Chapter Eight
Value-Added Tax

"Thanks for my pocket money Dad. But you forgot to add 17.5% v.a.t."

The Panel developed and analyzed a proposal to adopt a value-added tax (VAT) that would replace a portion of both the individual and corporate income taxes. The VAT is a type of consumption tax that is similar to a retail sales tax but is collected in smaller increments throughout the production process.

The "Partial Replacement VAT" proposal studied by the Panel would combine a VAT and a lower-rate version of the Simplified Income Tax Plan described in Chapter Six. As shown in Table 8.1, a VAT imposed at a 15 percent rate would allow the top individual income tax rate in the Simplified Income Tax Plan to be reduced to 15 percent. The top corporate income tax rate would also be lowered to 15 percent. Both the income tax and VAT rates are presented on a tax-inclusive basis, as is the norm for income tax rates and the way they are presented throughout this report. The tax-exclusive rates would be 17.6 percent. A discussion of the difference between tax-exclusive and tax-inclusive rates is provided in Chapter Nine.

Table 8.1. Proposed Income Tax Rates for Married and Unmarried Taxpayers

Simplified Income Tax Individual Rates - Modified with a VAT		
Tax Rate	Married	Unmarried
5%	Up to $64,000	Up to $32,000
15%	Above $64,000	Above $32,000

Simplified Income Tax Individual Rates		
Tax Rate	Married	Unmarried
15%	Up to $78,000	Up to $39,000
25%	$78,001 - $150,000	$39,001 - $75,000
28%	$150,001 - $200,000	$75,001 - $100,000
33%	$200,001 or more	$100,001 or more

Panel members recognized that lower income tax rates made possible by VAT revenues could create a tax system that is more efficient and could reduce the economic distortions and disincentives created by our income tax. However, the Panel could not reach a consensus on whether to recommend a VAT option.

Some members of the Panel who supported introducing a consumption tax in general expressed concern about the compliance and administrative burdens that would be imposed by operating a VAT without eliminating the income tax or another major tax. Some members were also concerned that introducing a VAT would lead to higher total tax collections over time and facilitate the development of a larger federal government – in other words, that the VAT would be a "money machine." Other Panel members suggested that studies of the international experience and domestic political realities did not support the "money machine" argument. Some argued that adopting a VAT, whether to reduce income taxes or payroll taxes, would make it more likely that higher taxes would be used to solve the nation's long-term fiscal challenges, especially unfunded obligations for the Social Security, Medicare, and Medicaid programs. Others expressed the opposite view and regarded the VAT as a stable and efficient tool that could be used to reduce income taxes, fund entitlement programs, or serve as a possible replacement for payroll taxes. A proposal to use the VAT to replace payroll taxes was beyond the scope of the Panel's mandate, which focused only on income taxes.

Despite the lack of consensus to recommend a VAT option, the Panel views a Partial Replacement VAT as an option worthy of further discussion. This chapter will highlight issues that policymakers would need to consider in evaluating such a proposal. First, the chapter describes modifications to the Simplified Income Tax Plan that would be made possible by the VAT and the resulting distribution of the overall federal income tax and VAT tax burden. The chapter then discusses how businesses would compute their VAT liability and the advantages and disadvantages of a Partial Replacement VAT from a tax policy perspective. Finally, the chapter addresses

arguments regarding whether the VAT would facilitate the growth of the federal government.

How it Would Work: Adjustments to the Simplified Income Tax Plan

The Partial Replacement VAT proposal studied by the Panel combined a VAT with a low-rate income tax modeled on the Simplified Income Tax Plan. This VAT would collect about 65 percent of the amount of revenue currently collected by our individual and corporate income taxes. As a result, tax rates under the income tax system could be substantially reduced.

The Simplified Income Tax Plan does not materially alter the current distribution of the federal tax burden. By contrast, a VAT absent other modifications would change the current distribution because the VAT is imposed directly on consumption, and therefore would tax all families equally on each dollar they spend on items subject to the VAT. Households with lower incomes generally spend a larger portion of their income than higher-income households, and therefore the VAT would generally impose a larger tax as a percentage of income on lower-income households. In considering the Partial Replacement VAT, the Panel sought to relieve the additional VAT burden through an appropriate income tax rate and credit structure. The Panel's goal was to maintain a distribution of the overall federal VAT and income tax burden that would be approximately distributionally neutral relative to current law.

In response to the Panel's request, the Treasury Department modified the Family and Work Credits described in Chapter Five to alleviate the additional burden of the VAT on lower-income families. This approach would be more effective than exempting food and other necessities from taxation because it could be targeted to lower and middle-income families alone, rather than all taxpayers.

The base credit amount of the Family Credit would be increased by $1,000 for married couples and $500 for all other taxpayers except dependent taxpayers. The additional Family Credit amount based on the number of children and other dependents would be increased by $500 for each child or other dependent. Like the Family Credit in the Panel's recommended options, this Family Credit would not phase-out; it would be available to all taxpayers.

The Work Credit would also be increased, so that the maximum credit amount in the first year would be: $1,832 for workers with no children, $6,820 for workers with one child, and $9,750 for workers with two children. The Work Credit would increase as the amount of work income increases, be refundable, and phase-out gradually above certain income levels. Further details regarding the modifications to the Family and Work Credits made by the Treasury Department in estimating the Partial Replacement VAT can be found in the Appendix.

Box 8.1. Reducing the Number of Individuals Who Pay Income Tax

If the Family Credit and Work Credit were expanded as described in this chapter, 101.1 million taxpayers would have no income tax liability, 51.1 million more than the 47.4 million taxpayers that would have no income tax liability under the Simplified Income Tax Plan. Some members of the Panel felt that it was inappropriate to increase the number of taxpayers who do not make a direct contribution to the cost of maintaining the federal government through income taxes. Others took the opposite position, commenting that taking additional lower and middle-income taxpayers off the income tax rolls would make the federal tax system simpler. Those taxpayers would continue to pay taxes, at the cash register through the VAT and through payroll taxes.

