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FEDERAL REVENUE OPTIONS

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HOUSE OF REPRESENTATIVES

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FEDERAL REVENUE OPTIONS

WEDNESDAY, OCTOBER 6, 2004

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:02 a.m., in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Gutknecht, Brown, Wicker, Franks, Garrett, Barrett, Diaz-Balart, Spratt, Neal, Edwards, Scott, Thompson, Emanuel, Davis, and Kind.

Chairman NUSSLE. Good morning and welcome, everyone, to today's Budget Committee hearing.

We have several current and former Members of Congress as well as other tax policy experts testifying before us today. We have, actually, a very large lineup, so I want to get started here right on time.

Our witnesses will be divided into three panels today, so in an effort to ensure that all our members are able to get their questions and comments in, I will try and keep my remarks brief and ask that all members try and stick to their allotted time as well, so that we can hear from our panel of witnesses who have assembled here today to give us, as representatives on the Budget Committee, who will start this process of tax reform, if it starts at all, some opportunity to hear their wisdom and their advice as we consider tax reform.

Back in July, this committee held a hearing to try and get a reasonable comprehensive understanding as to why our current Tax Code isn't working and the best interests, really, for that matter, anyone involved for America's workers who pay into the system and the Federal Government, which it funds.

I thought it was a pretty effective visual then, at the last hearing, so today I have asked to bring in the Tax Code again; and it sits across the hall over on the side table there. As you can tell from just looking at the pile on the desk, that is probably one of the main reasons why we are here. We have got 23 volumes of the IRS Code itself, with 21 volumes of Federal tax regulations written by the Treasury Department, which apparently are necessary to explain the first 23 volumes.

And that is just the base of our Tax Code. There is also walls and walls in the Library of Congress dedicated to housing the Tax Court decisions, IRS rulings, which were needed to further explain the 44 volumes which we have here. But we really had no adequate staff or space to bring in those volumes and get them over here for visual.

I think you get my picture. It is complicated. Although tax writers have perfectly good intentions, and I can tell you that because I am one of them serving on the Ways and Means Committee, we have good intentions providing tax relief to struggling American workers to make ends meet, to help boost our economy, which it certainly has. We have provided the relief and our economy has received a jolt and a boost, and that is positive. We just end up making the Code bigger and more complicated every year, even with those good intentions.

Ideally, we should have a Tax Code that is reasonably simple, efficient, not overly burdensome, as fair as we can possibly make it, and as understandable or transparent as possible. And I bet that we can all agree that our current tax system provides few, if any, of those things.

An important issue that was brought up at the last hearing was why do we have to deal with this now? The problems in our Tax Code certainly aren't new. It has been 20 years since we passed major tax reform legislation. 1986 was the last time this was attempted, so why should we do this now, with everything else that is going on?

Well, as we are all aware, several factors have been coming to a head in these next few years, including the retirement of the baby boomers, the expiration of tax provisions, and the individual alternative minimum tax, or the AMT. And we face all of these on top of a whole host of large relatively new demands in our budget, in a climate of deficits we have incurred in response to extraordinary circumstances in these past few years.

So now is exactly the right time to get about addressing the problem of our revenues. Given the background created by the previous hearing today, we have taken the next step. Today we have invited a whole range of experts, both within our Congress, fellow members and colleagues, to discuss some of the most prevalent proposals for reforming and, in some cases, totally replacing our Federal Tax Code.

This is an immensely complicated challenge, but it is also a great opportunity to get everything on the table and really begin the discussion on what may be one of our best options as we proceed forward. And I want to make it very clear that I am not here or we are not here to try and pick one of those that we think is best today. The purpose of this hearing, again, is to get a decent understanding of what there are in terms of a better way to tax.

I am not expecting today's discussion to give us an "aha" moment, where we all of a sudden say that's the answer to the problem. Well, maybe Mr. Linder may have one of those moments; we will see. He has had them before, I know; I have heard him give his talk before. But I do know that we will learn a lot if we listen closely to the ideas of our colleagues and members from outside our Congress who are experts on this issue.

Finally, I am sure that we could fill up an entire hearing with finger pointing on which parties to blame. I hope, even though there might be that temptation, today really was meant, I think on members' parts on both sides, to use this as a learning opportunity.

If people want to take that opportunity, I guess I would invite you to take it outside to the microphones; I am sure someone would want to listen to you. But today we really do want to learn; that is what the purpose of this hearing is all about.

So, with that, we have a very serious and important subject matter before us, and I would be happy now to turn to Mr. Spratt for any comments he would like to make.

Mr. SPRATT. Thank you, Mr. Chairman.

In the fiscal year just ended, revenues hit an all-time low, or at least a low level that has not been seen since 1950, 16.2 percent of GDP. This precipitous drop in revenues is directly related to a precipitous rise in the deficit. It too hit a record this year, $422 billion, the highest in history; $47 billion worse than last year. And even though the economy is eking out a recovery, slowly getting better, the bottom line is the burden is not getting better. We have what economists call a structural deficit built into the Tax Code and built into the spending side of the budget as well.

Faced with this same sort of problem in the 1990s, we adopted three multi-year budgets and put the budget in surplus phenomenally by $236 billion in the fiscal year 2000. Just four short years ago we had a surplus of $236 billion. Looking back at those years at the end of the 1990s and analyzing the budget and what accounted for this success finally in subduing the deficit, CBO attributed half of our success, half of our success to the increase in revenues and half to the curbs in spending that we adopted from 1990 to 1993 to 1997.

In the year 2001, when President Bush took office, he had an advantage that no president in recent times has enjoyed: a budget in surplus, big-time surplus, $127 billion that year. We begged him not to bet the budget on huge tax cuts tilted to the rich. He did, and we see the result today: worse than we feared, a deficit of $422 billion.

As we go into fiscal year 2005, we have no budget resolution, no multi-year plan, no plan at all, and no prospect of any kind of program for erasing the deficit over the next fiscal year. Sooner or later the day of reckoning will come; the deficit will have to be dealt with, and when it is revenues will have to be part of the solution, as they were in the past.

One way to increase revenues is to broaden the tax base by abolishing the accretion of deduction, credits, preference in exemptions that have grown up over time. We did this in 1986; we broadened the tax base and brought revenues and rates down significantly. And, frankly, the Tax Code is long overdue, another closet cleaning like that, where we go through the accretion of deductions and exemptions and credits and preferences. Instead, we are doing just the opposite; every time a tax bill is passed, it picks up more accretions like this.

One purpose of tax reform is simplification, and it is a worthy purpose. There is no question that the Tax Code and tax regulations even more have grown enormously. But there is another, and in my feeling, more important goal, and that is tax fairness, and we never should lose sight of it, distributing the tax burden equitably over all income classes and all people in our society. In this connection it is important that we not buy into plans that are superficially simple, but shift the burden of taxation off wealth and onto wages, off capital and onto salaries and wages and earned income.

That is not just some rhetorical concern. We had a chairman of the Council of Economic Advisors say not long ago that the best rate for income from wealth is zero; and you see that pattern in many of the proposals presented today. Indeed, virtually all of the proposals presented today do just that, they shift the burden of taxation off wealth and onto wages. And I don't really think that, stated in that fashion, that is a goal that I know Democrats don't share, and I don't think most Americans share, that our objective in tax reform is to shift the burden off those who have done well onto those who are still working, and leaving them bearing the weight of the system.

So as these complicated proposals are made today, in the interest of simplicity, we have got to discern and be careful we evaluate them as to whether or not they shift the burden. If so, who ends up holding the real burden of supporting the Federal revenues. And I hope that today's hearing will begin to help us see the advantages and disadvantages of the different proposals before us, but also help us keep in mind that we do not want to sacrifice fairness for simplicity.

That said, we need to be looking at new ways of raising revenues, because if the next Congress gets earnest about the deficits, revenues will have to be part of any serious solution.

Mr. Chairman, thank you very much, and I thank our witnesses for taking the time to come and prepare their testimony.

Chairman NUSSLE. Thank you, Mr. Spratt.

I would ask unanimous consent that all members be given an opportunity to put a statement in the record at this point.

I will also tell our witnesses that your entire testimony will be made part of the record, and you may summarize your testimony as you wish. I will take you in the order in which you arrived, that way I assume for that reason your effort to get here will be rewarded so you can go out and take care of other business. I know Mr. Linder needs to be no the floor, so we will begin with Mr. Linder from Georgia.

Welcome to the Budget Committee, and we are pleased to receive your testimony.

STATEMENT OF HON. JOHN LINDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA; HON. MICHAEL C. BURGESS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS; HON. PHIL ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA; HON. CHARLES B. RANGEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK; HON. DAVID E. PRICE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA; AND HON. MAX SANDLIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

STATEMENT OF THE HON. JOHN LINDER

Mr. LINDER. Thank you, Mr. Chairman. I would like to have my statement put in the record, and I would also like to put in the record a response to a recently distributed critique of a national sales tax by Ms. Pelosi in a press conference, 20 plus pages, purporting to criticize H.R. 25, my bill, but obviously criticizing something of their own design. The criticism was simply not aimed at the bill that I actually drafted.

I would like to summarize by saying any plan we have for tax relief or tax reform ought to follow some guiding principles:

I think it ought to be fair. I think anything we do ought to untax essentials so that people living at or below the poverty line pay no taxes whatever.

It ought to be simple and easy to understand for every American. My bill is 132 pages, as compared to 55,000 pages of regulations.

It ought to be voluntary. Our current system is coercive, corrosive, intrusive and abusive. We ought to have a voluntary system where everybody pays taxes when they choose, as much as they choose, for how they choose to spend.

Anything we do ought to be transparent. We ought to know all the costs, including the hidden costs. One of the studies we commissioned out of Harvard, the head of economics at the time, Dale Jorgenson, concludes that on average 22 percent of what we are currently paying for at retail represents the embedded cost of the current system. We are paying all the income tax costs, the payroll tax costs, and compliance costs of every business entity that had a roll in building that house or that loaf of bread. On average, we are losing 22 percent of our purchasing power to the current system.

What we do ought to be border-neutral. Our exports must be unburdened by any tax component in the price system. We are uncompetitive in world markets simply because nations with which we compete that have a VAT, a value added tax, and we are uncompetitive because everything we sell has our social welfare costs embedded in it, as well as our other costs.

It ought to be industry-neutral. I never understood why I, as a dentist serving on the Georgia legislature, could make a pretty decent income without having to collect a State tax, but all my neighbors and retailers had to collect it. I think it should tax all goods and all services equally.

We ought to strengthen Social Security, Medicare, whatever we do. Larry Cutlicoff, an economist from Boston University, has concluded in a recent study that the 75-year unfunded liability in Social Security and Medicare in today's dollars is $51 trillion—trillion. The entire household wealth in America is $43.8 trillion.

If we took everything away from every American and took the value of their assets and applied it against the shortfall, we would cover 80 percent of it; and setting aside a few percent of whatever we do—of Social Security or Medicare—is simply not going to save it. Any system that is predicated on workers paying for retirees, when the baby boomers retire is going to fail. We are going to increase the number of retirees in the next 30 years by 100 percent. We are going to increase the number of workers paying for them by 15 percent.

That system simply cannot survive. If you go to a tax on personal consumption like I propose, what you wind up doing is tripling the numbers of people paying into the system; you go from 138.5 million in workers to about 290 million Americans every time they buy something, plus 40–50 million visitors to our shores.

The last thing is it must have manageable transition costs. The $51 trillion is simply unsustainable in our current system. Under my plan, the national consumption tax, we would have one transition rule, and that is any inventory held on the 31st of December can be used as a credit against collecting the tax in future years because that inventory already has a tax embedded in it. We should only tax everything one time. We have about $1.4 trillion in inventory in the economy at any given time. Roughly a fourth of that is $350 billion. That is the entire transition cost of my proposal.

There are some economic drivers that are going to force us to take a hard look at this. The first one is the 22 percent embedded. Every time we sell something overseas, we are losing to our competition because we have such a large embedded cost in the goods and services we sell.

Secondly, we spend somewhere in the range of $400 billion just complying with the Code. We spend 6–7 billion man hours filling out IRS paperwork. We spend probably that amount of time just calculating the tax implications of a business decision. We lose 18 percent of our economy to making tax decisions, as opposed to economic decisions. That adds up to somewhere in the range of $400 billion a year just complying with the Code.

We have a trillion dollar underground economy just in pornography, illicit drugs, and illegal labor. That doesn't include all the other things that happen under the table. But those three components make up a trillion dollar untaxed economy.

We have driven offshore $6 trillion in capital. The IRS thinks it is $5 trillion; offshore financial centers say it is $6 trillion. Those are dollars offshore that it is too expensive to repatriate; they would rather borrow at 6 percent interest than repatriate at 35 percent taxes. Those dollars would all come to our shores if we were to un-tax capital and labor, and my bill would totally eliminate all taxes on income whatsoever; personal income tax, corporate income tax, gift tax, State tax, capital gains tax, alternative minimum tax. All those would be gone for a one-time tax on personal consumption. The number is 23 cents. Currently, if you earn a dollar, you give 36 cents to Uncle Sam. Under my system, if you spend a dollar, you give 23 cents to Uncle Sam.

The rebate system that we have devised in this, to every household—not rich or poor, because we are not going to know who is rich or poor—totally rebates the tax consequence of spending up to the poverty line. For a family of one, that is $9,500 a year; for a family of six, that is $30,000 a year. They could spend that amount of money totally untaxed.

So low-income people are the big beneficiaries of going to a personal consumption tax as devised by H.R. 25, because they no longer lose the 22 percent of their purchasing power of the current system. Competition drives that out of the price system and prices decline by 20–30 percent. And then everybody gets rebated, a check sufficient to totally un-tax to the poverty line.

Who is going to pay for this? Accumulated wealth; people who have paid taxes on their earnings in older life. Pay taxes when they sell the company, pay taxes on interest it earns, and they are going to pay taxes one more time when they spend it. And to those with accumulated wealth, I just say you are already paying this. America is paying a hidden 22 percent sales tax today; it is just not recognized.

I think the transparency is a huge issue. I think my mother should know every time she buys a loaf of bread how much goes to the Government. I think that we have untaxed 47 percent of America's income tax payers. We have a huge bias for more Government and more taxes because of that, and I think that everybody should be pay every time they purchase something.

Mr. Chairman, I would be happy to take any questions.

[The prepared statement of Mr. Linder follows:]

PREPARED STATEMENT OF HON. JOHN LINDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA

Mr. Chairman, thank you very much for giving me a chance to testify before the Budget Committee this morning on fundamental tax reform generally, and H.R. 25, the FairTax specifically. I appreciate having the chance to share with the committee my thoughts on this pressing issue.

When debating any fundamental tax reform proposal, the Congress should judge any such bill by the following eight (8) key principles:

1. Fair: It must protect the poor and treat everyone else the same. No exemptions—no exclusions—no advantages.
2. Simple: It must be easy to understand for all Americans—no matter one's education, occupation, or station in life.
3. Voluntary: It must not be coercive or intrusive.
4. Transparent: We should all know what the government costs. There must be no "hidden" taxes.
5. Border-Neutral: Our exports must be unburdened by any tax component in the price system, while imports carry the same tax burden at retail as our domestic competition.
6. Industry-Neutral: It must be neutral between businesses and industries.
7. Strengthens Social Security & Medicare: Fundamental reform must address the long-term solvency of Social Security and Medicare.
8. Manageable Transition Costs: It must not be costly or difficult to implement.

The FairTax, which eliminates all Federal income and payroll taxes and replaces them with a national retail sales tax, meets these criteria. The FairTax is a compelling proposal that would benefit the U.S. economy, businesses across the nation, and all American taxpayers.

Allow me to briefly describe the problems associated with our current income Tax Code:

1. We spend 7 billion man-hours each year filling out IRS forms.
2. We spend at least that much calculating the tax implications of a business decision.
3. We lose 18 percent of our economy making "tax decisions" instead of "economic decisions".

Some economists believe that it currently costs us about $500 billion to comply with the income Tax Code in order to remit $2 trillion. Studies show that it costs the average small business $724 to collect, comply with the Code and remit $100 to the Federal Government.

We have $5 [trillion]–$6 trillion in overseas accounts because it is cheaper to borrow at 6 percent than repatriate dollars at 35 percent. Additionally, individuals shelter wealth in offshore accounts costing the U.S. an estimated $100 to $250 billion each year.

Just three activities—pornography, illicit drugs and illegal labor—constitute a $1 trillion economy that is untaxed.

The current dollar 75 year unfunded liability in Social Security and Medicare is $51 trillion. The total household wealth in America is less than $44 trillion. Taking every asset from every American and applying it to our retirement programs would cover only 80 percent of the shortfall.

The Alternative Minimum Tax (AMT) was passed in 1969 to ensure that those high income taxpayers, who have no tax liability due to their legal use of deductions and credits, would still be forced to pay some taxes. Within 6 years over 35 million Americans will be subject to the AMT.

We spend over $30 billion per year on the Earned Income Tax Credit (EITC) which is intended to refund the payroll tax burden of low income workers. It is estimated that nearly a third of that amount is fraud.

Upon close examination, it is crystal clear that the FairTax solves these problems: All of the above goes away if we stop taxing income and start taxing consumption.

HR 25 repeals all taxes on income and abolishes the IRS. Gone are personal and corporate income taxes, payroll and self employment taxes, capital gains, AMT, EITC, gift and estate taxes. They would be replaced by a single retail sales tax. Out of every dollar you spend on personal consumption—23 cents goes to the Federal Government.

The FairTax is fair. It contains a rebate for every household, which would totally rebate the tax consequences of spending up to the poverty line. This rebate mechanism ensures that every household could buy necessities untaxed. It totally untaxes the poor. All Americans receive equal, fair treatment.

The FairTax is simple. The FairTax eliminates 55,000 pages of Federal tax rules and replaces them with a 134 page law.

The FairTax is a voluntary tax system. Every citizen becomes a voluntary taxpayer, paying as much as they choose, when they choose, by how they choose to spend.

The FairTax creates transparency within the Tax Code. The FairTax eliminates the hidden tax component from the prices of goods.

According to a Harvard study, the current tax component in our price system averages 22 percent, meaning that those spending all they earn lose 22 percent of their purchasing power to the current system. The only mechanism businesses have to pay payroll taxes, income taxes, or compliance costs is price. Consumers pay those costs. By abolishing the IRS and abolishing the income paradigm in favor of a consumption paradigm we let the market drive the tax component out of the price system.

Knowing how much we pay in Federal taxes on every purchase would make all Americans more aware of the cost of government. The next tax increase will not be able to be sold with the argument that it only applies to the top 2 percent of Americans. The reason for any future tax increase must necessarily be so compelling that all of America would be willing to pay it.

The FairTax is border-neutral. Under a national sales tax, imported goods and domestically produced goods would receive the same U.S. tax treatment at the checkout counter. Moreover, our exports would go abroad unburdened by any tax component in the price system.

The FairTax is industry-neutral. There is not a good reason that our neighbor who builds a bookstore, hires our kids, votes in our elections and supports our community should be placed at a 7 percent disadvantage against Amazon.com. Governors have a keen interest in this due to the loss of tens of billions of dollars in revenue to Internet and catalog sales. A national system would collect that.

Nor is there a good reason why I, as a dentist, didn't have to collect a sales tax in Georgia while my neighbor, the retailer, did. The first principle of government ought to be neutrality. Services would be taxed the same as goods.

The FairTax would solve our Social Security problem. All of the arguments about private accounts saving Social Security miss an important point—we will increase the number of retirees in the next 30 years by 100 percent and increase the number of workers supporting them by 15 percent. That system will only survive by dramatically reducing benefits, increasing taxes or increasing the number paying into it.

Under the FairTax, Social Security benefits will be paid out of the general sales tax revenues. The sales tax will be collected from 300 million Americans and 40 million visitors to our shores. Revenues to Social Security and Medicare will double, as we expect the size of the economy to double, in 15 years.

The FairTax has manageable transition costs. The only transition rule would allow retailers to use inventory on hand on December 31, as a credit against collecting taxes on sales in the New Year. This is based on the principle that things should be taxed only once and goods produced before the transition would already have the current tax embedded in them. U.S. businesses have about $1.4 trillion in inventory on hand at any given time. Not collecting taxes on that inventory would cost the Treasury about $350 billion. Compare that to any estimates of transition costs just trying to bring some private investment into Social Security alone.

The FairTax would efficiently tax the underground economy. This alone would increase revenues by over $200 billion.

Beyond the above arguments, what will the new paradigm do in our present economy? Passing the FairTax does several things that will directly affect the economy.

1. The monies saved on compliance costs will immediately be put to efficient and profitable use. We will create millions of new jobs.

2. Our GDP will grow by $180 billion per year because we would no longer make "tax decisions."

3. Eliminating the income tax will bring long-term interest rates down to municipal bond rates, ultimately reducing interest rates by 30 percent. That is good for corporate profits and the market.

4. If all the world's investors could invest in our markets with no tax consequences, values would rise. With no tax on capital or labor, foreign domiciled international firms would build their next plant in America. We would be the world's "tax haven" and the $6 trillion offshore would come home, increasing values in our markets and creating jobs.

5. Having no complicated depreciation schedules, AMT, credits and deductions to confuse investors, and no tax or compliance costs, would force a whole new look at corporate accounting. Only three numbers have meaning: earnings, expenses and dividends. Nothing to hide behind. It will be easier for shareholders to evaluate and monitor the companies they own.

6. Deficits spook the market. Instead of a 20 percent decline in collections over the last 3 years, we would have had increased revenues in 11 of the last 12 quarters.

7. Add to the above a 26 percent increase in exports in the first year, as well as a 78 percent increase in capital investment. Capital investment increases lead to increases in productivity and then increases in real wages. We also will have a 10.5 percent increase in economic growth in the first year.

How does the FairTax compare to other fundamental tax reform ideas? The FairTax is decidedly simpler and fairer than flat tax proposals. The U.S. instituted a flat tax in 1913. Since then, it has been amended over and over, resulting in the very plan we are working to correct today. In 1986, we eliminated most deductions and drastically lowered tax rates to only two levels. We have amended the Code over 6,000 times since then. We have walked the flat tax path before, to no avail, and it simply does not make sense to implement the same mistake again. Also, by keeping the payroll tax and corporate tax in place, the flat tax proposals fail to remove the tax component from the price system.

Other sales tax proposals leave in place the payroll tax—the largest hidden tax component in the prices of our goods and services. The FairTax would completely eliminate these hidden taxes, allowing competition to bring prices down an average of 20–30 percent and increasing the transparency of the tax system.

In reviewing the FairTax, here are some important concepts to remember:

- Because of the tax component incorporated into prices under the current income Tax Code, we are already paying the equivalent of the FairTax!
- The FairTax eliminates payroll taxes, which are the most regressive of existing taxes.
- The FairTax is a tax on accumulated wealth. However, the holders of accumulated wealth are already paying it. It is just hidden. Their wealth will increase geometrically with all of the new investment expected.
- The FairTax saves Social Security and Medicare as Federal entitlements.
- The FairTax efficiently taxes the underground economy.

Chairman NUSSLE. Thank you, Mr. Linder.

Next to arrive was Mr. Burgess from Texas.

Welcome, and we are pleased to receive your testimony.

STATEMENT OF THE HON. MICHAEL C. BURGESS

Mr. BURGESS. Well, thank you, Mr. Chairman. I appreciate the opportunity to be here today. I thank the ranking member and members of the committee. I too have a formal statement that I will leave for the record.

One thing I feel I must correct, there may be a panel of experts down here, but I am not an expert. I am a country doctor who was elected to Congress. But under that guise of being just a regular guy, back in 1995 or 1996, I picked up an read an extraordinary book called "The Flat Tax." I believe in the flat tax. I could not understand why Congress was holding back. If they had a concept that was this good in front of them, it seemed like a reasonable proposal. Let us debate, let us hear about it, and let us see if we can't pass something that is simpler and fairer for the American people.

When I came to Congress, believing in the flat tax as I had, I thought it was important to keep that concept alive, and I have tried to do that. The difference in the flat tax that I have introduced last year, or actually last year, in H.R. 1783, was that I made the flat tax voluntary. One of the concerns I had, and Mr. Spratt eloquently pointed to it when they did the closet cleaning back in 1986. Again, I was a regular guy back in north Texas taking care of patients, but the closet cleaning resulted in a drastic change in behavior. People who had been encouraged to run their business or construct their lives in a particular way by the Tax Code suddenly had the rug pulled out from under them. In Texas the real estate sector and the energy sector were hit particularly hard and, as a consequence, we had some significant employment problems in Texas, and it affected my patients, and I got to see that pain up close and personal as people worked through those problems.

I feel that it is important for whatever we do up here to inflict minimal pain on the American people, and for that reason I think making the flat tax voluntary, allow a family or a business to elect whether or not to go into a simplified tax system. That is, if they like what they have got going on in the IRS Code, they should be able to stay in the Code. But if they are willing to give up their shoe box full of receipts and the quality time with their accountant every April, we ought to give them the opportunity for a flat tax.

I believe that part of our job here in Congress is to trust the American people to make the right decision. I think the voluntary flat tax would conform with being a pro-growth system, and I believe that the flat tax will encourage savings and investment.

I will give you another example from my life as a private citizen. When I started my private practice of medicine, I thought the prudent thing to do would be to keep 3 months of operating capital in a bank account where I could readily access it if I came on hard times. Having to borrow to make a payroll one time, I was extremely uncomfortable with that concept, and I thought, well, next time I am going to have those funds available. But what happened when I did that was I ended up paying corporate taxes on that money at the end of that year, and when that money eventually came back to the practice and was distributed as income, we got to pay taxes on it again; and my partners weren't happy with my prudence when that was pointed out to them by our accountant, and we did change accountants shortly after that.

I think it is reasonable to provide another option for our system that will reduce the complexity for the American people. And Mr. Spratt again eloquently alluded to the fact that we do need to have a Tax Code that is more simple, and I agree, and I believe the voluntary flat tax conforms to that.

We take a lot from the American people. We take their money, but, Mr. Chairman, just as importantly, we take their time. And Dr. Linder eloquently pointed out with the FairTax that he would be giving time back to the American people, and that is exactly right with the voluntary flat tax. We would offer the American people 6.1 billion hours of compliance time that they now spend filling out their forms and reading the regulations that we could refund to them immediately.

