tax to replace the personal income tax, corporate income tax, and estate and gift tax would have a salutary impact on the U.S. economy, the national standard of living, the cost of compliance, and the degree of intrusiveness of the tax system in citizens' lives. [4]

This analysis details the framework for a well-formulated national sales tax alternative. It addresses such sticky issues as the proper sales tax base; provisions to shield low-income families from the tax; and the tax treatment of nonprofit organizations, housing, government services, and financial intermediation services. Some, but not all, of the ideas set forth here are contained in H.R. 3039.

A properly constructed NST plan would replace all of the revenue from the individual and corporate income tax, transfer taxes, and most non-trust-fund excise taxes with a single 15 percent flat-rate tax on the purchase of final goods and services at the retail level. Fifteen percent would be the tax-inclusive rate. In other words, an 85 cent item would require a 15 cent sales tax and cost a total of $1 including tax. Even making the unrealistically adverse assumption that a low-rate NST would have no significant impact on economic growth rates, compliance costs, federal spending on social programs, or federal borrowing costs, a 15 percent national sales tax would provide more than sufficient tax receipts for revenue neutrality while exempting expenditures below the poverty level from tax. The plan should allow for a rebate to all households on their purchases up to the poverty level--thus exempting low-income households from the tax and allowing all taxpayers to purchase the necessities of life tax-free. To protect against "cascading" effects--imposing multiple levels of taxation on the same product--the sales tax would exempt from tax inputs at each intermediate stage of production.

We have calculated the rate of sales tax required to abolish the employer and employee shares of the 15.3 percent Medicare and Social Security payroll tax in addition to the income tax. We find that the rate required in 1995 for that alternative tax plan would be 23 percent (tax inclusive). Unless otherwise indicated, the discussion that follows does not refer to a plan replacing the payroll tax.

This analysis addresses many common questions about the national sales tax: What will be the tax base? How will the tax be administered? How will the tax be enforced? It also highlights how the NST proposal disposes of several problems commonly associated with alternative taxing schemes and proposes remedies for some of the problems peculiar to the sales tax. For example: How does the tax treat used property or "old capital" that was purchased with after-income-tax income? How does the tax treat financial intermediation services? Government services? Not-for-profit organizations? Finally, our analysis discusses some of the equity issues that arise when a tax system based on income is replaced with one based on consumption.

Why a National Sales Tax?

The current U.S. income tax system suffers from a multitude of defects that are well recognized by those who have to comply with the tax code each year. A major objective of the NST plan is to fix those deficiencies. For example, an NST should promote higher rates of economic growth by dramatically reducing the tax bias against work, savings, and investment. The marginal tax rate on consumed income that workers and investors face would be much lower, and the return on savings and investment would not be taxed until spent. Moreover, an NST would reduce economically inefficient distortions in the pattern of investments that are now dictated largely by tax shelters, deductions, and special-interest loopholes.

Although the magnitude of the economic growth generated by a single flat-rate tax system generates lively debate among economists, the large marginal tax rate reductions in any NST plan--or an Armey-Forbes style flat-rate income tax plan--combined with neutral tax treatment of savings vs. consumption, will have powerful positive effects on the economy. Work by Harvard economist Dale Jorgenson shows a 13 percent initial increase in the gross domestic product and a 9 percent long-range increase. [5] Similarly, Boston University economist Laurence Kotlikoff predicts a 7 to 14 percent increase in national output within 20 years, about half of which occurs within 2 years. [6]

The economic growth predicted by macroeconomic models is primarily a function of greater productivity due to increased capital investment. Those models typically do not assume large labor market responsiveness. Nor do they usually account for the large capital inflow from abroad that a sales tax is likely to engender. They tend to attach little importance to microeconomic efficiencies that would be caused by eliminating tax preferences. And they do not account for productivity gains from massively reduced compliance costs or from higher rates of technological innovation. Thus, there is reason to believe that replacing the current system with a national sales tax may cause economic growth even more robust than that predicted by the Jorgenson or Kotlikoff models.

One of the immediate consequences of a national sales tax is that interest rates would fall. Rates would drop in the direction of the current tax-free interest rate as the tax wedge between the pre-tax and the after-tax rates of return was removed. [7] We do not know precisely how much interest rates would fall because demand for credit would rise as well, given the increased after-tax rate of return on capital investment under an NST approach. [8] But if the standard prediction of a 200 basis point decline in interest rates is correct, the result would be to reduce federal borrowing costs by as much as $75 billion annually. [9] Industries and individuals that are sensitive to interest rates--such as homeowners who might wish to refinance their houses--would also benefit.

International capital flows to the United States are also likely to increase under an NST regime. Although the portfolio interest exception [10] and numerous treaties have reduced or eliminated the withholding on passive income on foreign investment, the complete removal of all taxation of nonconsumed income would increase the attractiveness of the United States for foreign investors. Direct investment by foreign firms in U.S. plants would be much more attractive than under current law. [11] Expatriated U.S. investment dollars can also be expected to find their way home. In the 1980s, when top federal tax rates were reduced from 70 percent to 28 percent, the United States attracted a net inflow of roughly 500 billion dollars. [12] Given the proposed tax treatment and the political stability of the United States, the nation would become the ultimate global tax haven--to the benefit of U.S. industry, workers, and consumers. [13]

Another economic advantage of eliminating the income tax would likely be a windfall produced by liberating capital unproductively spent on the cost of complying with the current complex tax system. [14] Currently, businesses and individuals in the United States spend more than $150 billion to comply with the federal income tax system. [15] In 1995 alone, compliance costs averaged an estimated 20 to 50 percent of the total revenue raised by the tax system and 1.9 to 4.1 percent of the GDP. Those compliance costs have insidious effects on small firms and potential small firm start-ups, which disproportionately bear their burden. As noted in the Kemp Commission report, small corporations endure compliance costs 3.8 times the tax actually collected. [16] High compliance costs are a pronounced drag on our standard of living and the international competitiveness of all U.S.-based firms. According to the Tax Foundation, with an NST, compliance costs for businesses and workers would fall by more than 90 percent. [17] That is the equivalent of adding $1,000 to $2,500 to the income of every household in the United States.

Under the NST most Americans would be freed from the intrusive scrutiny of the IRS. More than 100 million Americans who are not business owners or self-employed would no longer have to file tax returns. The number of tax returns filed may fall as much as 80 percent. [18]

Although businesses would have to collect the NST, they would experience a dramatic decline in compliance costs. Business-to-business purchases would be exempt from tax. Vendors would simply need to keep on file copies of purchasers' exemption certificates. Retailers would be required to determine the sales that they made to consumers. Most stores have to do that under current state law. In any event, tracking consumer sales would be a much simpler task than complying with the complications and mountains of paperwork associated with the existing income tax system. Business compliance costs would decline with the elimination of

- the alternative minimum tax,
- multiple depreciation schedules,
- complex international tax provisions,
- complex pension and deferred compensation rules, and
- uniform capitalization rules.

The advantages of lower compliance costs and a more productive economy could be amplified if states conformed their own sales taxes to the federal NST. Currently, 45 states and the District of Columbia impose sales and use taxes. [19] To the extent that those states were to decide to conform (the choice would be theirs), retailers would no longer be required to cope with various exemptions and local rates. If jurisdictions that already collect a sales tax conformed their systems to the federal system, the marginal cost of complying with the federal sales tax system would be low, probably producing net savings to retailers compared to complying with multiple state systems (particularly if a credit of one-half of 1 percent for administrative costs is provided to retail firms, as in H.R. 3039).

That is not to say that all complexity would disappear under the NST. Complex issues still arise in the context of mixed-use property, financial intermediation services, financing leases, and other transactions. Moreover, many of the problems regarding the underground economy that are problematic under the income tax would remain, particularly those involving cash transactions made with the explicit intent of evading taxation.

Nonetheless, the problem of evasion would be manageable under an NST as the costs of compliance shrank and hostility to the tax system declined. Because of lower marginal tax rates, the benefit from lawful tax avoidance or illegal tax evasion will be less at the margin relative to either the present system [20] or competing alternative tax systems such as the USA tax [21] proposed by Senators Domenici and Nunn, which all have higher marginal tax rates. [22] Research has confirmed the intuitively obvious relationship between higher tax rates and higher rates of evasion. [23] Lower rates, all other things being equal, imply lower evasion because the benefit from evasion declines while the costs of evasion remain comparable. [24]

A national sales tax would place the responsibility for tax collection on the retail sector, a sector of the economy in which small businesses are strongly represented. Small businesses are viewed as more likely to evade taxes since the owners, who would benefit from tax evasion, are more likely to also be responsible for keeping the books and filing the tax returns. There is, of course, some truth to this proposition. A number of factors, however, would mitigate the problem. First, those small business owners who are inclined to evade the sales taxes are probably already evading the income tax and would be inclined to do so under any tax system. Second, the economic importance of small firms in the retail sector is usually grossly overstated. According to Congress's Joint Committee on Taxation, small firms account for only 14.9 percent of gross receipts by all retailers, wholesalers, and service providers. [25] Sole proprietorships, perhaps the most likely to evade tax under the present system and under a sales tax, are not included in the committee's figures.