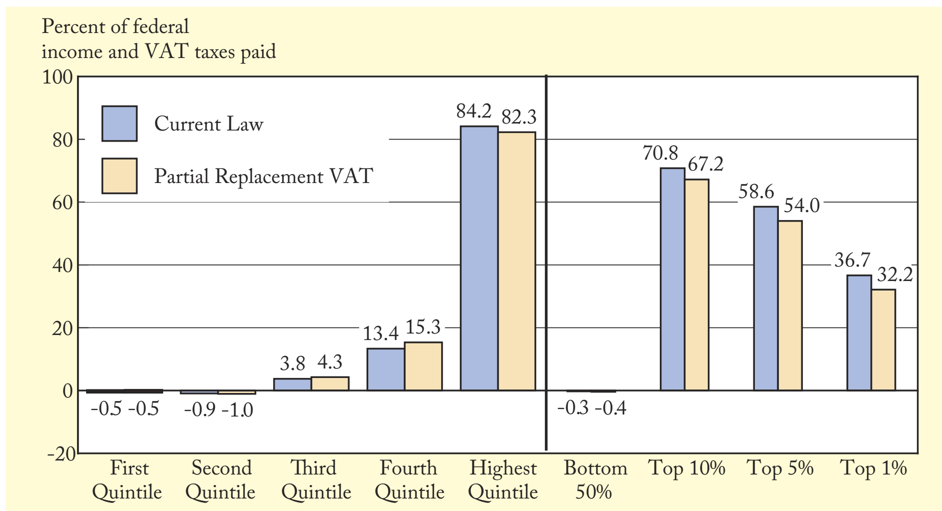
Who Pays the Tax?

As shown in Figures 8.1 through 8.4, the Family and Work Credits as modified by the Treasury Department would ensure that the tax system would be roughly as progressive as current law for families with incomes in the bottom two quintiles of the income distribution. However, for families in the third and fourth quintiles, the modified Work and Family Credits and rate structure presented here do not fully offset the increased burden of the VAT. Families in the highest quintile would bear less of the total tax burden.

The Treasury Department did not develop a modified credit and rate structure that would make the Partial Replacement VAT proposal approximately as progressive as current law. While the Partial Replacement VAT described in this chapter does not entirely alleviate distributional concerns, the Panel believes that with additional work, it would be possible to develop an approximately distributionally neutral tax credit and rate structure. Such a structure might, however, require somewhat higher income tax or VAT rates.

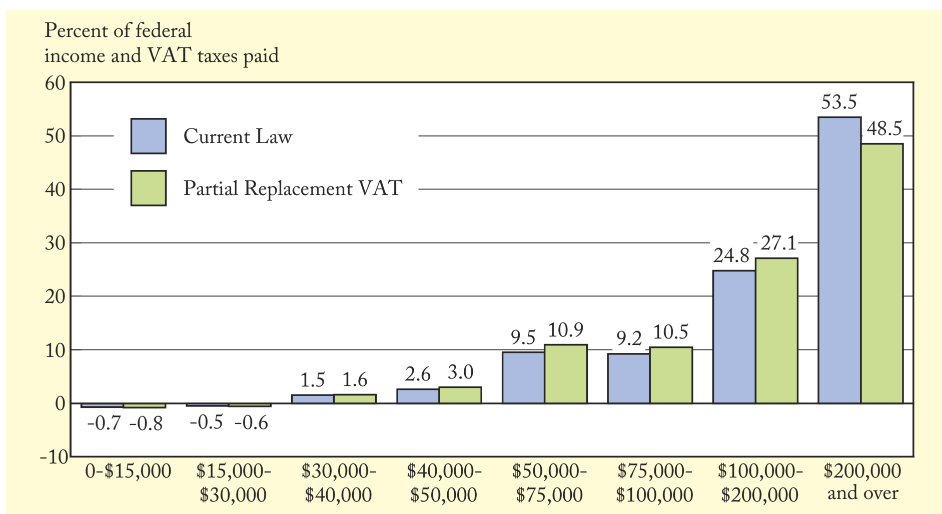
Figures 8.1 and 8.2 show how the distribution of the burden of the individual and corporate income taxes under current law for 2006 would compare to the distribution of the income and VAT taxes under the Partial Replacement VAT proposal.

Figure 8.1. Distribution of Federal Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

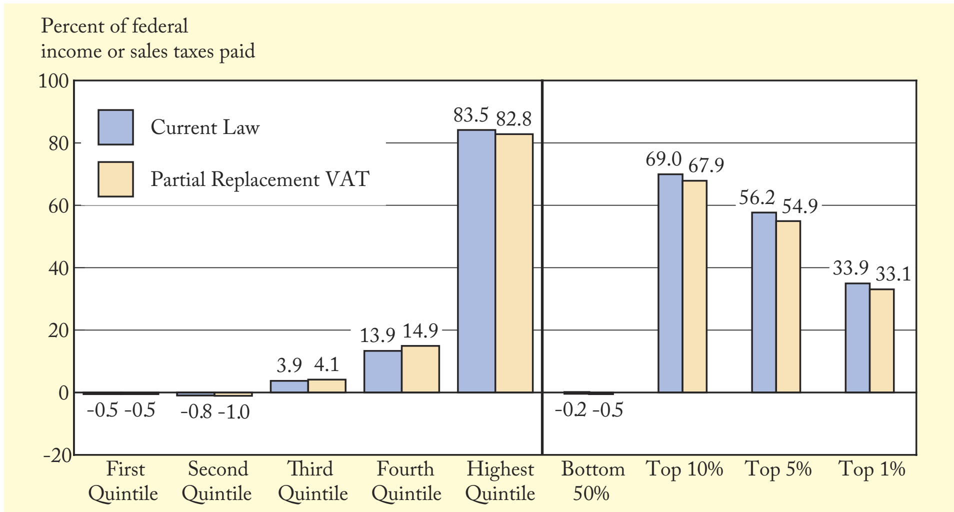
Figure 8.2. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

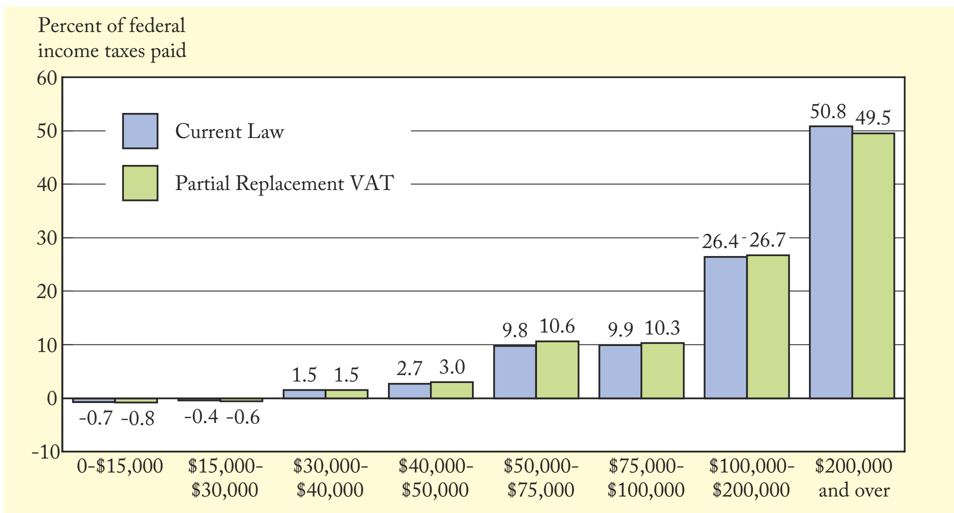
Figures 8.3 and 8.4 provide distributional estimates for 2015, the last year of the budget window.