Mr. Spratt also said we needed to make the system fair, and I couldn't agree more. One of the moments that comes to me was back in 1993, when you all passed a retroactive tax back to January 1, of that year. By some strange coincidence, President Clinton and I earned about the same amount of money that year. Well, actually, I earned a couple of thousand dollars more, but I think I had a better year. But President Clinton paid about 19 or 20 percent of his total income in taxes; I paid 33 percent. And I think he was eligible for public housing that year, so clearly the system did not treat the two of us fairly.

I think the flat tax will ease the burden on the taxpayer and ease the burden on entrepreneurs. I know, as a young person starting out, if someone said you can either form a close relationship with your accountant through the rest of your business life or you can just simply fill out a postcard size form, I would elect for the postcard size form.

The fact of the matter is there are other countries who have adopted a concept along the lines of a flat tax, the former Soviet Union being one, and their economy has responded accordingly. This is, I think, one of the most important points: the flat tax right now is doable. With a minimum of heavy lifting, we could make a voluntary flat tax available to the American people, and it wouldn't inflict that much pain on the American people. But immediately it would eliminate the marriage penalty. Consider this: For a husband or wife whose spouse earns $60,000 a year, that spouse pays in at the 50 percent level from the first dollar earned for the rest of their life. That is not fair. That is truly a marriage penalty, and we could do away with that.

We have made some efforts to repeal the death tax, which is one of the things that has put us on a glide path to a fundamentally flat or a fair system. The alternative minimum tax is really what is looming out there, which is going to give us the political courage to do something about our tax system, because the American people are going to demand it when the alternative minimum tax begins to erode more and more of their earning power.

Finally, the flat tax would eliminate the capital gains tax and would allow for immediate expensing of capital equipment.

The 2001 and 2003 tax cuts were good starts on repealing the harmful provisions, but now it is time for us in Congress to finish the job and give the American people the power to choose an alternative tax that would be fairer.

Thank you.

[The prepared statement of Mr. Burgess follows:]

PREPARED STATEMENT OF HON. MICHAEL C. BURGESS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

First, I want to thank Chairman Nussle for holding this important hearing today. As a long-time supporter of fundamental tax reform, I believe that this is one of the most important issues that Congress will face in the next few years. I would also like to thank the chairman for the opportunity to testify before you to explain my voluntary flat tax proposal.

Ten years ago, when I was a private citizen living in north Texas, I thought the flat tax made a lot of sense. It meets the criteria by which all tax systems should be evaluated—it is fair, simple, transparent, and efficient, thereby promoting economic growth today. I will discuss how the flat tax meets each of these important criteria, but first I would like to explain how the Freedom Flat Tax works.

THE FREEDOM FLAT TAX ACT

In April 2003, shortly after coming to Congress, I introduced H.R. 1783, The Freedom Flat Tax Act, which would establish a voluntary flat consumption tax. It is simpler, fairer, more transparent and more efficient than the current income Tax Code. The flat tax concept is simple—there are two components, the individual wage tax and the business tax.

Individuals pay a flat rate on their wage and pension income, and there will be no deductions. H.R. 1783, however, would allow for the following personal exemptions:

- $24,600 for a married couple filing jointly;
- $15,700 for a single head of household;
- $12,300 for a single person; and,
- $5,300 for each dependent.

A family of four, for example, would not be subject to the flat tax until their combined income reached $35,400, which is 194 percent above the 2002 Federal poverty level of $18,244. Thus, the flat tax system is slightly progressive because the exemptions ensure that lower wage earners do not pay any Federal tax until they reach a certain threshold, after which they pay the flat rate of 17 percent.

It is important to note that the marriage penalty is repealed under the flat tax because the exemption for a married couple filing jointly is twice that of a single person.

Businesses would pay a flat rate on the total costs of taxed inputs subtracted from total sales; only employee wages and pensions will be tax deductible—this ensures that income is only taxed one time. Under H.R. 1783, both the business and individual tax rates are 19 percent, but would decline to 17 percent after the initial 2 years of participating.

Unlike past flat tax proposals—The Freedom Flat Tax Act allows taxpayers to choose if and when to opt into a flat tax system. That is because I do not believe that we should penalize those who have made investments based on the market-distorting Tax Code. It would be like changing the rules in the middle of the game. My flat tax plan allows taxpayers to transition to the flat tax system on their own timetable.

Now that I have explained the mechanics of my flat tax proposal, I'd like to discuss the advantages to the flat tax system. Why would anyone want to opt into the flat tax system?

FAIR

First, it is fair—no matter how much money you make, what kind of business you are in, or whether or not you are married, you will be taxed at the same low rate as every other taxpayer.

The Tax Code should strive to be fair both vertically and horizontally. The flat tax system has vertical fairness because it taxes everyone at the same rate, while ensuring that the tax burden does not fall too heavily on lower wage earners.

The Tax Code should also have horizontal fairness, and that is best illustrated by what I call the "Clinton paradox," which I encountered in 1993. 1993 was the year that Congress increased the tax rate, retroactive to the first of the year. By some quirk of fate, former President Clinton and I earned almost an identical amount that year. But when it came time to pay to the Federal Government, President Clinton paid just over 20 percent, and I paid over 30 percent. Why should such a discrepancy exist? What is the benefit for the country when we are taxed at different rates on exactly the same income? Currently, simplicity and fairness in taxes are sacrificed for the sake of pursuing a social agenda.

But a social agenda is not the purpose of the Federal income Tax Code. That is why the Freedom Flat Tax Act does not allow credits or deductions, which means that people who earn the same wages pay the same amount in taxes, thus the flat tax has horizontal fairness.

Congressman English's Simplified USA Tax, however, does allow deductions for home mortgage interest, charitable donations, and secondary education. My concern is that allowing deductions now allows additional deductions in the future. Look what has happened since the 1986 tax reform, during which a large number of deductions were repealed. Over time, many of those deductions have been restored, which has added complexity to the Code.

SIMPLICITY

A major advantage of the flat tax is its simplicity—a tax system so simple that you can understand it without a CPA. By eliminating tax credits and deductions, abolishing multiple layers of taxation, and eliminating the complex depreciation schedules for businesses, the flat tax will simplify the Tax Code. The flat tax will allow families and businesses to take back the more than 6 billion hours per year that they currently spend to comply with the income tax. Some simple arithmetic is all that is needed to determine your tax liability each year. The flat tax has the ability to give time back to families because it is easy to understand and easy to comply with.

The Simplified USA Tax, by contrast, is more complicated than the flat tax for individual taxpayers because it allows several deductions and has several tax brackets.

The FairTax, on the other hand, is very simple for individual taxpayers—after they get over the sticker shock—but is extremely onerous for businesses, especially small businesses. That is because the Fair Tax would require small businesses to become the tax collector. I am concerned that this would serve as an additional tax on mom-and-pop shops and would discourage entrepreneurs from starting new small businesses.

TRANSPARENT

It is important that the tax system be transparent—otherwise the government can easily raise rates, as they have done in Europe with the VAT tax. With a flat tax, you will easily be able to tell how big a bite the Federal Government takes out of your income each year. After some simple and brief subtraction, you simply pay 17 percent percent of your wages above your personal exemptions. And because everyone pays the same rate, it would be obvious to all Americans if it was raised.

The FairTax, in contrast, is less transparent than it would appear at first glance. Although the FairTax would be separately stated on each receipt, to determine your total Federal tax liability, you'd have to add up all your receipts from the whole year. That means saving receipts from every trip to the grocery store for milk, every latte from Starbucks, every newspaper, or magazine, etc.

EFFICIENT/PRO-GROWTH

An efficient Tax Code is one that does not cost a lot. The current system is clearly not efficient—according to the CATO Institute, collecting the income tax costs the Federal Government 10–20 percent of all tax revenue collected. That is a lot of deadweight in the Tax Code.

The flat tax will encourage economic growth by easing the burden on the taxpayer and entrepreneurs by reducing the cost and time spent on tax forms. A flat tax would be much less costly, saving taxpayers more than $100 billion per year and reducing tax compliance costs by over 90 percent, according to one estimate by The Tax Foundation, a non-profit, non-partisan 501(c)(3) educational organization. This savings will give people and businesses more money to spend, ultimately boosting take-home pay, spurring the economy and creating jobs.

The flat tax will especially benefit small businesses, which today create the majority of new jobs and account for half of the economy's private output, by allowing for major simplification and the immediate expensing of capital equipment.

Multiple layers of taxation on savings and investment discourage taxpayers from adding to the capital stockpile for our economic engine. The flat tax encourages economic growth by ensuring that income is only taxed one time.

I would like, at this point, to raise my concern that under the FairTax there is a very real possibility that business purchases would be double taxed. The FairTax would ostensibly give businesses a rebate on business-to-business purchases in order to avoid double taxation, but the rebate would be very difficult to implement. Businesses, like individuals, would have to save all of their receipts—for everything from office supplies to raw materials—every year. Most large companies would not be hurt by this requirement; it would be the Main Street businesses to suffer. These are the same mom-and-pop shops that would now have to collect taxes under a national retail sales tax.

Perhaps my most serious concern with the FairTax is that it would discourage economic growth. By only taxing new goods, the Fair Tax creates an incentive to purchase used goods. To buy a used couch or a new couch does not seem like it would be all that significant to the economy, but imagine the ramifications if only new houses and new cars are taxed. We tax what we want less of, and I am concerned that taxing only new goods would discourage new production and ultimately shrink the economy.

POLITICAL DIMENSION

It is my belief that the flat tax is better than the Simplified USA Tax and the FairTax because it is fundamental tax reform that is achievable.

Unlike other tax proposals, the flat tax would not require repealing the 16th Amendment to the Constitution. If we cannot get ⅔ of the House and Senate to agree to protect marriage, it is doubtful that we could get ⅔ to vote to repeal the 16th Amendment.

I believe that the flat tax is achievable because we are already on the glide path after the 2001 and 2003 tax cuts. The Bush tax cuts allowed for bonus expensing for capital equipment, abolished the marriage penalty, reduced the multiple layers of taxation, reduced capital gains taxes and lowered rates.

To conclude, the American people deserve a tax system and a government that rewards them for their hard work. It is time for Congress to give that to them and I believe that the flat tax is the best way to achieve this goal.

Chairman NUSSLE. Thank you, Mr. Burgess.

Next up is our colleague from the Ways and Means Committee, Max Sandlin from Texas.

Welcome, and we are pleased to receive your testimony.

Mr. SANDLIN. Thank you, Mr. Chairman. It is good to be here with you this morning.

Mr. SPRATT. Would the gentleman yield for a moment?

Mr. SANDLIN. Certainly.

Mr. SPRATT. Mr. Lampson was to testify also and was not able to be here. I would like to ask unanimous consent at this point that his testimony be made part of the record.

Chairman NUSSLE. Without objection.

[The prepared statement of Mr. Lampson follows:]

PREPARED STATEMENT OF HON. NICK LAMPSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Thank you, Mr. Chairman, for holding this hearing and allowing me to testify today. I believe there are dangers inherent in the proposed National Retail Sales Tax. I am glad we finally have an opportunity to discuss the proposal seriously.

I am deeply concerned about potential problems with this proposal, that it will hurt home builders and automobile manufacturers, State governments and small businesses, and most importantly seniors and the middle class. I am also concerned that this supposedly simple proposed tax structure would be incredibly complex in its implementation, the cost of which has been grossly understated.

Under the current National Retail Sales Tax proposal, an additional $30 in taxes would be levied against every $100 in goods and services. That means southeast Texans would pay $130 for $100 in groceries. Where I come from that's a 30 percent sales tax—not the 23 percent many supporters claim.

Even this outrageously high projected rate is too low. Many economists estimate a true estimate between 50 percent and 60 percent. Even Harvard economist Ken Jorgenson, cited by many sales tax defenders as confirming a 30 percent or 23 percent tax rate inclusive, indicated that the rate would need to be 40 percent or 28.5 percent tax inclusive.

Former Republican leader Dick Armey discussed the many failures of a National Retail Sales Tax in a 1995 Policy Review article. He cites a 1993 report by the Organization for Economic Cooperation and Development arguing that while several countries have tried, almost no industrialized country has managed to sustain a National Retail Sales Tax above 12 percent.

A high tax rate assessed at the cash register would increase demand for black market goods. Consumers receive large price savings for engaging in what some consider low risk and minor criminal behavior. To prevent this we could assess the tax not at the cash register, but instead have each firm pass the tax on to consumers by charging it to their distributors. European nations have done this through a Value Added Tax ("VAT"). Unfortunately, administering a VAT requires government oversight and careful tracking by companies, creating additional work to our business community and a new, large governmental bureaucracy.

The National Retail Sales Tax also hurts small businesses. In states that use a sales tax, like my home State of Texas, small businesses generate between 20 percent and 40 percent of all sales tax revenue. Small businesses are not supposed to be impacted by State sales tax, yet if employees head over to Office Depot periodically to pick up supplies, that small business would pay an additional 30 percent tax on those items, unless it keeps all their receipts and asks the government for a refund. This amounts to a heavy tax levied against businesses. It's reasonable to assume that a similar 20 percent to 40 percent of the total revenue raised by a National Sales Tax would come from the same small business community.

The impact of this proposal on automobile dealers and home builders is also alarming. The National Sales Tax only taxes new goods. That means an $85,000 new home in my hometown of Beaumont would now be a $110,500 home, while an equivalent older home would still cost $85,000. This is a strong disincentive for people considering the purchase of a new home or a car. As a homeowner, this might be good for me because my home's value would go up, but what is the impact on new home sale rates our Administration sees as signs of recovery?

Many people would turn away from new consumer durables like cars and home appliances, instead opting to maintain older items or purchase older, used versions of the same items. Antique dealers and repair shops may benefit heavily from this, but our nation's automakers, dealers, and major retailers would suffer greatly!

Under this proposal, it is estimated that the Texas State government would now owe the U.S. government over $20 billion. The only way to make up that money is to increase an already high sales tax—further driving up home, health, food, and energy costs—or increase property taxes by around 82 percent. This does not even include the money Texas would now spend enforcing the Federal Government's new tax laws. This added cost would fall most heavily upon Americans whose paycheck is largely spent on housing. Rental rates would increase, and between losing their mortgage tax exemption and the increase in property tax rates, lower and middle income homeowners may be unable to pay for their current housing.

I've read the arguments about how the Texas State government already pays taxes to the U.S. Government. Any reputable economist would acknowledge that employees of the State government are the ones who pay in the form of their income and payroll taxes. Unless the Texas State government offsets its new tax burden by cutting State employees wages, it would have to increase its property taxes.

The biggest question is not how this proposal impacts big or small businesses or State governments, but rather, how does this proposal affect average Americans?

This proposal would crush seniors in my district. Currently seniors pay little or no income tax, spending from their savings and pensions. The most horrifying tax increase will be upon them. Seniors will surely be surprised to see the price of all their goods rise by 30 percent, and appalled as the cost of medication and health care also increase by the same percentage. Many seniors currently find it very hard to balance their budgets. This policy would make that task impossible.

Even with a reasonable exemption, this policy would amount to a tax increase on the poorest Americans. Under current law, the refundable earned income tax credit actually provides income subsidies to the poorest Americans. This essentially gives them a negative tax rate, meaning the government pays them more than they pay in taxes. Current provisions in this bill aim to give these Americans a zero percent tax rate, ignoring secondary effects from increased rental rates. Even with this optimistic assumption, it still amounts to a tax increase.

The richest Americans would benefit from this policy. If someone has the means to own two Ferraris, he or she likely has the ability to put more money into investments or the bank. All that money would go untaxed in a National Retail Sales Tax scheme. Some people estimate that their tax rates would drop to as low as 5 percent, while many less well-off Americans would experience rates much closer to 30 percent.

Even if one grants generous assumptions about how well poorer Americans would do under this proposal, one must ask where the tax burden falls if the rich go untaxed and the poor go untaxed. We talk a lot in this body about helping the middle class, but it is very clear that this proposal means bad news for the middle class. Ultimately, the consequences of a National Sales Tax are burdens that come to rest on the shoulders of America's working families. I hope the members of this committee will agree we must not be the ones to put them there. Thank you.

Chairman NUSSLE. Please proceed.

STATEMENT OF THE HON. MAX SANDLIN

Mr. SANDLIN. Thank you, Mr. Chairman. Mr. Chairman, I wholeheartedly support meaningful efforts to reform our tax system to reduce a comparatively extreme burden and to ensure efficiency combined with ease. We need to focus our efforts on reforming our Nation's revenue generation in ways that ease the burden on working families and small businesses, are fiscally responsible and realistic, and provide a foundation for solid economic growth.

Along those lines, I would like to comment for just a moment this morning on H.R. 25, the national retail sales tax. The unquestioned reality is that consumption taxes such as the national retail sales tax proposed in H.R. 25 are extraordinarily regressive and punitive on the vast majority of working families. Far from providing the much touted relief, the national retail sales tax would dramatically increase the effective tax rate on at least 60 percent of American working families, while simultaneously dramatically decreasing the effective tax rate on the 20 percent of Americans who earn the most money.

An additional problem arises from the proposal embodied in H.R. 25 because the tax increase imposed on the 60 percent of American working families is based on excessively rosy revenue assumptions of its proponents. The reality of the scope of the tax increase under H.R. 25 is likely far worse, according to most experts. According to the Joint Committee on Taxation, the 23 percent tax inclusive rate is not revenue-neutral and, in fact, grossly understates the national retail sales tax rate required to maintain current services.

The JCT estimate suggests that the actual rate required to maintain revenue neutrality under the H.R. 25 proposal would exceed 50 percent. Economists agree that the rate proposed in H.R. 25 will have extraordinarily deleterious economic effects on the Federal tax burden and household budgets of our Nation's working families.

Despite its proponents' claims, H.R. 25 is anything but pro-family and pro-business and pro-growth; it amounts to a massive tax increase on a clear majority of Americans.

Under current law, effective tax rates start low and increase as income goes up. Accordingly, at present, the effective Federal tax rate on the lowest 20 percent of earners is around 5 percent, while the top 1 percent of earners, individuals making in excess of $315,000 per year, have an effective Federal tax rate of 25 percent. By contrast, under H.R. 25 as introduced, at minimum—and this is based on the assumption that H.R. 25 is revenue-neutral, which is almost certainly not the case—60 percent of American workers would experience a Federal tax increase, in many cases a dramatic increase, while the top 1 percent of earners would see their effective Federal tax burden drop to 5 percent.

Under current law, a family of four is exempt from the Federal income tax until their household income exceeds $40,000. Thanks to the earned income tax credit, a family of four with an income below $25,000 does not even bear the burden of payroll taxes and is in effect exempt from all Federal earnings taxes. By contrast, under H.R. 25 as introduced, these lower income working families would experience dramatically and potentially devastating Federal tax increases. Instead of being virtually exempt from Federal tax, these families would see fully 30 percent of every dollar of their income over $19,000 eaten away by the national retail sales tax. For hardworking families such as these, who are already struggling, such a tax increase would push many over the edge and into bankruptcy.

Even working families with moderately higher incomes would see their Federal tax burden increase dramatically if H.R. 25 were enacted. A home-owning family of four with a household income of $65,000, and more or less typical expenses and savings patterns, would see its Federal tax more than double, from $4,417 under current law to $9,600 under the proposed national retail sales tax embodied in H.R. 25.

Tax affects not only individuals, but also local and State governments. In Texas, H.R. 25 would cost State and local governments $20 billion per year, which according to one estimate could require property tax increases of up to 80 percent.

Again, there is no doubt that our Tax Code is riddled with complexity and must be simplified. But there is just as little doubt that increasing the Federal tax burden on the vast majority of working Americans is not an appropriate solution to that problem. That is exactly what the national retail sales tax proposed in H.R. 25 would do.

Thank you, Mr. Chairman. Appreciate the opportunity to be before your committee this morning.

Thank you, Mr. Spratt.

[The prepared statement of Mr. Sandlin follows:]

PREPARED STATEMENT OF HON. MAX A. SANDLIN, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, Ranking Member Spratt, distinguished members of the committee, colleagues—current and former—I first want to thank you for affording me the opportunity to appear before the committee today to address one of the most important issues within the jurisdiction of Congress.

More often than not, the debates on the floor of the House and in the committee rooms revolve around defending our nation against the threat of terrorism at home and abroad, the education of our children, access to health care for the uninsured, improving health coverage for our nation's seniors, ensuring that our nation's highways and infrastructure are adequately improved and maintained, enhancing the opportunity of our nation's working families, or protecting our environment. All of these are without question noble goals and worthy of debate. However, the common thread running through each and everyone of these issues is the fundamental question: How do we pay for it?

The Constitution confers original authority over this question on this, the People's House, in Article I, Section 7: "All Bills for raising Revenue shall originate in the House of Representatives * * *." Accordingly, it is fitting that we gather today to discuss several options for raising the revenue needed to fulfill our constitutional admonition to "establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty" for the American people.

For more than 10 years, my friends on the other side of the aisle have made tax reform and simplification a cornerstone of their economic program. Their commitment to this notion is one with which I wholeheartedly agree. Their expertise and understanding of many of these issues is indeed admirable. However, for all their effort, they seem to have fallen far short.

There can be little doubt that taxpaying American citizens and businesses—particularly small businesses—spend far too much time not just preparing their tax returns and paying their taxes, but in even figuring out just how to file, which forms to fill out, what tax preferences they qualify for, what they can deduct, and what elections they should make to best serve their personal needs or the interests of their family, business and employees. The need for simplification is something on which we can all agree.

On top of that is the anxiety that all taxpayers experience when confronting the daunting complexity of the Tax Code and trying to make sound tax-planning decisions with the prospect of taking a wrong turn in a mind-numbing maze that makes tax lawyers and accountants shudder.

In January 1996, then Speaker Newt Gingrich stated, "The Tax Code has over the years become increasingly politicized and is seen less as a simple tool for raising revenue than as an instrument for social and economic engineering * * * exponentially increasing the complexity of the Code * * *. The current system is indefensible. * * * Today's Tax Code is so complex that many Americans despair that only someone with an advanced degree in rocket science could figure it out. They are wrong. Even a certified genius such as Albert Einstein [would have] needed help in figuring out his Form 1040."

Such complexity is both unnecessary and unhealthy for the taxpayer and our nation's economy. Accordingly, let me be clear. I wholeheartedly support meaningful efforts to reform our tax system to reduce a comparatively extreme burden and to ensure efficiency combined with ease. We need to focus our efforts on reforming our nation's revenue generation in ways that (1) ease the burden on working families and small business, (2) are fiscally responsible and realistic, and (3) provide a foundation for solid economic growth.

Nine years ago, then Ways & Means Committee Chairman Bill Archer declared his intention to "tear out the income tax by its roots and discard it and replace it with a new form of taxation." Just 3 years ago, continuing this theme, Majority Leader DeLay derided the "mind-numbing complexity" of the Tax Code and declared his intention to make the Code "fairer, flatter, simpler and less burdensome on the American people."

Again, easing the burden our Tax Code imposes on working families and small business is a worthwhile goal, and I will gladly join with my colleagues in working toward that end. However, the proposals that have gained the most popularity and attracted the most attention of late are neither realistic nor fair. They may represent a "new form of taxation" and have a "flatter" rate structure, but they are hardly "fairer, simpler * * * [or] less burdensome."

The unquestioned reality is that consumption taxes, such as the national retail sales tax proposed in H.R. 25, are extraordinarily regressive and punitive of the vast majority of working families. Far from providing the much-touted relief, a national retail sales tax would dramatically increase the effective tax rate on at least 60 percent of American working families, while simultaneously dramatically decreasing the effective tax rate on the 20 percent of Americans who earn the most money.

An additional problem arises from the proposal embodied in H.R. 25, because the tax increase imposed on 60 percent of American working families is based on the excessively rosy revenue assumptions of its proponents. The reality of the scope of the tax increase under H.R. 25 is likely far worse. According to the Joint Committee on Taxation, the 23 percent tax-inclusive rate (30 percent tax-exclusive) is not revenue neutral and, in fact, grossly understates the national retail sales tax rate required to maintain current services.

The JCT estimate suggests that the actual rate required to maintain revenue neutrality under the H.R. 25 proposal would exceed 50 percent. Economists agree that the rate proposed in H.R. 25 will have extraordinarily deleterious economic effects on the Federal tax burden and household budgets of our nation's working families, many sectors of our business community, and the American economy overall. Despite its proponents' claims, H.R. 25 is anything but pro-family and pro-growth. It amounts to a massive tax increase on a clear majority of Americans.

Under current law, effective tax rates start low and increase as income goes up. Accordingly, at present, the effective Federal tax rate on the lowest 20 percent of earners is around 5 percent, while the top 1 percent of earners—individuals making in excess of $315,000 annually—have an effective Federal tax rate of 25 percent.

By contrast, under H.R. 25 as introduced, at minimum, 60 percent of American workers would experience a Federal tax increase—in many cases, a dramatic increase—while the top 1 percent of earners would see their effective Federal tax burden drop to 5 percent.

When the 60 percent of American workers with the least income would experience a substantial Federal tax increase, as they would under H.R. 25, that is hardly the "relief" American taxpayers deserve, and it certainly is not the reform or simplification we should be considering seriously.

When we focus on consumption-based tax systems, particularly as a replacement for a graduated, progressive income tax, we are really asking ourselves "which middle class tax increase do we prefer?" For my part, I believe middle-income working Americans have suffered enough and deserve relief and reform that benefit their household budgets—not so-called "reform" that punishes their hard work, rewards wealth that will be increasingly difficult for working families to obtain, and significantly widens the opportunity gap.

On Monday, in Des Moines, IA. President Bush signed bipartisan legislation that continues the tax relief for working families we passed in 2001. I was proud to support that legislation in 2001 and in 2004, because it provides directed and meaningful relief for American taxpayers who very much need it. It extends the $1,000 child tax credit, marriage penalty relief and the expanded 10 percent tax bracket. As a consequence, according to the President, 7 million low-income families will see an increase in their child tax refunds, and "94 million Americans will have a lower tax bill next year, including 70 million women and 38 million families with children."

That's genuine tax relief. That is what we should be doing for the American people.

Yet today we gather to consider tax reform proposals that would deny working families with children their personal exemptions, the child tax credit, the earned income tax credit, and the mortgage interest deduction.

