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TAX POLICY

Choosing Among Consumption Taxes

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Preface

Federal budget deficit reduction and tax reform are two of the most important issues the current Administration and the 99th Congress have faced. The long-sought goal of income tax reform now seems closer than ever and is being pursued with the intent of enacting legislation that will be revenue neutral—that is, neither adding to nor subtracting from federal revenues. Many observers, however, believe that expenditure cuts will not be sufficient to significantly reduce the federal deficit and that increased tax revenues may also be required. Because of this belief, interest has been growing in tax structures other than the income tax to assist in deficit reduction. One alternative that has been proposed is some form of consumption tax.

We prepared this study to provide the layman with a general overview of consumption taxes and related issues. The study is intended to acquaint the general public, the Congress, and other interested parties with the principal features of various consumption taxes, their relative advantages and disadvantages—with particular attention given to administrative considerations—and some of the key questions and issues associated with consumption taxes. The study should be particularly useful to those interested in tax policy and deficit reduction The study contains no conclusions or recommendations. Should readers want more information, the study provides listings of sources in the appendix and bibliography.

We obtained most of the information in this study from published sources, including textbooks, government reports, professional journals, popular periodicals, and other research sources. We did not develop original statistical data or verify the specific data used in the study We discussed the study, particularly the administrative aspects, with The Internal Revenue Service and various trade, industry, and professional organizations, and incorporated their comments in the study, where appropriate.

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Abbreviations

CBO	Congressional Budget Office
EEC	European Economic Community
IRS	Internal Revenue Service

Introduction

The prospect of sizable federal deficits for the rest of the 1980s prompted Congress to enact legislation in 1985 setting deficit reduction targets for the next 6 years. The law requires the deficit to be zero by fiscal year 1991 Many people believe that, in order to meet these targets, a tax increase will be necessary.

Today the principal sources of federal revenue are the individual and corporate income taxes. In the past, when Congress elected to increase taxes in response to a need for more revenue, it usually increased the income taxes to meet the bulk of its needs. Today this alternative has become less attractive.

For a number of reasons, the general public and, in turn, the Congress are apparently less willing than previously to accept higher income taxes. One reason may simply be that the income tax no longer commands public approval as the fairest and best tax. In recent surveys, more persons named the federal income tax as the most unfair of all taxes than named any other tax.[1] Changes in the tax laws since World War II have made the federal income taxes highly complex. The complexity of the laws has nourished a popular impression that the tax system contains tax loopholes for the well informed and well-to-do, many of whom, it is believed, take advantage of obscure provisions to avoid paying their fair share of taxes. In addition, some observers maintain that certain features of income taxation have diminished the vigor of the Nation's economy and that the United States relies too heavily on income taxes for its public revenues, to the detriment of its prosperity

The wide-ranging and comprehensive tax reform legislation now being considered by the 99th Congress may, if enacted, help restore public confidence in the income tax system. But since the proposed legislation is being considered within the context of revenue neutrality, the issue of revenue with which to address the budget deficit will remain. This has stimulated interest in other forms of taxes—one being a consumption tax.

A consumption tax is levied on a taxpayer's expenditures for goods and services rather than on that person's income. Various types of consumption taxes are used in the United States today. On the state and local levels, retail sales taxes are used to generate revenues based on consumers' expenditures for goods and services. On the federal level, excise

[1]See U S Advisory Commission on Intergovernmental Relations, Changing Public Attitudes on Governments and Taxes 1985 (Government Printing Office, 1986), table 4, p 19

taxes are used to generate revenues based on the consumption of such items as alcohol, tobacco, and petroleum products

Consumption taxes could be used to supplement or even replace income taxes. In 1982, for example, revenues to states and localities from taxes on consumption amounted to 35.3 percent of all their tax revenues. Revenues from income taxes amounted to nearly 25 percent. At all levels of government in the United States, taxes on consumption accounted for 15.0 percent of all tax revenues in 1982, while income taxes accounted for 44.8 percent Among the member countries of the European Economic Community (EEC), an average of 28.4 percent of tax revenues in 1982 was raised by consumption taxes.[2]

Consumption taxes differ from income taxes in many ways, such as the location of responsibility for collecting and remitting the taxes to the government, and the occasion of their payment. In the view of some economists, greater reliance on consumption taxes and less on income taxes could spur greater saving and investment because income used for these purposes would not be taxed.

The next chapter of this study describes three types of broad-based consumption taxes that could be used in the United States to raise significant additional revenue. They are (1) a national retail sales tax, (2) a value-added tax, and (3) a personal expenditure tax. In discussing these taxes, we have paid particular attention to administrative considerations. Chapter 3 addresses some of the questions commonly asked about consumption taxes.

The objective of this study is to acquaint the layman with the subject of consumption taxes. It is intended to be informative and to help those who want to improve their understanding of a method of taxation that is less widely used in this country than in most European countries. No conclusions or recommendations are made, e.g., that the federal government needs more revenue to reduce its deficit, or that it should enact a consumption tax.

The information presented in this study has been collected primarily from published sources, including textbooks, government reports, professional journals, popular periodicals, and publications of accounting firms, international organizations, trade associations, and similar

[2]All figures from Organisation for Economic Co-operation and Development, Revenue Statistics of OECD Member Countries 1965-1983 (Paris OECD, 1984)

groups We also spoke with officials of the Internal Revenue Service (IRS or Service), American Bar Association, American Institute of Certified Public Accountants, and several business associations, including the American Retail Federation, The Conference Board, National Federation of Independent Business, Tax Executives Institute, and United States Chamber of Commerce, to solicit their views about the administration of consumption taxes.