Because the tax collection points would be concentrated at retail establishments rather than individuals or other businesses, it would be easier for revenue agents to concentrate their enforcement efforts. The collection points in an NST system would be perhaps 20 percent of those under the current income tax system or other alternative tax systems. [26] Because the number of collection points is so much lower, if enforcement funding is held equal, then the likelihood of the tax evader's being discovered is correspondingly higher. In other words, the risk of detection would increase and the risk-adjusted cost of evasion would increase. Increased evasion among retailers would, in our judgment, be outweighed by a rise in business compliance resulting from greater simplicity and the perceived greater legitimacy of the tax system, reduced temptation due to lower marginal tax rates, [27] and higher risk of detection due to a smaller collection population. Even if evasion rates were higher under a sales tax, however, they would have to be much higher to justify, even from the narrow view of government revenue, the huge compliance costs that are largely deductible as a business expense. If compliance proved to be a problem, information reporting along the lines of today's Form 1099 could be implemented to facilitate cross-checking by government auditors. Such reporting would reflect the quantity of product sold to retailers. An auditor could then ensure that the retailer's books either reflected the sale of those products or that the products were in inventory.

Among all tax proposals--and particularly in comparison with the current tax system--the NST would be the tax most clearly visible to the consumer. Any NST plan should require vendors to separately state and charge the tax imposed. In that way, the consumer will see the full cost of government every time taxable property or services are purchased. Under the sales tax, hidden taxes would be eliminated.

Calculating the Tax Base

Perhaps the most difficult issue with respect to the national sales tax is deciding what tax rate to impose. To establish the proper rate, we need to first define the proper tax base. What is to be taxed? An ideal NST should have a wide tax base with few, if any, exemptions. Exempting certain goods and services--such as food and medicine--is problematic for two reasons: First, the more exemptions that are carved out, the higher the rate will be on everything else. Second, exemptions inject distortions into the tax system and eliminate the neutral tax treatment of goods and industries.

Thus, the NST should be imposed on gross payments for the use, consumption, or enjoyment in the United States of any taxable property or service. Taxable property and services include any tangible property (including rents and leaseholds on tangible property) and services. Securities, contract rights, copyrights, patents, and the like are not taxable. Housing, financial intermediation services, government goods and services that are sold to the public--such as bus rides, postage stamps, and publications of the Government Printing Office--gaming services, and the unrelated business activities of not-for-profit organizations are also included in the tax base. Property (or services) produced or rendered outside of the United States (imports) would be taxed at the point of sale. Thus, virtually any consumer good (ranging from food to video games to cars) would be taxed. Apartment and house rents and home purchases also would be subject to tax. Goods purchased abroad by consumers would be taxed upon entry into the United States. [28] Services to individuals and households (including, for example, services provided by barbers, plumbers, therapists, accountants, lawyers, doctors, and the like) would also be taxed.

The sales tax base is not exactly equivalent to personal consumption expenditures as defined in the national income product accounts. Adjustments, both enlarging and reducing the tax base, must be made, as shown in Table 1. [29] Using 1995 as the base year, the total sales tax base was $5,978 billion. This includes all final-use goods and services including government expenditures except education.

How would an NST plan prevent tax cascading? Cascading refers to the repeated taxation of the same items as they are sold and resold at successive stages of production and trade. Cascading is a deficiency of many state sales taxes. [30] Under an NST, exemptions should be provided for purchases for resale, purchases to produce taxable property or services, and exports. A good or service should be defined as "purchased for resale" if it is purchased by a person in an active trade or business for the purpose of reselling it in the ordinary course of trade or business. The term "purchased to produce taxable property or services" is a general exemption meant to exempt business inputs generally. The exemption is available if the property or service is purchased for use in the production or sale of other taxable property or services. Education and training services are treated as investment expenditures rather than consumption and thus would not be taxed. Wages paid by an employer engaged in an active trade or business are not treated as taxable services. By contrast, wages paid by a household to an accountant, a maid, or a gardener would be taxable since they are providing a final-use service.

Table 1
Tax Base for National Sales Tax (billions of dollars)

Description of Taxable Item	Tax Base (1995)
Personal consumption expenditures	$4,924.9
Purchases of new homes	156.4
Improvements to single-family homes	73.9
Imputed rent on housing	-534.3
Additional financial intermediation services	53.0
Foreign travel by U.S. residents (one-half)	-26.4
Expenditures abroad by U.S. residents	-2.7
Food produced and consumed on farms	-0.4
State and local government consumption	682.6
State and local government gross purchases	159.1
Federal government consumption	453.8
Federal government gross purchases	62.7
Less: Education expenditures	-97.5
Plus: Expenditures in U.S. by nonresidents	73.1
NST Base	$5,978.2
Source: National Income Product Accounts, Survey of Current Business, August 1996.	

The NST plan must avoid cascading to ensure the same effective tax rate across all types of property and services (horizontal equality), irrespective of the number of companies or stages of production that were necessary to bring the good or service to market (vertical equality).

With a cascading tax, the effective rate increases, depending on the number of times a good changes hands before it is purchased by a consumer. There is thus a major incentive for vertical integration and for firms to perform as many functions in-house as possible, reducing economic efficiency and distorting the marketplace (largely to the detriment of small firms that do not have the capital or other resources necessary to source everything in-house). The number of firms involved in getting a product to the consumer should be thoroughly irrelevant to how heavily the good is taxed. [31]

A sales tax is not a value-added tax (VAT). A value-added tax is levied at each stage of production on the value added by the firm. [32] Value added is typically defined as gross receipts from sales less purchases from other businesses. In Europe, VATs are levied by imposing a tax on sales, whether to consumers or businesses. Businesses are then allowed to add up the taxes paid on their inputs and receive a credit for taxes paid against tax due.

Calculating the Tax Rate

In the previous section we defined the total consumption tax base for the national sales tax in calendar year 1995 as $5,978 billion. Now we ask, What rate of sales tax would need to be imposed to collect the same amount of revenue that was gathered from the income tax? Table 2 shows the total amount of federal revenues collected from taxes that would be replaced with the national sales tax. In fiscal year 1995 those revenues amounted to $803 billion ($1,293 billion if payroll taxes are also included).

Table 2
Tax Revenues to Be Replaced by National Sales Tax, 1995 (billions of dollars)

Income tax	$759.9
Estate and gift taxes	15.1
Excise taxes (estimated)	28.0
Subtotal	803.0
Payroll taxes	490.3
Total	$1,293.3
Source: Federal Receipts, Analytical Perspectives, FY 1997 Budget of the United States Government. Calendar year basis.	

Putting together the information in Tables 1 and 2, we discover that an NST with no rebate could collect the same amount of revenue ($803 billion) as the current income tax regime with a tax inclusive rate of 11.8 percent, as shown in Table 3. This tax inclusive rate with a rebate to fully protect the poor from the tax (as discussed below) would bring the rate to 14.2 percent. Throughout this study we use a rate of 15 percent, which would offset any losses from tax avoidance beyond the amount that occurs with the current income tax.

Table 3
Calculation of National Sales Tax Rate

	Tax Base (billions)	Revenues to Be Collected (billions)	Tax Rate (tax exclusive)	Tax Rate (tax inclusive)
No rebate,				
excluding payroll taxes	$5,978.2	$ 803.0	13.4%	11.8%
With rebate,				
excluding payroll taxes	4,841.1	803.0	16.6	14.2
No rebate,				
including payroll taxes	5,978.2	1,293.2	21.6	17.8
With rebate,				
including payroll taxes	4,841.1	1,293.2	26.7	21.1
Source: National Income Product Accounts, Survey of Current Business, August 1996; Federal Receipts, Analytical Perspectives, FY 1997 Budget of the United States Government.				

It is important to distinguish between tax-inclusive and tax-exclusive rates. The income tax and the flat tax are imposed on a tax-inclusive basis while traditional sales taxes are imposed on a tax-exclusive basis. Let us take as an example someone who earns $100, pays $20 in taxes (whether an income tax, a flat tax, or a sales tax), and spends the remaining $80 on a CD player. Is the tax rate 20 percent or 25 percent? The income tax and the flat tax would be imposed on the $100 and thus the rate is 20 percent (i.e., 20/100 = 20%). The flat tax and income tax base are tax inclusive. Traditional state sales taxes are imposed on the after-tax or tax-exclusive base. Thus, we typically would say that the sales tax rate needed to raise $20 is 25 percent (i.e., 20/80 = 25%). In each case the government is extracting the same resources from the economy. Thus, to compare apples to apples, the sales tax rate that is comparable to the income tax rate or the flat tax rate is the tax-inclusive rate. [33] The 15 percent rate proposed in this analysis is the tax-inclusive rate.