Under current law, a family of four is exempt from the Federal income tax until their household income exceeds $40,000. Thanks to the earned income tax credit, a family of four with an income below $25,000 does not even bear the burden of payroll taxes. By contrast, under H.R. 25 as introduced, these lower income working families would experience dramatic and potentially devastating Federal tax increases; instead of being virtually exempt from Federal tax, these families would see fully 30 percent of their income over $19,000 eaten away by the national retail sales tax. For hard working families such as these, who are already struggling to survive, such a tax increase would push many over the edge and into bankruptcy. America's hard working families deserve much better.

Even working families with moderately higher incomes would see their Federal tax burden increase dramatically if H.R. 25 were enacted. A home-owning family of four with a household income of $65,000 and more or less typical expenses and saving patterns would see its Federal tax more than double from $4,417 under current law to $9,600 under the proposed national retail sales tax embodied in H.R. 25. A similar family of four with a household income of $130,000 would see its Federal tax liability jump more than 50 percent from around $17,000 under current law to $27,000 under the tax plan proposed by H.R. 25.

Again, there is no doubt that our Tax Code is riddled with complexity and must be simplified, but there probably is equally no doubt that increasing the Federal tax burden on the vast majority of working Americans is absolutely not an appropriate solution to that problem. That is exactly what the national retail sales tax proposed in H.R. 25 would do.

I would call on the committee to consider just a few of the extraordinarily adverse impacts H.R. 25 would have on the American people and economy.

The national retail sales tax as proposed by Mr. Linder would impose a huge unfunded mandate on State and local government well in excess of $300 billion in the first year alone, because State and local governments would not be exempt from paying the tax proposed by H.R. 25, except with respect to education-related expenditures. Accordingly, every time a State or municipal government buys a new fire truck or improved communications equipment for its law enforcement agencies, they will have to pay a 30 percent Federal tax on those purchases. Such increased costs will either lead to the financial ruin of our State and local governments or require significant increases in State and local taxes to make up the difference. In my home State of Texas, enactment of H.R 25 would cost State and local governments $20 billion per year, which, according to one estimate, could require property tax increases of up to 80 percent. Under H.R. 25, "simplification" of our Federal tax system would lead to dramatic tax increases at the State and local level. I have every confidence that proponents of the national retail sales tax will have a hard time convincing Texans that H.R. 25 is a good idea.

The passage of H.R. 25 would lead to huge tax increases on our nation's seniors and effectively require them to pay twice for their Social Security and Medicare benefits. Moreover, such consumption taxes would have particularly harsh effects on seniors who live on their lifetime savings, monies on which they have already paid Federal taxes, because they will now be required to pay a new, much higher Federal tax each time they buy a prescription, see a physician, fill up their car, or go to the grocery store.

H.R. 25 imposes a new 30-percent Federal tax on health insurance, health care services, the purchase of new houses, housing rents, and energy, virtually all of which are not presently subject to Federal tax. Accordingly, a person's $100 monthly health insurance premium will now be $130. His $1,000 monthly rent will now rise to $1,300. At current prices, every gallon of gasoline he consumes will go up 60 cents. Moreover, a portion of the interest payments families pay on their mortgages, instead of being allowed as a deduction from their income, will be subject to a new, 30-percent Federal tax.

H.R. 25 will deal a double blow to our nation's charitable institutions. First, under current law, they are exempt from Federal tax; that exemption is eliminated under H.R. 25, and their costs will increase concomitantly, thereby reducing their ability to serve the communities and missions to which they are dedicated. Second, under current law, Americans have an incentive to contribute to their churches, schools and other charitable agencies: they can deduct those contributions from their income. Under H.R. 25, that incentive is stripped away, a potentially crippling blow to charities that often barely survive as it is.

Automakers and homebuilders will suffer an extreme setback if the national retail sales tax proposed by H.R. 25 becomes the law of the land. Consumers will rethink purchasing new cars when the reality that a $15,000 car they thought they could afford, becomes an out-of-reach $19,500 car after the national retail sales tax is tacked on. Domestic production of new cars will be decimated. Those along the southern and northern borders will be advantaged, however, as they will be able to go to new car dealers in Canada and Mexico and purchase their new cars without being subject to the national retail sales tax.

Moreover, the impact on new home sales will be equally negative; a new $200,000 home will now cost $260,000, which is quite a different proposition for many young families. Add to that the fact that those families, under H.R. 25, will both lose the mortgage interest deduction and pay a new Federal tax on their mortgage payments. The effect on our nation's new home market will be dramatic to say the very least—and not in a positive way.

Our nation's farmers will also face an unsustainable situation, which will likely lead to the elimination of one of our nation's most important institutions—the family farm. Under current law, family farmers buy seeds and feed—the factors of farm production—and are able to deduct those expenses for purposes of calculating their annual Federal tax bill. In years when nature works against them—crop loss, drought, disease—farmers may account for those losses against future income, which, in good years, serves to reduce their tax liability and make them whole.

Under H.R. 25's national retail sales tax, family farmers face an entirely different reality. They will be forced to pay this new Federal consumption tax on every packet of seeds, pound of feed, and bag of fertilizer. The national retail sales tax is an upfront cost for farmers. If it's a good year, then they will have merely dealt with a dramatic tax increase; by contrast, in a bad year, all those costs will be lost with no allowance for prior or future year offsets. In sum, for family farmers who already struggle to make it, H.R. 25 will be a perfect storm that will drive far more into bankruptcy. The traditional family farm is likely unsustainable under H.R. 25's national retail sales tax.

Other sectors of the economy that benefit from tax preferences under current law will also be dealt a serious blow should H.R. 25 become law. Under its national retail sales tax proposal, developers of affordable housing and renewable energy projects, among others, will face a retroactive repeal of the tax credits that provided the incentive for those entrepreneurs to take those business risks.

In sum, H.R. 25 is regressive. It punishes working families in our society with dramatic tax increases. While proposed as a means of tax simplification, the national retail sales tax proposed by H.R. 25 is neither simple nor fair. Moreover, the assumptions underlying it are terribly flawed. Virtually every economist and tax authority agrees that such a national retail sales tax would create extraordinary problems of administration and enforcement. Moreover, while H.R. 25 proposes a tax-inclusive rate of 23 percent (30 percent tax-exclusive), the Joint Committee on Taxation acknowledges that as a gross understatement of the real rate required to maintain revenue neutrality; some estimates set the rate as high as 57 percent. If, as has been demonstrated, the 30 percent rate provided for in H.R. 25 represents a tax increase on at least 60 percent of America's families, then doubling that would be economically devastating and is totally politically untenable. Making matters worse, H.R. 25 allows for no evasion, no avoidance, and no statutory base erosion. It is not rooted in reality.

We need reform. We need fundamental tax reform. However, we do not need more cynical, unworkable, election-year plans that create a world of losers in a redistribution whirlpool without any real gains in economic efficiency or fiscal responsibility. H.R. 25 represents radical reform, but it is reform of the worst kind—reform with virtually no winners and a sea of economic casualties.

Thank you again for the opportunity to testify this morning. I look forward to continuing to work with my colleagues on both sides of the aisle to enact meaningful, workable, pro-growth tax reform and simplification.

Chairman NUSSLE. Did the gentleman have a proposal for reform? We will mark you down as against H.R. 25, I guess is what your point is.

Mr. SANDLIN. Yes, Mr. Chairman. We were here this morning and I was commenting on H.R. 25. I don't have a particular proposal at this time other than to comment on H.R. 25 would be a simplification, but it would be an increase and a tax burden on working families and local government and small business, and I don't think it is a viable alternative to the current progressive system that we have. So I think Mr. Linder's proposal should not be considered. While we certainly should consider some sort of simplification of the current code, this isn't an acceptable alternative.

Chairman NUSSLE. OK. We will mark you down.

Mr. English, colleague from the Ways and Means Committee from Pennsylvania. We are pleased to receive your testimony.

STATEMENT OF THE HON. PHIL ENGLISH

Mr. ENGLISH. Thank you, Mr. Chairman. It is a real privilege to be here this morning.

Mr. Chairman, the American tax system is a Frankenstein's monster that haunts individual taxpayers while casting a cold shadow over the productive sectors of the U.S. economy. It is too complicated, it is riddled with obvious inequities, it punishes savings and investment while reducing economic growth and burdening domestic industries struggling to remain competitive.

To address these inequities, and because I want to reform the American tax system in a way that makes sense to average tax citizens, I introduced the Simplified USA Tax Act, H.R. 269. Not only do we need a Tax Code that is fair and simple, we need one that is stable. As bad, as awful as the current Tax Code is, and I am one of its severest critics, the last thing we need to do is enact some reform that is so radical and experimental that we have to redo it all over again a few years hence. The new Tax Code I have developed, the Simplified USA Tax, is based on sound and familiar principles that are easy to understand and will provide the correct incentives for today's modern economy.

Although the Joint Committee on Taxation has never completed a revenue score of SUSAT, it is designed to be revenue-neutral.

The USA Tax for individuals is simplicity itself, a minimalist approach that achieves a great deal without a lot of complex rules. In terms of past studies of the complexity of this system, they have indicated it would reduce the complexity of the current tax system by 75 percent, as opposed to 91 percent for the flat tax. In addition to providing a simple way to calculate taxes, the USA Tax brings several key reforms to the table.

First, the Tax Code must give Americans a fair opportunity to save part of their earnings. Thrift has helped to provide Americans the security and independence that is the foundation of freedom. Productivity raises our living standards to the highest in the world.

In my tax reform proposal, USA stands for unlimited savings allowance. Everyone is allowed an unlimited Roth IRA in which they can put the portion of each year's income they save after paying taxes and living expenses. After 5 years, all money in the account can be withdrawn for any purpose and all withdrawals, including accumulated interest and other earnings or principal, are tax free.

Nothing can be simpler and nothing would give people a better opportunity to save, especially young people.

The Tax Code must also give everyone the opportunity to keep what they save and, if they wish, to pass it on to succeeding generations. My tax reform proposal repeals the Federal estate and gift taxes permanently.

Under the new Tax Code, tax rates must be low, especially for wage earners who now pay both an income tax and a FICA payroll. The Simplified USA Tax starts out with low tax rates: 15 percent at the bottom, 25 percent in the middle, 30 percent at the top. Then the rates are reduced even further by allowing wage earners a full tax credit for the FICA payroll tax that they pay that is withheld from their paychecks under current law. I don't propose to repeal the payroll tax because of its impact on the Social Security system, but the Simplified USA Tax would provide tax relief for all Americans, especially who own their home, give to their church, educate their children, and set aside some savings for a better tomorrow. What we anticipate under this tax system is very low tax rates on workers' wages, in the 7–17 percent range for nearly all Americans.

Under my proposal, everyone gets a deduction for the mortgage interest on their home and for charitable contributions they make. We also provide for a deduction for tuition paid for college and post-secondary education. Generous personal and family exemptions are also allowed under my proposal. On a joint return, the family exemption is a little over $8,000, and there is an additional $2,700 exemption for each member of the family. Thus, a married couple with two children pays no tax on their first $18,940 of income.

This tax is simplicity itself. The tax return will be short, only a page or two for most of us. But more to the point, the tax return will be comprehensible.

In summing up, I also want to make the point my proposal contains a better and new way of taxing corporations and other businesses that will allow them to compete and win in global markets in a way that exports American made products, not American jobs. I have studied this issue and I believe, if enacted in America, this innovative approach to business taxation will soon become the worldwide standard to which all other countries subscribe. In a nutshell, it is a simple subtraction method value-added tax on the business side that would provide full expensing and also, importantly, border adjustability so that our products, as they go offshore, do not contain the cost of the tax system built in; and as we import products, they will pay their share of taxation.

I believe that this is a huge reform and potentially a hybrid of several of the other systems, including the flatter tax that have been proposed and also the consumption tax, because this system has all of the incentives of a consumption tax.

I apologize to my colleagues, though, for one. This tax reform will not fit on a bumper sticker. I realize it will require a certain amount of salesmanship, but I do believe it has the potential to provide America with a modern tax system that will allow our economy to grow, savings to grow, investment to grow, productivity to grow, and improve our trade situation.

I thank you, Mr. Chairman.

[The prepared statement of Mr. English follows:]

PREPARED STATEMENT OF HON. PHIL ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Thank you Chairman Nussle, Ranking Member Spratt and members of the committee for the opportunity to appear before this committee today.

The American tax system is a Frankenstein's monster that haunts individual taxpayers while casting a cold shadow over the productive sectors of the U.S. economy. It is too complicated, and riddled with obvious inequities. It punishes savings and investment, while reducing economic growth and burdening domestic industry struggling to remain competitive.

To address these inequities and because I want to reform the American tax system in a way that makes sense to average citizens, I introduced the Simplified USA Tax Act, H.R. 269. Not only do we need a Tax Code that is fair and sensible, we need one that is stable. As bad as the current Tax Code is—and I am one of its severest critics—the last thing we need is to enact some reform that is so radical and experimental that we may have to redo it all over again a few years later. The new Tax Code I have developed—the Simplified USA Tax Act or "SUSAT"—is based on sound and familiar principles that are easy to understand and will provide the correct incentives for today's economy.

Although the Joint Committee on Taxation had never completed a revenue score of SUSAT, it was designed to be revenue neutral.

TAXING INDIVIDUALS

The USA Tax for individuals is simplicity itself; a true minimalist approach that achieves a great deal without a lot of complex rules. In addition to providing a simple way to calculate taxes, the USA tax brings several key reforms to the table.

First, the Tax Code must give Americans a fair opportunity to save part of their earnings. Thrift has helped provide Americans the security and independence that is the foundation of freedom. Savings buys the tools to make Americans more productive. Productivity raises our living standards to the highest in the world.

In my tax reform proposal, "USA" stands for unlimited savings allowance. Everyone is allowed an unlimited Roth IRA in which they can put the portion of each year's income they save after paying taxes and living expenses. After 5 years, all money in the account can be withdrawn for any purpose and all withdrawals—including accumulated interest and other earnings or principal—are tax free.

Nothing can be simpler and nothing could give the people a better opportunity to save; especially young people. Because only new income earned after enactment of the Simplified USA Tax can be put into the USA Roth IRA, young people starting to move into their higher-earning years are the ones who will benefit the most for the longest time.

The Tax Code must also give everyone the opportunity to keep what they save and, if they wish, to pass it along to succeeding generations. To that end, my tax reform proposal repeals the Federal estate and gift taxes.

Under the new Tax Code, tax rates must be low; especially for wage earners who now pay both an income tax and a FICA payroll tax on the same amount of wages. The Simplified USA Tax starts out with low tax rates—15 percent at the bottom, 25 percent in the middle, and 30 percent at the top. Then, the rates are reduced even further by allowing wage earners a full tax credit for the 7.65 percent Social Security and Medicare payroll tax that is withheld from their paychecks under current law. I do not propose to repeal the payroll tax because to do so would imperil Social Security, but I do allow a credit for it and when the credit is taken into account, the rates of tax on workers' wages are very low indeed—in the 7 percent to 17 percent range for nearly all Americans.

The Simplified USA Tax provides tax relief for all Americans, especially those who own their home, give to their church, educate their children and set aside some savings for a better tomorrow. Under my proposal, everyone gets a deduction for the mortgage interest on their home and for charitable contributions they make. In addition—and this is brand new and long overdue in my opinion—the USA plan allows a deduction for tuition paid for college and post-secondary vocational education. The annual limit is $4,000 per person and $12,000 for a family.

Generous personal and family exemptions are also allowed under my proposal. On a joint return, the family exemption is $8,140 and there is an additional $2,700 exemption for each member of the family. Thus, a married couple with two children pays no tax on their first $18,940 of income.

The Simplified USA Tax is simplicity itself. The tax return will be short, only a page or two for most of us, but more to the point, the tax return will be understandable. For the first time in a very long time, America's tax system will make sense to the citizens who file the tax returns and pay the taxes.

Since inception of the Federal income tax, Americans will have a full and fair opportunity to save whatever portion of their income they wish and for whatever purpose they wish. For the first time, working people will be allowed a credit for the payroll tax they pay, and also for the first time, families will have generous tax-free allowance for the education of their children.

TAXING BUSINESSES

My proposal also contains a new and better way of taxing corporations and other businesses that will allow them to compete and win in global markets in a way that exports American made products, not American jobs. I have studied this issue and believe that, if enacted in America, this innovative approach to business taxation will soon become the worldwide standard to which other countries aspire.

All businesses—corporate and non-corporate—are taxed alike at an 8 percent rate on the first $150,000 of profit and at 12 percent on all amounts above that small business level. All businesses will be allowed a credit for the payroll tax they pay under current law.

All costs for plant, equipment and inventory in the United States will be expended into the year of purchase. This is a major departure from our current, and frankly archaic, depreciation system, but a crucial element of the Simplified USA Tax.

If they are to survive and prosper, American manufacturers must make big-dollar purchases of capital goods, but they need the lower cost and financing help that first-year expensing provides. If American manufacturers have state-of-the-art machinery and equipment, they will not only create high-paying jobs, they will be able to compete effectively with low-cost producers outside of the U.S.

Since its enactment last March, the 30 percent expensing allowance followed by a 50 percent allowance stopped and reversed a 2-year decline in capital spending that was one of the worst in history. Every economic principle and every piece of data tells us that first-year expensing must be a major component of fundamental tax reform because it directly translates into high-paying manufacturing jobs and decreases the cost-of-capital thus making American companies more competitive.

Another key element of the business side of the Simplified USA Tax, is the way income earned outside of our borders is taxed. What we need to move toward—and what SUSAT embodies—is a system that does not tax foreign-source income on a worldwide basis or export sales of American made products and services.

The absence of some type of border tax adjustments for exports of American made goods to correspond to the export rebates under foreign countries' Value Added Tax systems puts our businesses—manufacturers and eventually service providers—at a severe disadvantage. If anyone doubts the disadvantage American exporters are faced with, they should to look at our trade deficit of astronomical proportions. The trade deficit is so large in part because the relative cost of producing a good or service for export in the U.S. is much higher than in those countries that employ VAT or other consumption-tax systems.

One of the underlying fundamental absurdities is that we currently condition territoriality on foreign subsidiaries reinvesting profits in foreign countries instead of repatriating the profits for investment in the U.S. In the least, the Tax Code should be amended to provide that investment in an active trade or business in the U.S. does not trigger U.S. tax any more than investment in France triggers U.S. tax.

Under SUSAT, all export sales income is exempt, as is all other foreign-source income, and all profits earned abroad can be brought back home for reinvestment in America without penalty. Because of a 12 percent import adjustment, all companies that produce abroad and sell back into U.S. markets will be required to bear the same tax as companies that both produce and sell in the United States.

CONCLUSION

The Simplified USA Tax is a hybrid of the others we often hear about. This plan combines the biggest strengths of other mainstream tax proposals and most importantly, it does not contain their weaknesses.

For too long the Tax Code has been a needless drag on the economy. That is unproductive as a national policy and more importantly, is unfair to those Americans whose living standards are lower because of it. For years, its complex inanities have been the object of ridicule. It is also the ultimate source of bureaucratic excess that is inconsistent with a free society.

It is high time that we restore people's faith in the integrity and competence of their tax system and, in the process, take a major step toward restoring people's confidence in the good character of their government.

Thank you Chairman Nussle, Ranking Member Spratt and members of the committee for the opportunity to testify.

Chairman NUSSLE. I thank the gentleman for his proposal.

Next is a former member of the Budget Committee.

I notice you didn't break out in hives when you walked in, so that is at least good news. Welcome back to the committee, and we are pleased to receive your testimony, Mr. Price.

STATEMENT OF THE HON. DAVID E. PRICE

Mr. PRICE. Thank you, Mr. Chairman. It is good to be back.

Mr. Spratt, other members, it is an honor to be able to testify before you today on this important topic.

I would like to begin by saying there is no question in my mind that the U.S. Tax Code has become excessively complex and convoluted. I believe we probably would all agree on that, as would the American people. The IRS estimates it takes the average American 28 hours plus to complete a tax return. I believe most Americans actually would accept a basic tax reform bargain, that is, fewer deductions and credits in exchange for lower rates and a simpler system.

And I would hope that with all the focus on taxes these past few years, Congress would have done something to simplify our Tax Code. Instead, the changes to the Tax Code during the past 4 years have made it more complex. I believe they have made it less fair.

At the heart of the proposals before us today, the ones that you have been considering, is whether or not the United States will have a progressive or a regressive tax system. Particularly in the midst of a sluggish economic recovery, there are strong arguments for a progressive tax that puts more money in the hands of those most likely to spend it and stimulate the economy.

But ultimately this is a debate about values. I was brought up believing that from those to whom much is given, much is expected. That principle at the heart of the progressive tax structure has guided our tax system through America's most prosperous economic years. A progressive tax is sound economic policy and it is indicative of an advanced and enlightened society where those who have reaped the benefits of living in a free, stable, and prosperous land understand their obligation to contribute to the common good.

The problem with the flat tax and the sales tax being discussed today is that both violate the principle of progressive taxation, resulting in significant tax savings for the rich, significant tax increases for the poor and middle class. Such a redistribution of the tax burden is bad economic policy, and I believe it is ethically deficient as well, violating our common sense of equity and justice.

Because of time constraints, I will focus my comments on the national sales tax, a proposal that has been introduced and has some 55 cosponsors, H.R. 25.

Nationwide, only Americans in the top 20 percent of income would benefit from converting from an income tax to a national sales tax. Everyone else would see their tax burden increase by an average of 50 percent. Some national sales tax advocates have described the tax rates required in their proposals in a way that is simply misleading, creating an inaccurate perception that we could replace the current tax system with a national sales tax rate as low as 15 percent. It just isn't so.

The Joint Tax Committee, the Brookings Institution, Citizens for Tax Justice, and the Institute on Taxation and Economic Policy have all stated that in order to keep Federal tax revenues constant, a 50 to 60 percent sales tax would be required. That is, a levy of $50 to $60 would be imposed on a $100 purchase.

I would like to draw your attention to the chart on the screen, which shows the grossly unfair redistributive effects of what H.R. 25 would do in my home State of North Carolina. I know that the supporters of H.R. 25 claim that their bill's rebate would offset the regressive impact on the poor. So the numbers in the chart include all of the rebates and other assumptions in H.R. 25, with the only difference being that I am using a true revenue-neutral tax rate of 50 percent, which in fact is a conservative estimate.

The reason the poor would be negatively affected by this type of proposal is that they would lose the earned income tax credit and other income tax rebates they have under the current system. In North Carolina, a working family in the bottom 20 percent income bracket makes on average $9,100 a year. A national sales tax, assuming a 50 percent tax rate, including the rebate, but also eliminating the EITC, would increase their Federal tax burden by $4,214.

For a family in the 20 to 40 percent income bracket making an average of $19,700 a year, this national sales tax would increase their tax burden by $4,013. For the middle 20 percent the average tax burden would increase by $3,811. For those in the 60–80 percent income bracket, the taxes would increase by $2,935. And even North Carolinians in the 80–95 percent income bracket, making up to $124,000, would see their taxes increase by an average of $600 a year.

So why are we even considering a tax proposal that would significantly raise taxes on 9 out of 10 Americans? The answer to that question can be found by following the money. The proponents of a national sales tax cannot deny that if low-and moderate-income people are paying more in taxes, then other people must be benefitting by paying less. And we know who those people are. North Carolinians making between $124,000 and $333,000 would see their tax burden decrease by an average of $4,722 under a national sales tax under the terms of H.R. 25. And those making over $333,000 a year would see their tax burden decrease by an average of $151,268.

Finally, here are a few concrete examples of how North Carolinians would be affected by a national sales tax. The median cost of a house in North Carolina last year was $110,000. A national sales tax would raise the cost of buying a new home in North Carolina to $165,000, while at the same time eliminating the significant home ownership tax incentive of being able to write off mortgage interest payments. It would raise the cost of a $20,000 new car to $30,000; it would raise a $100 grocery bill to $150; a $200 bill for medication to $300; and a gallon of gas from $2 to $3. And seniors would be especially hard hit because most are paying very little tax now because they have little or no income. But, instead, they are spending down their savings and, therefore, they would do much worse under the national sales tax than they do under our current system.

Mr. Chairman, it boggles my mind to imagine that any legislator would even consider such a policy as H.R. 25. Yet I am sad to say that even some members of my own North Carolina delegation have expressed their support for this gross redistribution of the tax burden.

This and other tax proposals being considered today I believe do not represent what is best for my constituents and my State, or what is best for the economy, or what is right, and I believe that as the elected representatives of the people, we can and should do much, much better. Thank you.

[The prepared statement of Mr. Price follows:]

PREPARED STATEMENT OF HON. DAVID E. PRICE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH CAROLINA

It is an honor to be able to testify today before this committee. I'd like to begin by saying that there is no question in my mind that the U.S. Tax Code has become excessively complex and convoluted. The IRS estimates that it takes the average American over 28 hours to complete a tax return. I believe most Americans would accept a basic tax reform bargain: fewer deductions and credits for lower rates and a simpler system. And I had hoped that with all the focus on taxes these past few years, Congress would have done something to simplify our Tax Code. Instead, the changes to the Tax Code during the past 4 years have made it more complex and less fair.

At the heart of the proposals before us today is whether or not the United States will have a progressive or regressive tax system. Particularly in the midst of a sluggish economic recovery, there are strong arguments for a progressive tax that puts more money in the hands of those most likely to spend it and stimulate the economy. But ultimately, this debate is about values.

I was brought up believing that from those to whom much is given, much is expected. That principle, at the heart of a progressive tax structure, has guided our tax system throughout America's most prosperous economic years. A progressive tax is sound economic policy, and it is indicative of an advanced and enlightened society where those who have reaped the benefits of living in a free, stable, and prosperous land understand their obligation to contribute to the common good.

The problem with the flat tax and the sales tax being discussed today is that both violate the principle of progressive taxation, resulting in significant tax savings for the rich and significant tax increases for the poor and middle class. Such a redistribution of the tax burden is bad economic policy, and I believe it is ethically deficient as well, violating our common sense of equity and justice.

Because of time constraints, I will focus my comments on the national sales tax. Nationwide, only Americans in the top 20 percent of income would benefit from converting from an income tax to a national sales tax. Everyone else would see their tax burden increase by an average of 50 percent.

