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Should the Federal Income Tax Be Replaced with a National Sales or Value-added Tax?

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[Editor's Note: It appears that the question of changing the federal tax base will be part of the public debate for the foreseeable future. In a Brief that we published in April, Alan Auerbach of UC Berkeley summarized the effects and uncertainties of replacing the federal income tax with a federal flat tax. In the following discussion, Steven Sheffrin of UC Davis reviews several important issues embedded in a possible shift to a national sales or value-added tax, two other forms of consumption tax.]

In the last year, there has been active discussion of replacing the federal income tax, both personal and corporate, with either a national retail sales tax or a national value-added tax. These taxes, along with the Hall-Rabushka flat tax, are actually different forms of consumption tax. This designation is intended to distinguish them from the income tax, which taxes income regardless of whether it is consumed or saved. Perhaps the feature of consumption taxes that its proponents cite most often is that they are not imposed on income derived from savings and investment, making higher rates of saving and economic growth more likely.

To follow this discussion and to understand its implications for policy makers and other citizens, it is useful to begin by outlining the general features of consumption taxes before turning to specific aspects of a national sales or value-added tax. Five key points need to be kept in mind as we think about consumption taxes:

1. It is far from clear that even with a tax base geared strictly to consumption, Americans will therefore consume less and save more. While Americans have a relatively low rate of savings, there is no consensus on how much saving would be stimulated by shifting to this tax base, nor on how much the change would improve the productive use of economic resources.

There are several reasons for the lack of agreement. Some economists believe that income from capital is already taxed relatively lightly when one considers the combination of accelerated depreciation, nominal interest deductibility, leasing, and unreported capital income. If this is the case, moving to a consumption tax base would not result in that large a reduction in the overall rate of taxation on income from capital. Second, the increase in the rate of saving in response to decreases in the tax rate on capital income is also subject to some dispute. The evidence from various changes in the federal income-tax rates during the 1980s does not suggest that these changes spurred substantial rises in saving. Third, although there is debate over the impact that the current income-tax system has on saving, most economists agree that it generates substantial non-neutralities, or distortions, between economic sectors that make the economy less productive. Nonetheless, most of them think that these distortions can be eliminated without resorting to a tax system based on consumption.

2. In general, the burden of consumption taxes would fall more on lower- and middle-income households. As shown in detailed and careful studies by the Congressional Budget Office, other agencies, and many economists, this shift in tax burden is especially true of the retail sales tax and the value-added tax. The flat-rate tax of Hall and Rabushka effectively offsets this shift in the tax burden by providing a generous exemption to lower- and middle-income households and individuals. However, studies of the Hall-Rabushka proposal typically show that for *revenue-neutral* changes in tax rates under their flat-rate tax -- changes that would collect the same amount of taxes as the current federal income tax -- still only the upper ninth and tenth decile of taxpayers (upper middle class and higher-income individuals and households) would actually have a lighter tax burden. This means that, under a revenue-neutral change, other taxpayers would have their taxes increased. Of course, individuals differ in their consumption patterns. At any income level, individuals with relatively high consumption levels would face an increased relative burden in a switch to a tax on consumption.

3. Introducing taxation on consumption would impose a one-time additional burden on holders of accumulated assets. This group would be disproportionately comprised of the elderly and the retired. To understand this one-time effect, consider a recently retired worker. This worker has already paid income taxes as he or she worked and saved for old age. Now this worker would face additional taxation on his or her consumption. It is possible, under some tax plans, to reduce this burden by crafting transition rules that effectively exempt taxation on consumption financed from accumulated assets. However, several economists have noted that providing this relief also reduces the increases in savings and economic growth that might be expected from shifting to taxation on consumption.

4. Although consumption taxes are designed to favor savings and investment, industries will not benefit equally. Because certain industries are favored under our current tax system, they will be relatively hurt under a system that is more neutral across types of investment. Tax economists have shown that moving to a consumption tax from an income tax would be equivalent to disallowing interest deductions for businesses (and not taxing interest income) while allowing investment expenditures to be deducted in full in the first year rather than depreciated over longer periods of time. Thus, industries with many interest deductions and low investment levels would be relatively disadvantaged in a switch to taxation on consumption. A 1995 California Franchise Tax Board study, "The Impact of the Flat Tax in California" (the only detailed study for California), found that the transportation, communications, and utilities industries would be the foremost beneficiaries under a consumption tax.