That 15 percent tax rate is about half the rate that opponents of the NST claim would be required to raise as much revenue as do the current income tax and the payroll tax. Bruce Bartlett of the National Center for Policy Analysis has argued, for example, that the NST rate would need to be as high as 32 percent. [34] Bartlett's analysis is misleading because he compares apples to oranges. He compares a flat tax rate necessary to replace the current income tax structure with a national sales tax rate that would be required if *every* federal tax were replaced (including payroll taxes, all excise taxes, estate and gift taxes, and corporate and individual income taxes). He then proceeds to assume that many exemptions would arise under a sales tax but none would arise with a flat tax. Finally, he compares a tax-*inclusive* flat tax or income tax rate to a tax-*exclusive* sales tax rate, which has a particularly dramatic impact on the stated rate since he requires the sales tax to replace all federal taxes.

A Note on the Sales Tax and Government Output

Under the sales tax system outlined in this study, government output would not be exempted from the sales tax. Hence, government output is included in the tax base. Since this is an issue of some controversy, the following is a brief explanation of the logic for this tax treatment. [35]

Our goal is to create a sales tax system where the government can provide the same amount of output at the same real cost as it does under the current income tax structure. We want to ensure that the relative prices of a government service versus a privately provided service are unaltered after the tax shift. In sum, the government should be held harmless by the switch to the national sales tax.

The Gross Domestic Product includes both government value added and private value added. Government value added is included at "cost," which is approximately equal to the wages paid to its employees. Under the income tax, output is taxed whether the source is government or the private sector. The government pays its employees a gross amount and then deducts the income tax from their paychecks. In other words, by imposing an income tax on the wages and salaries of government workers, Uncle Sam essentially collects a tax from itself. It could, of course, just pay them a lower tax-free wage, but we choose not to do that and have higher spending (from paying pre-tax wages) and higher tax revenue (from the income tax on wages paid by the government). If government did not impose a tax on the wages of government workers, then we would not want to do so under the sales tax regime, or else those workers would be adversely affected.

Subtraction method value added taxes or VATs (sometimes referred to as "business transfer taxes" or BTTs) do not typically tax government value added. By contrast, the Hall-Rabushka flat tax introduced by Rep. Armey (R-Tex.) and Sen. Shelby (R-Ala.)

does tax the income of government workers. [36] Unlike a normal subtraction method VAT, the flat tax allows a deduction for wages and then taxes wages at the individual level. Its tax base is consequently larger than a normal BTT.

Similarly, under a sales tax system, if government payrolls were not taxed, the tax base would be smaller than it is under the current income tax and under the proposed flat tax. The rate of tax on all other goods and services would thus have to be higher than under the flat tax because of that difference in the tax base.

One way of examining this issue further is to simply take the National Income Product Accounts and start calculating the tax base under the various tax systems. If one goes through that exercise to demonstrate the oft-repeated equivalence of the various consumption tax plans, it becomes clear that the flat tax has a broader base than a sales tax that does not tax government output because the flat tax taxes government wages. Similarly, a pure income tax is broader not only by the amount of unconsumed capital income but also by the amount of government wages. [37]

In the context of a sales tax, then, a payroll tax on government wages simply achieves parity with the income tax and the flat tax. Failure to impose this tax would exempt government value added from tax for the first time and constitute a dramatic incentive to consume through the medium of government. [38] In other words, failure to tax government output would alter relative prices in favor of government output. A sales tax should also be imposed on government purchases from the private sector. [39]

Protecting the Poor from the Tax

A common assumption about the NST is that it is naturally regressive, since lower income individuals spend a greater percentage of their income in any given year on consumption of necessities. Because a sales tax is an altogether different paradigm of taxation, any judgment on the equity of the tax must be accompanied by a different analysis of regressivity.

To examine how a national sales tax could address such concerns, a number of issues should be broached. First and foremost, taxing *income* at a graduated rate is not the only means of making a tax system progressive. Moreover, a tax on income, no matter how steeply graduated, does not necessarily make an income tax progressive. Even if progressivity is measured by the common standard of "ability to pay," the income tax is imposed only on productive labor and the return to capital and not on wealth. An income tax does not tax consumption of older accumulated capital, whereas a sales tax does.

Equally important, using taxable income as the basis to determine progressivity is necessarily based on a year-to-year analysis where the ability to pay is measured as a function of income per unit of time. Consumption over the life of a taxpayer is in many respects a better measurement of the ability to pay taxes. Because people's incomes fluctuate throughout their lives, the lifetime application of a sales tax is much less regressive than it would appear to be when examining a cross-section of taxpayers in any given year. [40] Since all income is earned for the purpose of eventual consumption, under a national sales tax, the taxpayer can defer taxation by saving his income. But he cannot forever avoid the tax.

In any case, an NST plan can be made progressive through a rebate mechanism that would shelter low-income people from paying the tax. One manner in which the NST could be made less regressive would be to exempt certain necessities--such as food and clothing--from the tax. That approach would exempt, however, the most expensive food (lobster and caviar) and the most expensive clothing ($1,000 designer suits). It is a very inefficient means of providing tax relief to lower and middle income Americans and would necessitate a much higher overall rate. [41] A more neutral and less distortive approach is to simply provide each family a level of consumption free of tax by providing a rebate of the tax on expenditures up to the poverty level. That is the device we recommend and the approach chosen by Representatives Schaefer and Tauzin in H.R. 3039. [42]

The rebate could work as follows: A family consumption refund would be established for each household at an amount equal to the sales tax rate times the poverty level. The poverty level is defined by the Department of Health and Human Services guidelines and should be raised by the sales tax rate. [43] For a family of four, the HHS poverty level for 1996 is $15,800, so the sales tax poverty level would be $18,588. The annualized rebate, which would be refundable for households with earnings below the poverty level, would therefore be $2,788. Assuming the head of household was paid 26 times per year, the rebate amount included in each paycheck would be $107**.**23. Earnings would be reported to the Social Security Administration. Employers would pay less payroll tax, and the Treasury would reimburse the SSA for the rebate amounts provided to families in order to ensure that the balance in the trust funds was unchanged. [44] Only the source of the payments to the trust funds would change. [45]

Families with no annual wages and salaries would apply directly to the Social Security Administration for a rebate check. Table 4 indicates the applicable poverty thresholds and maximum rebates for 1996 assuming a 15 percent national sales tax rate. [46]

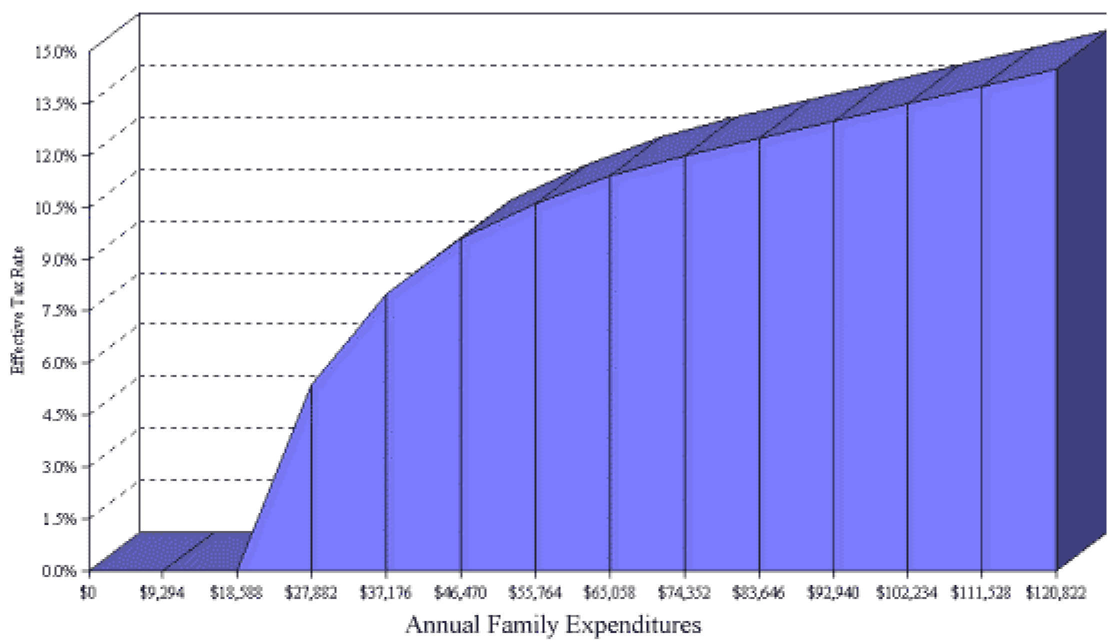
All workers would receive a rebate up to the maximum rebate amount shown in the table. Thus, the average tax rate for a family of four earning and spending $37,176 would be 7.5 percent. The average tax rate for a family of four earning and spending $74,352 would be 11.25 percent. Figure 1 illustrates how the average tax rate increases with spending. This assumes that the sales tax falls on the consumer. The view that it falls on the factors of production is commonly, though by no means universally, held by economists.