Some national sales tax advocates have described the tax rates required in their proposals in a way that is simply misleading, creating an inaccurate perception that we could replace the current tax system with a national sales tax rate as low as 15 percent. The Joint Tax Committee, the Brookings Institution, Citizens for Tax Justice, and the Institute on Taxation and Economic Policy have all stated that in order to keep Federal tax revenues constant, a 50–60 percent sales tax would be required—that is, a levy of $50 to $60 would be imposed on a $100 purchase.

I'd like to draw your attention to the chart on the screen, which shows the grossly unfair redistributive effects of what HR 25 would do in my State of North Carolina. I know the supporters of HR 25 claim the bill's rebate will offset any regressive impact on the poor. The numbers in the chart include all of the rebates and assumptions in HR 25 with the only difference being that I'm using a true revenue-neutral tax rate of 50 percent. The reason the poor would be negatively affected by this type of proposal is that they would lose the Earned Income Tax Credit and other income tax rebates they have under the current system.

In North Carolina, a working family in the bottom 20 percent income bracket makes on average $9,100 a year. A national sales tax, assuming a 50 percent tax rate including the rebate but also eliminating the EITC, would increase their Federal tax burden by $4,214. For a family in the 20–40 percent income bracket making an average of $19,700 a year, this national sales tax would increase their tax burden by $4,013. For the middle 20 percent, their average tax burden would increase by $3,811. For those in the 60–80 percent income bracket, their taxes would increase by $2,935. Even North Carolinians in the 80–95 percent income bracket, making up to $124,000 would see their taxes increase by $600 a year.

So why are we even considering a tax proposal that would significantly raise taxes on 9 out of 10 Americans? The answer to that question can be found by following the money. The proponents of a national sales tax cannot deny that if low and moderate income people are paying more in taxes, then other people must be benefiting by paying less. North Carolinians making between $124,000 and $333,000 would see their tax burden decrease by an average of $4,722 under a national sales tax, and those making over $333,000 would see their tax burden decrease by an average of $151,268.

Here are a few concrete examples of how North Carolinians would be affected by a national sales tax. The median cost of a house in North Carolina last year was $110,000. A national sales tax would raise the cost of buying a new home in North Carolina to $165,000, while at the same time eliminating the significant home-ownership tax incentive of being able to write off mortgage interest payments. It would raise the cost of a $20,000 new car to $30,000. It would raise a $100 grocery bill to $150, a $200 bill for medication to $300, and a gallon of gas from $2.00 to $3.00.

Seniors would be especially hard hit because most are paying very little tax now because they have no income, but instead are spending down their savings and therefore would do much worse under the national sales tax than our current system.

It boggles the mind to imagine that any legislator would even consider such a policy, yet I am sad to say even some members of my own North Carolina delegation have expressed their support for this gross redistribution of the tax burden.

The tax proposals being considered today do not represent what is best for my constituents and my state; they do not represent what is best for our economy; they do not represent what is right; and we as the elected leaders can and should do much, much better.

Chairman NUSSLE. Thank you.

My understanding is that Mr. Rangel, our final witness, is appropriately detained at the conference on FSC and the tax bill that is being discussed and negotiated. They are having a conference now. So I guess I would ask unanimous consent that, at this point in the record, Mr. Rangel would be allowed to put in written testimony, because I am sure he has some very interesting thoughts on this as well.

[The prepared statement of Mr. Rangel follows:]

PREPARED STATEMENT OF CHARLES B. RANGEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Chairman Nussle and Congressman Spratt, I am very pleased to participate in your hearing on fundamental tax restructuring.

I am rather surprised that these hearings are being held by this committee rather than the Committee on Ways and Means. Perhaps it is a recognition by this committee that only tax increases, disguised as fundamental tax reform, can address the long-term fiscal problems faced by our country.

The Republicans took control of the House of Representatives in 1994 with big promises to "pull the Tax Code out by its roots" and substitute a simpler, fairer tax system. Despite that rhetoric, the Republican Congress has enacted legislation since 1994 that has dramatically increased the complexity of our current tax system:

According to the Internal Revenue Service, today it takes an average middle-income American family 7½ hours longer to fill out their Federal income tax return than it did in 1994, an increase from 11½ hours in 1994 to 19 hours today.

Since 1994, the Republican-controlled House of Representatives has successfully initiated 42 new laws with 3,533 changes to our Tax Code contained in more than 10,000 additional pages of complex public laws.

Millions of Americans now are required to fill out two Federal income tax returns each April 15, the regular tax return and the alternative minimum tax (AMT) return. All of this complexity is due to the decision by the Bush Administration to use the AMT to take back many of the benefits promised in the big print of the 2001 Bush tax cut. Before the Republicans took control, only 369,000 individuals were subject to the AMT.

President Bush has continued to complicate our tax law. Even conservative economist Bruce Bartlett concedes that "over the past three and a half years, Bush has made the Tax Code more complicated."

Now it appears that the Republican House Leadership intends to use the complexity of our current system, much of which they are responsible for, to argue for tax reform.

Frankly, I enthusiastically support efforts to reform and simplify our current system. I am hopeful that the rhetoric will be followed by action, unlike what has happened in the past. The only issue that may divide me and some of the other members of this panel is whether we should attempt to reform our current income tax system, or enact a new tax on consumption. Although our current tax system is too complex, I strongly dispute the notion that abandoning it in favor of a more consumption-based system is the magic cure-all.

I think Representative Linder's national retail sales tax proposal (H.R. 25) is an especially bad idea and have detailed why in a recent report issued by my Ways and Means staff, which I submit along with this testimony. To summarize:

It is extraordinarily regressive. The effective tax rates under Rep. Linder's bill would start at over 30 percent at the bottom of the income scale, and then decline to 5 percent at the very top. This is the reverse of the current law pattern of effective rates.

The Linder bill would impose over $300 billion per year in unfunded mandates on State and local governments in the form of sales taxes on their purchases.

It repeals all current-law deductions and credits, including current-law benefits for healthcare and housing.

It repeals the charitable deduction at a time when the Republicans are attempting to place more burdens on the charitable sector.

The other proposals for fundamental tax reform discussed at this hearing are essentially the same. They may be more complicated than Rep. Linder's bill, but they essentially are all taxes on consumption, and they all are quite regressive. Any doubt over their regressivity was eliminated when one of the architects of the Armey flat tax (who will be on the panel of economists) described the flat tax as "a tremendous boon for the economic elite."

Rep. Linder's bill and Rep. English's bill also dramatically change the nature of our Social Security system. Both essentially repeal the current payroll taxes used to fund the Social Security system. They replace the revenue through new consumption taxes.

These taxes will place large burdens on the elderly since they apply to all goods and services, including healthcare, long-term care, and prescription drugs. Essentially, the elderly will be forced to pay twice for their Social Security and Medicare benefits, once during their working years, and again when they purchase goods and services in their retirement.

I believe that everyone should examine with care the studies conducted by the Treasury Department during the Reagan Administration. Those studies considered several different alternatives for tax reform, including consumption tax proposals very similar to the ones being proposed today.

The conclusion of the study insofar as a retail sales tax is concerned was straightforward:

"Because if its inherent regressivity, a Federal, value-added tax, or other form of general sales tax, should not be adopted as a total replacement for the income tax the disadvantages are regressivity, a one time increase in prices, Federal intrusion into the sales tax area, and compliance costs of a new Federal sales tax."

All other consumption tax proposals also were rejected by the Reagan Treasury Department, and I believe that an objective analysis of the various consumption tax proposals being discussed today would reach conclusions similar to the Reagan Administration.

Therefore, I believe that instead of talking about a radical and frankly unrealistic switch to a broad-based consumption tax, we should begin the difficult task of reforming our current income tax system.

Chairman NUSSLE. Are there questions for our panel of witnesses that remain? I know there are members that had to leave, but are there any questions for these witnesses?

Mr. Spratt.

Mr. SPRATT. Mr. Price, let me just make clear your testimony. Is it your understanding that the correct rate of sales taxation is 30 percent per the advocates? They acknowledge that what you would really be paying is 30 percent. In other words, under their proposal, if I bought a shirt for $10 and paid, I would have to pay, under their tax, $13 with the sales tax added. They then convert that to 23 percent by taking the $13 and claiming that the right number to derive is what percentage of 13 is the total tax, and that is 23 percent. But, in truth, the add-on to the price you would pay at the retail counter is 30 percent.

Mr. PRICE. That is correct. And I stress that this is the advocates' own estimate. The estimates from objective analysts is much higher. But even from the advocates' own standpoint, the rate is 30 percent. They are using a tax-inclusive rate in citing 23 percent. That is not the way anybody I know calculates a sales tax.

Mr. SPRATT. They propose to repeal the individual income tax, the corporate income tax, the State and gift taxes, and FICA, payroll tax and all. So this is $1.9 trillion, probably. It is virtually all of the tax base, and, consequently, their consumption base to which this sales tax applies has to be extremely broad and all-inclusive also.

Mr. PRICE. That is right. Almost nothing is left out. As a matter of fact, this 30 percent rate wouldn't be even close to being revenue-neutral. But from their own standpoint it is 30 percent.

Mr. SPRATT. The base includes new homes, new cars. In our State new cars are at least exception. New homes aren't taxed. I am not aware of any place in the United States where new homes are subject to a sales tax. But this would subject a new home, if you had a home priced at $200,000, you would have to pay $260,000 for it under their proposal. Medical care, which in most places is not taxes; electricity, a big rate increase; insurance.

And then this comes as a surprise to many people. In order to have a sufficient consumption base to which to apply this tax so you can replace all of the taxes they would repeal, you have to tax State and local government expenditures under H.R. 25. Is that your understanding?

Mr. PRICE. That is right. National defense expenditures are subject to this tax, as are non-defense Federal expenditures. Veterans health care is subject to the tax; a whole range of things that I think haven't been discussed fully.

Mr. SPRATT. Notwithstanding McCulloch v. Maryland and all these other constitutional precedents about the Federal Government being able to tax the local government, this, for the first time, would impose a Federal tax, a sales tax on what county governments spend or State governments spend. In addition, it would impose a sales tax on what the Federal Government spends, on what the Pentagon spends. Hundreds of billions of dollars every year would be subject to taxation when the Defense Department spent that money.

Now, there was one particular mistake of some magnitude that we will explore a little bit later when Dr. Gale comes here from The Brookings Institute, and that is in levying the tax on Federal expenditures, the proponents of a national retail sales tax acknowledge the receipt of income from levying that 30 percent tax, but they don't acknowledge the cost; the fact that if the Government receives the money with one hand, it will be paying it with the other hand. And, in fact, you either have to raise the rate to cover the additional cost or you have to cut Government spending by 30 percent.

Do you know if any correction has been made in the sales tax to account for that anomaly?

Mr. PRICE. No, I don't. It will be important to hear from Dr. Gale on this point. I understand that that mistake alone is a $500 billion mistake in calculating the amount of revenue we are talking about.

Mr. SPRATT. Let me show one last thing, which is a chart, then I will turn it over to other members to ask questions of their own. As to distribution, as to fairness, which I think is the cardinal objective, this is what a national retail sales tax would do. The bottom line is annual consumption, thousands of dollars. The bar charts measure the percentage increase in taxes for different income groups. For example, this would have no exemptions at all, so this is a sales tax that applies to everything. The shift in taxes paid for those who consume between $27,000 and $36,000 a year, modest income Americans, would be 59 percent. For those consuming between $36,000 and $54,000 per year, the increase in taxes would be 38 percent. You would have to get to a consumption level well above $135,000 a year, upper income Americans, before the sales tax became net-gainer. For the most part, for middle Americans and low-income Americans, this would be a huge shift in the tax burden from the wealthy to those who make wages.

Does this comport with your own studies?

Mr. PRICE. Yes, it does. The figures I quoted are slightly different because they refer to North Carolina, and there the average income is a bit lower than the national figure, but those are the correct national figures as far as I know.

Mr. SPRATT. Thank you very much.

Chairman NUSSLE. Before you take that chart off, could you put it back up? Just so we are clear, that is before exemption?

Mr. SPRATT. Without exemption.

Chairman NUSSLE. I don't know whose chart that is. Mr. Linder, unfortunately, had to go and manage a rule on the floor, and it is his bill; he can defend it just as well on his own. But just so we are clear, he testified, at least, that there was a fairly substantial exemption, and this says the burden sales tax without the exemption. So it is fine to put up the chart, but——

Mr. PRICE. Well, Mr. Chairman, I can tell you about my figures, and maybe Mr. Spratt can tell you about his. My figures included the exemption.

Chairman NUSSLE. Let me finish my question.

Mr. PRICE. My figures included the exemption.

Chairman NUSSLE. That may be, but just so we are clear, because there is a lot of interest in this chart, the sales tax without exemption——

Mr. SPRATT. Mr. Chairman, to the best of my knowledge, the bill has no exemptions. That is one of the other unrealistic aspects; it assumes no tax avoidance, no tax evasion, and it provides no exemptions.

Mr. SCOTT. Mr. Chairman.

Mr. SPRATT. It does have a emigrant. It does have a demigrant equal to the sales tax rate times the poverty level, and that demigrant is factored into these figures here.

Mr. SCOTT. Mr. Chairman.

Chairman NUSSLE. Again, I am not trying to argue with you or defend Mr. Linder's bill; that is something he can do. But just to clarify, he testified there was an exemption.

Mr. SCOTT. Mr. Chairman.

Mr. PRICE. Mr. Chairman, maybe I can shed some light on this. When I said the exemption was included——

Chairman NUSSLE. Well, I will be the judge of that, but go ahead and try.

Mr. PRICE. Alright. We have a semantic problem, perhaps.

Chairman NUSSLE. Alright.

Mr. PRICE. When I said that the exemption was included, I was in fact referring to the rebate or the demigrant.

Chairman NUSSLE. That Mr. Linder was referring to.

Mr. PRICE. That is right.

Mr. SCOTT. Mr. Chairman.

Chairman NUSSLE. OK. Thank you.

You will have your own time.

Mr. Gutknecht is recognized.

Mr. SCOTT. Were you on your time during that?

Chairman NUSSLE. I control all the time.

Mr. Gutknecht.

Mr. GUTKNECHT. I will yield to the gentleman.

Mr. SCOTT. Thank you.

There are four different charts, Mr. Chairman. There are four different combinations and permutations: with a cash payment, without a cash payment, with exemptions and without exemptions. There are four different charts; that was one of them. All of the charts have the same pattern.

Mr. GUTKNECHT. Reclaiming my time.

Mr. SCOTT. On my time I will show all four charts.

Mr. GUTKNECHT. Reclaiming my time.

We can all have charts. The problem is—in fact, let me start with thanks to my friend, Mr. Wicker. Yesterday we lost a patron saint, Rodney Dangerfield. In some respects he was the patron saint of those of us who believe it is time to reform the Code. One of my favorite lines from Rodney is he comes home one night; his wife is packing. He says, are you leaving? And she said, yes. He said, is there another man? She looked at him and said, there must be.

It is just amazing to me to listen to some of this discussion, and with all due respect to all the people who have testified, but essentially for those who are opposed to the national consumption tax, the arguments come down to a fundamental argument we have around here an awful lot of the time, and that is equality of opportunity versus equality of result. All of a sudden we have made the assumption of how people will react if you change the Tax Code.

More importantly, we have forgotten, in this discussion we have been having for the last 5 minutes, that the truth of the matter is the tax system today isn't fair. It isn't fair to those who save and invest. Now, I know there are people in this room and people in this country who will disagree with me, but my assumption starts with this. There are only three things that people can do with their money: they can spend it, they can save it, or they can pay taxes.

Now, if at the end of the day one of our goals in terms of Federal policy is to help grow the economy faster to encourage more manufacturing jobs to stay here in the United States, to repatriate more of the dollars that are currently being invested around the rest of the world, it strikes me that one of the first things you ought to look at is the tax system. And essentially what we are saying is we couldn't change that because behavior would remain the same and, therefore, we would have to tax even more.

The other thing that unfortunately the critics of the national consumption tax have missed, it seems to me, is a very important point, and that is that people will get to keep everything they earn, and then they decide whether they are going to spend it or whether they are going to invest it. OK? And I think people will decide. I have a lot of faith in the American people and how they spend their money.

Now, how you handle the rebate, at least I will say I do understand if you convert from an income tax system where roughly 20 percent of the taxpayers pay 80 percent of the taxes, anything you do to reform that system and try to redistribute the way taxes are collected, or any reform, is going to create some inequities from the systems that exist today. But that assumes that this system is fair and that it ultimately is good for our economy. I don't assume that. But that is a fundamental debate we have to have.

But in terms of getting charts out and saying this is what will happen, I don't think anybody here is smart enough to know exactly how people will react. Once people get to keep all of their paychecks, I think it will change consumer behavior.

Now, the other point that the charts tend to ignore that Mr. Linder pointed out is that there is an enormous amount of money going to the underground economy. We can argue how much that is; the truth of the matter is we don't know. But what we do know is that if you are a drug dealer and you go down and you buy a brand new Maserati, you are going to pay tax on that. If you spend an expensive yacht, you are going to pay tax on that. There are two things that I think are important about the consumption tax, in my opinion. First of all, it recovers an awful lot of the money that is going through the black economy. They are not filing their taxes. The second thing is it makes American made manufactured products, American products period, services as well, because embedded in the cost of every one of those products and services that we try to sell in other places around the world are taxes, whether we want to admit it or not.

And we can argue whether it is 18 percent or 20 percent or 22 percent or 30 percent. But the bottom line is there are embedded costs in that, and all of a sudden it makes everything made in the USA anywhere from 18 to 30 percent more competitive in the international marketplace. I think that is something that is worthy of serious discussion.

Now, it is great to be a critic and it is great to come in here and say we can't do that because this is exactly what will happen. We don't know what will happen. I think in the end the consumption tax, like Rodney Dangerfield, gets no respect, but I think the American people are beginning to figure out we have got to get out of this business of predicting equality of opportunity versus equality of result. We have to worry about saying let us have a system that is fair and let the American consumer decide how they want to spend their money.

I yield back.

Chairman NUSSLE. Mr. Edwards.

Mr. EDWARDS. Mr. Chairman, are we operating under the 5 minute rule?

Chairman NUSSLE. Yes.

Mr. EDWARDS. OK, good.

Let me first say that the problem with today's economy is not that sales at Saks Fifth Avenue and Neiman Marcus are in trouble, it is that sales at Wal-Mart and J.C. Penney and Target have not been increasing like sales at Neiman Marcus and Saks Fifth Avenue. And I want to commend the people for looking at tax reform ideas, but I will say, Mr. Chairman, there are two common bonds I find in each of these tax reform proposals. One is the promise of no pain, all gain. We have heard that before in 1981, when we were told that we could have massive tax increases, huge defense increases, and balanced budgets. We quadrupled the national debt in 12 years.

Well, we heard no pain, all gain in 2001, 2002, and 2003 with tax cuts. And we could increase defense spending, a promise 20 years after the false promises made in 1981. We could balance a budget and have massive tax cuts. What did we do? We, this year, as a consequence of some of the people proposing tax reform now, have the largest deficit in American history.

And I would point out, Mr. Chairman, that while I do welcome this hearing, 2 days before the scheduled end of the 108th Congress, we don't have a budget resolution passed. We haven't pass 12 out of 13 appropriation bills, and we have the largest deficit in American history and an economy that is struggling for middle class families. It seems to me we should keep first things first and focus on the huge problems that have been caused by those who promised no-pain simple solutions to massive tax cuts and balancing the budget.

What I would like to ask you, Mr. Price, since Mr. Linder understandably could not be here to answer questions, on the national sales tax proposal, I want to be sure I am correct in what they are proposing. A new home costing $200,000 would have a $60,000 tax added to that $200,000 purchase price, is that correct?

Mr. PRICE. That is right, assuming a tax rate that made the overall proposal revenue-neutral.

Mr. EDWARDS. And I believe this is a proposal, either exactly or almost like it, that Majority Leader Tom DeLay has endorsed.

So a new home buyer would pay $60,000 sales tax on that new home.

Then I understand that bill would get rid of the home mortgage interest deduction. Is that correct?

Mr. PRICE. That is correct.

Mr. EDWARDS. So that is a second burden put on new home purchases for hardworking families.

And then the third thing I understand, instead of getting a deduction on your home mortgage interest payment each month, you would actually have to pay this 30 percent sales tax on that home mortgage interest payment, I think less 1.5 percent. Say if it is a 6 percent mortgage, you would pay 30 percent tax on 6 percent minus 1.5 percent.

So what this proposal would do is not only put a huge increase in tax burden on middle class families making $40,000 a year with a couple of children, it would devastate the housing and real estate industry, one of the most important segments of our economy, the segment of our economy that kept us from going into a deep recession over the last several years. And you would hammer new sales in three ways: $60,000 national tax on the purchase of your new home; you would no longer get the home mortgage interest deduction; and you would even have to, to add insult to injury, pay a tax on the interest payment you pay to the mortgage company every month. I would just suggest that would have a devastating impact on one of the most important industries in our country.

Do I understand also, Mr. Price, on the Linder bill that Mr. DeLay is supporting, a senior citizen buys $300 worth of prescription drugs every month, they are struggling to pay their prescription drug bill. Thirty percent on that would be a $90 tax on $300 of drug purchases every month, is that correct?

Mr. PRICE. That is right. And if the provision is to be revenue-neutral, it would be twice that.

Mr. EDWARDS. And then even using their underestimated sales tax rate, their 30 percent rate, if someone struggling, making $20,000 a year, goes out and buys groceries for what costs $100 today, it would be $130; and if they bought $100 worth of gasoline over a period of a month or two, that would be a $30 tax on the groceries and $30 new tax on the gasoline, right?

Mr. PRICE. That is my understanding.

Mr. EDWARDS. But we are going to assume that the market system is so perfect that all these oligopolies and foreign companies selling products to the United States are going to automatically reduce the embedded tax cost. There is no real proof that is going to happen, is there?

Mr. PRICE. No, there is not.

Mr. EDWARDS. I thank the gentleman.

Chairman NUSSLE. Thank you.

Mr. Wicker, do you have questions for the witnesses?

Mr. WICKER. Thank you, Mr. Chairman. Well, I had some very pointed and, I think, excellent questions that I was going to ask Mr. English, but, unfortunately, he had to leave.

Let me observe one thing and then ask Mr. Price something.

There is certainly some truth in "no such thing as no pain, no gain," or however Mr. Edwards put it, but the fact is President Reagan led this Nation to a significant tax cut in 1981 and revenues increased dramatically. Revenues to the Government increased dramatically. The tax tables are there; I could go back to the corner of the room and find them. There is no question about it, we got a lot more money into the Treasury after we cut taxes.

Now, Mr. Price, I haven't signed onto this bill either. I think it is good that we are having this debate. I want to commend all of you; you are in the arena, you are thinking, and I think this is one of the most important debates of the next decade.

But with regard to your assumptions, Mr. Price, do you discount completely what Mr. Linder says about the built-in cost on everything, whether it is the building supplies that go in to build that house or the ingredients in a loaf of bread over time, that there is 22 percent, even some people say as much as 30 percent, built in cost, a hidden tax because of the way we have an income tax in the United States? Do your calculations totally discount that?

Mr. PRICE. No, they do not totally discount that. There are some built-in costs of those sorts. I do not have precise figures before me, but that is not a totally fallacious analysis. What I think is indisputable, though, is that we are talking here about radical redistribution. And I don't want to take your time, Mr. Wicker, but Mr. Gutknecht was saying that we don't know what kind of behavioral results there are going to be from this. I actually think we can guess pretty well that for the lowest quintile of earners, $99,100 a year average in North Carolina, I think we know how that money is being spent now and how it is going to be spent under any Tax Code, and that is it is going to be spent on the necessities of life, because that is what is required. And we also know that under this proposal these people would pay $4,214 more in taxes. That I think is virtually indisputable.

Mr. WICKER. I will be happy to yield. You are so much better than I am.

Mr. GUTKNECHT. For him to say that it is indisputable, if you get all of your money back, how do you lose?

Mr. PRICE. Excuse me? What money?

Mr. GUTKNECHT. If you get all of that tax money back from the Federal Government, how does that family lose?

Mr. PRICE. The family is not getting all that money back.

Mr. GUTKNECHT. Yes, they do. Under the Linder plan they get it all back.

Mr. PRICE. My calculation includes that rebate. My calculation includes it.

Mr. GUTKNECHT. How do they lose if they get all their money back?

Mr. PRICE. They don't get all their money back; they get a certain portion of the sales tax money back, but they lose the EITC. They lose all of the EITC. They lose the refundable child tax credit; they lose the dependency care tax credit; they lose the hope and lifetime learning tax credits. The average additional tax burden for those low-income families is well over $4,000.

Mr. WICKER. OK, and I appreciate my friend, and I was sincere when I complimented my friend from Minnesota, because he has done a lot of study on this subject. But let me make sure I understand, David. When you give the chart about North Carolina and you talk about the extra money that that person in a certain income bracket is going to pay you do not assume for purposes of argument Mr. Linder's assumption that the loaf of bread itself will cost less because of the absence of the built-in cost of the income tax throughout the process. You do not assume that for purposes of your chart, do you?

Mr. PRICE. I do not have a precise assumption as to the costs of these items.

Mr. WICKER. So if he is correct about that, that this hidden built-in 22 percent of a loaf of bread would not be there, then your numbers would not add up, would they, because you don't assume that that is a fact at all?

Mr. PRICE. The changes, I think, in those numbers would be minor. I am drawing here on——

Mr. WICKER. But you don't build them into your chart about North Carolina.

Mr. PRICE. I am drawing on the work of four institutions here, and the exact assumptions about costs I can furnish you for the record, but basically nothing comes close, even Mr. Linder's own assumptions don't come close to a 60 percent surcharge basically on these consumer goods. They don't come close.

Mr. WICKER. How do you explain the fact that so many of the European countries that are left wing and are considered so progressive rely heavily on a consumption-based tax?

Mr. PRICE. They relay on a value-added tax, which has a modest tax on various stages of the production process; it is not levied all at once on all consumer goods and transactions. And, moreover, it is not layered on top of State and local taxes, which in this country, of course, already approach 10 percent in many jurisdictions, sales taxes, I mean.

Chairman NUSSLE. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Price, you had one of these charts up. Let us just go through all four of them right quickly. You can go through all four of the different charts. This is tax with a payment, without exemptions.

The next chart.

Chairman NUSSLE. We will give you some time here, Bobby, at the end.