Broad-Based Consumption Taxes

All consumption taxes, regardless of type, share the feature that they only tax the consumption of goods and services No part of saving is taxed They differ among themselves in what their bases include Some consumption taxes are broad-based, meaning that a large fraction of all goods and services are subject to the tax. The familiar retail sales tax imposed by many states and localities is an example of a broad-based consumption tax at a non-federal level. Other consumption taxes are more narrowly based. Many excise taxes only apply to one or a few goods: cigarettes, for example, or certain alcoholic beverages, or tires for use on heavy trucks. In this chapter we discuss three broad-based consumption taxes that are capable of raising significant revenues. Also, we focus on what the federal role would be in collecting, administering, and enforcing such taxes.

National Retail Sales Tax

In the United States, the retail sales tax is the best-known of the broad-based consumption taxes because of its extensive use by state and local governments. The distinguishing features of a retail sales tax are that it is levied on a broad range of consumption products and that it is imposed at the time of retail sale. A national retail sales tax could be set at some percentage of the retail price of all taxable goods and services and would be collected from retailers selling those goods and services.

A national retail sales tax would be capable of raising large amounts of revenue. Estimates we have seen of the revenue yield of a 1-percent tax range from $8.1 billion to $18.2 billion per year. These estimates depend on the comprehensiveness of the tax base. They may be too high if adding a national sales tax to existing state and local sales taxes provoked an appreciable increase in sales that were concealed from the tax collector, such as those that take place in the underground economy

Economists who have studied the issue generally believe that a national retail sales tax would be a regressive tax, that is, that it would require the poor to pay relatively more of their income in taxes than the rich. Its regressivity could be lessened in a number of ways. First, following the example of most state sales taxes, certain consumption items on which lower income individuals spend relatively more of their income, such as food consumed at home, could be exempted from the tax. Bureau of Labor Statistics data indicate that as incomes rise, the percentage of income spent on home-consumed food declines. Between 1962 and 1983, the number of states exempting food from their general sales taxes rose from 9 to 28. Second, the regressivity of a sales tax could be reduced by providing some sort of rebate to low-income individuals for a part of their sales tax payments. Either of these actions, however, would make the tax more complex. Regressivity could also be reduced by incorporating as many services as possible into the tax base, because higher income groups tend to spend more of their income on services than lower income groups.

There are two sets of costs associated with administering and collecting a sales tax. The first set is borne by retailers in complying with the tax These costs are difficult to quantify but are associated with bookkeeping and preparing tax returns. According to a study of retailers in Ohio in the early 1960s, the average cost to retailers of complying with the state sales tax amounted to 3.9 percent of the retailers' sales tax liability [1] Given the current use of sophisticated cash registers and computers, it is reasonable to assume that retailer compliance costs would be lower now.

The other costs are those incurred by the government, such as the cost of processing returns and conducting audits. In about half the states that use a sales tax, the state tax authorities directly reimburse retailers for collecting the sales tax. These reimbursements represent significant costs to these states. Nevertheless, some officials believe that reimbursements promote tax compliance because the reimbursements are not paid unless returns are filed on time. Others who criticize reimbursements point out that they often exceed the retailers' compliance costs and represent a significant revenue drain on the state. They also argue that it is a long-standing principle of taxation that taxpayers should not be compensated for their efforts in complying with tax laws. Nonetheless, all businesses receive indirect compensation in the form of the use they may make of the taxes that they collect before those taxes must be remitted to the government.

Administrative costs to the government and businesses increase with the number of exemptions. For example, if certain food items are exempt, taxpayers who sell both exempt and taxable items must keep more detailed records of sales, and each audit becomes more burdensome for authorities.

Many states do not separate the costs they incur to administer their sales taxes from those associated with other taxes. Among those that do

[1]John F Due and John L Mikesell, Sales Taxation State and Local Structure and Administration (Johns Hopkins University Press, 1983), p 325 This work is the source of much of the information on retail sales taxation that appears above

maintain distinct accounts, the costs of administering the sales tax averaged 0.73 percent of tax revenue over the period 1979 to 1981. These costs have fallen steadily since 1959-60, when costs averaged 1 1 percent of revenue.

Administrative Considerations

Before introducing a national retail sales tax, the federal government would have to undertake a number of pre-implementation activities, including writing regulations, designing tax forms, recruiting personnel, and conducting education and training. It would also need to plan programs to register vendors, process returns, determine delinquency, and audit returns.

Pre-implementation activities. In preparation for implementing the tax, the agency administering it would have three major tasks to complete. First, it would have to write regulations relating to the tax and its administration. Second, it would need to design new forms. These forms would require taxpayers to include information on gross sales, total deductions, net taxable sales, tax due, and any penalty and interest due

The third important pre-implementation activity would be in the areas of recruitment, education, and training. The federal government would need to establish a program to educate both businesses and individual consumers about the requirements of the tax. This program could be modeled after those run by many states. Most state education programs use two main approaches to reach taxpayers. First, they send all businesses a booklet explaining the tax and its requirements. Second, they usually make tax information available from local or district tax offices or from local government offices. These taxpayer education or information programs are also responsible for notifying businesses of any changes in the tax.

In addition to taxpayer education, the administering agency would have to determine what additional resources it required to discharge its new responsibilities. Recruitment programs would have to be established and training programs conducted for its own personnel.

In our conversations with IRS officials, we were told that the Service had undertaken no study of retail sales taxation and was unable to say how much time would be required to implement a newly enacted retail tax. Officials agreed, however, that in view of most Americans' familiarity with the tax at the state and local level, a new federal retail sales tax might take effect within a year or so of enactment, little more than half the time that the Service estimates it would require to begin administering a value-added tax.