The family consumption allowance approach has several effects. First, it makes the sales tax applicable only to consumption beyond the necessities of life. Second, it makes the tax in effect progressive, not only because it is based on consumption, a better index of true ability to pay, but because--if one wants to continue to view progressivity through an income tax lens--it entirely exempts lower income workers. Third, unlike most state taxes, it does not undertake the complex and politicized task of determining what to tax and what to exempt, thereby minimizing administrative and compliance questions and economic distortions.

Table 4
Poverty Thresholds and Maximum Rebates

Family Size	Applicable	Maximum
Poverty Level	Rebate	
One	$ 9,106	$1,366
Two	12,188	1,828
Three	15,271	2,291
Four	18,588	2,788
Five	21,435	3,215

Figure 1
15 Percent National Sales Tax: Effective Tax Rate with Poverty Exemption for Family of Four



Source: Authors' calculations.

The rebate is universal, meaning that every household regardless of income would receive relief from the tax up to the poverty level. Because the poverty level is adjusted for family size, families with children would receive a larger rebate than childless households. Notice in Table 4, for example, that the rebate for a couple with three children (a household size of 5) would be almost twice as large as the rebate for a couple with no kids (a household size of 2). This ensures that the NST plan does not impose an unfair tax burden on families with children--which tend to have higher consumption demands.

We believe that such a rebate mechanism is sensible on both political and equity grounds. Table 5 shows that a refundable rebate would cost the Treasury $205 billion a year. The revenue-neutral tax inclusive tax rate would rise to 14.2 percent.

Table 5
Estimates of Rebate Cost (1996 poverty level)

Number in Household	Households (thousands)	1996 Sales Tax Poverty Level	Rebate Cost* $ billions
One	23,611	$9,106	$32
Two	31,211	12,188	57
Three	16,898	15,271	39
Four	15,073	18,588	42
Five	6,749	21,435	22
Six	2,186	24,262	8
Seven	1,379	27,089	6
Total	97,107	not applicable	$205
Reduction for lack of refundability			10
Total rebate			$195
* Calculated by multiplying the number of households by the maximum rebate amount, as shown in Table 4.			

Payroll Taxes

One way of providing extra relief to lower income working families is to abolish the payroll tax for Social Security and Medicare as well as the income tax and then to raise the NST rate accordingly. The Social Security payroll tax is regressive (if viewed without reference to the benefits structure) because it is imposed on the first dollar earned and is capped--at $62,700 of income in 1996. The Medicare portion of the tax is imposed on all wages and is not subject to a cap. Eliminating the payroll tax would shift the tax burden onto more affluent taxpayers.

If the payroll tax were also replaced with the NST, the new tax-inclusive rate would rise to 21 percent in 1995 and the tax-exclusive rate to 27 percent. The figures are shown in Table 3.

Administration of the National Sales Tax

Ideally, states, both because they have the most experience administering sales taxes and because of the principles of federalism, should be the primary administrators of the federal sales tax system. [47] The federal government would act only as the administrator of last resort and in most cases would only monitor the collection activities of the states. The states would be provided with three strong inducements to function as administrators:

- States would be provided with a percentage of the revenues collected and remitted to the federal government to compensate them for administration costs. H.R. 3039 provides a 1 percent fee. That would ensure that the NST plan does not impose an unfunded mandate on the states. Since the marginal cost to a state of collecting the federal tax in addition to its own sales tax (for which it already incurs costs) would be quite small, the 1 percent fee (on total revenue collected) should constitute a strong incentive to become a conforming and administering state.
- The information sharing, allocation, and destination rules that should be part of such a plan would, for the first time, provide the states with a practical means of taxing mail order and other sales of goods shipped into their jurisdictions from out-of-state vendors--but only if they became conforming and administering states. A conforming state is a state that has conformed its state sales tax to the broad federal sales tax base. An administering state is a state that chooses to administer the federal sales tax for the federal government. In the event that a state does not conform or administer the tax, the federal government would function as the tax administrator.
- The broader federal tax base would enable states to increase the breadth of their own tax bases (and, presumably, lower the state sales tax rate).

What about the five states that currently have no sales tax? An NST would not force them to adopt a state sales tax if they chose not to do so. The federal government would directly administer the national sales tax in those states. Perhaps the federal government would choose to contract with the state to collect the federal tax even in the absence of a state sales tax, although the federal government may have reservations about allowing a state without sales tax experience to do so. Alternatively, the non-sales-tax states could choose to allow another state under contract to administer the federal sales tax collections in their jurisdictions. [48]

States would be permitted to retain their state income tax systems if they chose to--though without a federal income tax system in place, those systems would be much more difficult to administer and enforce. We believe that states would have a strong incentive to eliminate their own income taxes and to piggyback on the federal sales tax system, much as many states piggyback on the federal income tax system today. In most states that would create a combined federal-state sales tax (tax inclusive) of 20 to 25 percent.

Vendors Would Collect and Remit Taxes to the States

The responsibility to collect and remit taxes would fall upon the vendor--in most cases the retail business. Taxes would be paid monthly. Businesses collecting and remitting taxes or purchasing goods exempt from tax would be required to keep records for a period of three years after filing a report or asserting an exemption. Those records would allow audits of businesses, including, when appropriate, cross-firm audits such as occur in connection with existing state sales taxes. The state administrator would have subpoena power, the power to audit, the power to levy, and the authority to issue tax exemption certificates. [49]

To ensure maximum visibility, the NST should require that the sales tax be separately stated and charged on each receipt of final sale. Specifically, each receipt should be required to show the price of the property or service exclusive of taxes, the tax paid, the tax rate, the price of the property or service including tax paid, the name of the vendor, the registration number of the vendor, and the date of sale. De minimis rules should be established to exempt gross payments received in connection with casual or isolated sales by persons not engaged in an active trade or business.

Reimbursing Businesses for Collecting the Tax

Any NST plan must spread the hidden costs of compliance equitably among all taxpayers. Unlike the current income tax system--which is the largest of all the unfunded mandates imposed on employers--a sales tax regime should include payment to firms for their compliance burden. An administration credit should be provided to retailers equal to at least the one-half of 1 percent of the revenue collected and remitted that H.R. 3039 provides. In 1995 that credit would have provided a return of nearly $4 billion to the retailing community. [50] H.R. 3039 would also provide a compliance equipment cost credit equal to 50 percent of the cost that vendors incurred if they needed to purchase new equipment to comply with the receipt requirements. That credit would considerably ease the costs of transition by retailers with less capable point-of-sale systems.

Abolition of the IRS

The Internal Revenue Service should be disbanded as quickly as possible after the establishment of the NST and certainly within three years. Some transition period is, of course, required so that the IRS can administer the income tax (collect deficiencies, conduct audits, provide refunds) for the years prior to its abolition. Out-year appropriations for the IRS should decline and then be suspended as part of the enacting legislation. All IRS tax records should be destroyed within five years of the new law's enactment. A new excise tax bureau would be established within the Treasury

Department to collect remaining excise taxes. The Social Security Administration would collect Social Security and Medicare payroll taxes.

Taxpayer Rights

Under the current income tax system, taxpayer rights have been gradually eroded. Only recently has much attention been paid to taxpayer rights issues by participants in the tax reform debate. Under the NST, enhanced taxpayer rights provisions would be imperative. Most important, the burden of persuasion should rest with the government, but the burden of production of documents and records should remain with the taxpayer. Each state administrator should be required to establish a problem resolution office with authority to enjoin collection activity. Such administrative injunction could be lifted only by the highest officer in that tax authority. Taxpayers should be entitled to reimbursement for professional fees incurred in disputes unless the government's position was substantially justified. The NST plan should establish a series of penalties for noncompliance, including failure to register, failure to pay, and failure to file.

Destination and Allocation Rules

In the current international tax system, two primary questions must always be raised. First, which nation-state has the primary taxing jurisdiction? Second, if the United States can exercise jurisdiction to tax, what is the source of the income, foreign or U.S.? Both the income sourcing and expense allocation rules and the rules of juridical taxation in the international context can be quite complex, as international tax practitioners recognize. Those issues can hinge upon questions of residency; where property is located, sold, or used; where services are performed; even where the property used to produce the goods is located. In the case of interest or research and development expenses, the tax rules can be determined by specific formulas.