Mr. SCOTT. Well, let me ask another question.

Mr. Burgess, does your plan expect to raise the same amount of revenue that we are raising now?

Mr. PRICE. I am sorry, I was distracted. Your question?

Mr. SCOTT. To Mr. Burgess.

Mr. PRICE. Oh, I am sorry.

Mr. SCOTT. Do you expect to raise the same amount of money that we are raising now?

Mr. BURGESS. Under the bill introduced by Congressman Armey in previous congresses that was scored to be revenue-neutral. No, I do not have figures back from Joint Committee on Taxation about a voluntary flat tax. Obviously, the behavior may be different and the scoring may be different. So I do not have that information for you, but when it becomes available I will make it available to you.

Mr. SCOTT. Does your voluntary flat tax exempt capital gains interest and dividends from taxation?

Mr. BURGESS. That is correct.

Mr. SCOTT. So that if a person had——

Mr. BURGESS. If a person, from a business aspect, opted into the flat tax.

Mr. SCOTT. Right. You have an option to pick which form you are in, so if you make all of your money in capital gains interest and dividends, you would pay no tax.

Mr. BURGESS. That is correct.

Mr. SCOTT. OK. And if you pay less tax, then somebody else has to pay more tax to be revenue-neutral. Everybody can't pay less tax and raise the same amount of money.

Mr. BURGESS. But I would point out Mr. Wicker's point, that when you reduce the capital gains tax, you end up increasing productivity in the country, thereby increasing the tax base.

Mr. SCOTT. Well, some people would pay less tax and no one will have to pay more tax, is that your testimony?

Mr. BURGESS. Well, at the present time I don't have a precise answer for you, but the increase in productivity was felt to be, on the flat tax, the basis for allowing the flat tax to be revenue-neutral. To what extent we will capture that with a voluntary flat tax I am not certain.

Mr. SCOTT. That is with exemptions, without a cash payment.

And the next one? That is with a cash payment, exempting.

Basically, with all combinations and permutations, you have the same form, right around $100,000 in consumption you start paying less; under that you are paying more.

Mr. Linder, under this form, I like a progressive form of tax where the more the make, the higher percentage of your income goes to taxation, and ability to pay is important. Someone who makes $100,000 and spends $50,000, someone who makes $50,000 and spends $50,000, and someone who makes $40,000 in income and spends $50,000 because they borrowed money to buy the car, all spent the same amount but, in my view, would have different abilities to pay.

You are one of the more thoughtful Members of Congress, and I appreciate that. Does ability to pay factor in to your calculation as to who should pay how much?

Mr. LINDER. Frankly, this tax is progressive. Nobody will be taxed on anything up to the poverty line. Today people are losing 22 percent of the purchasing power to the current system. Everybody will get to keep their entire check; no deductions for payroll tax or income tax. And the more you spend, the more you pay. But we need to get out of the business of worrying about who pays what. If Bill and Melinda Gates want to move to a farm and grow their groceries and live off the rebate, why should we care? We will borrow their money and we will create jobs with it. Costs about $100,000 to create a job in this country.

Mr. SCOTT. For the very low-income, does your plan eliminate the earned income tax credit, child tax credit, and other tax credits such as that?

Mr. LINDER. Correct. We have no taxes on income whatever. So, currently, if you are spending 100 percent of what you earn, you lose 22 percent of your purchasing power.

Mr. SCOTT. You pay tax on a new car, but not a used car?

Mr. LINDER. Correct. Only new goods.

Mr. SCOTT. You pay tax on a new house, but not an old house.

Mr. LINDER. Correct. Let me touch on the house thing for a moment.

Mr. SCOTT. Let me ask another question, then you can get them all in. And if you buy something made in Canada, sold to somebody in Canada, and then you kind of buy the car with 50 miles on it, as an individual, you wouldn't pay——

Mr. LINDER. No, there would be a cost at customs. There would be a cost at customs, everything coming in.

Let me deal with the house. Currently, 28 percent of what we spend on a new house represents the embedded cost of the IRS. Any new construction, 28 percent of that new construction is the embedded cost of the IRS. You are paying all the business taxes and compliance cost of every business entity that had a role in producing the products that go into the production of that new house.

Under our system it would be 23 percent. So the house would be less expensive. Under our system, if you make $60,000 a year, you take home $5,000 a month; currently you take home $3,800 a month. So you have an easier time making the payment and interest rates fall by 30 percent because the difference between a municipal bond rate and a corporate rate is essentially tax complication. When we have no taxes on investment, interest rates will fall by 30 percent.

Sixty six percent of us file a short form and don't take advantage of the interest deduction anyway, so we think housing will do very well under this system because people will have more money to take home.

Chairman NUSSLE. Mr. Brown.

Mr. BROWN. Mr. Linder, I know that we all have a concern with the current Tax Codes and we are all trying to make a fix for it, and I appreciate your presenting your plan today. And we have talked about, while you were out of the room, whether it was a 23 percent consumption tax or whether it is 30 percent. Have you heard the debate on that? Which is accurate? And I guess your plan is revenue-neutral, right?

Mr. LINDER. That is correct. I have also heard what has been booted about here, that it is a 50 percent tax. I want to deal with that first, and then I will come to yours.

There has never been an analysis of H.R. 25. Joint Committee for Taxation did an analysis of a bill that they thought might pass and changed it dramatically; it got an increased rate. The 25 or 27 page release last week by the Democratic minority analyzed a bill that was not my bill. We have done everything we could to find out how they got their analysis. The most interesting thing to me is that whoever did the analysis didn't sign it. But nothing has ever been done on our bill to analyze what the costs will be.

We say it is an inclusive 23 cents. We compare it with the tax we are replacing, which is an inclusive tax. You pay 36 percent of everything you earn today; under ours you would pay 23 percent of everything you spend. If we were to treat it like a State sales tax, which would be you spend a dollar and it is on top of that, it would actually be a 29.9 percent tax. But then if you are going to compare it to the income tax and divide the $64 you have left to spend out of the $100 you earned after you give the Government $36, divide 64 into 36, you would get an exclusive income tax of 56 percent.

So if you are going to compare it to exclusive, I would be the first to tell you it is 30 percent compared to 56 percent income tax exclusive, or it is 23 percent inclusive of what you spend, just like you are giving the Government 36 percent inclusive of what you earn.

Mr. BROWN. Under the current plan, approximately 43 percent of Americans don't pay any Federal income tax.

Mr. LINDER. I think it is 47 percent now.

Mr. BROWN. Don't pay any income tax now. So it is difficult to formulate a plan that won't have the bumps in it. If people aren't paying now, I noticed under your plan you have some rebate coming back to try to offset some of that deficiency. But, according to Mr. Price, apparently all that is not included. Is that correct?

Mr. LINDER. We provide for every household a check at the beginning of every month sufficient to totally rebate the tax consequences of spending up to the poverty line. Poverty level spending, by definition, in this country is that spending necessary for a given size household to buy your essentials. Using that definition, we effectively un-tax essentials. For a family of one, that is $9,500 a year; for a family, it is about $25,000; for a family of six, it is about $30,000. They would spend that much money totally untaxed.

Mr. BROWN. Do you agree with that, Mr. Price? I know you said they would pay $4,000.

Mr. PRICE. Yes. And I don't believe Mr. Linder disputes the studies that suggest that. And where that comes from is from the cancellation of the earned income tax credit, the removal of other credits that many of these lower income families now enjoy: the child tax credit, the dependency care tax credit, the hope and lifetime learning credits. These studies that I cited are virtually unanimous in suggesting that for a person in that bottom quintile. That is, in North Carolina someone making on average only $9,100 a year, they would be paying $4,214 more than they are paying now in taxes.

Mr. LINDER. I dispute that. I dispute that aggressively.

Mr. PRICE. Does your proposal preserve, for example, the earned income tax credit, which is what accounts for most of this problem?

Mr. LINDER. An individual earning $9,100 a year in North Carolina, or any other State, would pay no taxes whatever.

Mr. PRICE. We are not talking about whether they pay no taxes whatever; we are talking about how much they would lose vis-a-vis what they now pay. That is a differential figure. All of my figures I quoted have to do with additional tax burden that everybody but the top 5 percent would incur.

Mr. LINDER. Nothing in our bill prevents the Congress from making available cash contributions or grants to any family whatever. All we do is change the income paradigm to a consumption paradigm. The income paradigm is a limited—first of all, we had eight quarters in a row of declining revenues to the Federal Government, from the middle of 2001 to the middle of 2003. Under our proposal, the last 14 quarters would have been only two quarter would have a modest decline, so we would have dramatically increased revenues to the Federal Government. But nothing that we do precludes the Congress from making grants to families on any basis whatever; all we do is change the way we raise the revenues. And it is a more steady predictor of economic activity than is the income economy.

In 2003 we had about $9.1 trillion, roughly, in consumption. The adjusted gross income, against which we levy an income tax, for the Nation was about $4.2 trillion. So the consumption economy was twice as large as the adjusted gross income economy. You could have a dramatically reduced tax and raise the same revenues.

But we do not take any other positions with respect to programs. If you want to give a grant to a low-income family, you are perfectly willing to do that; you are just not going to be able to use the income tax system to do it with.

Mr. PRICE. All I am saying is whatever the hypothetical future programs may be, we are talking here about the instant impact of H.R. 25. Those are the ground rules of the analysis. We are looking at the impact on various income quintiles of this particular proposal.

Mr. LINDER. Are you aware that those people will not pay any payroll taxes either?

Mr. PRICE. I am quite aware of that. This is taken into account, as is the rebate feature that you have written into the bill.

Chairman NUSSLE. Mr. Emanuel.

Mr. EMANUEL. Thank you, Mr. Chairman. Thank you for holding the hearing.

I think it is ironic we are having this hearing on the fact that there is some discussion of passing another tax cut, which would actually further complicate the Code like the additional three that were passed from 2001 forward that now we are becoming bastions and advocates for reforming the Code and simplifying it, when the last three tax cuts did anything but that, No. 1.

No. 2, what I find interesting is that everybody that has talked about how Europe has a consumption model, many of those countries also have an income tax on top of consumption model, and that gets left out of the discussion.

Three, the one consistent point about all these reforms is there is a regressive nature to them. That is the thing that you can say is most consistent.

If you take a step back, in 1986, when we simplified the Code and reduced deductions and definitions, and we had basically three categories for income, we made great progress on simplification. The problem since 1986 is that—and it has been under Democratic administrations and Republican—in achieving certain social goals, whether that is in health care, whether that is in savings, whether that is in affording college education, we have loaded up the Tax Code with credits and deductions and, therefore, made it more complicated. And we don't aspire to expand Pell grants by putting more money into it. So what do we offer? A tax deduction. We do that on other areas as an example. I am for the tax deduction on higher education, but I would be for a massive expansion of public financing of higher education. We decided not to do that; we gave it as a tax credit.

We all, since 1986, basically in the last 18 years, have made the Code more complicated. And, to tell you the truth, it has never been worse than in the last 3 years, number two on that point.

And John knows this; we have talked about it. He doesn't particularly like the idea, which makes me even warmer to my idea at some points. I have offered the idea of a simplified family credit. It takes the earned income tax credit, the per child, and the dependent care and makes it one credit; takes 2,000 pages of code down to 12 questions. And takes that segment of the population, well over 30 million families, and reduces the tax burden, simplifies it, and makes it more progressive.

Now, one of my objections to all the plans here, whether it is flat or consumption, is that they all, in one way or another, are more regressive. Yes, they do shift the burden to consumption away from savings, hopefully encouraging savings, but they end up, regardless, more regressive in nature.

Now, since we can't reform health care, I don't believe we are going to throw out the Tax Code and end up with a consumption code base code. It is not going to happen. So take a segment of the population and try to reform the Code and simplify it for that area.

Ronald Reagan was the one that created the earned income tax credit, but Bill Clinton, under his administration, expanded it. I believe it is a very good credit. It is progressive. Richard Nixon admired it, Ronald Reagan created it, Bill Clinton expanded it. But we have about $8 billion worth of some type of fraud or abuse you all hype on all the time, and the main reason is because of complexity.

Now, I think if we simplified the earned income tax credit and the dependent care and the per child, and put it into one family credit, you would achieve a great deal of progressivity and a great deal of simplicity, and do it the right way. But the notion that we are going to take the Code and throw it out I don't think is politically possible, and I don't think we would end up with the results we want.

Lastly, because of the complexity we have in the Code, $340 billion goes uncollected and under-reported, mainly by very wealthy individuals who can game the system. And that is where the fraud exists. Now, I would be willing to attack and tackle the fraud in the earned income tax credit, but I find the silence deafening on the other side when it deals with what has happened, all of it reported by IRS, not exactly political entities, saying that the major part of fraud that exists in the system and the major types of problems, because $350 billion goes unreported. We basically cut the deficit by more than what the President is promising in 5 years; we would do it in 1 year. It happens mainly on very wealthy individuals who are moving their income and their tax contribution outside this country and basically try to figure out games to not pay it.

I know I have a couple seconds left.

Saturday's New York Times reported in a little story that in 2004 we had more individuals than ever making $200,000 and above who paid no income taxes at all. Highest ever over year over year, from 2003 to 2004. And that is where this code is regressive and needs to be reformed. You should take the low- and moderate-income people, simplify it for them, be progressive and reach simplification.

Chairman NUSSLE. Does the gentleman have legislation on that?

Mr. EMANUEL. I do.

Chairman NUSSLE. Thank you for bringing that up. We appreciate any proposal for simplification and reform. I am serious. That is the reason I asked. Do you have a bill number, for the record? If you don't, we will put it in the record later. But I appreciate that.

Mr. EMANUEL. I knew you would try to make me act like a legislator. No, I don't have the bill number here. I didn't expect any movement on it.

Chairman NUSSLE. Today is called Federal revenue options, so all of the options are on the table.

Mr. EMANUEL. I do appreciate the fact that we are having this hearing. This is going to be, I think, regardless of who wins in November, the piece of reform we are going to do, and I think we have got to all seriously look at it. I don't think you are going to throw out the entire Code; it is not going to be accomplished. So can we take a part of the population and achieve the two goals of progressivity and simplicity? I offer that.

Chairman NUSSLE. That is part of the discussion today.

Mr. Neal.

Mr. NEAL. Thank you very much, Mr. Chairman. After all those years we spent on the Ways and Means Committee, I am not nearly as optimistic as Mr. Emanuel is about what we are going to do with the Tax Code.

I would like to yield two of my minutes to Mr. Edwards, and then I would like to come back with a question I have for my friend John Linder.

Mr. EDWARDS. I thank the gentleman.

Mr. Burgess, I want to ask about your proposal. Do I understand that someone making $1 million a year in capital gains and dividend income would pay zero dollars in taxes on that income?

Mr. BURGESS. That is correct. This is a consumption tax, and capital gains and dividend income would not be taxed.

Mr. EDWARDS. You would have no tax on that?

Mr BURGESS. That is correct.

Mr. EDWARDS. But an Army sergeant making $30,000 a year who just returned from Iraq, would that sergeant pay taxes on his $30,000 salary for having served his country in uniform?

Mr. BURGESS. The standard exemption for a family of four would be 200 percent of the poverty level, or about $36,500.

Mr. EDWARDS. So an Army sergeant with one child would pay more taxes under your plan than someone sitting here safely at home making a million a year in dividend and capital gains income?

Mr. BURGESS. Tell me the income that you are reporting for that individual?

Mr. EDWARDS. Let us just say it is a first sergeant making $40,000 a year with one child. Would that sergeant, who just returned home from Iraq, serving our country in Iraq, pay more in taxes than someone sitting here at home who just made $1 million a year in dividend and capital gains income?

Mr. BURGESS. That is correct. But I think as Mr. Emanuel just pointed out before he left, the tax avoidance that is currently going on allows that to happen every day of the week right now.

Mr. EDWARDS. Well, thank you for answering the question. So someone making $1 million a year, sitting here safely at home, would pay zero dollars in taxes, wouldn't even contribute to the cost of national defense for which that person is benefitting, but the Army sergeant having to defend our country would pay more taxes than that person. Thank you.

Mr. NEAL. Thank you, Mr. Chairman.

Even though Mr. Linder and I disagree with the proposal he has offered, I must tell you that he has approached this very thoughtfully, and I think it kind of elevates the discussion that we have had in the House over the last 2 years.

But let me ask you something, John, if I can. Dick Armey is going to testify, former majority leader. In an article that he offered in 1995 he wrote, "Any sales tax will inevitably become a complex, pervasive, multi-rate value-added tax. The evasion at the retail level will necessitate reaching back into various levels of production to ensure compliance and adequate revenues." He also went on to warn: "A national sales tax may well exempt many basic necessities from this tax. This will lead to bitter disputes over the differences between food and candy, between real clothes and costume accessories." Finally, he doesn't hold out much hope for the abolition of the IRS either. He goes on to say, "Under a sales tax, there is no direct tax on individuals, so businesses will be responsible for collecting several times what they collect today. That means IRS scrutiny of American businesses could be expected to rise proportionately."

John, why is it that Dick Armey so thoroughly dislikes your proposal?

Mr. LINDER. Because he has got his own proposal he authored, and he would like to have us consider it. He is simply wrong.

Mr. NEAL. Did you ever say that while he was majority leader?

Mr. LINDER. Sure I did. Sure I did. He is simply wrong. A universal across-the-board tax on personal consumption would be the easiest tax to collect. Most States, 45 States collect sales tax; they claim 90 to 92 percent compliance. Under the current system, all you have to do is lie on your tax and send it in, and your wife doesn't even have to know about it. Under our system you have to have two people conspire to cheat. I don't know how many friends you have that are willing to save you 23 percent, I have none, if they ever risk going to jail. We have an underground economy.

Rahm is wrong about the $350 billion in the underground economy that is avoided. We have just three components of the underground economy: pornography, illicit drugs, and illegal labor. They constitute a trillion dollar underground economy. Untaxed.

It would be the easiest tax to collect. The reason we have no exclusions or exemptions is so that nobody gets in a fight in front of your committee about what is a necessity. We define necessities as up to poverty level spending and leave it at that. And everybody gets that check no matter how much they make.

I would like a system that gives the American people in a free society the privilege of anonymity. Nobody should know as much about us as the IRS does. I would like a system where the only role for the IRS is about 5,000 people in the Treasury Department that contract with the States, the States get a quarter of a point for collecting the tax; the retailer, whomever sells you the product, gets a quarter of a point for collecting the tax. But we contract with the States to do the collecting for us.

And there will be some problems and there will be some cheating. We are Americans; we cheat. But we cheat on the current system. I don't know if you have ever owned a company and taken your wife out to dinner and written it off as a company expense, but I know some people who have. That is cheating.

It is going to be tough for the States to collect money on services. What is going to happen is the guy who paints your house, personal consumption, is going to charge you the tax and not remit it. That is the biggest risk we have. But already the IRS says they are collecting 75 percent of what they know is due. Charles Rosetti has just recently written a book in which he says there are $350 billion a year that we know is due and is not collected. It is just not collected. So there is going to be cheating. I think we will have better than a 75 percent compliance rate. I think we will get a significant part of the underground economy.

But the most important thing, and this is the most important point in any tax reform, we must get the tax component out of the price system. It is crazy for us to continue to sell goods and services in a global economy with a 22 percent tax component in the price system. And for those people who, I think it was Mr. Emanuel who said, are going offshore with their money, I think I mentioned there are $6 trillion offshore. There is a reason for that: a confiscatory tax policy is chasing people and jobs away. And if we got rid of the tax on capital labor, we would be the world's tax haven. Those trillions would be in our economy creating jobs in America.

Mr. NEAL. Thank you.

Mr. Chairman, I would disagree with the latter part of that statement strongly. The fact that the Ways and Means Committee has been reluctant to take up the issue of offshoring, and apparently is not going to take it up again in the Fisk bill that is going to be before us in the next couple of days, I think indicates how little enthusiasm there really is for chasing down that money that is owed.

Mr. LINDER. Well, the way to fix it is not to punish people. The way to fix it is to change the Tax Codes so they are attracted here.

Mr. NEAL. A minute?

Chairman NUSSLE. Well, not a minute, but——

Mr. NEAL. Thirty seconds.

Chairman NUSSLE. Sure.

Mr. NEAL. The idea that corporations move profit offshore in a time when there are 135,000 American soldiers in Iraq and 12,000 in Afghanistan, and they preach patriotism and they put profits between patriotism is simply outrageous.

I thank the chairman.

Chairman NUSSLE. Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Let me try to go back to the colloquy that Mr. Price and Mr. Linder were having when I initially walked in the room. If I understood it correctly, Mr. Linder, your mindset and your argument is that your sales tax proposal would actually remove the tax burden from a significant number of lower-and middle-income individuals, and it would cancel out a certain portion of liability that they would otherwise hold.

And if I understood his point correctly, Mr. Price's argument is that while that might be the case that the sales tax would not incorporate such things as the earned income tax credit, the child tax credit, any host of other redistributive features, if you will, of our tax system. That was the philosophical debate you all were having.

Mr. Linder, your response was, well, it may well be the case that under a consumption-base system we would sacrifice certain redistributive elements, but I think your quote was there is nothing that would prevent this Congress from engaging in whatever grant-making that it wished to do, whatever direct transfers of cash that it wished to do that might in effect serve the same purpose as these things such as the earned income tax credit

My first question to you is it strikes me that—and you have obviously been here a lot longer than I have, but it strikes me that this is an institution that appears to be very, very deeply reluctant, and our whole political culture seems somewhat reluctant, to embrace the idea of giving poor people anything. When we have managed to give poor people something, it is almost always been in the context of something like the earned income tax credit or the child tax credit. In other words, we have had to staple our generosity onto the very familiar vehicle of the progressive tax system.

Do you think that there would be any political enthusiasm in this Capitol on your side of the isle if we were to do away with the income tax system? Do you think there would be any political enthusiasm on your side of the isle for making direct cash transfers to low-income Americans?

Mr. LINDER. Yes.

Mr. DAVIS. And what is your basis for that? Because Richard Nixon proposed doing that in the early 1970s, and Ronald Reagan strongly opposed it, a number of people in his party strongly opposed it, and I don't know of any bills on your side of the isle that would do that.

Mr. LINDER. The earned income tax credit is one of those things that was, I believe, sponsored by Dan Quayle.

Mr. DAVIS. But it is stapled onto a progressive tax structure. I understand that we have got enthusiasm for it and the familiar guise for a progressive tax structure, but if, as you want to do, you slice away the progressive tax structure, where is the political enthusiasm to do the equivalent of what the child tax credit does, the equivalent of what the earned income tax does through just a direct transfer of cash or some other kind of allotment? Wouldn't your side denounce that as welfare and giving people something for nothing?

Mr. LINDER. We have had a Republican chairman of the Agriculture Committee for about 10 years, and they have destroyed the WIC program yet. Sixty two percent of the Agriculture budget goes to food programs for low-income people. That has not been taken away.

I just think you are wrong. The whole notion——

Mr. DAVIS. Let me give you an example.

Mr. LINDER. Do you mind if I finish?

Mr. DAVIS. Sure. Sure.

Mr. LINDER. The whole notion that we are some kind of ogres that don't like poor people is just simply wrong. I never lived a day above the poverty line until I was in the Air Force.

Mr. DAVIS. Alright. Well, rather than have you engage that strawman, let me give you a very specific recent example. When Congress was debating the expansion of the child tax credit last year, as you know, initially the House bill, unlike the Senate bill, did not expand the child tax credit from $600 to $1,000 for certain portions of Americans earning less than $26,000 a year.

And when Ms. DeLauro, Mr. Rangel and myself introduced a bill that would correct that discrepancy, the response from many on your side of the isle was, well, a lot of these folks really aren't paying income taxes, or the income taxes they are paying is so low that they don't deserve this benefit. So the argument was that we shouldn't be engaging a redistribution for people who aren't paying taxes.

Mr. LINDER. Did they get the benefit in the final analysis?

Mr. DAVIS. It was about 14 months later, and initially they didn't get it. As you recall, your leadership wouldn't even bring it to the floor.

Mr. LINDER. Did they get it ultimately?

Mr. DAVIS. After 15 months, and only after producing a bill that stuck a lot of things that were completely unrelated.

Mr. LINDER. You are welcome.

Mr. DAVIS. That kind of leads to my next point.

Mr. LINDER. You are welcome.

Mr. DAVIS. That conveniently leads to my next point. Mr. Emanuel I think made a very sound argument that the hallmark of tax simplification was the 1986 reform, which I concede to you was bipartisan and President Reagan embraced it. We have had a long-running retreat from that hallmark of simplification the last 18 years.

Now, I think you would concede to me that your party has been in control of the Congress since 1994, you have been in control of all three branches for the last 4 years, and I think it would be enormously difficult to argue that we have had greater simplification, not less.

If the Chair would just let me finish this question up.

It is near impossible to argue that we have had greater simplification, not less, in the last 4 years. As you know, the corporate tax bill that we will see on the floor perhaps as early as tomorrow is undoubtedly one that will contain a number of additional elements of complexity. A lot of the bills from the past several years have that feature.

So my question to you is why has your party been so resistant to tax simplification in the last 4 years?

Mr. LINDER. You are not speaking to me on that one. I am author of a bill that goes from 55,000 pages of regulations to 132 pages. You are going to come to this because the public is going to demand it. The people are so far ahead of the politicians on this issue, it is amazing.

Mr. DAVIS. No, I hear that. But I just want to get one simple answer to my question, if I can.

Chairman NUSSLE. Why don't we let the witness answer it?

Mr. DAVIS. Well, I would like to, but I would simply like to get an answer as to why your party has consistently been resistant to tax simplification the last 4 years.

Chairman NUSSLE. That is fine. The gentleman's time has expired. The witness may answer the question.

Mr. LINDER. I think I did.

Chairman NUSSLE. OK.

I would like to use my time to end up by offering our witnesses, who have been very patient and have engaged in what I think has been a very spirited, high-minded debate here, which I think has been excellent. I think this has been an excellent kickoff to a discussion that we have to have, regardless of where it ends up and regardless of people's opinions. This is the kind of discussion that members need to have on this policy. We are going to disagree, and that is fine; that is what this is about. But at least we are having the discussion.

What I would like to do is to use my time offering it to the witnesses to wrap up, to close, to give their final thoughts before they leave, and I will go in reverse order. Because Mr. Linder's bill has been the subject of probably the most discussion today, I am going to give you the chance to be the last one.