Figure 8.3. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 8.4. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Level (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

How it Would Work: Implementing the VAT

The VAT can be thought of as a retail sales tax that is collected in stages, instead of all at once from the final consumer. The tax is collected by all entities providing taxable goods and services and is imposed on sales to all purchasers. A business calculates its VAT liability by taking the total value of its taxable sales and multiplying by the VAT rate. The business is then permitted to offset its VAT liability by the amount of VAT paid for its purchases of goods and services. The simple example first provided in Chapter Three provides an easy way to understand the process.

Imagine that a boot maker makes and sells custom-made cowboy boots. He buys leather and other supplies enough for one pair from a leather shop at a cost of $200 before taxes. The boot maker sells each pair of boots he makes for $500 before taxes.

If a 10 percent retail sales tax were in place, the boot maker would add the tax to the cost of the $500 pair of boots, and the consumer would pay $550 per pair. In the meantime, the leather shop would not impose a retail sales tax on its sale to the boot maker because such a business-to-business transaction would not be treated as a retail sale.

Under a VAT, the tax calculation works somewhat differently. The VAT, like a sales tax, is separately stated on invoices or receipts. However, because the VAT is charged on all sales of goods and services, and not just sales to consumers, the leather shop would collect a VAT of 10 percent, or $20 on the $200 of supplies purchased by the boot maker. The boot maker would pay the leather shop $220, and the leather shop would send the $20 to the government. When the boot maker sells the boots, he computes the VAT as $50, and charges the purchaser $550 for the boots.

Instead of sending $50 to the government, the boot maker would subtract the $20 of VAT already paid to the leather shop and remit $30 to the government. The government would receive $50 total — $20 from the leather shop and $30 from the boot maker. The $20 credit that the boot maker applies against his VAT liability is called an "input credit," and the invoice received from the leather shop showing $20 of VAT paid serves as proof that the boot maker can take the credit. The government receives the same revenue under a VAT as it would under a retail sales tax, and from the consumer's perspective the taxes look identical.

Design Assumptions

In studying the proposal, the Panel made certain decisions about the appropriate design for a VAT if it were ever adopted at the federal level.

- The VAT should be imposed on the broadest consumption base consistent with:
  - The structure of our federal system of government, and
  - The need to maintain neutrality between public and private sector provision of goods and services.

- The VAT should use the credit-invoice method.
- The VAT should be border adjusted.
- The VAT should be imposed at a single uniform rate.
- The VAT should be set at a rate that is high enough to raise sufficient revenue to accomplish substantial income tax reform, justify the administrative burden of the VAT on businesses and government, and discourage subsequent rate increases.

Tax Base

The Partial Replacement VAT base considered by the Panel would be broad in order to prevent economic distortions between taxed and non-taxed goods and services. The proposed VAT base would include all domestic consumption except for non-commercial government services, primary and secondary education, existing residential housing, and charitable and religious services. Special rules would apply to financial services and certain other goods and services that are difficult to tax. A more detailed discussion regarding the proposed VAT base and the mechanics of VAT exemptions are provided in the Appendix.

Government Services

Noncommercial services provided by federal, state, or local government would be outside the VAT base. However, commercial activities conducted by the government, such as electricity supplied by a government-owned power plant, would be taxed like any private sector business. The rationale for this treatment is to prevent federal, state, or local government from having an advantage over the private sector in areas where the two might compete to supply similar products. Rules would be necessary to distinguish between commercial and non-commercial government services. Further discussion of these issues appears in the Appendix.

Box 8.2. State and Local Government Services

Taxing the imputed value of noncommercial state and local government services would be technically feasible. New Zealand, for instance, does this by requiring local governments to pay a VAT on the total value of the salaries they disburse to their employees. However, if the federal government assessed a VAT on state and local government services in this way, those governments would need to raise taxes to pay the VAT on their purchases and on the imputed value of their services. The Panel concluded that it may be inappropriate for the federal government to directly assess an excise tax of this sort on state and local governments in the context of our federal system. Instead, state and local governments would pay a VAT on their purchases, but would receive refunds from the federal government for VAT paid.

Border Adjustments

Because the VAT is intended to tax domestic consumption, exports are outside the VAT tax base. However, because the VAT is assessed at every level of production and distribution, a "border adjustment" is necessary to exclude exports from the VAT. These adjustments are made by allowing businesses to claim input credits on exports while exempting their sales from the VAT. All of America's major trading partners remove the VAT from their exports in this way, and the World Trade Organization specifically defines a VAT as border-adjustable tax. Border adjustments are discussed in greater detail in Chapter Seven.

Small Business

Because the compliance costs associated with a VAT may be low overall but require a significant investment for some small businesses, it would be important to consider how to treat such businesses under a VAT. One advantage of the VAT is that it is possible to exempt many small businesses from collecting the tax without significant revenue loss. There are two reasons for this result. First, because the VAT is collected at every stage of production (rather than once at the retail level like a retail sales tax), and many small businesses buy many of their inputs from larger businesses, exempted small businesses would still pay tax on their inputs. As a result, much of the tax on any final good sold by a small business would still be collected. Second, exempted small businesses would be allowed to voluntarily register to collect the VAT. Some exempted businesses that sell primarily to other businesses would choose to collect VAT voluntarily in order for them and their customers to be able to claim input tax credits on their purchases.

The Partial Replacement VAT designed by the Panel would not require businesses with less than $100,000 in taxable annual gross receipts to collect the VAT. The Government Accountability Office estimated in 1993 that a VAT collection threshold at this level would reduce the number of businesses filing VAT returns from about 24 million to about 9 million. They further estimated that approximately 19 percent of small businesses qualifying for the exemption would nonetheless voluntarily collect the VAT. Preliminary estimates for 2003 suggest that only 1.8 percent of gross receipts are collected by businesses with less than $100,000 in annual gross receipts. Thus, a VAT collection threshold at this level likely would not lose significant revenue, particularly when voluntary collection is taken into account. Whether a higher VAT collection threshold would be feasible could be the subject of future study.

Tax Policy Considerations — Advantages and Disadvantages of Adopting a VAT

Economic Growth

A Partial Replacement VAT could achieve many of the advantages of moving to a consumption-based tax system discussed in Chapter Seven. Economic research shows that consumption taxes have a positive effect on economic growth compared with an income tax.

A broad-based VAT applied at a single rate is economically efficient because it generally does not distort consumers' choices among goods and services and does not discourage savings or distort the allocation of capital. Economists agree that a well-designed VAT imposes a lower excess burden than most other taxes for any given amount of revenue raised. Reducing the excess burden of taxation on the economy is an important way that the tax system can encourage economic growth.