The sales tax rules proposed in this study are far simpler. Allocation of taxable property and services (and therefore revenue) among the various states is based on the destination of the taxable property or service. [51] As the tax applies only to consumption, questions of how to source business-to-business transactions are irrelevant, as are determinations for the allocation of interest, research and development, and other expenses.

While the taxpayer may remain relatively indifferent about which state imposes the federal tax (except to the extent that state tax rates differ), the outcome of jurisdictional questions will determine which state gets the revenue at issue. Consequently, the federal government may need to arbitrate disputes that arise among the states.

Some Commonly Raised Problems

Shifting from an income tax base to a national sales tax raises many problems related both to the transition from one system to another and to the correct tax treatment of various types of income and consumption. This section provides an explanation of how those problem areas are best addressed under an NST.

Investment Income

Interest, dividends, capital gains, and other investment income should not be taxable until the income is used to purchase taxable property, goods, or services.

Used Property

The NST should provide a credit for tax previously paid on used property that is subsequently resold. The basic idea is that the government should tax an item only once and that the sales tax should not cascade every time the same property is subsequently sold (as is the case under many state statutes). A set of transition rules must be established to ensure that property purchased with after-income-tax dollars is not then also subjected to a sales tax.

Under H.R. 3039, the rules would operate differently with respect to depreciating and appreciating used property. Let us take two examples to illustrate the application of the rules. In the first example, after enactment of the sales tax law, Consumer A purchases an automobile from a car dealer, paying a total of $23,529 of which $3,529 is tax (Table 6). Later, Consumer A sells the car at a lower price to Consumer B for a total price of $5,882 of which $882 is tax. Consumer A would be entitled to a refund of $882.

In this example of a depreciating asset, the seller would be entitled to a credit of $882, which equals the amount of tax the buyer would pay. That may be thought of as the buyer of the new car paying tax only on the portion of the value of the car he "used up" and the subsequent buyer paying tax on his share of the value of the car.

In our second example (Table 7), the asset owned by Consumer A and sold to Consumer B appreciates in value.

Here, the seller would be entitled to a credit of $882 (the tax he has already paid on the item). As the seller, he is responsible for collecting from the buyer and remitting the tax liability on the sale of $3,529. [52] The seller would have to remit $2,647 to the tax authority, which is the difference between the tax collected from the subsequent purchaser on resale ($3,529) and the tax paid on the original purchase ($882). In this way, the full value of the collectible is taxed but the tax does not cascade. The tax liability never exceeds the tax rate times the current value of the item. On both the appreciating and depreciating property, the government would receive the full tax ($3,529) on the value of a $20,000 item, but the credit mechanism prevents cascading and allocates tax liability fairly among owners of used property.

Table 6
Taxing a Depreciating Asset

Automobile	New Purchase	Subsequent Sale
Total price	$23,529	$5,882
Tax	3,529	882
Net of tax price	20,000	5,000
Credit due seller	0	882

Table 7
Taxing an Appreciating Asset

Collectible	New Purchase	Subsequent Sale
Total price	$5,882	$23,529
Tax	882	3,529
Net of tax price	5,000	20,000
Credit due seller	0	882

Homes

The NST should be applied to housing as it is to any consumer item. The general used property credit rules described above apply to primary residences. However, in the case of a primary residence, special rules may be established that allow the purchaser of a primary residence to elect to pay the tax over 30 years with interest. In the event this choice is made, the responsibility for remitting the tax rests with the buyer. If the primary residence is subsequently sold, then the entire tax is due (but any used property credit due would be allowed as well).

Let us take the example of a couple buying their first home. Assume they purchase the home for $100,000 plus sales tax of $17,647 for a total price of $117,647. They may borrow from their bank to pay this amount or they may elect to pay the tax over 30 years. The tax would then be $588.24 per year or $49 per month. Under H.R. 3039, interest would be charged on the tax balance unpaid. Interest charges on this tax would be a little over $100 per month, declining to about $50 per month in the 15th year. The couple would be billed this amount by the tax-collecting authority. [53]

An existing homeowner would be entitled to a credit against his next house on any sales tax actually paid. In addition, existing homeowners would receive a credit equal to the sales tax rate times equity payments (both downpayments plus mortgage principal payments) made under the income tax. A homeowner who purchased a house for $100,000 before enactment of the sales tax, made a $15,000 downpayment, and has made

$10,000 in principal payments before enactment of the sales tax would, when he sold the home, be entitled to a credit of $3,750 ($25,000 times 15 percent) toward any tax due on the purchase of his next home. If he did not purchase a subsequent home, he would be refunded the $3,750.

Homeowners are, in effect, paying a tax on their equity or principal payments toward a house at a 15 percent rate. Homeowners today must make their principal payments from after-income-tax dollars at rates typically in excess of 15 percent. Thus, under a sales tax most homeowners will fare better. Moreover, interest rates should drop considerably and most homeowners will be able to refinance their mort-gages at lower interest rates. The monthly housing payments for most homeowners, even new homeowners, will decline.

Let us examine the case of a homeowner who sells a home and purchases a more expensive home. Assume he sold a home for $117,647 (of which $17,647 is tax). The seller would then be entitled to a credit of $17,647. If he then purchased another home for $176,471 (of which $26,471 would be tax), he would owe a net tax of $8,824 (the $26,471 of tax less the $17,647 credit from the sale of the previous home). Moreover, under the special rule for primary residences, the $8,824 could, at the taxpayer's election, be paid over 30 years (i.e., $294 per year or $25 per month plus interest). If, however, he had purchased a less expensive home and saved the difference, he would be entitled to a net refund. Of course, if he later took the savings and then spent it on, say, a new car, he would pay tax at that time on the car.

Financial Intermediation Services

The taxation of financial intermediation services poses a difficult problem for all consumption tax proposals. Interest rates may be viewed as having three components. One, the normal (risk-free) return on capital. Two, the premium paid for the risk that the capital will not be repaid. And three, the payment for financial intermediation services--the servicing of the loan or deposit. What we want to tax is the last component: the financial intermediation services. That is not simple. Although some financial intermediation services are separately charged, in practice they are usually incorporated into the interest paid. Similarly, insurance premiums have a financial intermediation services component. Under the NST, financial intermediation services (FIS) purchased by consumers are taxable services, while FIS purchased by businesses are exempt as business inputs.

The issue can be resolved by defining FIS to include both explicit and implicit services. Explicit financial intermediation services include brokerage, banking, safe deposit boxes, trustees' and mutual fund management, and exit fees, as well as sales loads and insurance premiums to the extent that the premium is not allocatable to the underlying investment account. [54] If the services are explicit, they are taxable.

The NST undertakes to define implicit FIS in order to tax the intermediation fees imbedded in interest rates. The implicit fee is the difference between the applicable interest rate and the interest rate provided or charged times the debt balance. In the case of deposits, it is measured as the excess of the applicable rate over the rate provided. In the case of borrowers, it is measured as the excess of the rate charged over the applicable rate. The applicable rate is defined in H.R. 3039 as 2 percent plus the rate that the federal government pays when it issues securities of like term and like issuance date to the transaction for which an amount is being imputed. The 2 percent rate is designed to be an arbitrary risk premium. This figure should be empirically determined. [55] The rate could be periodically adjusted. An alternative method would be to dispense with an arbitrary risk rate and provide investors with a credit for bad debt expense.

Government Services and Purchases

The question of the proper tax treatment of government services--such as municipal garbage collection, utilities, visits to national parks, and rides on Amtrak--presents special problems. [56] To the fullest extent possible, a national sales tax should provide parity between government services and private services. Excluding commercial activities of the government from the tax base would provide a tax advantage when government is competing with private providers of services. Hence, when the government sells a good or service, such as public transit or publications, the sales tax should be imposed on the sale price. [57]

The complication is that most government goods and services are not sold in the marketplace. They are often given away and in many cases no market price exists for the services in question. Moreover, the recipients or beneficiaries of the services are unclear or unknown. For example, how would we allocate the benefits conferred on the public by national defense, the State Department, the Environmental Protection Agency, National Public Radio, or the White House?

Taxing this part of the economy is not as administratively simple under a sales tax as it is under an income tax. Government services are taxed by both the current graduated income tax and the flat tax--through the income tax imposed on government workers' wages and salaries (i.e., most of government value added). One conceivable way to tax government fully and equally under the NST system would be to impose a separate excise tax on government wages. That is the approach we have adopted in this study. [58]

Not-for-Profit Organizations

The tax system should not discourage provision of goods or services that serve a public need or good that cannot be provided by the for-profit sector and that can more effectively be provided by charities or other not-for-profit organizations than by government. Likewise, the system ought to encourage volunteerism and contributions to charitable purposes. On the other hand, not-for-profits' commercial activities should not be allowed an unfair competitive advantage vis-à-vis the business activities of the for-profit sector.