Registration. Business registration would be the first step in implementing a national retail sales tax. Because in most states businesses are already familiar with state sales tax registration procedures, the federal government could again follow the examples of the states. State registration systems usually require businesses to apply for a sales license Some states also register tax-exempt organizations, which receive exemption certificates (instead of sales licenses) permitting them to purchase and sell items tax-free.

As of 1983, six states required businesses to renew their licenses each year. The advantage of this requirement is that it helps states to eliminate inactive vendors from their registration lists. If a state is unable to keep its list current, it may label as delinquent and later investigate nonexistent businesses. However, requiring annual license renewal imposes an additional burden on both businesses and states. Partly to cover administrative costs, several states charge a license fee at the time of registration.

Tax collection. By comparing the due date of taxes with the date received, a computer can determine whether a return is delinquent All states allow taxpayers a few days between the due date and the time when they will be declared delinquent. This period varies between 10 and 60 days (although only 12 states allow more than 1 month) In addition, in most states taxpayers may request permission to file late.

If a return is delinquent, states generally assess a penalty. The penalty is usually a percentage of the unpaid balance. After determining that a business is delinquent, the states may initiate a series of actions to secure tax payment. These actions generally begin with a letter of delinquency notification. If the delinquency remains unresolved, the states may file liens on a business and sell its assets to settle the tax liability

Audit. Another responsibility of tax authorities under a retail sales tax system is the examination or audit. Tax officials must devise systems to select businesses for audit and to allow businesses to appeal audit results. States use a variety of systems in selecting businesses for audit and achieve varying degrees of audit efficiency and effectiveness All states examine returns for completeness and mathematical accuracy In addition, many conduct office audits of returns to determine whether a field audit may be warranted. Some states audit many or all large firms in their jurisdictions along with others that, based on previous audits, have established some pattern of reporting irregularities. Because they want to avoid any suggestion that only large firms are audited, a few states also select firms randomly.

All states provide mechanisms for reviewing the results of their audits. While the mechanisms vary among the states, they usually include processes to check overall audit accuracy, auditor competence, and uniformity of audits among auditors. The states also provide taxpayers with administrative and legal channels through which to appeal audit findings. In many states, taxpayer appeals, which must be filed within a specified period of time, must exhaust all administrative remedies before moving to the courts. Most appeals are settled through the administrative process with relatively few moving into the courts.

IRS officials were unable to say how much audit coverage would be required to effectively administer a national retail sales tax. They stressed that after the Service had gained experience administering the tax, it would learn where to concentrate its audit resources for maximum effectiveness. As time passed, fewer resources would be required to achieve a given level of audit efficiency.

Views of others. Few of the business organizations with which we spoke expressed any views about a federal retail sales tax. The American Retail Federation and National Federation of Independent Business raised concerns over the possible burden on retailers, who would be required to collect the tax and remit it to the federal government.

Value-Added Tax

A retail sales tax is collected entirely at one point in the production and distribution process, namely, when a good or service is finally sold to a consumer. Instead of making collections at the point of final sale, a value-added tax divides the collection process among the various stages of production according to the value added to the good or service at each stage. This type of tax was pioneered by the nations of the EEC and has since been adopted by other nations.

Although there are three principal forms of value-added taxation, which differ in their treatment of long-lived capital goods, the consumption form is almost universally used by nations that impose a value-added tax and is likely to be the one that would be chosen in the United States.

Under this form, capital equipment in effect bears no tax [2] The tax base for a value-added tax of the consumption type that exempts exports and includes imports and that extends through the retail stage—features common to the value-added taxes of most nations—is identical to the base of a retail sales tax.

All developed countries that use a value-added tax collect the tax by the so-called invoice or credit method Under this method, for every sale within the production and distribution system, a tax is calculated, added to the price of the product, and shown on the invoice that sellers in these countries normally are required to furnish to purchasers.[3] At the end of each tax period, a business subtracts the sum of the taxes that it paid on its purchases from the taxes that it collected on its sales. The difference is its net tax liability, which it remits to the government.

The invoice method allows for a readily administrable verification of tax liability because each business must keep accurate records of total tax paid and charged, with supporting invoices. The trail of invoices also allows cross-checking for accuracy should the business be selected for audit.

An example may help to clarify how the invoice method works This example is of a value-added tax of 20 percent applied to the production and distribution of baseball bats. A tree farmer harvests an ash tree and sells it to a lumber yard for $5 per unit. This represents the value added to the ash seedling by the farmer. The farmer adds $1 of tax to his price (20 percent of $5) and collects a total of $6 from the lumber yard. He remits $1 of tax to the government. The lumber yard takes the $5 unit of ash, cuts it into rectangular prisms, and sells them to the bat maker for $10 (another $5 being added in value by cutting the wood). In addition to the $10, the bat maker pays $2 of tax. The lumber yard remits to the government the difference between the total amount of tax it collected ($2) from the sale of its product and the total amount of tax it paid ($1) for raw materials. If audited, the lumber yard must be able to produce

[2] Under the income type of value-added tax, capital equipment is initially subject to tax, but firms may thereafter deduct from their tax base each year depreciation charges on that equipment until it is written off The gross product type of value-added tax taxes capital goods and allows no deduction for depreciation

[3] The requirement to give an invoice does not always extend to the retail stage Practices vary, but, in general, developed countries, such as those of the EEC, do not require retailers to give invoices to consumers or even to display the tax separately Consumers in these countries often do not know how much tax is included in the price of a product

the invoice from the tree farmer showing the $1 tax paid to support its claim for the $1 tax credit.

The same procedures are followed by the wholesaler and retailer The wholesaler buys the bats for $20 plus $4 of tax and sells them to the retailer for $25 plus $5 of tax. Eventually, the consumer buys the finished baseball bats from the retailer for $36—$30 for the bats and $6 for the value-added tax.