Housing also is favored under our current system; we allow mortgage interest and property tax deductions and do not tax imputed rent (the rental value of living in one's own home). Under a consumption tax, resources that are not currently taxed, such as these, would presumably shift into other, more productive activities. The shift in these resources would take some time as homeowners adjust to less favorable tax treatment. However, there could be immediate effects on prices of homes because new purchasers will not be willing to pay as much for housing without the benefits of mortgage interest and property tax deductibility. However, we do not know what the size of these effects will be; for example, in the housing industry, we do not know the relative effects of falling interest rates that would result from ending interest deductibility, as the Hall-Rabushka flat tax proposes to do. Several studies have found large adverse effects on California residents and business from an increase in the taxation on housing, but they have not fully explored the effects of lower interest rates.

5. To judge from poll results and public opinion surveys, Americans have not completely understood the issues involved in shifting the basis of the federal tax system. Public perceptions are important, but the public has a difficult time understanding that tax plans which look dissimilar may have similar economic effects. For example, the public believes that the provision in the Hall-Rabushka flat tax that exempts capital income from individual taxation is a big loophole. Yet they typically support retail sales taxes, which have very similar economic effects.

A more subtle issue, which few understand, is that it is possible to eliminate the double taxation of corporate in-come (once as corporate income and once as dividends distributed to individuals) without shifting the tax base from income to consumption. For example, it is possible to avoid double taxation by taxing exclusively at the level of the business enterprise within an income tax and levying no taxes on dividends and interest at the individual level. The U.S. Treasury recently made such a proposal, and European countries typically offer dividend relief either at the personal or corporate level.

Public perceptions of tax systems might also matter on political economy grounds. Some economists worry that the public would not be aware of the burden of taxation under a value-added tax because the taxes are embedded in the prices of goods and services. In particular, some conservatives have argued that the value-added tax is a "money machine" that would lead to the growth of government. Others have argued, on similar grounds, that a retail sales tax is preferable to a value-added tax because people would be more aware of the tax. These issues are important, but we know very little about how the public will respond, as voters, to different systems of taxation.

A National Retail Sales Tax

While retail sales taxes at the state and local levels are familiar to almost everyone, few citizens have been exposed to arguments for the adoption of a national sales tax. There are several important considerations in contemplating a national retail sales tax.

Compliance. Compliance problems increase as the tax rate rises. Using what the Congressional Budget Office envisions as the broadest feasible base for a consumption tax, economists have calculated that a federal retail sales tax would require a 20% rate to replace federal corporate and personal income-tax revenues.(1) As the base is narrowed in the legislative arena, this rate increases sharply. These high rates create tremendous incentives for cheating at the final distribution point, the business from which the sales tax would be collected. The conventional wisdom from international experience with retail sales taxes suggests that compliance problems already become very serious at a 10% rate.

Burden. A national retail sales tax will inevitably fall much more heavily on lower-income households.

Exempting some goods will help a bit, but this will lead to much higher rates. Nor is it easy to draw a line on exemptions. Exempting food eaten at home, for example, would have the most beneficial effects because food represents a large expenditure among people with low incomes, but there will also be strong pressures for exempting medical expenses.

Coexistence with state and local tax systems. How can a federal sales tax be combined with state sales taxes that exist in 45 states plus the District of Columbia? Ernest J. Dronenburg, Jr., a member of the California's State Board of Equalization, has examined this issue thoroughly.(2) Dronenburg recommends offering the option of adding a national sales tax to existing state sales taxes, but having it administered by each state. States could choose whether or not to use the base of the national sales tax as the base for their own sales tax. Another option would be for the federal government to impose its tax on top of the existing sales taxes in each state. To impose the same effective rate of tax in each state, the rate for the federal retail sales tax would vary in each state to account for the fact that tax bases for retail sales taxes differ from state to state. Under this formulation, a federal tax would not be uniform across states. In general, proponents of state administration of a federal retail sales tax argue that the states' experience with retail sales taxes would result in greater compliance and smaller administrative costs than would be possible with a new federal bureaucracy.

Dan R. Bucks, Executive Director of the Multistate Tax Commission, has warned that replacing the federal personal and corporate income taxes will make it impossible for states to rely on income taxes. The absence of federal data on income will prevent states from running their own personal and corporate income-tax systems cost-effectively, and states, for a complex set of reasons involving legal and administrative matters, could not enforce a system of withholding on their own. Moreover, if states have to raise their existing sales taxes to make up for the loss in personal and corporate income taxes, the sales tax rates would total between 30% and 40%. This rate would stretch compliance beyond any reasonable standard.