The Partial Replacement VAT also would make it possible to substantially reduce income tax rates for all individual and corporate taxpayers. Lower marginal income tax rates on individuals and businesses would strengthen incentives to save, invest, work, and innovate while making our tax system more efficient.

U.S. Competitiveness

Reducing the corporate income tax rate should improve incentives for investment of capital in the United States by both U.S. residents and foreigners. U.S.-based multinational corporations and multinationals based in countries with territorial tax systems would have incentives to shift investment and operations to the United States to take advantage of the lower income tax rates relative to other countries. These incentives would be similar to those discussed in Chapter Seven, although the incentives would not be as strong as those discussed with respect to the Progressive Consumption Tax Plan because an income tax would be retained, albeit at lower rates.

The Partial Replacement VAT also would be compatible with existing bilateral tax agreements with our major trading partners because it would retain a corporate income tax. These agreements facilitate cross-border investment and ensure that U.S. multinationals operating in foreign markets receive tax treatment comparable to the tax treatment of companies based in the country in which the U.S. multinational is operating.

Box 8.3. Border Adjustments and Competitiveness

Border adjustability has been a longstanding priority for many American businesses with substantial export sales. All our major trading partners border adjust their VATs, and exporters of goods and services imported into the United States receive VAT rebates.

American businesses sometimes argue that the lack of border adjustability of the U.S. income tax system puts U.S. exports at a competitive disadvantage in global markets. However, economists generally believe that exchange rate adjustments or other price level changes offset border tax adjustments in the long term and eliminate any advantage or disadvantage border adjustments might otherwise create. Regardless, a border-adjustable VAT that reduces corporate income tax rates could positively affect the competitiveness of U.S. goods and services in the global marketplace. Further discussion of border adjustments and the advantages of destination-based taxes appears in Chapter Seven.

Benefiting from International Administrative Experience

In implementing the VAT, the United States would be able to take advantage of the wealth of worldwide experience in administering and complying with the tax. The VAT has been adopted by every major developed economy except the United States. Thus, the Treasury Department and IRS could study and apply best practices from around the world. Moreover, U.S. multinational corporations already have extensive experience in complying with the VAT, as they currently collect and remit VAT taxes in most countries in which they operate outside the United States.

Compliance and Administration Costs

One significant benefit of the Simplified Income Tax Plan is that it would reduce administration and compliance costs for the government and taxpayers. In contrast, having to collect and pay both VAT and a business income tax might increase total compliance costs for businesses. It would also create an additional set of administrative responsibilities and costs for the IRS.

On the other hand, the Panel heard testimony that taxpayers' compliance costs for the current income tax amount to approximately 13 cents per dollar of tax receipts, whereas compliance costs for European VATs ranges from 3 to 5 cents per dollar of tax receipts. Further, compliance costs per dollar of income tax revenue could fall as a result of reduced incentives for income tax evasion due to the lower income tax rates accompanying the introduction of a VAT. Thus, it is not clear whether the overall compliance and administration cost savings from introducing a Partial Replacement VAT and lowering income tax rates would be larger or smaller than the cost to businesses of complying with the VAT.

Noncompliance

Some evasion is inevitable in any tax system. For 2001, the IRS estimates that the evasion rate for the income tax was between 18 and 20 percent of taxes due. Some analysts suggest that evasion rates for a Partial Replacement VAT could be somewhat lower. One reason is that invoices used to claim input credits under a VAT create a paper trail based on third-party information reporting that facilitates audits and may induce businesses to comply more fully with both the VAT and the corporate income tax. Under the current income tax, compliance rates are highest where there is third-party information reporting or withholding.

Further, business-level tax evasion is often concentrated in smaller businesses, and the VAT exempts many of these businesses from the collection process. To the extent that tax avoidance and evasion are motivated by high income tax rates, lowering income tax rates with a Partial Replacement VAT might also reduce incentives to avoid or evade the remaining income tax.

However, the VAT would not put an end to tax evasion. Evasion in a VAT can range from simple non-filing and non-payment of tax by businesses to complex schemes in which goods pass through a series of transactions designed to generate counterfeit input tax refunds. The Organization for Economic Cooperation and Development (OECD) reports noncompliance rates of 4 percent to 17.5 percent in major developed economies with VAT systems. United Kingdom Revenue and Customs, which employs one of the most sophisticated approaches to estimating VAT evasion, found VAT evasion of 12.9 percent in the U.K. as of April 2004. One should note, however, that the U.K. VAT base is substantially narrower than the Partial Replacement VAT base studied by the Panel and includes more than one VAT rate. VATs are more prone to evasion when they exclude more categories of goods and services and utilize multiple rates. In its revenue estimates, the Treasury Department assumed a noncompliance rate of 15 percent for the VAT.

Coordination of State Sales Taxes and the VAT

Coordinating between states' retail sales taxes and the VAT would be a major challenge. States likely would view a VAT as an intrusion on their traditional sales tax base. Differing federal and state consumption tax bases, with different forms and administrative requirements, would be complex for business. In states that continued to apply their pre-existing sales taxes, the weighted average combined tax-exclusive state and federal tax rate would be approximately 24 percent.

If states were to bring their sales tax bases into conformity with the broad federal base and coordinate their sales tax collection systems with the federal regime, the economic efficiency of state sales taxes would be improved. Compliance burdens for multistate businesses and administrative costs for states could be reduced. Even greater gains in terms of simplicity and lower compliance burdens might be achieved if the states moved to impose state level VATs.

However, the result of a similar harmonization effort in Canada is not encouraging. Canada considered adopting a unified federal and provincial VAT 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. The United States has many more sales tax jurisdictions than does Canada, and so it is quite likely that the U.S. experience could be fraught with even greater difficulties.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a VAT. Although there may be some such consequences, those considerations were secondary in the Panel's decision not to recommend the Partial Replacement VAT. Any consequences associated with price level adjustments under a Partial Replacement VAT would be less severe than those under a full replacement retail sales tax or a full replacement VAT, because the tax rate would be lower and therefore any required adjustments would be less extensive.

Political Economy Concerns

The Partial Replacement VAT proposal would add a major new federal tax without eliminating any existing taxes from the federal system. One important factor in the Panel's decision not to recommend the Partial Replacement VAT proposal was several Panel members' concern about how introducing a supplemental VAT might affect the size of the federal government in the medium or long run. These Panel members were concerned that adding a VAT on to the current income tax structure could, over time, lead to growth of federal outlays as a share of GDP — as the tax rate for the Partial Replacement VAT could rise, or corporate and individual income tax rates could return to their present levels. The Panel members who were concerned about this possibility viewed growth in the government's share of the economy as undesirable. Other Panel members were not concerned about this possibility, either because they were more confident that Congress would use the VAT only to offset existing taxes, or because they believed that allowing some growth in tax revenues as a share of GDP would offer a means to finance the growing cost of entitlement programs.