A retail sales tax of 20 percent would generate the same tax revenue ($6), but the responsibility for collecting the tax and remitting it to the government would belong to the retailer alone. Under the value-added method, four businesses remit 1 dollar and one business, the bat maker, remits 2 dollars of tax.

In this example, the value-added tax is imposed at all stages of production and distribution, including the retail stage. Most of the world's value-added taxes extend through the retail stage. But the tax can be structured to terminate earlier in the production and distribution chain—at the manufacturing stage, for example. In that case, all value added up through manufacturing would be taxed, unless specifically exempted. Value added thereafter, by wholesalers and retailers, for example, would not be taxed.

Like a national retail sales tax, a value-added tax would be capable of generating large amounts of revenue. Potentially, all personal consumption expenditures on goods and services could be subject to the value-added tax, giving it the same revenue generating potential as a national retail sales tax.

A value-added tax, like a retail sales tax, is generally considered to be regressive. Many countries have addressed this problem by incorporating exemptions and multiple rates in their value-added tax structure. For example, lower tax rates may be applied to certain necessities (such as food and clothing) and higher tax rates to luxury items.

Depending upon how the value-added tax is structured and what business a firm is engaged in, the accounting requirements can be complicated and increase the cost of compliance. For example, if the tax contains multiple rates and exemptions, a business must record separately its purchases and sales of items that are taxed at different rates or exempted from tax.

Nevertheless, studies have shown that the tax does not appear to impose an unusual accounting burden on most firms, particularly larger ones.[4] For smaller businesses, the accounting and administrative requirements may be more irksome. An official of the National Federation of Independent Business expressed concern about these burdens to us. Partly because of these burdens and the relatively high cost of administering the tax among small businesses, most countries treat small businesses differently, allowing them more time to remit the taxes they collect, for example, or even permitting the smallest businesses to opt out of the tax system entirely.

Administrative Considerations

Much of what is known about administering a value-added tax comes from the experience of EEC countries. Despite the differences that exist between these countries and the United States, their experiences provide important insights into the administrative difficulties U.S. tax officials might reasonably expect. Introducing a value-added tax and administering it effectively would require extensive preparations

Pre-implementation activities. One of the first decisions that officials must make when adding a value-added tax to the revenue system is which government agency ought to administer the tax. The basic choices are between the agency that administers a country's income tax, the agency that administers the excise and customs taxes, and an entirely new agency. Most countries have placed the responsibility in the agency handling the income tax, for two reasons. First, the information collected while administering the value-added tax can facilitate income tax enforcement. Second, the professional skills needed to administer the value-added tax closely resemble those needed to administer an income tax.

The IRS has already developed plans to administer a consumption type of value-added tax in the United States. IRS officials estimate that 20,000 additional employees would be needed, at a cost of roughly $700 million annually.[5] The employees would require extensive training to administer the new tax. When the United Kingdom substituted a value-added tax

[4]U S Department of the Treasury, Office of Tax Analysis, Value-Added Tax European Experience and Lessons for the United States (Government Printing Office, 1980), p. 61

[5]U.S Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth The Treasury Department Report to the President, vol 3, Value-Added Tax (Government Printing Office, 1984), p 113

for its wholesalers' sales tax in 1973, it experienced an increase in personnel and costs. From 1975 to 1979, its administrative costs averaged about 2 percent of collections. After tax rates were increased in 1979, administrative costs were 1.25 percent of collections.[6]

Many of these new personnel would first be occupied with phase-in or preparatory work. The tax authorities would have to promulgate extensive rules and regulations for the new tax. If the tax contained more than one rate, tax officials would have to classify all goods and services to determine which rate each would be subject to. In addition, personnel would have to be available to instruct taxpayers about the various requirements of the tax.

Registration. Authorities would have to register taxpayers as the first step. At that time, the taxpayer would receive a unique identification number, either a new one or the taxpayer's current identification number

Tax collection. Payment and filing frequencies typically range from once a month to once every 3 months. An EEC commission recommended that returns be filed and taxes paid once a month, even though doing so that often can be burdensome. Both returns and any tax due must be submitted to the tax authorities within a specified interval, ranging from a few days to a month or more, following the end of the tax period.

In general, a longer filing and payment period is advantageous to business, while a shorter period may be preferred by the government. Business benefits from a longer period by having to file less frequently and by having the use of collected but unpaid taxes for a longer time. A shorter period reduces the variability of the government's cash flow

Audit. Another major responsibility of the tax authorities under a value-added tax would be the examination or audit. Auditors would verify reported totals of a taxpayer's purchases and sales. To do so, it would often be necessary to check inventories and review invoices. Auditing a value-added tax return requires less time and fewer resources than auditing a business income tax return, but more than auditing a retail sales tax return, since officials must check not only reported sales totals

[6] U S. Department of the Treasury, Value-Added Tax. European Experience, p 61, Richard Hemming and John A Kay, "The United Kingdom," in The Value-Added Tax Lessons from Europe, edited by Henry J Aaron (Brookings Institution, 1981), p 86

but also credits claimed for taxes paid on purchases of inputs The audit would be complicated by multiple rates and exemptions

Many EEC countries supplement their audit work with "control visits" to taxpayers One of the purposes of these visits is to increase the tax authority's understanding of the taxpayer's business During a control visit, a tax officer might inquire about a firm's supplies or inventories and might ask to examine accounting documents. Some countries target their control visits to businesses claiming refunds or to certain large corporations. In the United Kingdom, for example, the tax authorities visit the country's largest corporations five or six times each year, and all other taxpayers (depending on their size) once every 1 to 5 years [7]

Views of others. The business and professional organizations that we spoke with were well acquainted with the value-added tax. Few, however, expressed themselves in favor of one form of the tax over another Their responses to our questions were dominated by their distaste for any new tax. The American Bar Association, while neither favoring nor opposing a value-added tax, repeated its recommendation that if Congress enacted such a tax, tax liabilities should be determined by the invoice or credit method and multiple rates of tax should be minimized in order to simplify administration and compliance.