Mr. Price, I will start with you, and then Mr. Burgess, and then Mr. Linder. Two minutes each just to kind of sum up what your feelings are on tax reform here today as we move forward.

Mr. PRICE. Thank you, Mr. Chairman. I do think it has been a good discussion, and I commend you for holding the hearing and the obvious interest to the members in pursuing these issues. I hope this will be on the agenda as a lead item, however the elections come out in the next Congress. As I said at the beginning of my statement, I think there is widespread support for the basic bargain of tax reform, which is simplification and lower rates in exchange for less in the way of credits and deductions. That was the bargain struck in 1986, more or less, and I think it is a bargain that we can strike now, although one is always struck with how much devil there is in the details of figuring out just which credits and deductions are dispensable and exactly what the terms of that bargain are.

My main focus here today has simply been on the question of the fairness of the Tax Code and the implications of both the flat tax and H.R. 25, the national sales tax, for how that burden is distributed. And I do believe that there is very little dispute that we are talking with both proposals and I focused on the latter—about a major redistribution of the tax burden away from the wealthiest 5 percent of payers to almost everyone else, including some of the poorest people in this country.

And it has been interesting to me to hear Mr. Linder basically acknowledge that we are talking here about an increased burden of some $4,000 on the average taxpayer in that lower quintile, and he is saying some interesting things, I think, about the possibility of additional congressional action that would rectify that.

But the point holds that H.R. 25, the proposal we are talking about, does have that profoundly regressive impact. I don't believe that has been disputed here today, and I know you are going to hear from other witnesses who will have more in the way of technical backup for that proposition. So I think the basic case for a progressive Tax Code where we affirm that principle, from whom much has been given, much will be required, and that those who have benefitted most from the blessings of our society have a special responsibility for maintaining the common good, I think that principle is sound, and I would hope that whatever we do by way of tax simplification could also honor that principle of fairness.

Chairman NUSSLE. Thank you for helping us engage in this debate today, Mr. Price. And, again, welcome back to the Budget Committee.

Mr. Burgess for 2 minutes to get the last word in.

Mr. BURGESS. Well, again I thank the chairman and the ranking member for holding this hearing, and I thank the members who have stuck with us through the long morning. I think we have heard some good ideas today. Again, I am not an expert, but simply wanted to continue an idea that back in 1995 or 1996 I thought was an exemplary idea, and I couldn't understand why Congress would not enact it.

Again, back in 1986 the Tax Code was simplified and, unfortunately, it was not left alone. Perhaps if it had been, or perhaps if we went back to those changes back in 1986 and left them alone, that would be a good enough change. But I am afraid without some sort of fundamental change in our Tax Code, we in Congress, from what I have seen in the past 20 months, we don't have the ability to not meddle in something even if it seems to be working OK.

Finally, as far as Mr. Price's comments about those who have had the blessings of the American society—and certainly I am one of them and I am certainly willing to pay my fair share—the issue is, though, why do we have to make it so painful to do that? Why does it cost $100 billion a year for the American taxpayer to have to do that?

And, Mr. Edwards, that would include the young sergeant coming back from Iraq. Why is it that our tax compliance could be increased by 90 percent and we won't take the simple steps to do that?

So I am certainly not someone who has all the answers, but I am grateful that the committee sought fit to have this discussion. Certainly in Mr. Bush's second term he has said we are going to address this in a great deal more detail, and I look forward to being part of the discussion then.

Thank you.

Chairman NUSSLE. Thank you for helping us engage in this debate.

Mr. Linder for the actual last word.

Mr. LINDER. Thank you, Mr. Chairman, for having this discussion. I hope this is a beginning, and not an end. There are a lot of good ideas around that we ought to listen to all of them. I do not agree with Mr. Price that there is a $4,000 burden on some low-income people. I have not seen any studies of my bill yet. I have seen a lot of studies of bills similar to mine or what people think might pass, but I have seen no studies of my bill.

The fact of the matter is my tax is a tax on accumulated wealth. People have paid taxes all their life, paid tax when they sold the company, are paying tax on the interest it earns are going to pay tax one more time when they spend it. And to those people I just say you are already paying this tax. People living at or below the poverty level today are losing 22 percent of their purchasing power to the current system. Under my system they would not pay that tax; prices would fall, and everybody would be rebated the tax up to the poverty line.

This is going to be a long discussion, and it is a complicated discussion. I think the people are so far ahead of the politicians that they are going to demand a simplification of the Code.

We have gotten so out of line with income tax, I don't think it is fixable. When 49 tax preparers were sent the same information for Money Magazine, they had 49 different tax returns, none of which were right; and 50 percent of the answers you get from the IRS on the help line to do your tax returns are given to you in error.

I am reminded of a comment made in 1911 or 1912, when they were starting to discuss the income tax. A southern Senator was ridiculed and laughed off the floor of the Senate for saying something terribly outrageous. This is what he said: "Mark my words. Before this is over, they will be taking 10 percent of everything you earn," which gives fresh meaning to my favorite country song: "If 10 percent is enough for Jesus, it ought to be enough for Uncle Sam."

Chairman NUSSLE. I thank the gentleman. As I say, this really has been a good discussion, and I hope members have learned from it and taken something away. We appreciate the members of our panel who have stuck with us and helped us with this discussion, and this will no doubt continue as we go into the next Congress.

With that, we will dismiss this panel. Thank you again.

We next will turn to our second panel, and we will invite those witnesses forward.

I would like to welcome our second panel before the Budget Committee.

Let me say both personally and professionally, first, with regard to both Majority Leader Armey and Chairman Archer, we are honored to have probably the two godfathers of tax reform before us today in both Representatives Armey and Archer, former colleagues of ours here in the House of Representatives.

I can say personally it was an honor to serve with you and in both instances, under you as majority leader and as the chairman of the Ways and Means Committee when I served on that committee. I can tell you both there is no question that I am, in part, sitting here today because of both of your leadership and your support as well as, let me say to my friend, Mr. Archer, in particular, that if I run the Budget Committee half as well as you ran the Ways and Means Committee I think at least by some measure I will be successful. I appreciate that.

Dick, in particular I know that because your support, I have the honor of being the Budget Committee chairman.

Today, we have the opportunity to discuss tax reform which is something that I know personally and professionally has been something on your agendas for quite some time. Both of you had legislation, made spirited attempts to do what you could in order to push reform, some of it successfully, some of it I know you know the spade work is still left to be done.

Today, we wanted to talk about Federal revenue options for reform, talk a little bit about the doability which has been discussed today; is it possible to even reform this Tax Code in any measure and what are some of the options we have available to do that.

We welcome you both before the committee. Your entire testimony will be made a written part of the record. We would be particularly pleased if you would summarize your testimony and give us some of that spirit in your testimony here today.

Mr. Spratt.

Mr. SPRATT. Mr. Chairman, let me join you in welcoming both of our witnesses. It is good to see you again and I look forward to your testimony.

Thank you very much for coming and participating.

Chairman NUSSLE. It is always difficult, especially looking at both of you, which one do you let go first. I am going to pick the majority leader. That was the way I think we were supposed to do it. I am going to yield first for testimony to my friend, Mr. Armey. Welcome to the Budget Committee.

STATEMENT OF RICHARD K. ARMEY, CO-CHAIRMAN, FREEDOMWORKS

Mr. ARMEY. Thank you, Mr. Chairman. I think that was exactly the correct choice because one should always save the best for last.

Let me thank you for the invitation to be here. It is particularly enjoyable for me having served on this committee, to be here. I should say I am here today as co-chairman of FreedomWorks, an organization that is the integration of the Citizens for A Sound Economy and Empower America. I enjoy my co-chairmanship with Jack Kemp and Boyden Gray.

We represent some 360,000 activists across the Nation, all of whom hold tax reform as a very high objective for the Government.

I can summarize and enter the statement. Let me say, I became very actively interested in tax reform in the fall of 1993 I think largely out of the frustration I am sure I share with millions of Americans over the complexity and the difficulty and the insecurity that they feel in trying to comply with the existing Tax Code.

When I decided I wanted to once again engage this issue, I went back to my core roots as an economist and began with what I thought was fundamental propositions. The two fundamental propositions that I began my thinking with was one, every nation state must have a Tax Code and means by which they raise revenue and that was the legitimate objective of a Tax Code.

I also had the observation that no matter how you levy taxes, in the final analysis, all taxes are paid by people and all taxes are paid out of current income flows.

Thirdly, I went back to the Wealth of Nations, circa 1776, and recalled that great text axiom of Adam Smith that ought to strip the down off the goose with the least amount of squawks. I was clearly aware that we were not doing that with our current Tax Code.

I began my study quite frankly with the national sales tax with the idea that I might go in that direction in terms of my own advocacy and the more I studied the efforts across the globe to implement a national sales tax, the more I saw the difficulties governments had in its implementation and finally turned my attention away from it on the premise that it was virtually impossible to legislate and even more impossible to enforce.

Having looked at a couple of plans, went back to the work of Hall and Rabushka from 1984 and rediscovered the flat tax. The flat tax comported with my fundamental premises and allowed in my estimation for us to fulfill what should be I think the generally agreeable tax objectives.

I might mention by the way my colleague, Jack Kemp, who chaired the Kemp Commission that we created in 1995, came to these sort of general principles and Chairman Archer and myself had general agreement on that. The principles I think are foundation enough that there are any number of ways you can fulfill them.

First, the Tax Code should be direct, obvious and simply understood so that compliance with the Code should not be in any way mysterious, costly or rigorous.

Secondly, the Tax Code should not engage in efforts to socially engineer or efforts for income redistribution. Its fundamental purpose should be to raise money. The compliance costs should be nominal and the Code should be very clear and direct.

The flat tax fulfills these objectives. It makes the Government neutral with respect to decisions. If you are making family or business decisions, the decision criteria should be economic criteria, family criteria, not criteria that are directed along the lines of minimizing your tax burden.

One of the aberrations we see in the current Tax Code causes American business enterprise to make the rational decision in the interest of minimizing tax burden, to engage in offshore operations. This is regrettable and is something that we often are offended by but in fact, if you can advantage yourself legally under the law to engage in a business practice that minimizes your cost of doing production, which business considers tax to be, it is the most logical expectation we should have that business will do that.

I would like to point out to my friends and colleagues, and I am sorry that Ms. DeLauro is not here because she and I always enjoyed this discussion.

There s a sharp difference between tax evasion, which is illegal, and tax minimization which is of course something we all attempt to do in full compliance with the law to minimize the burden of the tax. Most American business enterprise that takes what otherwise would seem to be the irrational course of action of moving the enterprise offshore to do so because they are trying to reconcile their business interest, the interest of their stockholders and employees against what is a fundamentally prejudicial and irrational Tax Code. That is just one of many examples of what we find in the complexity of the current Code.

There will be differences of opinion about what would be the best formula by which we can replace the current Code but I would daresay you could rarely find a proposition with greater national consensus than the general proposition that the current Code must be replaced with something.

In my belief the flat tax as first iterated by Hall and Rabushka, as later iterated by myself, is the best way to go one, because it is most easily legislated and two, because it is most easily enforced and can fulfill the general propositions for Tax Code.

One final point, I would be very careful of anybody who promised you they have the solution by which you will get rid of the IRS. The fact of the matter is when any nation state has a Tax Code by which they expect to collect the level of revenues that this Nation must, they will have a tax collection agency. It can be called the IRS, it can be called the National Sales Tax Agency. You can call it what you will, but it will need to be there for the purposes of collection and compliance.

If the agency we have today does not seem civilized to us, it is because they have an uncivilized Code to enforce. My own personal attitude toward the employees of the IRS is pity the poor souls, we have given them an impossible Tax Code, an impossible job and now we criticize them because they don't always enforce it with what I would say is the highest of good humor.

The last time I had what I perceived to be an impossible job, I don't recall whether I approached it with the best of humor. So these are good, decent, honest, hard working people who I don't think are properly appreciated for what must be for them day in and day out as they try to earn their living, an even more frustrating experience than it is for those of us who visit the Code only periodically.

Thank you.

[The prepared statement of Mr. Armey follows:]

PREPARED STATEMENT OF HON. RICHARD K. ARMEY, CO-CHAIRMAN, FREEDOMWORKS

Good morning Mr. Chairman and members of the committee. I am Dick Armey, former House majority leader, and currently co-chairman of FreedomWorks, a non-partisan, non-profit grassroots organization with more than 360,000 members that works for lower taxes, less government, and more freedom. Thank you for inviting me here today to discuss the issue of fundamental reform of the U.S. Tax Code.

As you know, Speaker Dennis Hastert has renewed the call for sweeping, fundamental reform, and at the Republican Convention this summer President Bush further revitalized the issue in his acceptance speech when he told the nation, "The American people deserve—and our economic future demands—a simpler, fairer, pro-growth system." [1]

This debate is important because America has one of the most outdated and complex Tax Codes in the industrialized world. Taxpayers are forced to spend many frustrating hours fighting forms and figures, digging for documentation, and checking and rechecking their math to make sure everything is right first to comply with the Tax Code, and gain to make sure they do not fall prey to the parallel alternative minimum tax (AMT). The Code exceeds 60,000 pages,[2] and it takes Americans 6.2 billion hours to complete their taxes every year. Simply complying with the Tax Code imposes national costs as high as $194 billion, according to the Tax Foundation.[3]

Even worse, these cost of compliance figures do not include the broader economic distortions and inefficiencies caused by the current code that begins with an overly broad definition of income—which has necessitated the creation of any number of "loopholes", i.e., exemptions, deductions and credits to ameliorate the perverse disincentives to work, save and invest resulting from that overbroad definition of income. For example, Congress taxes savings and investment—the engines of economic growth—two, three, and sometimes even four times. This punitive approach puts many American businesses at a competitive disadvantage and even encourages some of them to move offshore. John Kerry may like to scorn "Benedict Arnold companies,"[4] but these corporate inversions are often rational moves in response to anti-business tax, labor, and regulatory policies coming out of Washington, DC.

Most importantly, I think, is that the current Tax Code offends our sense of what it means to be an American. This country was founded on the right of everyone to be treated equally before the law, but the current tax system doles out special treatment to those who have the power and money to lobby for it. The Code is so complicated and expansive that it now touches nearly every aspect of our lives. Americans can no longer make a decision in the family or in business based simply upon family or financial economic criteria. We have to make decisions based on tax criteria, and it is an undue burden. Politicians, in this way, are using the Tax Code to expand the reach of government control of our economy and of our lives.

Complete and fundamental tax simplification and reform is the only answer. Other ideas, such as giving more power to the IRS, will fail or even make the problem worse. The IRS assessed nearly 28 million penalties last year,[5] and it wants more power and control.

No, it is time to completely scrap the Tax Code. We need to get rid of all the Code's social engineering and special interest handouts. We need a new Tax Code that recognizes the goodness of the American people, not the guile of the Federal Government and crafty tax accountants.

No doubt, fundamental tax reform has been on the Congressional agenda since Republicans first took control of Congress in 1994. At that time, Congress created the National Commission on Economic Growth and Tax Reform, chaired by Jack Kemp, which concluded in 1996 that America needed to completely scrap the Tax Code.[6]

The Kemp Commission produced Six Points of Principle for tax reform:

1. Economic growth through incentives to work, save, and invest.
2. Fairness for all taxpayers.
3. Simplicity, so that everyone can figure it out.
4. Neutrality, so that people and not government make choices.
5. Visibility, so that people know the cost of government.
6. Stability, so that people can plan for the future.

It is interesting to note that this past July, Jack Kemp and I helped merge Empower America and Citizens for a Sound Economy (CSE) into a new organization, FreedomWorks, where we both serve as co-chairmen. Along with C. Boyden Gray, Jack and I are leading a renewed grassroots effort to educate and mobilize ordinary Americans on the Tax Code and the urgent need for reform.

No doubt, there is a way forward. Supporters of fundamental tax reform have rallied around five basic principles—"Five Easy Pieces"—first put forward by veteran Washington tax lawyer Ernest Christian. They are 1) Lowering and flattening marginal rates, 2) moving toward full expensing of business investment, 3) reducing or eliminating the double taxation of dividends and capital gains, 4) expanding tax-free savings vehicles, and 5) international tax reform.

These five goals will move us toward a simpler, fairer, and flatter tax system. Reducing marginal rates makes the tax burden more equitable and creates incentives for people to work. As both Ronald Reagan and George W. Bush have proved, cutting marginal tax rates creates incentives to work more, save more and invest more resulting in greater economic growth. Allowing corporations to fully expense investments in business plant, equipment and technology will maximize business investment necessary for long-term economic growth. And it's obvious that lowering taxes on dividends and capital gains reduces the penalties on saving and investment, creating economic growth.

Finally, the current code is hostile to U.S.-based firms that have significant operations overseas. The Kerry-Edwards detailed international tax reform plan states, "John Kerry does not believe that we should force a U.S. company that chooses to create jobs in the United States to pay higher taxes and suffer a competitive disadvantage with a company that chooses to move jobs to a tax haven and keep profits there permanently." His solution? Eliminating the tax deferral for foreign-earned income as they earn it rather than being allowed to defer taxes.

In other words, Senator Kerry would create incentives for companies to take not just the jobs overseas, but to move the entire operation overseas as well. The Kerry campaign misses the obvious solution. As is written in their own report, a U.S.-based firm can "expect to pay an average tax rate of 31 percent. When this company invests abroad, it faces an average tax rate of 21 percent." The same Kerry report acknowledges that 80 percent of U.S. manufacturing assets abroad are based in countries with tax rates lower than the rate in the United States.

It seems obvious to most people that if U.S. tax rates are so high and uncompetitive that firms are being encouraged—driven—overseas, the solution is not to punish the firms, but to reduce the tax rates to more competitive levels. Cutting the tax rates by 5 percent, as Kerry wants to do, is a good starting point for debate, but is simply insufficient to make America's Tax Code more competitive internationally.

The ultimate purpose in all of this is that we need a simple pro-growth Tax Code that is consistent with our values. A better code would reward hard work, encourage investment, and reflect our fundamental belief that individuals can spend their own money better than Washington can. This new system, by harnessing the power of freedom, would make the American economy stronger and more dynamic. I think that millions of taxpayers agree. Americans deserve a "simpler, fairer, pro-growth system," and we are working hard to that end.

In the past, as you may recall, Citizens for a Sound Economy (CSE) helped organize the Coalition for Fundamental Tax Reform (CFTR), a loose confederation of groups committed to fundamental overhaul of the Tax Code. One of the group's activities was to promote a set of six principles that were essentially a distillation of the Kemp Commission's Six Points of Policy and Six Points of Principle.

The CFTR principles were incorporated into a "Commitment to Tax Reform" pledge that candidates for public office were asked to sign. As everyone here knows, candidate surveys and pledges of this kind can be a powerful political and policy tool.

Now that Citizens for a Sound Economy has joined with Jack Kemp and Empower America as FreedomWorks, we will again be leading with a tax reform pledge based on core principles that should guide sound tax reform. For the purposes of discussion, I'd like to share our current working draft of a new legislative tax reform pledge:

COMMITMENT TO TAX REFORM CANDIDATE PLEDGE [WORKING DRAFT]

I pledge to support tax reform legislation that:

Applies a single, low rate to all Americans

Provides tax relief for working Americans

Eliminates the bias against savings and investment

Requires a supermajority of both chambers of Congress to raise taxes

Protects the rights of taxpayers and reduces tax collection abuses

Promotes economic growth and job creation

I think you'll all agree that these ideas all form an excellent basis from which to build consensus on fundamental reform. And, rest assured, we, at FreedomWorks, are not standing still. FreedomWorks and our 360,000 members nationwide care deeply about our economy and the state of our Tax Code. On behalf of all of our members, we look forward to working together you to scrap the Code, replacing it with a system that is fair, flat, and simple.

Thank you.

ENDNOTES

1. "Transcript: George W. Bush", Fox News, 9/02/04
2. "Fiscal Facts and Figures", The Cato Institute, 2004
3. "The Cost of Tax Compliance", The Tax Foundation, 2/02
4. "The Kerry-Edwards Plan to Protect and Expand Automotive Jobs in the United States", www.johnkerry.com,
5. Internal Revenue Service Data Book 2003, page 34.
6. "Unleashing America's Potential", National Commission on Economic Growth and Tax Reform, 01/96

Chairman NUSSLE. The last impossible job that I am aware you had, Dick, was managing the House of Representatives and you did it always with good humor and we appreciate your testimony here today.

Chairman Archer, welcome to the Budget Committee and we are pleased to receive your testimony.

STATEMENT OF WILLIAM ARCHER

Mr. ARCHER. Thank you, Mr. Chairman. Thank you for letting me come and talk to you about what I think is the single most important economic issue facing this country, one where you can do more good with far reaching effects on the economy and on jobs, which as all of us know, is very, very important.

I am currently associated with PriceWaterhouseCoopers but I do not appear on behalf of PriceWaterhouseCoopers. I come to talk to you about my own personal views. I have no written testimony and therefore you won't have to wade through anything other than perhaps the record when this is all over.

I agree with my friend, Dick Armey, on almost everything he said. We are going to have to have taxes. I had a town meeting several years ago in my district and laid out my view that we should get rid of the income tax and go to a consumption tax.

I got a lot of applause and at the end in the question period, a man in the back of the room held his hand up and I recognized him. He said, I don't like your idea. I said, why not? He said, because we still have to pay taxes. I said that is right, and Dick Armey is right, we have to raise revenue in order to pay the Government's bill. So the real question is how are you going to do it.

There aren't a lot of options. There is an income tax whether it be in the form of a flat tax or whether it be in the form we have today. There are several vehicles for a consumption tax. You could levy a property tax or a wealth tax, I suppose. I certainly would oppose any of that and I agree with my friend, Dick Armey, that it should come out of the stream of commerce in some way or another.

I think you first have to determine your goals and then try to figure how you are going to get there. You have to set priorities to your goals.

Everybody wants to have a simpler tax. Dick Armey and I differ. I submit that you will never simplify an income tax. I had great hope in 1985 when Reagan pushed for reforming the income tax. I don't know if Dick knows this but I went to the White House and said, do a flat tax. I was very intrigued with using a postcard, which would simplify everything.

However, after we got through the tax reform deliberations, I gave up on ever fixing the income tax; because in spite of the fact that it was proposed in 1986 as fairness, growth and simplicity. That was the front page title. It was a 500 page summary of what they were going to do.

I scanned through it the night before the hearing before the Ways and Means Committee and in disbelief I read the part on foreign source income and it said as follows, "The current law is very complex and difficult to administer. Our proposal will make it even more complex and more difficult to administer."

At the hearing I read this to my friend, Jimmy Baker, then Secretary of the Treasury, and I said, how can you claim simplicity? He said, Congressman, that is why we put simplicity third in the order of things.

In the end, the simplicity that came out of that massive effort in 1986, in retrospect, was to knock 6 million people off the rolls at the lower income levels.

I said, I won't argue with that. If you don't have to file an income tax, it's simpler than having to file one, but for those of us who continue to have to file our income taxes, it is more complicated now than before you started.

I would submit to you that complexity is the history of any income tax, no matter how you devise it because no two economists agree on the definition of income. That was what I began to realize early on. So you have to redefine and redefine and every time you redefine, you create inequities and then you have to try to fix those with patch after patch after patch. That is why we have the Code that we have today.

I think you have to determine what are your goals. If you want simplicity, with lower costs of administration and compliance, a flat tax—if you could keep it—would go a long way to getting there.

I would submit to you that history tells you that you can't keep a flat tax because of what I just said. An income tax is like an attractive nuisance for those of you who are lawyers, it just brings in all kinds of untoward things that become negative over time. We have plenty of history to show that.

It is a big jump to get away from an income tax. I don't know if you can do it but I will tell you that if you want the goals of the lowest possible administrative cost, less underground economy, ultimate incentive for savings, taxpayer personal privacy from the IRS and economic advantage to U.S. exports/disadvantage to foreign imports, then you cannot use any form of an income tax.

I will submit to you that with the income tax we have now and the advent of the smart card where you can put a computer chip in the card and transfer money electronically without trace anywhere in the world, the IRS is going to have more and more and more problems with non-compliance and how do you get after it.

It has been estimated and you have seen some of the estimates that range anywhere from $200 [billion]–$300 billion a year being lost to the underground economy under our current income tax. So I think one of the goals should be how do we have a tax where we can actually have more compliance.

The compliance costs themselves are unbelievable with our current income tax. They have been estimated to be anywhere from $250 [billion]–$600 billion a year just for the compliance costs. Part of that is that 3 days a year I spend doing my own income tax. That doesn't show up in dollars and sense anywhere but that is part of the compliance cost. When you get into bigger corporations, it boggles your mind

The last audit Exxon had done which I was privy to before I left the Congress, included paperwork for the audit alone was 200 feet high, the equivalent of a 20 story building and Exxon regularly has anywhere from 35–50 IRS employees in their office every day.

All of these compliance costs and the litigation in the Tax Court just boggles your mind. That is all wasted money in our economy.

Yes, it produces jobs. It even produces jobs for people in my shop at PriceWaterhouseCoopers but in the long run, it is not producing wealth. So I think you have to focus on that and decide what you want to do, but also how important is privacy and intrusion into the lives of individual citizens. You can't put a dollar and cents value on it but I think you should think about that goal.

Thomas Jefferson made only two speeches while he was President. One was his second inaugural address, where he said one of his most notable achievements while in public office was to eliminate the Federal taxpayer from any direct contact with the citizens of the country. How important is that?

I had one witness before my committee in one hearing, and Jim, you may have been there, I don't know, but it was a woman from Connecticut, a middle-income woman. I asked her what she would you give not to have to deal with the IRS. She said "I would give my firstborn child." The reality is you had an untoward experience with the IRS and privacy from the IRS in her life was very, very important. Any income tax puts the IRS in the middle of the lives of every American. They can get your records. You have to keep those records and you are always on call to the Federal Government. How important is that? You have to determine your goal in tax reforms.

Finally, and perhaps most important to a lot of people is what is it going to do for the economy. If you use the flat tax, it is clearly going to do more for the economy. It is going to lighten the load on savings which we desperately need to invest to create jobs, but it doesn't give you border adjustability.

In the world marketplace, the global marketplace where our products being exported have to carry the cost of government, incoming foreign products bear no part of our cost of government under any income tax.