Nonuniform application of state sales taxes. Straightforward and familiar as the sales tax seems, no state has a pure sales tax. An ideal retail sales tax would tax all final goods and services at the same rate and exempt all intermediate goods. This would ensure that all consumption is taxed once and only once. In practice, such taxes exempt many final services and also tax 30% to 45% of intermediate goods. This pattern has not changed much since the 1930s, when sales taxes were introduced as a replacement for property tax revenues and were imposed on tangible goods, not services. One would certainly expect resistance from those sectors or businesses that benefit under the current, non-neutral arrangements.

There are also political problems in taxing services. From a theoretical standpoint, services purchased by businesses would be exempted from a sales tax since they are intermediate inputs. However, state officials would find it difficult to explain to the public why an individual going to H & R Block for help with taxes would pay a sales tax but a corporation using the services of a Big Six accounting firm would not. There is also the problem of imposing sales taxes on goods used for both personal and business purposes.

Value-added Taxes

Value-added taxes can be imposed from the local to the federal level, and can be collected in different ways. The most common and familiar value-added taxes are those levied in Europe in invoice-credit form: Firms pay taxes on their sales but receive credits for taxes paid on their purchases. As this example indicates, a value-added tax collects the retail tax in pieces all the way up the production and distribution chain. The advantage of a value-added tax is that it can in principle reach all economic activities, including services, which are not typically touched by a retail sales tax.

Compliance. The invoice-credit value-added tax is self-enforcing because a business needs to see that its suppliers paid the tax. It induces greater compliance than a retail sales tax. Nevertheless, a tax rate of at least 20% would be required to raise the same amount of taxes as now, even with the broadest feasible base. In practice, the base would be narrower (because of exemptions enacted in the legislative process) and the rate higher. The resulting noncompliance would strain the tax-collection system by driving up enforcement costs while preventing it from collecting enough taxes. Again, based on the experience of other countries, the United States would be in the upper ranks of governments that raise revenues from the value-added tax. In other countries, the value-added tax coexists with personal and corporate income taxes but does not replace them.

Replacing both personal and corporate income taxes with a federal value-added tax would eliminate the government's costs of enforcing compliance with the income tax, but would create new costs for enforcing the value-added tax. Economists estimate that this would, however, probably lead to an overall savings in total compliance costs.

Burden. Under a federal value-added tax, as under a federal retail sales tax, the burden of taxation would again be shifted to those on the lower end of the income scale. The Congressional Budget Office found that having a zero tax rate on some goods did not make a large difference in the shift in tax burdens associated with a value-added tax.(3)

Coexistence with state and local tax systems. If there were a federal value- added tax, would states keep their existing sales taxes or replace them with their own value-added taxes? If states do maintain their existing sales taxes, there are a number of basic questions. Should the value-added tax be calculated on the price before or after the sales tax? Should sales taxes be assessed on goods and services that already include a federal value-added tax? Dronenburg emphasizes that the registration requirements are different for a value-added tax and a retail sales tax and that, in general, dual systems would impose large accounting costs on business.

If states were to try to "piggy-back" on a federal invoice-credit value-added tax by adding their own, there would be a number of difficulties. First, new rules and procedures would have to be developed for tracking interstate sales. This would be necessary as long as rates differed across states or it were policy to allocate tax revenues to individual states. Second, what would happen to all the small localities around the country that levy their own sales tax along with state sales taxes? If there were a common base, who would do the collection? In Canada, federal collection is an option, but only one province has adopted it.

Finally, in adopting a federal value-added tax, we would face essentially the same problem as with having to repeal state and local personal and corporate income taxes: The total effective value-added tax rates would far exceed rates anywhere else in the world because of the combination of federal, state, and local value-added taxes, and noncompliance could be expected to cut significantly into the amount of revenue collected.