There are relatively few empirical studies on the relationship between the adoption of a VAT and the growth of government spending. None of these studies resolve the fundamental difficulty of determining the direction of causality between the tax structure and the size of government. Simple country comparisons suggest that countries without VATs, like the United States, have a smaller government sector than countries with a VAT. However, more sophisticated statistical studies that control for other factors that may affect the relationship between the size of government and the presence of a VAT yield mixed results. The evidence neither conclusively proves, nor conclusively disproves, the view that supplemental VATs facilitate the growth of government.

Even if the findings were conclusive, studies of VATs in other nations may not provide much guidance on the effect of adopting a VAT in the United States. Most developed countries initially used a VAT to reduce or eliminate other consumption taxes, such as existing sales or excise taxes. The VAT proposal studied by the Panel would replace part of the income tax with a VAT. The United States has no broad-based pre-existing federal consumption tax to replace. Thus, whether adopting a VAT would fuel the growth of U.S. federal spending remains an open question.

Box 8.4. Visibility of the VAT

Some critics of the VAT express concerns about its visibility to taxpayers, because in some countries VAT is included in marked prices and no reference is made to the tax on receipts. However, the Panel assumed the VAT would be separately stated on all sales, so consumers would know the amount of VAT paid with each purchase.

Some members of the Panel suggested that even a separately stated VAT would be less visible to taxpayers than the burden of the income tax. These members pointed out that taxpayers would not know their total VAT liability for any given year unless they kept all their receipts and added together all VAT paid. Others noted that a similar observation could be made about the income tax, which many taxpayers pay over time through withholding from their compensation, and about payroll taxes, where the employer-paid portion is "invisible" to most workers. These members stated that taxpayers are much more likely to know the amount of the refund check they received as a result of excess tax withholding than the amount of their overall tax liability. Others responded that if true, these observations were an argument against tax withholding, not an argument for a Partial Replacement VAT.

Some members of the Panel who opposed a Partial Replacement VAT suggested that once a VAT was enacted, it would never be repealed. International experience suggests that few countries retreat from a VAT, and that VAT rates generally do not decline. These Panel members were unwilling to support the Partial Replacement VAT proposal given the lack of conclusive empirical evidence on the impact of a VAT on the growth of government. Others were more confident that voters could be relied upon to understand the amount of tax being paid through a VAT, in part because the proposal studied by the Panel would require the VAT to be separately stated on each sales receipt provided to consumers. These members of the Panel envisioned that voters would appropriately control growth in the size of the federal government through the electoral process.

Box 8.5. Comparing the Enforcement of a VAT and a Retail Sales Tax

Because the VAT is similar to a retail sales tax, one might ask why the Panel chose to study a VAT rather than a retail sales tax as a partial replacement to the income tax. Although they are similar taxes, there are four principal reasons for concluding that a VAT may be more enforceable than a retail sales tax.

First, VAT taxpayers – especially intermediate producers – have an incentive to demand VAT invoices from suppliers because they are needed to claim the VAT credits that reduce the buyer's VAT liability. The invoices used to claim a tax credit create a paper trail that may induce businesses to comply more fully with the law. Most taxable transactions will appear on two tax returns – the buyer's and the seller's – so that tax authorities will have two opportunities to detect evasion. Further, because sellers provide the tax administration a record of their purchases by claiming input credits, tax administrators are more able to estimate what sales and therefore VAT due should be and thereby can detect evasion more easily in a VAT than in a retail sales tax.

Second, the credit-invoice system eliminates the need for business exemption certificates. Under the credit-invoice system, every taxpayer pays tax on its purchases, and then taxpayers show proof to the government that they are entitled to input tax credits, rather than presenting an exemption certificate to a supplier. As described in Chapter Nine, the business exemption system requires retailers to play an enforcement role and is fraught with evasion opportunities.

Third, under the VAT the amount of tax liability at risk in most transactions is only a fraction of the total tax assessed on the sale of the good or service to a consumer. This is because the VAT is collected in smaller pieces at each stage of production, while the entire retail sales tax is collected on a final consumer sale. The lower effective tax rate on each transaction may reduce the incentive to evade the VAT.

Finally, in contrast to a VAT, the proper administration of a retail sales tax would require all small retailers to collect tax. With a tax collected solely at the retail level, a small business exemption would be unworkable from enforcement, efficiency, and revenue perspectives. Because the compliance costs associated with a retail sales tax or a VAT may be low overall, but significant for small retailers, the need to require small retailers to act as collecting agents in a retail sales tax is a significant disadvantage.

The VAT's advantages over the retail sales tax in minimizing evasion should not be overstated. Because large firms are less likely to cheat, evasion problems in either system are likely concentrated in smaller firms. When those firms are retailers, the incentive to cheat at the margin under the VAT and the retail sales tax is roughly equal, assuming the same tax rate applies.

Further, more transactions are subject to a VAT than to a retail sales tax, creating additional opportunities for evasion. Under a VAT, firms could fabricate invoices to claim input credits, even if such purchases were never made. Claiming excess input credits in a VAT also can produce a tax refund for a business. This temptation does not exist under the retail sales tax.

Chapter Nine

National Retail Sales Tax

The Panel considered a number of proposals to reform the income tax, including replacing the entire income tax system with a broad-based national retail sales tax. A retail sales tax is perhaps the most obvious form of consumption tax because it is imposed on the final sales of goods and services to consumers. Like other consumption taxes, the retail sales tax does not tax normal returns to saving and investment and thus may lead to greater economic growth than our current tax system.

After careful evaluation, the Panel decided to reject a complete replacement of the federal income tax system with a retail sales tax for a number of reasons. Two considerations were particularly important to the Panel's decision:

- Replacing the income tax with a retail sales tax, absent a way to ease the burden of the retail sales tax on lower and middle-income Americans, would not meet the requirement in the Executive Order that the Panel's options be appropriately progressive.

- Although a program could be designed to reduce the burden of a retail sales tax on lower-income and middle-income taxpayers by providing cash grants, such cash grants would represent a new entitlement program – by far the largest in American history. Adjusting the distribution of the burden of the retail sales tax through a cash grant program would cost approximately $600 billion to $780 billion per year and make most American families dependent on monthly checks from the federal government for a substantial portion of their incomes. The Panel concluded that such a cash grant program would inappropriately increase the size and scope of government.