If you use a consumption tax, and there are a number of vehicles, you then reduce the price, and I think John Linder just talked about this, of our products being exported to the world marketplace by an average of over 20 percent and you tax incoming foreign products by an equal amount. It is all WTO legal without starting a trade war.

To me, in the long run, these jobs for export which pay 17 percent more on average than jobs for the domestic market, are worth trying to get. This is a big way to get it.

How do you get from A to B assuming you have to decide what goals you want. It is not going to be easy. I realize now being on the outside it is going to be more difficult than I did when I was actually in the Congress. This is a massive change.

People who are used to the current Code are going to resist you if they feel they have any niche in the current Code that helps them. That is human nature. I don't know that I can tell you the best way to get there but I have about come to the conclusion that you are better off reforming the corporate income tax first and then taking on the reform of the individual income tax.

Then, of course, what are you going to do about the payroll tax? So you have three elements you have to work with.

Our friend, Congressman Linder, believes you can do it all in one fell swoop and maybe he is right. I don't know, but you are going to have all kinds of transition problems that you have to deal with and I won't get into the details of a lot of them.

I thank you for giving me the opportunity to at least give you a thumbnail sketch of my feelings about structure tax reform.

Chairman NUSSLE. Thank you.

Mr. Spratt.

Mr. SPRATT. Thank you both for your testimony.

I am sorry, Mr. Armey, we couldn't sit you side-by-side with Mr. Linder and recite a few things you have to say about the sales tax in your pilgrimage and finally coming to the flat tax as a better alternative.

You both remember, I am sure, the bill called Bradley-Gephardt, a precursor of 1986, which tried to strip out as many deductions and credits and preferences from the Code and get it down to what they thought was a bare minimum. That included home mortgage interest, State and local property taxes, charitable contributions and maybe a couple other things.

They recognized there was no political prospect of repealing those particular provisions. They were popular and that was why they were in the Code to start.

As we got the bill, even though it was a complicated bill, the 1986 tax reform bill, we started getting phone calls from lots of people who were about to lose their particular provision or exemption deduction or credit in the Tax Code. You found out they weren't there by accident, those things had been put there for a reason and they were dearly loved by the people whom they benefitted.

I have to wonder if you can realistically propose the passage of a tax reform bill that doesn't accommodate the home mortgage interest deduction, the State and local property tax deduction and the charitable contributions. Do you think that is realistic? You are both astute politicians.

Mr. ARMEY. Let me begin and under the general heading of eating your crow when it is served up to you, may I acknowledge the fact that I not only made what I consider to be the most bad judgment vote of my lifetime when I voted for the 1986 bill, but I even had the audacity to do that against Bill Archer's advice. So I think it is only appropriate that I take that big dish of crow right now and gulp it down.

Yes, it is difficult. I understand, Mr. Spratt, what you are saying and I appreciate the work that was done by Bradley and Gephardt in the early 1980s to try to kick this thing off.

I am sort of guided in my thinking here by a couple of song titles, first, "I Can Dream Can't I," and then a second one called "All or Nothing at All." There is indeed a very, very broad spectrum of what I call tax complexity professionals that will work very hard to retain the SOPs that they have in the current Code, so there is also a good deal of confusion about it.

If you are going to do the flat tax as I vision it, it is going to have to be done I think in one fell swoop and that is a big load, a big task to undertake. Anything done a bit at a time as for example, the 1986 bill, will likely be even more complex and difficult.

I had made the decision in 1994–1995 that this was a big job that was worth doing but it would only be done as I like to say when America beats Washington because 90 percent of all the tax complexity professionals make their living in this town. It is not a small task.

Yet, I think my own view it is a dream worth dreaming and a goal worth fighting for and an objective work pursuing. That is why I have sought in my after congressional life to pursue it through an activist organization such as FreedomWorks to engage the American people to, in effect, demand that they get this relief in the Tax Court.

I still remain convinced despite all the difficulty that it is a doable thing and it is the one formula we can find that will get the simplicity and the civility in the Tax Code that the American people desire.

Mr. SPRATT. Your proposal has an additional complication and that is depreciation on existing undepreciated assets which would not be available.

Mr. ARMEY. I think we expense business decisions at the outset and moving from where we are now.

Mr. SPRATT. Assets which had not been fully depreciated, could not be depreciated?

Mr. ARMEY. There would be a clear transition problem there that would have to be addressed, but in the final analysis, after the transition, business capital expenditures would be expensed at the time they are made.

Mr. SPRATT. Let me read you what Rabushka said in exalting over their idea in their book, their first publication called, "Low Tax, Simple Tax, Flat Tax." On page 67, he said, "This will be a tremendous boon to the economic elite." Then he went on to acknowledge some bad news, "It is an obvious mathematical law that lower taxes on the successful will have to be made up by higher taxes on the average people."

Do you acknowledge there will be this kind of shift from higher income people to lower income people in implementing this tax?

Mr. ARMEY. I think it is really difficult to make a good measure but let me give you some of the observations I would have.

First of all, the majority of tax loopholes, as it were, tax avoidance mechanisms, are advantageous to the wealthy as opposed to the lower income Americans. One thing the flat tax does is eliminate that. For example, we discerned in 1996 that in that year under the flat tax, H. Ross Perot would actually have paid a higher rate of tax, average tax rate on his earnings than he would have and did in fact pay in that year because all his tax avoidance opportunities would have been lost.

There is today a maldistribution of the burden of taxes. Generally speaking, it goes like this. The top 20 percent of taxpayers in Americas pay around 46 percent of the total tax burden. That is over twice a proportionate share. The bottom 20 percent of the taxpayers pay 1 percent of the tax burden. The middle, 60 percent of the taxpayers pay 54 percent of the total tax burden. So there is a maldistribution.

The flat tax is predicated on this simple assumption and definition of fairness. Fairness is when you treat everybody exactly the same as everybody else. In the flat tax world, everybody would pay exactly the same rate as everyone else so that when you broke it down into tax paying percentiles like this, it would always come out proportionate in the distribution.

The fact of the matter is there are many people, I happen to be one of those who think that when you have a large caste of non-taxpaying citizens, you create what is known in the discipline of economics as free riders. Free riders always want more of the transportation they are riding because they don't pay the cost and that gives you a foundation impulse and a large segment of the population for big government.

I happen to be of the school of thought that subscribes that old adage that the Government that governs best governs least and one of the things I feel is sort of a general disposition regarding America is that we have too much big government in America.

The reduction of the number of people that subscribe to big government theories through the free rider impulse I believe in the long run is not only an appropriate correction in the course of our Nation, but it is also an equitable correction given my definition of fairness being as I said to treat everybody exactly the same as everybody else.

Mr. SPRATT. Thank you both for your testimony.

Mr. ARCHER. I would like to take a stab at your question. It is a very good one.

I think it is going to be exceedingly difficult to get rid of a lot of deductions because it is human nature. No matter what the long term benefit is, it is human nature to say, wait a minute, next year I am not going to be as well off under the Tax Code and that is one of the tough obstacles we have to overcome. It is a sales job to the American people to let them understand that taxes are a part of their economic life but they can be a big part or they can be a small part and ultimately, what do you have in spendable economic income at the end of the day to buy the things you want for your family and the things that you need.

It is a tough sales job because people will myopically focus just on the immediate tax impact of a specific provision. This is true of individuals, it is true of businesses and that is where the big problem has come in passing the FISC–ETI bill because businesses fight each other to see who is going to get the benefit and who is going to be hurt the most.

It is a microcosm in my view of what you are going to run into when you start talking about fundamental structural tax reform but one thing I didn't mention is if you get rid of an income tax, and you use the consumption tax vehicle, there are several vehicles with three major ones.

It is not just the sales tax. You have can have a valued added tax, the European style of which I do not think would be suitable for the United States or you can have a uniform business transfer tax like the Japanese use for part of their revenue raising. So there are a number of ways you can look at it to have an alternative.

You can have another problem which is growing in doing any fundamental tax reform, regardless of whether it is a flat tax or it is a consumption tax. Today, 43 percent of the American people pay no income tax and we Republicans are mainly responsible for that, beginning with Reagan in 1981 and then again in 1986 where 6 million people were dropped from the rolls.

When I passed the child credit in 1997, that dropped millions of people from the income tax rolls. It has been a succession of events as time has gone on where as I said today you have 43 percent or 125 million Americans who pay no income tax. Many of those Americans actually get a check from the Treasury under the earned income tax credit.

If you don't have a vested interest in getting rid of the current tax system, you have a hard time motivating the political force at the grassroots to get the job done.

Chairman NUSSLE. Are there other members who wish to inquire? Mr. Edwards.

Mr. EDWARDS. I, first, want to thank you, Mr. Chairman, for bringing these two distinguished leaders before our committee. It is not often we have a chance to think outside the box and gain the benefit and practical real world implementation insights from two members who have had the distinguished careers the two of you had. I thank you for inviting them and thank you both for being here.

Mr. Archer, I am a former constituent of yours and thank you for all your courtesies.

Chairman NUSSLE. There are experts outside Texas.

Mr. EDWARDS. I understand. In fact, speaking of Texans, I am reminded of our other former colleague, a Texan, Senator Phil Gramm, a former economics professor at A&M, who said he taught me everything I knew but I didn't learn everything he knew. I think he said something, a paraphrase, we all want to go to heaven, a lot of people just don't want to do what it takes to get there. I think that is one of the challenges we face in trying to take the important idea of simplifying and making a fairer Tax Code.

It is great there are two leaders out there thinking outside the box.

Mr. Armey, I would like to ask you this question. You have been consistent in this throughout your public career, that you want social engineering tax policy or even fiscal spending policy and you define fairness as treating everyone the same as everyone else.

Yet, the flat tax proposals that we have heard from other members, Mr. Burgess a minute ago said that someone making $1 million a year in dividend income would pay zero dollars in taxes but a sergeant making $40,000 serving his or her country would pay a flat tax rate on that.

If we want to define fairness as you have and don't want to do social engineering, should it be the Government's business to put a value and a bias on how they earn their income?

Why shouldn't a factory worker making $50,000 a year pay the same marginal tax rate, if you want a flat tax, as someone making investments and making dividend income sitting in an air conditioned office making $50,000 a year and specifically, does your flat tax proposal treat everyone the same in terms of $50,000 income from one source is treated the same as $50,000 from another source?

Mr. ARMEY. Again, thank you for the question. Let me say, by the way, you are dragging me back into my old academic classroom again.

One of the principles of the flat tax is that every dollar is taxed in the year in which it is earned and taxed only once. Under current Tax Code, dollars earned from the capital sector contribution to production, usually dividends, are double and triple taxed. Where you get into problems in terms of imagery is if I earn my wage, I pay tax on it one time. If I own half the stock in the business, we have first a tax on the earnings of the business, then when we distribute the earnings of the business, then I pay taxes on my dividends. So I am double taxed.

The fact of the matter is it is efficient and I am not sure I think it is the appropriate way. I think if I could write it exactly the way I would prefer to do it, I would do away with withholding taxes so that every taxpayer in America had to sit down at his kitchen table at the end of every month as I did and still do when I write my check to the gas company, I cuss the gas company. When I write my check to the electric company, I cuss them. When I write my mortgage payment, I cuss them and when I write my check to the Government, I could cuss them with equal enthusiasm and an equal awareness of the burden of the tax.

That would be collecting the tax then by the person who finally pays it so he clearly sees the burden of his tax. Do the same thing with capital earnings and rather than tax it as earnings to the business, tax it to the recipient of the dividends. Tax it one time. You would have a greater sense of the equitable treatment of people. You would have to give up the fiction that when you tax business earnings, you didn't tax people. You would tax the people when they finally receive their earnings and tax them the same way.

I think that would be probably the most transparent and socially more desirable.

Mr. EDWARDS. It would seem fairer, certainly, from taxing all income at the same rate.

Mr. ARMEY. It is very important though to eliminate the double taxation on capital because it is through capital expenditures that we innovate technology, science and engineering which gives us increased productivity, enhancing the workers wages. I think probably the best way would be to not collect any taxes at their source but at their distribution.

Mr. EDWARDS. Thank you and I had a question for Chairman Archer but my time is up, I will wait until others have a chance.

Chairman NUSSLE. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Armey, that was a long answer but as I understand the answer, if you make all your money in capital gains, interest and dividends, you would pay no tax on that income, is that right?

Mr. ARMEY. No. I am saying you should pay taxes on it once just like I pay taxes once on my wages and I would prefer that as we do away with the withholding tax and I write my own check to the IRS that we do away with the first element of the double taxation by not taxing it at its source as business earnings but tax it as distribution, as dividends or bond interests or whatever.

Mr. SCOTT. If you are just going to tweak the present system, do I hear you repealing corporate taxes?

Mr. ARMEY. In order to eliminate double taxation of capital earnings, I would repeal corporate taxes by not taxing it at its source as business earnings but tax it as distribution, as dividends or bond interest or whatever.

Mr. SCOTT. If you are just going to tweak the present system, do I hear you repealing corporate taxes?

Mr. ARMEY. In order to eliminate double taxation of capital earnings, I would repeal corporate taxes and tax dividends, yes, but I would not double tax the same source of income, same flow.

Mr. SCOTT. And if the holder of the stock were a non-profit or tax exempt or held in tax exempt in some kind of way, it wouldn't be taxed at all?

Mr. ARMEY. No, they would pay taxes. There would be some changes. One of the reasons, for example, I find a great deal of opposition to a flat tax from the university community is because they now enjoy the certain benefits under the Tax Code that they believe guides public generosity in their direction. These things would change.

Mr. SCOTT. Mr. Armey, rather than asking Mr. Archer questions, can you tell me what is wrong with the national sales tax?

Mr. ARMEY. One of the first things I would like to tell you is there is no entity that applies the sales tax that I know of that doesn't have a very complex law that is fraught with exceptions, whether it be certain products are exempt and so forth. As an example, in Texas when I go to the store and buy something for my home, I pay sales tax. If I say it is for the ranch, I do not because it is a farm exemption. So sales taxes are very complex.

The biggest problem I have is that in every nation state that has ever tried to implement a sales tax, there has been a growth of the underground economy to the extent that the tax became unenforceable and that is the principal reason why Europe has gone to the value added tax. You cannot achieve the simplicity, you still get the social engineering and in the end you don't have an enforceable tax.

Mr. SCOTT. Mr. Archer, isn't that right? [Laughter.]

Mr. ARCHER. As I mentioned earlier, I have never identified with any specific vehicle to try to get rid of the income tax. That ultimately, of course, has to be done and I have struggled with what would be the best way to do it.

Another thing that really bothers me about the income tax, particularly the one we have today, is that we are in a tax trap. The harder you work, the longer you work, the more you pay. I think that is wrong. I think that is basically, economically wrong. I think it is a far better and fairer to tax that the more you spend, the more you pay.

We see all the anomalies within the income tax, for example, and I don't want to get into the presidential debate but let me take some fictional characters and say that there are some people who have large amounts of annual income who pay an effective tax rate of 12 percent. There are other people who have large amounts of income that are not as large as the first hypothetical individual who pay an effective tax rate of 28 percent. Gee whiz, what are we doing with our Tax Code?

If you look at the polls taken of the public, one of the reasons they don't like the income tax and, by the way, Congressman Scott, these polls show the same in the inner cities as they do in the suburbs and in the rural areas, the same basic results come back that people believe if you are rich, you can hire the best PriceWaterhouseCoopers type people to find ways to reduce your effective tax burden. If you are not that rich, you don't have the capability of doing it. There are just a lot of factors.

I am not directly responding to you and I will try to do a better job but there are problems with every tax system. There is going to be some leakage in every tax system. You can debate what one is going to have the most leakage or not going to have the most leakage but to me I am not going to defend the sales tax other than in my book it is better than the income tax for a lot of reasons, the time we don't have to get into today.

In the end, if you want to get rid of the income tax, you are going to have to take a long look at the three basic vehicles you can use to replace that income tax and make a judgment as to the pros and the cons.

The last thing I will tell you is that there is any system that is going to be perfect or any system that isn't going to be flawed, or any system that isn't going to have objections to it in some way or other. That is why I started out talking about goals. You have to determine what are your goals, what are your priorities and then try to get as close as you can to those goals.

Chairman NUSSLE. Mr. Baird, do you want to sneak in a question? We have two votes on the floor.

Mr. BAIRD. First of all, I want to thank you for being here. I applaud your efforts to try to think out of the box, so the questions are not meant hostilely. I agree we have to simplify this.

My father passed away a couple of years ago but before he did, he worked with the RSVP Program volunteering to help seniors with their taxes. He had a doctorate in education. He said, son, I can't tell you how to do the damned Tax Code and I am supposed to advise people how to do it. He said, when you are in Congress, don't make the Tax Code more complicated. Well, I am glad, in some ways, he passed away a couple of years ago because he would perhaps chastise me.

Mr. Armey, here is the puzzle I have and I don't understand it. Let us say my father, which he didn't, but let us suppose he had given me $1 million of inheritance. I say terrific, I have $1 million in inheritance from my dad, I am going to invest it at 6 percent, I am going to do pretty well. I don't ever have to work a day in my life. Do I pay taxes?

Mr. ARMEY. Yes. Again, this is the problem with double taxation. The question is where you levy the tax. You can levy the tax on the corporations in which you invest and take the tax at the source or you can levy the tax on the dividends as they are distributed and take the tax at that end.

I think most people would perceive the burden of the tax, I go back to my initial principle, all taxes are paid by people, all taxes are paid out of current income. I think a prudent Nation ought to have the people who pay the tax clearly perceive the burden of the tax. Yes, you would under my system pay those taxes because I think the transparency of the tax burden is a greater public benefit than what efficiencies you might get by collecting them at their source.

Mr. BAIRD. Mr. Archer, I live in a State that is unique and there are seven of us but we have no income tax on our side of the river and there is no sales tax on the other side of the river. It is a pretty great place to live. You can make your income on our side, shop the other side and not pay sales tax, so I appreciate what Mr. Armey said earlier about people dodging taxes.

I also appreciate your principle that you want to reward savings. One of the questions I have is would there be adverse sort of disstimulative effects if you put a heavy sales tax on the products people buy, do you suppress the consumer aspect of the economic engine of the country?

Mr. ARCHER. Again, I am not here to defend the sales tax but there is an answer to that and the answer is that you already have embedded in the price of every product you buy, the incidence of the income tax. You just don't see it.

Different economists disagree on where the burden of the income tax goes. Part of it clearly goes to the investors, part of it goes against labor but a big, big chunk of it has to be passed through as a cost of doing business to the ultimate consumer. If you did away with the income tax, you are not going to have that embedded in the price of the products. So you get that benefit.

From a perception standpoint, it is tough. It is tough to explain all of this and the ultimate impact of who pays what under what circumstances, but the reality is that you are going to eliminate that built-in part of the price of the product.

Mr. ARMEY. May I make a quick response? Even as an undergraduate, I pondered the question of what is the public interest? I found my definition of public interest in Adam Smith where I found so many things—if I may, the real Adam Smith.

Consumption is the sole end and purpose of all economic activity and to the extent that the Government intervenes in the affairs of the community, it should do so on behalf of the consumer. This also coincides with my mama saying you work to eat.

I find it difficult to accept a Tax Code that is expressly directed at taxing consumption. That is what we are living for. I understand the idea of not being adverse toward savings and investment, but then being, as it were, prejudicial against consumption activity I think is a poor correction of that.

Mr. ARCHER. Let me jump in quickly and say one of the things that concerns me about our society today economically is that we are not a saving society and we all know that, so what do we have to do to get the money to build the plants, to invest to create the jobs, foreigners. We are dependent more and more and more on the influx of foreign investments here. What if some day they decide, it is not as appealing to invest in the United States. We are in big, big trouble.

Chairman NUSSLE. In the time I have, I saved my time to give to you because we are done with questions and we have votes. I noticed you got a little twitch in your face when you heard the bells go off again. I noticed you weren't used to hearing those for some time and it is a nuisance.

Just to wrap up, I would like to reverse the order and let you give us your advice based on what you have said today, on the consumption based tax, on a more income based tax and just wrap it up, give us your advice in closing. Mr. Archer, go first.

Mr. ARCHER. I would like to simply recap what I have already said. The Congress has to decide what is the goal or what are the goals, what are the priority goals and then decide the best way to get there. It isn't going to be easy. It will be one of the most difficult lifts that you have ever done maybe other than health care.

I reached this conclusion because on the outside I now think it is going to be even more difficult than I did when I was on the inside. As I spoke to labor union halls or I spoke to the CFOs of the Fortune 500, it didn't matter. I got a resounding, standing ovation when I said I want to get the IRS completely and totally out of your individual life. Wow. But it is a long way to get from there to the implementation. You see all of the struggles of those people who have a vested interest in some portion of the income tax today that are going to be out there fighting you in whatever you do.

I don't think an individual Member of Congress can make this happen. I don't think a group of you can make it happen. I don't know whether it can be developed at the grassroots level. I think it is going to take a President who is willing to invest his political capital to go directly to the American people to override all of the objections and the special interests that are going to come when you try to find a way to get to this goal.

Chairman NUSSLE. Mr. Armey.

Mr. ARMEY. Let me just say after years and years of studying this and looking at the other alternatives, and I hope with a reasonable degree of academic objectivity, I have remained convinced that while it is no policy for the timid and a difficult job, the first best solution to our problems and our concerns is the flat tax as first originated by Hall and Rabushka.

Now I am drawn to my natural humility when I say that in 1995, I took their very academic work and translated it into a book of my own called, "The Flat Tax" which is written, as it were, in common parlance. I say again, as I do through this natural humility that is a compulsion I have, if you would buy and read my book, we would all profit. [Laughter.]

Chairman NUSSLE. We deeply appreciate your advice and your testimony and the discussion that you stimulated today. We hope and trust this will not be the last opportunity for that kind of discussion to take place.

Thank you.

Mr. ARCHER. Thank you, Mr. Chairman.

Chairman NUSSLE. We have two votes on the floor, therefore, we will recess and then after the second vote, we will reconvene and take the third panel at that time. [Recess.]

At this point, I am pleased to call and invite to our witness table three very distinguished economists and experts in a number of different fields. We have before us for the final panel, William G. Gale, Doctor and Senior Fellow at the Brookings Institute; Dr. Robert E. Hall, Professor of Economics and Senior Fellow of the Hoover Institute and Stanford University; as well as Dr. Eugene Steuerle, Senior Fellow of the Urban Institute.

We have three very distinguished panelists and I also observed they were here for I believe almost all of the morning debate and discussion, so they are fresh with new ideas, I am sure as well as arguments and maybe even some rebuttal to our earlier witnesses.

We will begin in that order. Dr. Gale, welcome back to the committee. You have been here many times before.

All of your testimony as written will be made a part of the record and you may summarize during your 5 minutes.

Thank you very much and welcome.

STATEMENT OF WILLIAM G. GALE, SENIOR FELLOW, BROOKINGS INSTITUTION; ROBERT E. HALL, PROFESSOR OF ECONOMICS AND SENIOR FELLOW OF THE HOOVER INSTITUTE AND STANFORD UNIVERSITY; C. EUGENE STEUERLE, SENIOR FELLOW OF THE URBAN INSTITUTE

STATEMENT OF WILLIAM G. GALE

Mr. GALE. Thank you very much. It is a pleasure to be here.

I think we learned this morning what we already knew which is that almost everyone believes the tax system could be improved but agreement on the nature and severity of the problems and how to fix them remain allusive.

I would like to make several points in general and then talk about the flat tax and the national retail sales tax in particular.

The single most important point to think about in evaluating fundamental tax reform is to compare realistic alternatives to the existing system. Anyone can write down a simple tax system on paper and there is nothing wrong with that, but when we think about realistic alternatives, we have to think about tax systems that (a) survive the legislative and lobbying process, (b) are consistent with the public's view of fairness, and (c) are not subject to attacks by the tax shelter industry.

A number of the tax reform plans that are out there, I can design tax shelters for and I am not a tax lawyer, I am just an economist. If an economist can design shelters, the lawyers could go nuts with the new proposals.

The second thing to think about is whether these new taxes are add-on taxes or replacement taxes. This was not an issue in the 1980s and the 1990s when we debated fundamental tax reform the last time but now we have a long term fiscal gap that is getting closer and closer and we really don't have the luxury of considering only changes in the structure of taxation. To put it bluntly, unless Congress is willing to cut future spending by 20 percentage points of GDP, we will have to consider ways to raise revenue as well as ways to restructure the tax system.

Third, let me tell me what I think we should do before I talk about the flat tax or the sales tax. I think we need to do a combination of two items. One is simplify the income tax. If we can reasonably consider the flat tax and the sales tax, there is no reason we can't consider massive, wholesale simplification of the income tax.

The second thing we need to think about doing is adding on a value added tax to help meet future revenue needs.

These two taxes basically are base broadening and simplifying on the one hand and the value added tax could be used for some combination of funding social programs and fixing the budget situation or reducing tax rates. In any case, I think that is where we need to head.

I am going to talk very briefly about the flat tax because I presume that Bob Hall is going to talk about that, so I will spend most of the rest of my time talking about the sales tax.

I do want to mention the flat tax is a well conceived, internally consistent tax reform plan as opposed to the national retail sales tax which I will come back to in a second. The basic issue with the flat tax is that it generates wrenching tradeoffs. For example, if we had a flat tax rate of about 20 percentage points, we could break even, we could replace the existing income tax.

If we did that, according to work by a couple of MIT economists, we would increase the number of people without health insurance by 10 million. We would also hurt the charitable sector, we would have repealed the earned income tax credit, we would have firms not being allowed to deduct their payroll taxes, we would have to think about transition relief, et cetera.

Once we accommodated all those things, and notice I am not mentioning the mortgage interest deduction here because there is a way to solve that problem, but once we accommodated all those things like the health deduction, the earned income credit, payroll tax deductions for business, transition relief, State and local tax deductions, stuff like that, we are talking about rates of 28 to 30 percent. Most of the economic gains and economic growth that come from the pure flat tax with no transition relief disappear when you talk about a flat tax of 28 or 30 percent with transition relief.

On top of that, the flat tax would be regressive relative to the current system which has been discussed.

In addition, I just want to add that replacing the entire Federal Tax Code is not likely to be something that happens right the first time and it may be something that is very difficult to enact completely accurately. The flat tax would create new loopholes. It might eliminate some of the old ones, but it would create new ones and those would have to be dealt with. So it is not a cure-all by any means but it is an interesting proposal. It is worth talking about and I am sure Bob Hall will talk about it more.