Under an NST, as with current law, a balance must be struck between permitting some commercial activity and preventing such activity from competing against the for-profit sector. Not-for-profit organizations that roughly correspond to present law 501(c)(3)-(6) and 501(c)(8) organizations should be accorded special treatment under the NST by exempting them from tax on dues, contributions, and payments to qualified not-for-profit organizations. [59] In other words, a contribution to a church, synagogue, university, or food bank should not be treated as the purchase of taxable religious, educational, or charitable services. But if a qualified not-for-profit organization provides property or personal services in exchange for dues or contributions, the fair market value of the property or personal services provided should be taxable to prevent non-profits from having an unfair advantage by being able to sell goods or services in exchange for contributions on a tax-free basis. Girl Scout cookies, for example, would be taxed when purchased. [60] Such a provision would generally replicate current law treatment, which denies a deduction for contributions to the extent of the fair market value of goods or services received in return. [61]

Mixed-Use Property

Mixed-use property, or property serving both business and personal consumption needs, presents problems in virtually all tax systems. Purchases of property and services may give rise to taxation or exemption depending on the use to which the property is put. The essential question is whether the property is used essentially for consumption or for production.

One way to resolve the issue, as proposed under H.R. 3039, is to require that, in order for mixed-use property to be exempt, it must be used more than 95 percent for exempt purposes. Otherwise, the person purchasing the property (or service) is entitled to a business conversion credit equal to the product of the tax rate, the business use ratio, and the mixed-use property amount. [62] Special rules should be established to tax property converted from business to personal use, and conversely, to provide a credit for property converted from personal to business use.

The NST and International Trade

A national sales tax would be border adjusted--so that exports would not be taxed but imports would be. Imported goods would be taxed when sold in the United States or when brought into the country by a consumer. Exports would not be subject to tax since they are not sold at retail in the United States. A national sales tax would comply with the General Agreement on Tariffs and Trade. Under GATT, an indirect tax may be border adjusted while a direct tax may not. Since a sales tax is indisputably an indirect tax--because it is a tax on a good or service, not a tax on a person--this border adjustment feature would pose no difficulty. Foreign VATs are typically border adjusted. U.S. income taxes are not.

Many take the position that border adjustment gives foreign firms a large advantage since their goods do not include the VAT in their price while U.S. firms must include income taxes in their price. Most business leaders would agree. Professional economists are divided. The majority opinion is that foreign exchange rates change in response to border tax adjustment and no competitive advantage is afforded to U.S. exporters. [63] Others argue that, in the short term, exporters (i.e., the traded goods sector) will gain an advantage that will evaporate over time. [64] None seem to argue that border tax adjustment will have an adverse impact on the United States.

Transitional Considerations

Questions about the best way to convert from our current income tax to a national sales tax are of great consequence. How to structure appropriate transition rules so that changing the tax system does not unfairly burden some taxpayers nor provide a windfall for others is a difficult question. We need to ensure that neither new nor old investments receive competitive advantage as a result of tax changes. Issues of equity, economic impact, revenue loss or gain, and ease of administration must be balanced.

Possible criteria for determining whether transition relief is appropriate might include the following:

- Is a taxpayer's tax liability comparable to what it would have been under the law when an investment was made?
- Is a taxpayer's after-tax rate of return comparable to what it would have been under the law when an investment was made?

To address those concerns, any NST must provide certain transition rules, some of which have already been mentioned in the context of the structure of H.R. 3039. [65] Owners of existing property such as homes and automobiles are deemed to have previously paid sales tax to the extent of their equity in the property for purposes of the used property credit rules. That means that a homeowner would receive a tax credit toward his or her next purchase in an amount equal to the deemed paid credit. Thus, to the extent the taxpayer had made equity payments out of after-income-tax dollars, he or she would not incur additional sales tax liability.

Also, self-employed persons, for purposes of the self-employment tax, do not lose their existing basis in capital assets. Instead, they would be allowed to deduct any remaining basis in depreciable property and inventory over 10 years. [66]

There are various options for dealing with unused income tax credits and deductions. A special refund equal to the income tax rate times the present discounted value of the stream of deductions plus any unused credits could be provided. Were such an approach pursued, however, it would also seem appropriate to impose a corresponding tax on built-in capital gains, foreign-source income that has not been subjected to U.S. tax, and presumably even the capitalized value of future income streams. That revenue, in turn, could be used to fund the transition relief.

It may be appropriate to avoid a form of double taxation by providing some relief to persons--primarily the elderly--consuming out of savings that were previously subject to the income tax. This type of relief may be particularly desirable since the NST-plan family consumption refund outlined here benefits only wage earners. This may be handled by giving an extra exemption to senior citizens or a one-time increase in Social Security benefits. On the other hand, if one were to make the assumption that the true incidence of a sales tax is on the factors of production (i.e., workers and investors) rather than on consumers, such relief would not be appropriate, except in the case of wage earners or owners of assets purchased with after-income-tax dollars. [67]

Such relief is not appropriate for savings distributed from pension plans, individual retirement accounts, or other qualified plans because neither the original contribution nor the earnings on the plan would have been subjected to income tax. The NST deemed-paid transition rule with respect to existing tangible property protects wealth or savings in the form of real property or tangible personal property from double taxation. The problem primarily relates to financial instruments purchased with after-income-tax dollars. Qualified transition accounts could be established before implementation of the sales tax, and spending out of those accounts (subject perhaps to an annual maximum) would result in a credit equal to the sales tax rate times the distribution amount. Some sort of debt-netting requirement would have to be paired with such an approach to avoid heavy borrowing to fund the transition accounts.

Conclusion

This study examines the nuts and bolts of a comprehensive national sales tax replacement of the federal income tax. Many--though not all--of the features of the hypothetical NST constructed here closely correspond to the elements of H.R. 3039.

The 15 percent NST plan would have a highly beneficial impact on the U.S. economy and raise the standard of living of the American public. The tax compliance costs borne by our economy would fall sharply. And the degree of intrusiveness of the tax system in our lives would decline greatly. Once set free from the burdens of compliance with the current system and the punitive tax rates imposed on work, savings, and investment, the United States will become a more productive and more prosperous republic. A national sales tax is more compatible with the principles of a free society than any other alternative tax system.

Notes

[1]. H.R. 3039, the National Retail Sales Tax Act of 1996, had six original cosponsors: Reps. Sonny Bono (R-Calif.), Dick Chrysler (R-Mich.), Ralph D. Hall (D-Tex.), Joel Hefley (R-Colo.), John Linder (R-Ga.), and Bob Stump (R-Ariz.).

[2]. See "Archer Outlines Ways and Means Agenda," Bureau of National Affairs *Daily Report for Executives*, March 7, 1996, p. GG-1.

[3]. "Schaefer, Tauzin Offer Retail Sales Tax; Ways and Means Chairman Salutes Sponsors," Bureau of National Affairs *Daily Report for Executives*, March 8, 1996, p. G-5.

[4]. Stephen Moore, "The Economic and Civil Liberties Case for a National Sales Tax," Hoover Institution Conference Paper, May 11, 1995.

[5]. Dale W. Jorgenson, "The Economic Impact of Fundamental Taxing Consumption," Testimony before the House Ways and Means Committee, March 27, 1996. See also Dale W. Jorgenson, "The Economic Impact of Fundamental Tax Reform," Testimony before the House Ways and Means Committee, June 6, 1995.

[6]. Laurence J. Kotlikoff, "The Economic Impact of Replacing Federal Income Taxes with a Sales Tax," Cato Institute Policy Analysis no. 193, April 15, 1993.

[7]. This, of course, is the same result that occurs with tax-free bonds under Internal Revenue Code section 103, which exempts municipal bond interest from tax. The market may not clear at the present tax-exempt rate because such a high proportion of existing capital providers are tax-exempt or tax-deferred (most notably, governments, pension funds, retirement savings accounts, and, in selected circumstances, foreigners).

[8]. One reason to be relatively certain that interest rates would be lower without an income tax is that tax-exempt bonds yield 30 percent less than taxable bonds. Under the NST, all bonds would be nontaxable. Hence, interest rates would probably settle between the taxable and nontaxable rates.

[9]. This assumes roughly $3.5 trillion in debt held by the public and a 200-basis-point reduction in interest rates. Federal net interest expense in fiscal year 1995 was $232 billion. See *Economic Report of the President*, February 1996, pp. 370, 376.

[10]. Current Internal Revenue Code section 871(h).

[11]. Currently, income earned by a trade or business within the United States is taxed whether it is a foreign firm or a foreign-owned U.S. firm. Moreover, the Branch Profits Tax ensures that foreign firms' U.S. profits are subject to a double tax when repatriated. This is meant to impose the same double tax on foreigners that U.S. shareholders pay on corporate dividends.