Personal Expenditure Tax

Another frequently discussed consumption tax is the personal expenditure tax, which, unlike a retail sales tax or value-added tax, would be collected entirely from individuals. In many ways, a personal expenditure tax resembles our current individual income tax

An important difference, however, is that a personal expenditure tax would not tax an individual's expenditures for saving and investment Instead, a tax would be applied to an individual's consumption expenditures (income minus saving) over a given period. For example, suppose that during some time period a person earned $1,000, deposited $100 in a savings account, purchased stock for $100, and spent the rest. The difference between $1,000 and $200, or $800, measures that person's expenditures on the consumption of goods and services and would constitute the tax base

Our individual income tax also exempts some forms of saving from tax For example, contributions to certain pension plans are excluded from

[7]U S Department of the Treasury, Value-Added Tax European Experience, p 60

the income tax base In general, however, most income is taxed whether it is saved or consumed.

Unlike a national retail sales tax or a value-added tax, a personal expenditure tax can be made progressive simply by applying progressive tax rates to the base

At the present time, an expenditure tax may not be as attractive an option as some other form of consumption tax since most of the proponents of a personal expenditure tax favor it as a substitute for the individual income tax, not as a supplement to it. That is, few analysts advocate the enactment of a personal expenditure tax without also favoring the simultaneous repeal of the individual income tax [8] It is the deficiencies of the income tax that have prompted much of the support for a personal expenditure tax, and these would not be remedied by adopting the tax unless the income tax were also repealed.

The prospect of repealing the individual income tax when enacting a personal expenditure tax has probably contributed to the lack of enthusiasm among policymakers for a personal expenditure tax Officials have been reluctant to discard a proven productive revenue instrument in favor of a tax that has never been adopted anywhere as a mass revenue raiser

Foreign experience with the tax is limited to two countries India enacted the tax in 1957, repealed it in 1962, reenacted it in 1964, and repealed it again in 1966. Sri Lanka imposed the tax between 1959 and 1963 and again from 1976 to 1977 The two countries' experience was so short, the tax base so riddled with exceptions and omissions, and the social and economic environment within which the tax was enacted so different from that of this country that it is unclear what lessons their experience can teach us. It may be noted, however, that the difficulty of administering the tax was an important consideration in the decision of authorities in India and Sri Lanka to repeal it.

Administrative Considerations

If the United States were to enact a personal expenditure tax, it would not have past federal, state, local, or relevant foreign experience to guide it in designing or administering the tax. In India and Sri Lanka the tax was restricted to a narrow stratum of wealthy individuals It was

[8] In order to ease the transition to a personal expenditure tax, some advocates favor retaining the individual income tax for a time after the expenditure tax is introduced

not a mass tax that superseded an income tax and it raised only a small fraction of both countries' revenues The tax, moreover, was in force for only a few years, too little time for authorities to gain much experience with its administration

Most individual income tax revenues are collected by withholding taxes from wages and salaries There appears to be no way in which a personal expenditure tax could be collected by a system of withholding from personal expenditures—no way, that is, of collecting a tax from taxpayers every time that they made a taxable expenditure Withholding of tax from wages and salaries would probably have to continue in order to promote compliance and provide the government with a steady source of revenue Since the tax base would not be wages and salaries, however, but personal expenditures, taxpayers would have to calculate their tax liability at the end of the year, or report enough information to the IRS to enable it to do the job for them, just as they do now under the income tax

The accurate determination of expenditure tax liability would probably demand even more cooperation from taxpayers than the determination of an individual's income tax liability, because saving and dissaving would affect the amount of tax due Unless a greatly expanded system of information reporting were adopted, the IRS would have to depend primarily on taxpayers for information about saving, as well as for the information about income that is currently required to calculate income tax. An expenditure tax would require the same reporting of income by taxpayers that the income tax does, and moreover would require taxpayers to disclose annual totals of net saving Some observers believe that for effective administration, it would be necessary for taxpayers to include personal balance sheets of assets and liabilities with their annual expenditure tax returns.

These differences between an income and expenditure tax may have important administrative implications. For example, a significantly different allocation of resources within the IRS might be required to administer the new tax, and possibly an overall increase in the volume of resources devoted to administration

IRS officials told us that the Service has made no study of how to administer a personal expenditure tax One official expressed the opinion that if such a tax replaced the personal income tax, the IRS would continue to perform most of the functions that it now performs to administer the income tax, and that few new duties would be required of it

Views of others. Most of the organizations with which we spoke were unfamiliar with, and therefore had no views concerning, the personal expenditure tax concept The American Institute of Certified Public Accountants has cautioned, however, that elaborate transition rules might be required if a personal expenditure tax ever replaced the individual income tax.

Consumption Taxes—Questions and Answers

Because consumption taxes are not a familiar or well understood subject in this country, many questions have been raised about their use and effect on the economy. This chapter addresses some of the more frequently asked questions.

What Effect Would a Retail Sales Tax or Value-Added Tax Have on Inflation?

Because a value-added or retail sales tax would be an add-on to nearly all prices, it might be expected to cause an immediate increase in prices at least equal to the tax. In turn, because wages are often indexed to the cost of living, which includes sales taxes, an increase in prices could lead to an increase in wages, perhaps initiating another round of inflation. However, economists disagree about whether a value-added or retail sales tax would in fact be inflationary.