The Panel also had additional concerns with replacing the current tax system with a retail sales tax:

- Even with favorable assumptions, a retail sales tax on a broad base with a cash grant program would require a tax rate of at least 34 percent, and likely higher over time if the base erodes, creating incentives for significant tax evasion. A discussion of the range of potential estimates of the tax rate is provided later in this chapter.
- The federal administrative burden for a retail sales tax may be similar to the burden under the current system. A federal agency, such as the IRS, would be required to administer the tax in order to ensure adequate collection of federal revenues and uniform enforcement of the rules and regulations underlying the tax. Indeed, two types of administrations would be required – one to collect the tax and another to keep track of the personal information that would be necessary to determine the size of the taxpayer's cash grant.
- Taxpayers likely would continue to file state income tax returns, which would limit the potential simplification gains from replacing the federal income tax system with a retail sales tax.

Box 9.1. Comparing "Tax-Exclusive" and "Tax-Inclusive" Rates

The 34 percent tax rate mentioned in the introduction to this chapter is a tax-exclusive rate. Sales tax rates are typically quoted on a tax-exclusive basis, while income tax rates typically are quoted on a tax-inclusive basis. If a good costs $100 and bears an additional $34 sales tax, the tax-exclusive sales tax rate is 34 percent. The tax-inclusive rate is 25 percent – $34 (the tax paid) divided by $134 (the total amount the consumer paid). An individual who earns $134 and pays $34 in income taxes would think of themselves as paying approximately 25 percent ($34/$134 = 0.254) of their income in taxes.

Although tax-exclusive and tax-inclusive rates are both valid ways of thinking about tax rates, the easiest way to compare the retail sales tax rate to the state sales taxes paid by most Americans is to consider the tax-exclusive rate. On the other hand, it is appropriate to compare the retail sales tax rate with current income tax rates by utilizing the tax-inclusive rate. For ease of understanding, this chapter uses tax-exclusive rates unless otherwise specified in the text. Tax-inclusive rates are provided in the Appendix.

As explained in Chapter Three, the retail sales tax and the VAT represent similar ways to tax consumption of goods and services. A VAT and a retail sales tax that share the same tax base, tax rate, and compliance rates would generate the same amount of tax revenue. The Panel, therefore, analyzed a full replacement VAT at the same time it considered a full replacement retail sales tax. Although the Panel concluded that the full replacement VAT might mitigate some of the compliance challenges encountered with a retail sales tax, the Panel's primary objections to a retail sales tax applied equally to a full replacement VAT. As a result, the Panel does not recommend the full replacement VAT as a tax reform option.

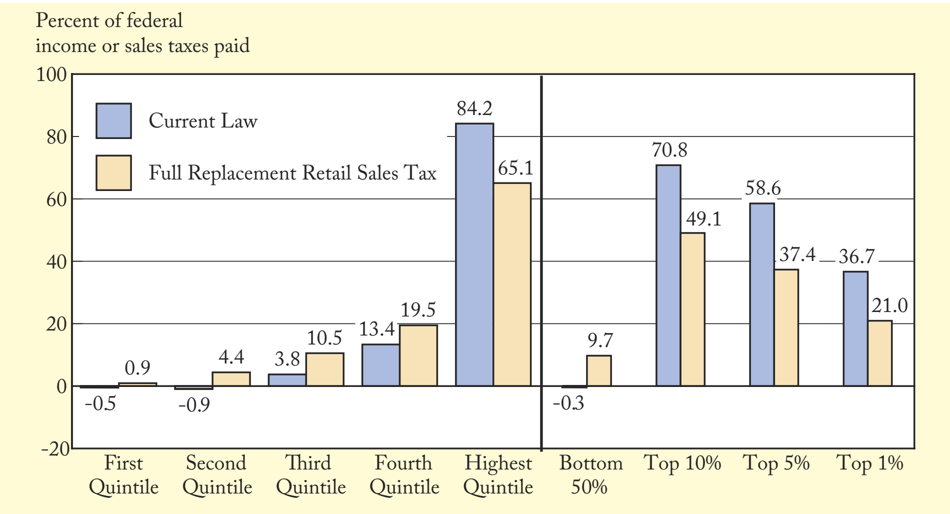
Retail Sales Tax with No Cash Grant

Forty-five states and the District of Columbia currently have retail sales taxes. Many states use multiple sales tax rates and exempt many goods and services from tax. The Panel, however, 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). The long-term likelihood of maintaining this broad tax base is addressed later in this chapter.

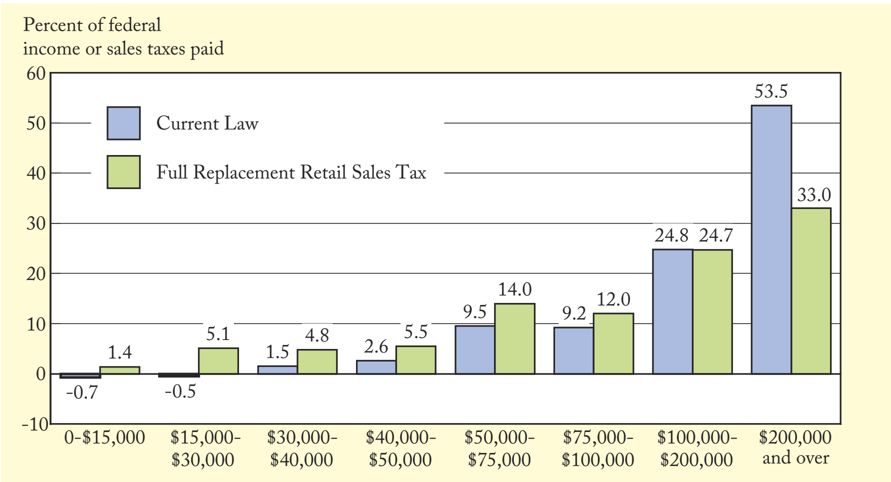
Using the Extended Base and assuming low rates of evasion, the Treasury Department calculated that the tax rate required to replace the federal income tax with a retail sales tax would be 22 percent on a tax-exclusive basis. This tax rate, however, does not include a program designed to ease the burden 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.

Figure 9.1. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.2. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.1 and 9.2 compare the current distribution of federal taxes paid with the distribution that would exist under a "stand-alone" retail sales tax at a 22 percent tax rate. Adopting this 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 pay today. 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 pay today.

Lower- and middle-income families would be especially hard hit by a stand alone retail sales tax. For example, 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). Under the stand-alone retail sales tax, her tax bill 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. Further discussion of the Treasury Department's hypothetical taxpayer analysis appears in the Appendix.

The Panel concluded that the distribution of the tax burden under a stand-alone retail sales tax would not meet the requirement in the Executive Order that the Panel's tax reform options be appropriately progressive.

Retail Sales Tax with a Cash Grant Program

Universal Cash Grant Program

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. The program would not be income based so there would be no need to have a federal agency to keep track of personal income. Nevertheless, it would require a federal agency to keep track of family characteristics, such as family size, on which the cash grant would be based.