[12]. Stephen Moore and John Silvia, "The ABCs of the Capital Gains Tax," Cato Institute Policy Analysis no. 242, October 4, 1995.

[13]. Paradoxically, this net infusion of foreign investment capital would cause the trade deficit to rise, as it did in the 1980s. An increase in the trade deficit, per se, is not economically harmful.

[14]. Although duly included in the national income and product accounts, and a source of employment to lawyers, accountants, IRS agents, and other tax professionals, the payments extracted from the economy due to the complexity of our tax system do not improve our collective standard of living.

[15]. See Arthur Hall, "The High Cost of Tax Compliance for U.S. Business," Tax Foundation Special Report, November 1993. In March 20, 1996, testimony before the House Ways and Means Committee, Hall presented his updated 1996 findings: $157 billion per year in compliance costs due to the federal income tax exemption. See also James L. Payne, *Costly Returns: The Burdens of the U.S. Tax System* (San Francisco: Institute for Contemporary Studies Press, 1993). Payne estimates total compliance costs at about $300 billion. Testimony before the House Ways and Means Committee, June 6, 1995.

[16]. National Commission on Economic Growth and Tax Reform, "Unleashing America's Potential," January 1996, p. 9.

[17]. See Arthur Hall, "Compliance Costs of Alternative Tax Systems," Tax Foundation Special Report, June 1995. See also Arthur Hall, "Replacing the Federal Income Tax," testimony before the House Ways and Means Committee, March 20, 1996. Hall estimates that under H.R. 3039 compliance costs would decline by 95 percent to $8.2 billion.

[18]. Authors' calculation comparing (1992) corporation, partnership, and sole proprietor returns with all returns using IRS Statistics of Income.

[19]. The states without a general sales tax are Alaska, Delaware, Montana, New Hampshire, and Oregon.

[20]. For 1995, the 28 percent marginal rate is effective on taxable incomes of $36,900 for joint filers and $22,100 for single persons. The top federal tax rate is 39.6 percent.

[21]. The proposed Domenici-Nunn USA tax has a top marginal tax rate of 40 percent (actually an effective rate of 32.35 percent once the payroll tax credit is considered) that takes effect at relatively low taxable income levels--$24,000 for joint returns and $14,400 for single persons.

[22]. For a particular taxpayer, the marginal benefit from failing to report a given amount of gross receipts under an income tax and a given amount of gross receipts under a sales tax are the same. The taxpayer will reduce his taxable income or taxable receipts one

dollar for each dollar not reported. Falsifying deductions or business expenses does not arise under a sales tax; the corresponding problem is using a business to purchase personal goods and services on a tax-exempt basis.

[23]. See Peter S. Spiro, "Estimating the Underground Economy: A Critical Evaluation of the Monetary Approach," *Canadian Tax Journal* 42 (1994): 1059-81; and Vito Tanzi, "The Underground Economy in the United States: Annual Estimates, 1930-80," International Monetary Fund Staff Paper no. 30, June 1983, pp. 283-305.

[24]. On the other hand, we acknowledge that their would be new types of monitoring problems in enforcing a national sales tax to avoid noncompliance through bartering, sales at the wholesale level, and other avoidance schemes.

[25]. IRS Statistics of Income, reported in U.S. Congress, Joint Committee on Taxation, "Impact on Small Business of Replacing the Federal Income Tax," 104th Cong., 2d sess., 1996. Committee print, pp. 109-127.

[26]. Hall, "Compliance Costs"; and Hall, Testimony.

[27]. The top marginal income tax rate is 39.6 percent for individuals and 35 percent for corporations. Those tax rates are more than twice as high as the 15 percent sales tax rate that would be imposed in their place.

[28]. The sales tax cannot be avoided by purchasing big-ticket items abroad and then bringing them into the United States.

[29]. For example, the imputation for the rental value of owner-occupied housing (farm and nonfarm) must be eliminated. Certain other imputations must be eliminated as well. The value of new owner-occupied housing must be added to the tax base. Since H.R. 3039 would tax purchases of old housing, the sale of old housing (net of deemed credits) must be added. As H.R. 3039 would allow the taxes on housing to be amortized until the unit was resold, this must be accounted for. Most important, government purchases must be added to the tax base if the sales tax plan taxes government. Government purchases include payments to government employees for the services they render and other government purchases. The flat tax, the income tax, and the USA tax all tax the value added by government.

[30]. David Joulfaian and James Mackie, "Sales Taxes, Investment, and the Tax Reform Act of 1986," *National Tax Journal*, 1992, pp. 89-105.

[31]. Avoidance of cascading also ensures that the final price paid by the consumer excludes hidden taxes. The exemption framework serves the same purpose as deductions under a flat tax, business transfer tax, or subtraction-method value-added tax framework or the credit for previously paid taxes under a credit-invoice method value-added tax.

[32]. There are two prominent types of value-added taxes. Under a subtraction-method value-added tax, a business fills out a tax return that is similar in some respects to an income tax return except that only purchases from other firms are deductible, and wages, taxes, interest, and other expenses are not. The business tax in the USA tax is an example of such a tax. The European Community and Canada employ a credit-invoice type of VAT that is levied on gross receipts; a credit is provided to businesses for the tax paid on business inputs.

[33]. When calculating the tax-inclusive sales tax base, two algebraically equivalent methods may be used. The tax-exclusive rate may be converted into a tax-inclusive rate by dividing the tax-exclusive rate by one plus the tax-exclusive rate: $t_i = t_e/(1+t_e)$. Conversely, a tax-inclusive rate may be converted into a tax-exclusive rate by dividing the tax-inclusive rate by one minus the tax-inclusive rate: te = ti/(1- ti). Alternatively, the tax-inclusive sales tax rate may be calculated by adding the repealed income tax revenue back into the tax base (consumers, after all, would have that money to spend), whereas one would not do so when calculating the tax-exclusive base (consumers would be spending that amount on tax and it would not be appropriate to include it in the calculation of a tax-exclusive base).

[34]. See Bruce Bartlett, "Replacing Federal Taxes with a Sales Tax," *Tax Notes*, August 21, 1995, pp. 997-1003, arguing that a 32 percent rate would be required.

[35]. This is consistent with the general sales tax framework laid out by Professor Dale Jorgenson, chairman of the economics department at Harvard University. See Dale Jorgenson, correspondence, April 1, 1997.

[36]. See, e.g., Statement of Robert E. Hall before the House Ways and Means Committee, June 6, 1995, Serial 104-28, p. 593, where he states, “The Hall-Rabushka flat tax is a value added tax.” Its base bears no resemblance to an income tax.

[37]. The amount of federal government wages was about $207 billion in 1995. Total federal government consumption (including compensation) was $454 billion in 1995. See NIPA Table 3.7B, Government Consumption Expenditures and Gross Investment by Type, Survey of Current Business, August 1996. Government “investment” was scored as $63 billion. Since we do not tax the “return” to that investment, taxing this investment would also seem appropriate as a tax prepayment approach that is equivalent in present value terms.

[38]. The Joint Committee on Taxation recognized this in their pamphlet, “Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax,” pp. 57-58.

[39]. Government enterprises (e.g., Amtrak, the Postal Service) are a separate case. They can easily be put on equal footing by taxing their sales and exempting their inputs as if they were private enterprises. If government (and non-profit) enterprises are not subject to tax, they will have a huge relative price advantage over private companies.

[40]. Gilbert E. Metcalf, "Lifecycle vs. Annual Perspectives on the Incidence of a Value Added Tax," National Bureau of Economic Research reprint no. 1892.

[41]. In 1994, food ($715.7 billion), housing ($706.6 billion), clothing and shoes ($247.8 billion), and medical care ($739.1 billion) accounted for 51.3 percent of National Income and Product Accounts personal consumption expenditures ($4,698.7 billion).

[42]. The legislation actually provides the rebate only against wage income. Although rules are provided that would mitigate taxation of consumption from the sale of homes, those with wage income less than the poverty level whose consumption was financed by the sale of financial assets or passive income would not be fully protected. Those who receive government benefits can be protected to the extent necessary by adjusting benefit levels. The level of benefit adjustment is uncertain since the repeal of the income tax should reduce pre-sales-tax prices to some degree. A large but unknown amount of corporate and individual income tax plus the associated compliance costs are embedded in the price of every product we buy. If the view commonly held among economists is correct and the actual incidence of a consumption tax is on the factors of production (labor and capital), it is not clear that any relief on nonwage income is appropriate.

[43]. The HHS poverty level is divided by the quantity one minus the tax rate.

[44]. An explicit provision to reimburse the Treasury for payroll taxes not remitted by employers, although included in earlier drafts of the legislation (as §6(b)), certainly intended by the sponsors, and referred to in cross refer-ences in H.R. 3039, was omitted from H.R. 3039. The legislation's sponsors believe that other existing statutory provisions ensure that the trust fund will be fully funded under current law. Indeed, 42 USC 401(a) seems to so provide.