Whether either would be inflationary depends on the interaction of various economic factors, including both fiscal and monetary policy. On the fiscal side, which tax, if any, the consumption tax replaced would be an important factor. If either tax were substituted for the corporate income tax, and if the corporate income tax is reflected in product prices, the risk of causing a general rise in prices would be lessened. If either replaced part of the personal income tax, some inflation might result, since it is less likely that reductions in the personal income tax would be reflected in lower prices. If either tax were simply added to the tax system without compensating reductions in the taxation of income or increases in the level of government spending, the government's fiscal policy would be less stimulative and inflationary pressures could be reduced. On the monetary side, Federal Reserve officials could reduce (or accelerate) the rate of growth of the money supply, causing a reduction (or an increase) in inflationary pressures. Thus, unless we know the circumstances in which a value-added or national retail sales tax is introduced, it is unclear how the tax might affect prices.

Other countries that have instituted value-added taxes have had mixed results with inflation. One economist analyzed how price levels were affected by the introduction of a value-added tax in 31 countries He identified four general patterns of price effects: (1) the shift case, in which the introduction of the tax caused a single upward shift in the level of prices but did not affect the rate of increase in prices, (2) the acceleration case, in which the introduction of the tax caused an acceleration in the rate of increase of prices, (3) the acceleration and shift case, in which the level of prices shifted upward and the rate of increase accelerated, and (4) the no effect case, in which the introduction of the value-added tax had no apparent effect on prices. In the 31 countries studied, the introduction of the value-added tax caused an upward shift in prices in five, caused an acceleration in the rate of change of prices in three, and caused the price level to be raised and the rate of price change to accelerate in one. In 21 countries, the introduction of the tax had little or no effect on prices. In one country the effect could not be determined.[1]

What Effect Would a Consumption Tax Have on Exports, Imports, and the Balance of Trade?

Since the 1970s, Americans have been disturbed by the deteriorating U.S. position in foreign trade. Concern has intensified as trade deficits have reached record levels in the 1980s. Until recently, U.S. trade problems were aggravated by an overvalued dollar, which was chiefly attributable to the sizable federal deficits of the past several years. These deficits caused U.S. interest rates to rise, attracting foreign funds to this country and increasing the demand for dollars. The strong dollar stimulated U.S. spending on imports and dampened foreign demand for American goods and services. Although a boon to U.S. consumers of imported goods, the strength of the dollar hampered efforts by domestic producers to sell U.S. goods in both domestic and foreign markets. The weakening of the dollar that began in 1985 should lead to a gradual improvement in the Nation's trade balance. Nevertheless, interest persists in other methods of promoting further improvement. Any change in the U.S. tax system that promises to enhance U.S. business competitiveness overseas is likely to command a great deal of attention.

Some supporters of a value-added tax or national retail sales tax believe that, partly because of the U.S. tax system, industry in this country suffers in competition with industry in countries that levy a value-added tax. Under the terms of the General Agreement on Tariffs and Trade, a country may refund indirect taxes paid on goods being exported and impose the same taxes on imports. Thus, this agreement allows countries to refund value-added taxes paid on exports, but not personal or corporate income taxes (to the extent that those taxes are included in the sales price of exports). Some proponents also believe that the United States should implement a value-added tax to help harmonize its tax structure with those of several of this country's major trading partners. In summary, they maintain that U.S. competitiveness overseas would be improved if a value-added or national retail sales tax replaced part or all of either the personal or corporate income tax.

[1] Alan Tait, "Is the Introduction of a Value-Added Tax Inflationary?" Finance & Development, vol 18 (June 1981), pp 38-39

Other economists and trade and tax experts doubt whether a U S value-added or national retail sales tax would enhance the competitiveness of American industries in the international marketplace They believe that this country's balance of trade deficit is a macroeconomic problem that is best addressed with macroeconomic cures. They argue that any improvement in the Nation's balance of payments induced by substituting a value-added or national retail sales tax for another tax, such as the corporate income tax, would be nullified by adjustments in exchange rates and internal rates of inflation. Accordingly, they caution against enacting a value-added or national retail sales tax in the expectation that by doing so the Nation's balance of trade will be improved.

What Is the Significance of the Fact That a Consumption Tax Does Not Tax Saving?

Another reason for considering consumption taxes if additional revenue is needed is the argument of some economists that income taxes penalize saving insofar as they tax the return on saving. Because saving and investment decisions may be sensitive to after-tax rates of return, income taxation may produce several unwanted effects. Taxing the return on saving takes income away from those with higher propensities to save and invest, reducing the pool of funds available for investment And because the after-tax return on saving is lowered, incentives to save and invest may fall. Thus, in the opinion of these observers, saving is made more costly and capital formation and growth are depressed

Consumption tax advocates claim that a consumption tax would stimulate economic growth. They state that by lowering the tax burden on saving, a consumption tax would encourage more saving and add to funds available for investment. Also, they maintain that depending on the type of consumption tax selected, its treatment of capital expenditures, and what current tax, if any, it replaced, investment might be made more attractive.

Other analysts disagree. They argue that if the after-tax return on saving is raised, some persons—"target savers"—may respond by reducing their saving, not increasing it. If some persons are induced to save less while others save more, it is unclear whether on balance total saving will increase, decrease, or remain unchanged. Furthermore, some analysts argue that if we are concerned that the Nation's rate of saving is too low, there exist other, more effective methods of raising the rate than using tax incentives. For example, reducing the federal deficit through a combination of lower government spending and heavier taxation would be a more direct method of raising the U.S. saving rate

Should a Consumption Tax Be Used (1) To Supplement an Income Tax or (2) In Place of an Income Tax?