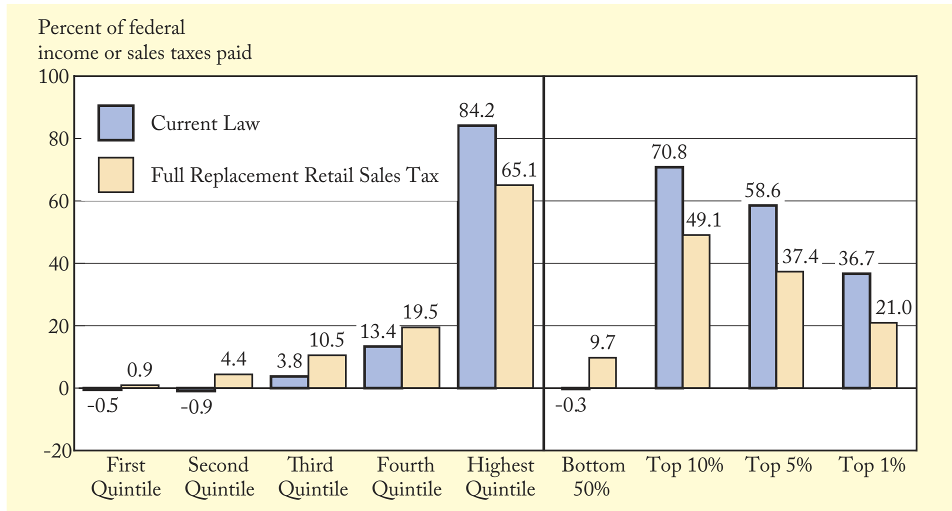
This cash grant program would be expensive, and would require raising the retail sales tax rate. To pay for the cash grant program and remain revenue-neutral, the required

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. If a narrower tax base were used instead of the Extended Base, the tax rate would be even higher.

How would the 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. 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.

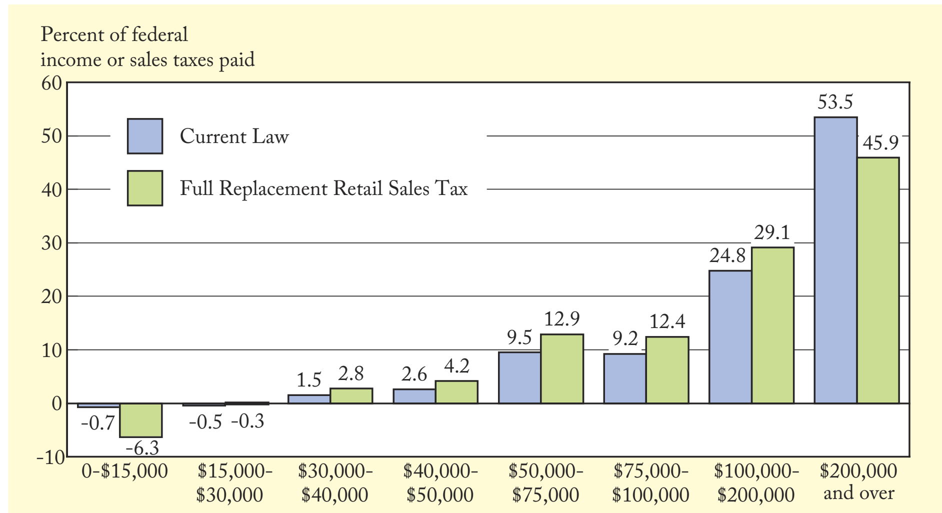
Figure 9.3. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461 Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.4. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.3 and 9.4 show that 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. Separate figures with distributional estimates for 2015 law are not provided because the distribution of the retail sales tax burden in these estimates was identical to the distribution shown in Figures 9.3 and 9.4. American families with the lowest 20 percent of cash incomes currently pay 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 at the cash register. In total, the bottom quintile would bear 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.

Targeted Cash Grant Program

The Panel requested that the Treasury Department develop a more targeted cash subsidy program to alleviate the burden of a retail sales tax on lower- and middle-income American families. The resulting program required a cash grant of up to $7,068 to married couples, plus $2,570 per dependent per year, with a phase-in and a phase-out. Further details regarding the program are provided in the Appendix, as well as a brief discussion of an alternative targeted subsidy program.

The Treasury Department's proposed targeted cash grant program would cost $780 billion in 2006. It would represent 30 percent of total federal government spending, and would dwarf all other federal entitlement programs and exceed the combined size of Social Security and Medicaid. To implement the program, the government would need to collect 34 percent more revenue and redistribute an additional 6 percent of GDP. The Panel concluded that this substantial increase in the amount of revenue collected from taxpayers and redistributed by the federal government was undesirable. Some Panelists were also concerned that the precedent set by the large cash grant program could set the stage for further growth in the size and scope of the federal government. To pay for the targeted cash grant program and remain otherwise revenue-neutral, the tax rate would need to increase to at least 37 percent, assuming low evasion and using the Extended Base.

Administration of a Cash Grant Program Would be Complex

The proposed cash grant programs 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.

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.

Evasion, the Tax Base, and the Required Tax Rate Revisited

The tax rate necessary to replace the revenues from the current individual and corporate income taxes is one key consideration in evaluating a retail sales tax. The 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 presented thus far have been based on relatively optimistic assumptions about the breadth of the tax base and the evasion rate. As explained above, even under these optimistic assumptions, the Panel does not recommend a full replacement sales tax at the resulting 34 percent tax rate.

The Panel also had 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. The 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. Accordingly, the Panel requested that the Treasury Department estimate the required retail sales tax rate using the same tax base as the Partial Replacement VAT described in Chapter Eight and using a base equal to the average state sales tax base.

The Partial Replacement VAT base described in Chapter Eight is slightly narrower than the Extended Base – primarily because it excludes the value of state and local government services. The Extended Base would require state and local governments not only to pay retail sales tax on their purchases from businesses, but also to pay tax at the retail sales tax rate to the federal government on the total value of the salaries that state and local governments pay their employees – this would be equivalent to the value of services provided by state and local governments to their citizens. The Panel concluded that it may be inappropriate for the federal government to directly assess a tax of this sort on state and local government in our federal system. For this reason, the Panel excluded state and local government services from the Partial Replacement VAT base discussed in Chapter Eight.

Existing state sales tax bases are substantially narrower than either of the broad bases studied by the Panel. 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 Panel requested that the Treasury Department estimate the tax rate using the average state sales tax base. The Panel acknowledges 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. Nevertheless, the Panel believes that estimating the tax rate using a base equal to the average state sales tax base is illustrative of the impact of base erosion on the tax rate.