The complex character of existing state value-added taxes. Existing state value-added taxes are not pure consumption taxes. Michigan's Single Business Tax is a good example. This tax is based on the value added by a business. Before the tax is levied on multistate firms, it is necessary to determine what part of the entire business's value added is attributable to its activities in Michigan. To assign this value and determine the tax, Michigan uses an apportionment method based on the value of the business's sales, property, and payroll within and outside of Michigan. This apportionment method, however, ends up transforming the tax on value added partly into a tax on in-state production, not consumption.(4) Thus, it has a very different character than a standard invoice-credit value-added tax. While the Michigan-style value-added tax could be administered along with some versions of federal value-added taxes, it is important to note that it is not exclusively a tax on consumption.

State Corporation Taxes and the

Hall-Rabushka Consumption Tax

While there has been extensive public discussion of flat taxes,(5) there is a key element that has not been carefully discussed: their effect on, and the collection and allocation of, state corporation tax revenues. This issue is best addressed in the context of a specific proposal, the Hall-Rabushka flat tax.

The Hall-Rabushka flat tax has two components: a business cash-flow tax and an individual wage tax, both imposed at the same rate. While many aspects of the Hall-Rabushka plan have been considered, there has been little discussion of how this tax would coexist with state and local tax systems. Perhaps the most interesting issue arises from the potentially large increase in collections at the business level (from all businesses, not just corporations) and the decrease that is projected to occur at the individual level under this form of the flat tax.

Tax revenues collected from individuals would fall because people would pay taxes only on their wage income and not on any income from capital. If the federal government adopted this type of flat tax, the states would not find it feasible to collect taxes on capital income (for reasons discussed above) and would also be restricted to collecting taxes on wage income only.

Although states would be collecting less revenue from individuals, they would be collecting substantially more from business, primarily because interest deductions would be disallowed. This would be a dramatic change for most states. To deal with the increase in tax collections from business under the Hall-Rabushka proposal, the states would probably use their conventional corporate income-tax systems and apportion the higher level of income among the states. States currently divide the income of multistate corporations among the states in which the corporations operate through a system of apportionment based on the property, payroll, and sales in each state. The apportioned income is then subject to tax in each state. However, the increased level of potential revenue to the states would put immense political stress on their respective systems for apportioning income. As tax experts know, methods of apportioning income among states are fraught with difficulty and subject to much litigation. It is not clear whether the current system could handle the additional burden that a Hall-Rabushka tax reform would impose without undergoing a major restructuring, and only then after protracted legislative wrangling.

Conclusion

This brief discussion has had several objectives. It has voiced some of the skepticism about the stronger claims that are being made for the benefits of replacing an income-tax base with a consumption-tax base, and sketched some of the current limits of both public understanding of competing tax systems and professional understanding of the full impact of shifting from one to the other. Most of all, this discussion has emphasized some of the practical political and administrative obstacles to shifting to a tax system based on consumption rather than income: concerns about equity in the impact of the taxes, the likelihood of higher than expected rates, questions about the enforceability of and compliance with tax rates that Americans are not used to paying, and the very complexity of administering the resulting tax system. Among all the promise and difficulties raised by the possible adoption and transition to a consumption tax base, two main points deserve more attention from policy makers and the public than they have received thus far:

Trying to replace the federal personal and corporate income tax with a national retail sales tax or value-added tax would lead to total tax rates on consumption between 30% and 40% -- far higher than anywhere else in the world. The experience of other nations suggests that these rates are unenforceable and would stimulate widespread noncompliance. Countries with higher tax burdens than those of the United States rely on a mixture of income and consumption taxes and avoid extremely high rates on consumption alone.We need to think carefully how a Hall-Rabushka or other federal consumption-tax plan would interact with state corporate income-tax systems. Such new consumption-based taxes may strain the capacity of these systems to allocate income and apportion tax burdens across states.

Notes

1. Based on *Effects of Adapting a Value-added Tax*, Chapter III. Washington, D.C., Budget Office, The Congress of the United States, February 1992.

2. Ernest J. Dronenburg, Jr. SAFCT: State Administered Federal Consumption Tax: The Case for State Ad-ministration of a Federal Tax. Presented at New York University, Annual State and Local Taxation

Conference, November 30, 1995.

3. *Effects of Adapting a Value-added Tax*, Chapter IV. Washington, D.C., Budget Office, The Congress of the United States, February 1992.

4. James Francis. A Closer Look at a State Invoice-Credit VAT. *State Tax Notes*, pp. 804-809, November 30, 1992.

5. For a discussion of flat taxes, see Alan J. Auerbach, Flat Taxes: Some Economic Considerations. California Policy Seminar, March 1996.

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