Much of the support for a federal tax on consumption is prompted by disapproval of several features of income taxation. Some analysts who disapprove of these features are likely to feel that the larger the role of consumption taxes in the Nation's tax structure and the smaller the role of income taxes, the better the tax system will be Many of them maintain that there is no reason why a broad-based consumption tax cannot completely replace an income tax. If the base of the tax is sufficiently broad, a tax on consumption is capable by itself of raising all the revenue that the personal and corporate income taxes now raise, plus any additional sums that are desired to reduce the federal deficit.

Most analysts, however, believe that an income tax and broad-based consumption tax are complementary and that the presence of both strengthens a tax system. In practice, although some countries rely much more heavily on income taxes for the bulk of their revenues than on consumption taxes, while others display the opposite preference, most use both consumption and income taxes to raise the required public revenues. The evidence of actual practice indicates that income and consumption taxes not only can be complementary but in fact are found together in the tax systems of nearly all developed countries In developing countries one or the other tax may be missing, usually for administrative reasons; that is, the inability of the tax service to administer the tax, not because one tax is incompatible with the other.

Because a Retail Sales Tax Is Familiar to Americans and Appears to Be the Simplest and Easiest Tax to Use, Why Are Other Types Even Considered?

Familiarity is certainly an important advantage of a retail sales tax. A value-added tax, by contrast, is unfamiliar to most Americans and its introduction would need to be preceded by an extensive publicity campaign. The Treasury Department would be responsible for preparing instructional materials to explain such features of the tax as credits, exemptions, refunds, etc. Still, as a transactions-based tax, a value-added tax at least resembles a retail sales tax and presumably could be instituted in this country, as elsewhere, without creating intolerable confusion.

A personal expenditure tax, however, is different from any tax that has ever been used in this country. Its unfamiliarity puts it at a disadvantage in competition with other consumption taxes for the attention of policymakers. A great deal of explanation to legislators, administrators, and the public would be required before the tax could be implemented.

If criteria other than familiarity are considered, the choice between a value-added tax and a retail sales tax is far from clear-cut. A value-added tax that extends through the retail stage suffers the disadvantage that more taxpayers must be included in the system and must file returns than under a retail sales tax. It is primarily retailers who file retail sales tax returns, which makes the tax administrator's job easier.[2] On the other hand, most of the responsibility for collecting a retail sales tax falls upon retailers rather than being shared by all businesses, as it is under a value-added tax. IRS officials told us that because many retail operations are small and unsophisticated, retailers as a class may be somewhat less capable of assuming the responsibility for collecting and remitting sales tax revenues than other businesses, and so a value-added tax distributes the tax-collecting burden in a superior way. Not only is the burden upon retailers onerous, but tax administrators also have more difficulty enforcing tax compliance among small businesses than larger ones—and many retailers are small. And if a retail business operates outside the tax system, either by evading the tax or by reason of an exemption, the revenue loss to the authorities is much greater under a retail sales tax than under a value-added tax.

A major disadvantage of a retail sales tax—one that is said to have prompted at least one foreign country to replace it with a value-added tax—is the difficulty of avoiding placing a tax on some goods that are used to produce other goods. In principle, a retail sales tax should be restricted to goods and services that are purchased for final consumption. If producers' goods are also taxed, the tax will be incorporated in the cost of the goods that they are used to produce. Some goods will incorporate more tax than others and will be disadvantaged in competition for the consumer's dollar. Imported goods, whose inputs were not taxed, would enjoy a competitive advantage over domestic goods. Sales of exports would be hampered.

Procedures exist for alleviating this problem, but only at the cost of increasing the administrative burden on retailers and enlarging opportunities to evade the tax. The problem is solved under a value-added tax by allowing businesses to credit any tax that they pay on their inputs against the taxes they remit to authorities on their sales. In this way no product bears more than a single tax.

The difficulty of distinguishing business purchases of services from personal purchases is one reason why many retail sales taxes in the United

[2]Some businesses that are not engaged in retailing may still be obliged to collect a retail sales tax and file returns, e g , manufacturers that occasionally sell products to their employees, or businesses that operate a cafeteria for their employees

States exclude services from their base. Since there is no reason to observe this distinction under a value-added tax, many countries that use a value-added tax include as many services as possible in the tax base The base of the tax may therefore be broader than that of a retail sales tax, allowing the same amount of revenue to be raised with lower rates.

There are additional differences between a retail sales tax and a value-added tax that must be considered. As this discussion indicates, not all of the advantages lie with one tax or the other. It may be significant, however, that all countries but one that have recently adopted a new broad-based consumption tax have preferred a value-added tax to a retail sales tax

What Narrowly Based Consumption Taxes Are Being Used or Considered?

The three taxes described here are generally considered to be the most attractive broad-based consumption taxes. Several more narrowly based taxes, however, have been favored by some advocates as alternatives to broad-based taxes for the purpose of reducing the federal deficit The federal government now levies numerous excise taxes on a wide assortment of products and services. Only a few of the taxes, principally those on alcoholic beverages, cigarettes, and motor fuels, raise much revenue.[3] With the exception of the taxes on motor fuels, none has a base that is large enough to produce the sizable revenues that would be required to materially reduce the federal deficit. Accordingly, if considerably more revenue is wanted from excises, new taxes must be devised.

No other object of excise taxation appears capable of producing as much revenue as energy. The federal government has taxed some energy sources for many years, but the scope of these taxes would be much broadened in some recent proposals.

Among the options most often discussed are tariffs on imported crude petroleum and petroleum products, taxes on both domestic and imported petroleum, additional excise taxes on motor fuels, and a broad-based tax on all uses of nonrenewable energy.