Table 9.1. shows the Treasury Department's estimates of the tax-exclusive retail sales tax rates required to replace the federal income tax using the alternative assumptions regarding evasion rates and the breadth of the tax base. The Extended Base and Partial Replacement VAT Base estimates include the Prebate-type universal cash grant program (calculated to provide all families with cash sufficient to pay a 34 percent retail sales tax on a poverty level amount of spending). The average state sales tax base estimate includes no cash grant program, because exclusions from the base are assumed to fulfill the burden-easing function of the cash grant. These tax rates should be compared both to each other and to the overall burden an individual faces under both the corporate and individual income tax today. Tax-inclusive rates are provided in the Appendix.

Table 9.1. Retail Sales Tax Rate Estimates – Range of Tax-Exclusive Rates

Evasion Rate	Extended Base	Partial Replacement VAT Base	Median State Sales Tax Base
Low Evasion (15%)	34%	38%	64 %
Higher Evasion (30%)	49%	59%	89%

Source: Department of the Treasury, Office of Tax Analysis.

Box 9.2. Comparing the Treasury Department's Revenue-Neutral Rate Estimate with Estimates Made by Retail Sales Tax Proponents

In their submission to the Panel, proponents of the FairTax claimed that a 30 percent tax exclusive sales tax rate would be sufficient not only to replace the federal income tax, but also to replace all payroll taxes and estate and gift taxes and fund a universal cash grant. In contrast, the Treasury Department concluded that using the retail sales tax to replace only the income tax and provide a cash grant would require at least a 34 percent tax-exclusive rate.

Some may wonder why the tax rate estimated by FairTax advocates for replacing almost all federal taxes (representing 93 percent of projected federal receipts for fiscal year 2006, or $2.0 trillion) is so much lower than the retail sales tax rate estimated by the Treasury Department for replacing the income tax alone (representing 54 percent of projected federal receipts for fiscal year 2006, or $1.2 trillion).

First, it appears that FairTax proponents include federal government spending in the tax base when computing revenues, and assume that the price consumers pay would rise by the full amount of the tax when calculating the amount of revenue the government would obtain from a retail sales tax. However, they neglect to take this assumption into account in computing the amount of revenue required to maintain the government's current level of spending. For example, if a retail sales tax imposed a 30 percent tax on a good required for national defense (for example, transport vehicles) either (1) the government would be required to pay that tax, thereby increasing the cost of maintaining current levels of national defense under the retail sales tax, or (2) if the government was exempt from retail sales tax, the estimate for the amount of revenue raised by the retail sales tax could not include tax on the government's purchases. Failure to properly account for this effect is the most significant factor contributing to the FairTax proponents' relatively low revenue-neutral tax rate.

Second, FairTax proponents' rate estimates also appear to assume that there would be absolutely no tax evasion in a retail sales tax. The Panel found the assumption that all taxpayers would be fully compliant with a full replacement retail sales tax to be unreasonable. The Panel instead made assumptions about evasion that it believes to be conservative and analyzed the tax rate using these evasion assumptions.

Evasion

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 Panel, the Treasury Department estimated the revenue neutral retail sales tax rate assuming evasion rates of 15 and 30 percent of personal consumption spending. The Treasury Department assumed no evasion by state and local governments. By comparison, for 2001 the IRS estimates 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.

The 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 retail sales tax. Further, 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.

Nevertheless, the Panel concluded that a number of features of the 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, would 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. For example, 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 should be taxed. Or, 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.

Empirical evidence suggests 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. There is no third-party reporting in a 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 government. The government would rely on retailers alone to report their own taxable and exempt sales.

To obtain exemption from tax, 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. Retailers are often ill-equipped to carry out this role. State 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.

Box 9.3. Dual-Use Goods and the Problem of "Cascading"

The difficulty of identifying whether dual-use goods are used for business or individual purposes is one reason that states typically include a significant number of business-to-business transactions in their sales tax base. For example, states often do not ask retailers to determine whether a buyer will use a computer for entertainment at home (taxable) or to run a business (exempt). Instead, many states treat sales of computers as taxable unless the buyer certifies that they are purchasing the computer for resale. Thus, many businesses pay sales tax when purchasing computers. That tax then "cascades" into the cost of the goods and services the purchasing business sells to consumers. Taxing goods and services bought by businesses to produce other goods and services is economically inefficient because it haphazardly imposes double (or triple or quadruple) taxation on some consumer goods and services.

Cascading taxes create incentives for business to produce fewer goods or services, shift resources into tax-favored activities, or adopt tax-driven business structures. Cascading taxes also may have a negative impact on U.S. competitiveness because they impose some tax liability on exports and result in less tax being assessed on imports relative to competing domestically-produced goods.

Comparison with State Sales Tax Evasion and Administration

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. 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).

Higher tax rates provide greater incentives for taxpayer evasion and avoidance. 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. State tax administrators told the Panel that they would expect significant compliance problems at such rates.

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. It is reasonable to assume that trying 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. Although it is difficult to know with any measure of certainty what the evasion rate would be under the RST, the Panel 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.

Other Concerns

Response of the States to a Retail Sales Tax

Although some 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 experience of Canada, which tried to federalize its provincial sales taxes, may be instructive. 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.

Variation in local sales tax rates within the United States could further complicate any effort to standardize U.S. sales tax bases and rates. As of 2001, 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. While some states might bring their sales taxes into conformity with a federal retail sales tax, it is unlikely that all would do so. 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.

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. 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.

State Income Tax

At the Panel's 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. Currently 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.

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.

Today, 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. 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.

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. But if states chose to impose reporting requirements independently, multi-state businesses could face many different sets of reporting obligations. Simplification of the federal tax system through a 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 retail sales tax also likely would 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. In 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 retail sales tax would cover 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.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a retail sales tax. Although there may be some such disruptions, those considerations were secondary in the Panel's decision not to recommend a retail sales tax.

Full Replacement of the Income Tax with a VAT

The Panel considered replacing the income tax with a VAT at the same time it analyzed a replacement retail sales tax because of the similarities between the two taxes. The Panel concluded that fully replacing the income tax with a VAT would be substantially more administrable than fully replacing the income tax with a retail sales tax. The advantages of a VAT over a retail sales tax with respect to enforcement and compliance are described in Chapter Eight. However, the Panel's objections regarding the increased tax burden on the middle class and increased size of government resulting from the full replacement retail sales tax apply equally to a full replacement VAT. Because of these concerns, the Panel did not recommend a full replacement VAT.

Conclusion

Like other consumption taxes, the full replacement retail sales tax has pro-growth features. Nevertheless, the Panel does 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 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. The Panel also was concerned with administrative and compliance issues associated with a retail sales tax, as well as difficulties involving coordination with existing state sales taxes.