[45]. The rebate would then be administered at the family unit level (as the poverty level is defined by reference to the family unit).

[46]. See *Federal Register 61*, no. 43 (March 4, 1996): 8286, for 1996 HHS poverty level.

[47]. A similar system is presently employed by Canada in the province of Quebec where Quebec administers both the federal and provincial goods and services tax and employed, until recently, a single-stage (retail) method.

[48]. H.R. 3039 would require states to conform their state sales tax bases to the federal base and impose a state sales tax of at least 1 percent in order to become an administering state.

[49]. Some vendors might choose to collect sales tax even on otherwise exempt sales rather than bother with an exemption certificate. In this case, the buyer would then be eligible for a refund on the tax paid on the exempt sale.

[50]. H.R. 3039 provides a credit of one-half of 1 percent of the taxes collected and remitted. This credit is subject to a minimum of $100 per month provided that the credit does not exceed 20 percent of the tax due.

[51]. The rules under the Schaefer-Tauzin plan are as follows: · The destination of tangible personal property (including property sold by mail order) is the state in which the property was first delivered to the purchaser.

· The destination of real property is the state where the property is located.
· The destination of services is the state where the use, consumption, or enjoyment of the services occurred.
· The destination of telecommunications services (including telephone, cable television, and satellite services) is the residence of the purchaser.
· The destination of domestic transportation services is the destination of the trip (in the case of round-trips, the services are equally divided). International transportation services are deemed 50 percent attributable to the U.S. destination or origin.
· The destination of financial intermediation services is the residence of the purchaser. Gross payment for financial intermediation services purchased by a U.S. resident from a financial intermediation service provider that has a permanent establishment in the United States would be subject to tax.
· The destination of rents and leaseholds is generally the location of the rented or leased property. In the case of vehicle rentals of one month or less, the destination is the location where the vehicle was originally delivered to the lessee. In the case of vehicle rentals of more than one month, the destination of the lease is the residence of the lessee.H.R. 3039, The National Retail Sales Tax Act of 1996.

[52]. The seller must collect the tax unless an exemption or de minimis rule applies.

[53]. In most cases, the homebuyer would finance the tax payment as a component of the mortgage, just as property tax payments are typically handled today.

[54]. If a health or property and casualty insurer makes a purchase on behalf of an insured (e.g., medical services or automobile body work) and the premium giving rise to the obligation is taxed, the insurer's purchase is exempt. Thus a hospital invoicing an insurance company would collect no tax, but if it were invoicing a consumer it would collect the tax. However, a mechanism should be provided to credit the insured for taxes paid if the insurance company reimburses the insured rather than making the purchase directly (again, assuming the premium is taxed). Similarly, a provision should probably be made to provide a credit to life insurance proceeds recipients if the life insurance premium is taxed.

[55]. The tax effect should not vary depending on whether the fees are implicit or explicit.

[56]. U.S. Congress, Joint Committee on Taxation, "Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax," 104th Cong., 2d sess., 1996. Committee print.

[57]. Exemptions otherwise available to business would be available to government. For example, government purchases of capital equipment used for the production of taxable property and services would be exempt. Thus, Amtrak's purchase of locomotives or sandwiches for resale would be exempt. The Government Printing Office's purchase of paper for printing books sold to the public (and therefore taxed) would be exempt.

[58]. The authors note that they have determined the sales tax rate based upon taxation of government output (value added). There is a general consensus that government output should be taxed under a consumption tax to prevent the creation of an incentive to consume through the medium of government relative to the private sector. However, there is not yet consensus over the issue of whether or not the receipts collected from the taxation of government output should be counted for purposes of determining the correct revenue neutral tax rate. In this study the authors do count these revenues because they maintain government output is taxed today in the form of income and payroll taxes on government workers and that this tax constitutes a significant portion of the revenue being replaced by the consumption tax. If these payments are included as income tax revenues, then they should likewise be included as consumption tax revenues. If instead we do not count the revenues from taxation of government value added, then we should also reduce the level of income tax revenue that we seek to replace by the sales tax. For a further discussion of this issue, see Joint Committee on Taxation, 1996.

[59]. The organizations that fall within the rubric of these special not-for-profit rules are those organized and operated exclusively for religious, charitable, scientific, testing for the public safety, literary, or educational pur-poses; as civic leagues or social welfare organizations; as labor, agricultural, or horticultural organizations; as chambers of commerce, business leagues, or trade associations; or as fraternal beneficiary societies, orders, or associations.

[60]. Girl Scout cookies are not presently taxed since the business of selling the cookies is not "regularly carried on."

[61]. Gross payments to qualified not-for-profit organizations for property and services that are not substantially related to the exempt purposes of the organization or that are commercially available would be taxable. That provision incorporates the principles of an improved "unrelated business income tax" (which has been frequently criticized by small businesses as unworkable).

[62]. The business use ratio is determined by the ratio of business use to total use using mileage for vehicles, floor space for real property, time for machinery and equipment, and a reasonable method for other items. Records substantiating use must be maintained. The mixed property amount for any given year is one-thirtieth of the purchase price for 30 years for real property, one-seventh of the purchase price for seven years for

machinery and equipment, and one-fifth of the purchase price for five years for vehicles. To illustrate, a $5,000 vehicle would give rise to a mixed property amount each year of $1,000. If the business use ratio were 50 percent, then the annual credit would be $75 (15 percent of $500).

[63]. See Martin Feldstein and Paul Krugman, "International Trade Effects of Value Added Taxation," in *Taxation in the Global Economy*, ed. Assaf Razin and Joel Slemrod (Cambridge, Mass.: National Bureau of Economic Research, 1990), pp. 263-82.

[64]. Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (Washington: Institute for International Economics, 1992); Gary Clyde Hufbauer and Carol Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments* (Washington: Institute for International Economics, 1996); David G. Raboy, "International Implications of Value Added Taxes," in *Value Added Tax: Orthodoxy and New Thinking*, ed. Murray Weidenbaum, David G. Raboy, and Ernest S. Christian Jr. (St. Louis: Center for Study of American Business/Kluwer, 1989), pp. 131-62.

[65]. In the Schaefer-Tauzin bill, income tax transition rules are not provided.

[66]. Generally for tax purposes, a taxpayer's basis in property is its original cost plus any improvements (but not including maintenance and repairs) less any depreciation taken with respect to the property.

[67]. Another transitional issue relates to government benefits programs. Those making their consumption purchases out of Social Security, veterans, AFDC, food stamp, or similar benefits will pay tax on their purchases. However, it is not clear what the appropriate level of relief would be to leave benefit recipients unaffected. All other things being equal, the market should clear pre-sales-tax goods and services at a lower price after the income tax is repealed, since income taxes are costs that will no longer be imposed on suppliers of capital and labor. Moreover, the consensus view is that the incidence--the actual burden--of the sales tax is on producers, not consumers.

Workers who have received income without a tax agent, such as an employer withholding appropriate taxes, must declare the value of this income. All lottery winnings, or winnings from any other games of chance, must be declared, no matter the amount.Â Generally speaking, the Russian Tax Code is intended to be a national arrangement for regional, federal and local taxes, but eliminates tariffs on customs. The system uses modest regressive tax or flat rates and is highly unified for a federal state; it immensely relies on profits from natural gas and oil organizations.Â In some cases non-residents may be exempt from the Russian tax rate of 30% if granted migration status as a highly qualified specialist. In such circumstances earnings are taxed in Russia at the typical rate of 13%. A sales tax is effectively a massive tax increase on the poor. The effective income tax rate on working people is arou...Â The article perfectly describes what is wrong with a national sales tax: it would fall heavily on those who can least afford it. A sales tax is effectively a massive tax increase on the poor. The effective income tax rate on working people is around 8%. The economic data shows that these people spend all or almost all of their income on consumption, so replacing an income tax with a sales tax would raise their taxes by 15% to 22% of their income. For a person earning $30,000 their tax burden would increase by at least $2,000 per year. What it does not mention, though, is the biggest problem wi Unsure about Income Tax and National Insurance? Donâ€™t know what the National Insurance threshold is? Unsure how the Personal Allowance applies to you? We explain how the tax system works and what to do if you think youâ€™re overpaying. Should I pay any Income Tax? The Personal Allowance if you earn over Â£100,000. What is Income Tax used for? How much Income Tax will I pay? National Insurance.Â Most allowances are increased each year and increases apply from the start of the tax year, 6 April. Jump down to â€˜How much Income Tax will I pay?â€™ to find out what youâ€™re liable for. What is a Personal Allowance? Everyone, including students, has something called a Personal Allowance â€“ the amount of money youâ€™re allowed to earn each tax year before you pay Income Tax.