In recent years, about 30 percent of all crude petroleum and petroleum products consumed in the United States has come from foreign sources

[3]The crude oil windfall profit tax, which is called an excise tax in the Internal Revenue Code, but is really a form of profits tax, i.e., an income tax, raised more revenue each year from its inception in 1980 to 1983 than any of the true excise taxes cited above Since fiscal year 1984 its yield has been surpassed by the taxes on motor fuels.

Although that figure is lower than it has been in the past, this country is still highly dependent on foreign supplies. Some analysts believe that U.S. consumers should pay a premium for oil that is vulnerable to supply disruptions. A tariff on imported oil and petroleum products could raise significant amounts of revenue. The tariff could be structured either as a fixed fee per barrel (a specific duty) or as a percentage of the value of the oil (an ad valorem duty). It could also be the same for both crude oil and petroleum products, or the fees could vary to provide tariff protection for either domestic producers or refiners. Some have suggested that because of the security risks involved with possible import interruptions, the tariff rate per barrel should be set at a level equal to the cost of maintaining a barrel of oil in reserve.

The Congressional Budget Office (CBO) estimates that a fee of $5 per barrel of imported crude oil and petroleum products would raise more than $7 billion per year.[4] Analysts in the General Accounting Office recently put the figure even higher, at $10.6 billion per year.[5]

An alternative to the tariff on foreign oil and petroleum products is a tax on both oil imported into the country and oil produced domestically. This tax could be either a specific tax or an ad valorem tax. Exports could be exempted. Such a tax could provide more revenue than a tax on foreign oil while serving many of the same policy objectives.

This tax would raise considerably more revenue for each dollar of tax per barrel than the oil import fee because the tax base would be much broader. The CBO estimates that a $5 per barrel tax on all oil—domestic and foreign—would raise about $22 billion annually, or about $15 billion more each year than a tax on foreign oil alone. Thus, if the goal was to meet a specific revenue target, a tax on all oil could be imposed at a much lower rate than a tax on imported oil alone.

By raising the price of oil, the tax would reduce consumption and encourage the development of alternative energy sources. But because a tax on all oil would fail to distinguish between domestic and foreign oil, it would be less effective at depressing demand for imported oil.

[4] U.S. Congressional Budget Office, Reducing the Deficit Spending and Revenue Options, A Report to the Senate and House Committees on the Budget—Part II (Government Printing Office, 1986), pp 232, 234 All CBO estimates reported here come from pp 232-36 of this document

[5] U.S. General Accounting Office, Petroleum Products Effects of Imports on U S Oil Refineries and U.S Energy Security, GAO/RCED-86-85 (General Accounting Office, 1986), p 56 The CBO estimate differs from the GAO's chiefly because it includes an allowance for the reduction in other tax revenues that would follow from the payment of an oil tariff by importers

Other taxes that might be exploited for additional revenue are the present federal excise taxes on gasoline and diesel fuel. Some energy analysts suggest that their rates, currently 9 cents per gallon on gasoline and 15 cents per gallon on diesel fuel, could be raised appreciably without causing harm to the economy. They point out that the current federal tax on gasoline is lower than it was in 1959 when expressed as a fraction of the net-of-tax price. The CBO has estimated that every cent per gallon of additional motor fuel tax would raise approximately $900 million annually.

Instead of limiting a tax to oil or motor fuels, the government could impose a broad-based tax on all energy uses. Under such a scheme, all personal and business expenditures for oil, gas, and fuels would be subject to the tax. One way to accomplish this would be to levy a severance tax on domestic crude oil production accompanied by a tariff on imported crude and refined oil and petroleum products. A similar set of taxes and tariffs could apply to natural gas.

Attractive features of this tax are its capacity to raise large amounts of revenue, its potential for encouraging conservation, and its economic neutrality. Because the base of the tax would be so broad, it could raise a great deal of revenue. The CBO estimates that a 5 percent tax on the value of all energy consumed would raise over $15 billion each year Such a broad national energy tax would also promote the conservation of energy resources by discouraging general energy consumption. Above all, it would be the least distorting and discriminatory of the four energy taxes that have been discussed here Since it would bear equally upon all energy uses, it would be neutral among alternative energy sources and products. It would also avoid discriminating against particular consumers or regions of the country, whose preferences for various fuels differ. Applying a broad-based ad valorem tax to all energy consumed would reduce variations in the tax burden.

On the other hand, the tax could become an administrative and regulatory quagmire. Depending on the structure of the tax and the stage at which it would be collected, the administration of this tax could be quite complex. The point of taxation would be important, because much value is added by refining, processing, transporting, and marketing. If some intermediate level (such as the wholesale or distributorship level) were selected as the point of collection, the tax would fail to capture the value added by retailers. But if the retail level were selected, the number of collection points would drastically increase. Little has been written about administering such a broad-based tax and no administrative mechanisms have been offered.

Bills Introduced, 99th Congress, Incorporating Consumption Tax Principles

Several bills have been introduced in Congress that, to varying degrees, incorporate consumption tax principles. The following is a list of these bills that had been introduced by March 20, 1986, in the 99th Congress

- Bills in the nature of a personal expenditure tax.

  "The Flat Rate Tax Act," introduced by Senators Dennis DeConcini and Steven Symms.

  "The Cash Flow Income Tax Act of 1985," introduced by Representative Cecil Heftel

  "The Broad-Based Enhancement Savings Act of 1985," introduced by Senator William Roth, Jr., and Representative W. Henson Moore.

- Bills in the nature of a value-added tax.

  "The Business Transfer Tax Act of 1985," introduced by Senator William Roth, Jr

  "The Superfund Revenue Act of 1985," Title II of S.51 as reported by the Senate Committee on Finance (S. Rep. No. 99-73, May 23, 1985)

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