I would like to spend the rest of my time talking about the national retail sales tax. I think there is a real disconnect here between reality and the sales tax proposal.

The required tax rate to replace all Federal taxes would be 60 percent on a mark up basis, 26 percent to replace the income tax alone. Those are my estimates. The JCT had similar estimates but it is important to note that both of these estimates are likely to be too low. They assume very low rates of evasion.

You heard Representative Linder acknowledge that evasion would be an issue and he hoped and expected the compliance rate would be above 75 percent in a retail sales tax. That is a very low hurdle to get over and if the compliance rate were 75 percent, the required rate would be significantly higher. These estimates assume the compliance rate is about 95 percent which is bigger than Representative Linder noted existing State sales taxes have. So it seems quite unlikely that the compliance rate would actually be that high.

Even if it were, the tax would be easy to evade. In the income tax, we collect revenue from several sources. Employers withhold taxes on wages, then send workers a W–2, workers file the W–2 because they know the employer has already sent in the money. There isn't any third party reporting in a sales tax. The possibility of altering sales contracts, selling you a car at $10,000 with a high interest rate on the loan instead of $20,000 in cash is another easy way to evade sales taxes.

For all these reasons, several countries and the OECD and even the Bush Administration in the economic report of the President last year have noted that rates above 10 to 12 percent don't seem to be enforceable. On top of that, the idea that States run sales taxes and therefore, we can run a Federal sales tax is completely misguided. The States have very low rates, they have lots of exemptions, they end up taxing businesses tremendously and they are just not a model for a Federal sales tax at all.

There was some discussion of the underground economy and Representative Linder discussed how the sales tax would capture revenues from the underground economy. All the evidence we have suggests that is wrong. Richard Armey, in an article in the mid-1990s, explained this very succinctly. There is an issue about border adjustments with the national retail sales tax. Economists are virtually unanimous in arguing that the border adjustment issue is a non-issue, that the exchange rate would adjust and hence, it would not be any more advantageous.

The last issue I want to talk about is the discussion of price level effects in the sales tax. There is an issue about whether prices fall or not if we move from an income tax to a sales tax, but it is a completely unnecessary issue in that none of the effects change, none of the distributional effects that Representative Price reported change if you allow the price level to fall as long as you allow wages to adjust also. You can't have the price level falling and wages staying constant unless workers are actually becoming more productive, for example.

As long as you make consistent assumptions about the price level, you will get that it is a very regressive tax. The 23 percent rate that Representative Linder discussed is based on an inconsistent treatment of the price level. When they calculate how much revenue the Government will collect, they hold the price level fixed. When they calculate how much the Government has to spend to maintain the programs, they assume the price level falls.

You can make either of those assumptions both times but you can't make one in the revenue case and one in the spending case. That might sound like green eyeshade but it is a $500 billion a year mistake and leads to the 23 percent tax being way too low. This is a simple math question, not an issue of ideology or anything else. If you look at the equations, they made a mistake in how they calculated the tax rate.

Let me close on that note. I think the flat tax provides a viable framework for talking about tax reform. Personally, I wouldn't go to the flat tax but it is a viable framework for talking about tax reform. I think the sales tax is non-starter. It is based on a variety of claims that verge on the fraudulent rather than just being simply value judgments. I think the debate would improve dramatically if we could get the sales tax off the table and discuss realistic reforms like either valued added tax, a base broadening income tax or a flat tax.

[The prepared statement of Mr. Gale follows:]

PREPARED STATEMENT OF WILLIAM G. GALE, THE BROOKINGS INSTITUTION, TAX POLICY CENTER[1]

Chairman Nussle, Ranking Member Spratt, and members of the committee: Thank you for inviting me to testify today on Federal revenue options. Almost everyone concurs that the tax system could be improved. But agreement on the nature and severity of the problems and how to resolve them remains elusive.

The basic goals of tax reform seem clear. First, taxes should be simple. Second, taxes should be fair. Third, taxes should be conducive to economic prosperity and market efficiency. Fourth, they should raise sufficient revenue to cover the "appropriate" level of government. Fifth, to the greatest extent possible, tax rules should respect people's freedom and privacy.[2]

Despite the "motherhood and apple pie" quality of these goals, tax policy remains controversial. One problem is that controversy arises over how to achieve each goal. Supporters of increased growth disagree over whether across-the-board income tax cuts, targeted tax cuts for saving and investment, or paying down public debt will do most for the economy. Another obstacle to consensus is that the goals are imprecise: views of what constitutes a fair tax, for example, vary widely. The most important source of controversy, however, is differing value judgments concerning the relative importance of the goals coupled with the fact that the goals sometimes conflict with one another. Research and data may answer technical questions, but they cannot resolve disagreements based on divergent values and preferences.

One strategy for reform is to improve the performance of the existing tax system. A second strategy, so-called fundamental tax reform, would toss out the current system and install an entirely new set of taxes. These approaches can also be combined in a hybrid reform—which improves some parts of the current system, throws out other parts, and installs new taxes.

The most important issue in analyzing tax reform options is to compare the current system to realistic alternatives. Anyone can write down a simple tax system on paper. Whether that tax system can survive the legislative process, the scrutiny of the tax shelter industry, and public notions of equity, and still raise sufficient revenue and remain simple is open to question. I have not yet seen a fundamental tax reform proposal that meets that test.

The focus on realistic options has at least three implications. First, it implies that almost all of the claimed benefits of various proposed systems have to be taken with an enormous grain of salt. Most of these benefits disappear when more realistic versions of the taxes are considered. Second, it implies that policymakers and the public won't be able to "have it all" in tax reform. That is, we won't be able to come up with a whole new system that everyone finds simple, fair, and more conducive to economic growth. We will have to make trade-offs. Third, it is possible to do worse than the current system.

A second key issue is whether the new taxes are considered to be add-ons or replacements for the current system. Given the current long-term fiscal imbalance, either revenues will have to be raised substantially, or spending cut, or both. This observation also changes the nature of tax reform debates. In the past, analysts debated revenue-neutral reforms. Now, however, unless policy makers intend to cut future spending by about 20 percent of GDP, revenue-neutral reforms are no longer sufficient, and serious thought needs to be given to the best way to structure taxes designed to raise additional revenues.

Proposals like a national retail sales tax, a flat tax, and a value-added tax have several common features. They are all consumption taxes, would tax at a flat rate, and would allow few or no deductions or credits. They would be regressive relative to the current system. In their pure form, they could have positive effects on economic growth, but once subjected to the realistic considerations noted above (legislative processes, tax shelters, public views of fairness), they would likely provide little net growth effect. The potential to simplify exists with each of these taxes, but it is likely to be overstated substantially. In particular, avoidance and evasion would continue under each of the plans, and could even increase in certain areas.

My estimates suggest that a sales tax that marked up the price of goods and services by at least 26 percent would be required to replace the income tax, and one that marked up the price of goods and services by at least 60 percent would be required to replace all Federal taxes.

The rest of my testimony provides more discussion of the national retail sales tax, the flat tax, and the relation between recent tax policy and fundamental tax reform.

NATIONAL RETAIL SALES TAX[3]

One proposal for fundamental tax reform is to replace part or all of the current tax system with a national retail sales tax (NRST). The NRST is one potential form of a consumption tax. Retail sales occur when businesses sell goods or services to households. Neither business-to-business nor household-to-household transactions are retail sales. For example, the sale of a newly constructed home to a family that will occupy it is a retail sale. But the sale of that same newly constructed home to a business that is planning on renting it to others is not a retail sale. Nor is a sale of an already existing home from one occupant to another.

Typically, proposed NRSTs would aim to tax all goods or services purchased or used in the United States. Exemptions would be provided for business purchases and education (both considered investments). Domestic purchases by foreigners would be taxed; foreign purchases by domestic would not. To ensure that no family in poverty has to pay the sales tax, the sales tax proposals typically also offer equal per household payments called "demogrants" and equal to the sales tax rate times the poverty line.

A national retail sales tax structured along these lines would represent a sharp break from the current tax system. The tax base would shift to consumption. Rates would be flat. All exemptions, deductions, and preferences would be eliminated. Tax administration, enforcement, and point of collection would altered radically.

To make sensible comparisons across tax systems, it is important to distinguish between two ways to express tax rates. Suppose a good has a sticker price of $100, excluding taxes, and that a $30 sales tax is placed on the good. The "tax-exclusive" sales tax rate is 30 percent, calculated as T/P, where T is the tax payment and P is the pretax price of the good. The "tax-inclusive" sales tax rate is about 23 percent, calculated as T/(P+T). The tax-inclusive rate is always lower than the tax-exclusive rate. At low rates there is little difference. But a 100 percent tax-exclusive rate corresponds to a 50 percent tax-inclusive rate. Sales taxes are usually quoted in tax-exclusive terms. Income taxes are usually quoted in tax-inclusive terms. Neither method is superior, but they must be distinguished to avoid confusion.

REQUIRED RATE

To determine the revenue- and budget-neutral tax rate in a national sales tax requires estimating the rates of evasion, avoidance, the extent to which deductions, exemptions and credit would be re-introduced, and the impact on economic growth. With extremely conservative assumptions about the magnitude of evasion, avoidance, and statutory base erosion, it would require a 60 percent tax-exclusive (38 percent tax-inclusive) tax rate to replace existing Federal taxes, and a 26 percent tax-exclusive (21 percent tax-inclusive) tax rate to replace the existing personal income tax. These estimates do not include any allowance for economic growth, but even if the economy grew by 5 percent, which would be an enormous effect relative to existing estimates, the tax-exclusive tax rates would only come down to 57 percent and 25 percent to replace all Federal taxes, or the income tax, respectively.

Note that the eventual sales tax rate that households would face would likely be significantly higher because existing State sales tax would be added. In addition, most or all State income taxes would probably be abolished in the absence of a Federal income tax system (since the states depend on the Federal income tax system for reporting purposes) and converted to sales taxes. These would add considerably to the combined sales tax rate. Any transition relief provided to households would reduce the tax base and raise the required rate further. And if major consumption items like food, housing, or health care were exempted from the base (the assumption above do not allow for such large exemptions), the tax-exclusive rate could rise to over 100 percent. In short, any realistic plan for a national retail sales tax that replaced the bulk of the Federal tax system would require extremely high combined federal-state tax rates. Sales taxes at such high rates raise crucial questions about enforceability.

Advocates and sponsors of sales tax proposals have suggested that much lower rates, on the order of 23–30 percent would be sufficient to replace the entire Federal system. These estimates are lower than the ones above for three reasons. First, they are quoted in tax-inclusive terms. Second, they assume that there is no evasion, no avoidance, and no statutory base erosion due to political pressures or hard-to-tax items.

Third, quite simply, the advocates made a mathematical mistake in calculating their required tax rate. An analysis of the required rate in a sales tax requires some assumption about what happens to the level of the prices that consumers see (before sales taxes are imposed) in the transition to a sales tax. Producer prices could (a) remain constant in nominal terms, (b) fall by the entire amount of the previously embedded taxes, or (c) fall by an amount between the first two benchmarks. In calculating their required rate, the NRST advocates assumed that producer prices would remain constant when they calculated the amount of revenue the government would obtain from a sales tax, but assumed that producer prices would fall when calculating the amount of spending the government would have to do to maintain current programs. These assumptions are obviously inconsistent, and they either understate government spending needs, overstate the revenue likely to be obtained, or both. Making a consistent assumption about producer prices—regardless of whether the assumption is (a), (b) or (c), leads to a higher rate than the advocates have assumed.

ENFORCEABILITY AND AVOIDANCE

The results above suggest that even with rates of evasion much lower than in the existing income tax system, the required national retail sales tax would be well into the 30s and possibly even higher (on a tax-inclusive basis). Governments have gone on record noting that at rates of more than 12 percent, sales taxes are too easy to evade. Thus, the most optimistic assessment would be that there is no historical precedent for a country to enact a high-rate, enforceable, national sales tax. That does not mean it is impossible, but extreme caution would be appropriate.

Sales tax advocates admit that evasion would be a certainty, yet make no account for it in their estimates and hope that sentiments of fairness will induce taxpayers not to cheat. They also point to low marginal tax rates as an inducement not to cheat, but as shown above, the tax rate would not likely be low. Another claim is that detection of cheating would rise dramatically since only retailers would have to be audited, but this is misleading. Under the sales tax, businesses that make retail sales would be responsible for sending tax payments to the government, unless the buyer used a business exemption certificate, in which case no tax would be due. But the buyer would have the legal responsibility for determining whether the good is used as a business input or a consumption item. This means that auditing and enforcement would have to focus not just on retailers, but also on all businesses that purchase from retailers, to ensure that business exemption certificates were used appropriately.

Most importantly, the sales tax would generate tremendous opportunities for evasion. For example, in the income tax, the rate of evasion is around 15 percent. But income where taxes are withheld and reported to government by a third party has evasion rates of around 5 percent. For income where taxes are not withheld and there is no cross-reporting, evasion is around 50 percent. Since the sales tax would feature no withholding and no cross-reporting, the possibility of high evasion rates needs to be taken quite seriously.

Advocates also assert that the sales tax would be more effective than the current system at raising revenue from the underground economy. The classic example is that of a drug dealer who currently does not pay income tax on the money he earns, but would be forced to pay taxes under a sales tax if he took the drug money and bought, for example, a Mercedes. The problem with this argument is laid out best by Rep. Richard Armey (R–TX): "If there is an income tax in place, he [the drug dealer] won't report his income. If there is a sales tax in place, he won't collect taxes from his customers" and send the taxes to government. In the end, neither system taxes the drug trade. Many other countries have attempted to implement a retail sales tax, or variants, and almost all have abandoned the tax and moved to a value-added tax.

Finally, some sales tax advocates would eliminate the IRS and have the states administer the tax. Even though the states would keep 1 percent of the revenue they collect, they would have poor incentive to collect Federal taxes adequately. Even the Wall Street Journal, no fan of big government, notes that "it is fantasy to think of 'getting rid of the IRS.'"

Few savings in compliance costs would be achieved, however, unless states also abandoned their personal and corporation income taxes. And if they replaced their income taxes with sales taxes, the combined rates would be astronomical, compounding the administrative difficulties that high Federal rates would cause. Furthermore, experience with the State sales taxes provides no guidance on how to administer a demogrant to over 270 million people. Payments would be based on family size, a design feature that necessitates filing by all families and raises problems of enforcement because two separate one-person families would receive larger grants than would one two-person family. In addition, almost all states collect a significant share of their sales tax revenue from business-to-business sales. Inputs may pass through many stages before reaching consumers, and taxes can accumulate. This situation is tolerable when rates are low, but not when rates are high. Distinguishing sales to businesses from sales to consumers will require detailed audits of retailers and other businesses, because incentives for households to masquerade as businesses to evade the tax will increase with the increases in the tax rate.

Almost all states exempt a large number of difficult-to-tax consumer goods or services. At low rates these gaps in coverage matter little, but when rates are high, distortions and inefficiencies would become serious. No state, for example, taxes financial services, and only a handful tax services generally, yet the NRST proposals would tax all services. A threshold administrative question regarding a national retail sales tax is whether it could be enforced at rates necessary to sustain revenues.[4] Retail sales tax rates in foreign countries are typically in the range of 4–6 percent, although a few countries have had higher rates.

No country has run a sales tax at anywhere near the rates that would be required to sustain revenues in the United States.[5] Although implementation of the sales tax at realistic rates might not prove impossible, extreme caution would be appropriate.

FAIRNESS AND THE DISTRIBUTION OF TAX BURDENS

The debate over whether consumption or income is a better measure of ability to pay taxes has been going on for centuries. Proponents of consumption taxes argue that consumption usually approximates lifetime income because few people inherit or bequeath more than a small fraction of their lifetime earnings. For that reason, taxing consumption is equivalent to taxing households on the basis of their ability to pay taxes over long periods of time. However, advocates of the income tax counter that current income may be a better measure of ability to pay because few households can borrow much against future income and the prospect of having a large future income may not prove much help.

The NRST would significantly redistribute tax burdens. The shift from an income base to the consumption base of the NRST would tend to reduce the burden on high-income filers because they consume a smaller than average share of their income. The shift from graduated rates to a flat rate would also tend to reduce their burden. It is also likely that avoidance options would be more available to high-income than to low-income households. As a simple matter of arithmetic, if wealthy households pay less in taxes, others have to pay more, assuming revenues are held constant.

If households are classified by annual income, the sales tax is sharply regressive. Under the AFT proposal, taxes would rise for households in the bottom 90 percent of the income distribution, while households in the top 1 percent would receive an average tax cut of over $75,000. If households are classified by consumption level, a somewhat different pattern emerges. Households in the bottom two-thirds of the distribution would pay less than currently, households in the top third would pay more. Still, households at the very top would pay much less, again receiving a tax cut of about $75,000. There appears to be little sound motivation for heaping huge tax cuts on precisely the groups whose income and wealth have benefited the most from recent events, and raising burdens significantly on others (Feenberg, Mitrusi and Poterba 1997).

Advocates like to assert that sales taxes are pro-family relative to the income tax. But children and families benefit disproportionately from numerous features of the current system, including dependent exemptions, child credits, child care credits, earned income credits and education credits. And the preferential treatment of housing, health insurance, and State and local tax payments also plausibly helps families, since they consume relatively more housing, medical services, and government-provided services such as education. All of these preferences would be eliminated under a sales tax. Moreover, compared to childless couples, families with kids generally have high consumption relative to income, so switching from income tax to a consumption tax would further raise tax burdens during years when family needs were highest. Based on 1996 data, a recent study found that enactment of a broad-based, flat-rate consumption tax like the sales tax or flat tax would hurt families with incomes less than $200,000, because of the loss of tax preferences, but would help families with income above $200,000, due to the dramatic reduction in the top tax rate. Incorporating the 1997 and 2001 tax changes—especially the child and education credits—would only exacerbate these results.

THE FLAT TAX [6]

Under a VAT, each business would pay tax on the difference between its total sales to consumers and other businesses less its purchases from other businesses, including investment. Thus, the increment in value of a product at each stage of production is subject to tax. Cumulated over all stages of production, the tax base just equals the value of final sales by businesses to consumers—that is, the same as in an NRST.

The flat tax, originally developed by Hoover Institution scholars Robert Hall and Alvin Rabushka, is simply a two-part VAT: the business tax base would be exactly like the VAT except that businesses would be allowed deductions not only for purchases from other businesses but also for cash wage and salary payments and employer pension contributions.[7] Individuals would pay tax on wages, salaries, and pension income that exceeded personal and dependent exemptions. Businesses and individuals would be taxed at a single flat rate. This implies that the flat tax is a consumption tax.

REQUIRED RATES

The Treasury Department has estimated that a pure flat tax with a 20.8 percent rate would have generated as much revenue as the personal and corporation income taxes and the estate tax in 1996.[8] Unlike the advocates' estimates for the sales tax, the flat tax estimates include tax evasion and are based on logically consistent assumptions about price level changes. Nevertheless, in practice, rates would likely be higher for several reasons. Congress would face intense pressure to offer transition relief to businesses that would be treated less generously under the new rules than under current rules. Repeal of the income tax would destroy remaining depreciation deductions for businesses that own capital at the time of transition. Owners of such "old capital" would be at a disadvantage in competition with owners of "new capital" purchased after the implementation of the new tax, which could be expensed. Similarly, companies that have borrowed funds would lose deductions for interest payments and would have a disadvantage in competition with companies that have not borrowed. The flat tax would also eliminate carryforwards relating to net operating losses, alternative minimum tax payments, and other items that business can currently use to reduce future taxes. Business owners would doubtless seek relief.[9]

More generally, taxes are deeply embedded in the structure of existing contracts and other transactions. Moving to a flat tax could upset these arrangements. For example, the flat tax would change the substance of every alimony agreement, because alimony payments are currently deductible and alimony receipts are taxable, but under the flat tax, those treatments would reverse. Likewise, the flat tax would alter every loan repayment plan because interest payments are currently deductible and interest receipts are taxable, but neither activity would affect tax liabilities under the flat tax.

These problems would create a dilemma. Most of the gains in economic efficiency and much of the political appeal of the flat tax derive from low rates made possible by a broad tax base. But providing transition relief would raise rates and would reduce gains in economic efficiency. Transition rules would also erode gains in simplicity. Beyond transitional concerns, the permanent elimination of existing deductions and credits would prove difficult. Removing deductions for mortgage interest and property taxes would raise tax burdens for about 29 million homeowners who itemize, reduce the real value of homes, and possibly increase mortgage defaults.[10] Terminating deductions for charitable donations under the personal, corporation, and estate and gift taxes would reduce contributions by about 11–23 percent.[11]

Eliminating deductions for health insurance premiums employers pay for workers would have increased the number of uninsured in 1994 by between 5.5 million and 14.3 million, about 14 to 36 percent.[12] Removing the deduction for State and local taxes would increase the effective burden of subfederal government on taxpayers who currently itemize. Deductions for casualty losses would end, meaning that a victim whose earnings were stolen would still have to pay taxes on them. Businesses would lose more than $300 billion in deductions for payroll taxes. The flat tax would also eliminate the earned income credit, which raises the labor supply of, and redistributes income to, low earners.[13] If Congress provided limited transition relief; retained individual deductions for mortgage interest, charitable contributions, and State and local income and property taxes; continued business deductions for health insurance premiums and payroll taxes; and kept the earned income tax credit the revenue-neutral rate would rise from 20.8 percent to 31.9 percent.[14]

Regardless of the economic wisdom of retaining these aspects of the current income tax under a flat tax, political support for them will be powerful. Even flat-tax designers now acknowledge that transition relief will be inescapable in practice.[15] And some recent proposals, termed "McFlat" taxes, would allow the flat tax to include deductions for mortgage interest and charitable contributions.[16] These cracks in the armor, which have appeared long before any serious legislative consideration has occurred, suggest that more would open in the political horsetrading surrounding actual legislation.

SIMPLICITY, COMPLIANCE, AND ADMINISTRATION

The appeal of fundamental tax reform stems in no small measure from claims that it would greatly simplify taxes, reducing compliance costs for households and businesses and defanging or even eliminating the IRS. However, while the NRST and flat tax clearly have some advantages over the existing system, they also create new problems. And responsible observers on all sides agree that an IRS-like agency is here to stay.

ADMINISTRATION AND ENFORCEMENT

The alleged simplicity of the flat tax, symbolized by a post card sized return, is one of its great selling points. A pure flat tax would be simpler than the current income tax, but some problems would carry over to the new system. These include distinguishing independent contractors from employees, determining who are qualified dependents, enforcing tax withholding for domestic help, limiting home office deductions, determining and collecting taxes from the self-employed, reconciling State and Federal taxes, and distinguishing travel and food expenses incurred while doing business, which should be deductible, from other travel and food expenses, which should not be deductible.[17]

Several problems for tax administration could actually intensify, including the sheltering of personal consumption as a business expense, the tax treatment of mixed business and personal use property, rules regarding how taxes or losses may be allocated among different taxpayers, and distinctions between financial and real transactions. The flat tax would also create new opportunities for avoidance and evasion. For example, wages and salaries would be deductible business expenses but fringe benefits would not. Businesses might find it desirable to hire physicians and nurses directly rather than purchase health insurance for their employees. Because sales proceeds are taxable to businesses but interest income is not, businesses would find it profitable to discount prices for installment purchasers who accepted high interest rates. One author concluded that the flat tax would create a dilemma—either a complicated tax law would be necessary to reduce the evasion possibilities or complicated business transactions would arise to game the law or both.[18] After a careful review of estimates of the costs of administering the income tax, another study concluded that administrative costs for a pure flat tax would be about half those of the corporation and individual income taxes.[19] If Congress retained some itemized deductions and the earned income tax credit and granted transition relief, however, these savings would shrink.

EFFECTS ON ECONOMIC GROWTH

Many of the problems and trade-offs created by fundamental tax reform could be reduced if reform boosted growth dramatically. Fundamental tax reform could increase growth by reducing marginal tax rates on capital and labor income, reducing the disparity in taxation of different types of capital and labor income, and imposing a lump-sum tax on old capital by not providing transition relief. But the impact on growth depends critically on the "purity" of the reform.[20]

A pure consumption tax—like the flat tax—with no personal exemptions or product exemptions and no deductions, credits, or transition relief could increase the size of the economy by 9 percent in the ninth year after reform and would require a tax-inclusive rate of 14 percent. Compared with the estimated impacts of other policies, these are enormous. Unfortunately, the growth effect shrinks rapidly as the pure reform is made more realistic. Adding modest personal exemptions (smaller than in the flat tax proposed by Representatives Richard Armey and Richard Shelby)[21] and providing transition relief for existing depreciation deductions (but not interest deductions) reduces the growth impact by 80 percent, leaving increased growth of only 1.8 percent in the ninth year, and requires a tax-inclusive rate of 24 percent. Allowing for additional deductions, credits, and child exemptions or other forms of transition relief would raise the tax rate considerably. There are no estimates of the growth impacts of these changes, but the available data suggest that at the required rates, the growth effect would likely be near or below zero.[22]

RECENT TAX POLICIES AND TAX REFORM

Some advocates of moving to a consumption tax have shifted to trying to achieve fundamental tax reform in several steps, rather than in one fell swoop, and defend the Bush tax cuts as effecting such a piecemeal move toward a consumption tax. Indeed, as Bartlett (2003) argues, "By Bush's second term, it is possible that we will have made enough incremental progress toward a flat rate consumption tax that we may finally see fundamental tax reform fully enacted into law."

Although they bear a superficial and partial resemblance to broader tax reform measures, the recent tax cuts create new structural flaws in the tax system, have the opposite effect of well-designed fundamental tax reform in key areas like saving and growth, and will actually make fundamental reform more rather than less difficult.

THE RECENT TAX CUTS AND CONSUMPTION TAXES: COMPARING RULES AND EFFECTS

The recent tax cuts share several features with fundamental reform plans. They reduce the top marginal individual income tax rates, reduce tax rates on capital income (dividends and capital gains) even further, and eliminate the estate tax. The bonus depreciation rules move toward a system where investments are expensed in the first year, albeit on a temporary basis.

Recent regulatory changes also push in the same direction. For example, in January 2002, the IRS published a notice of proposed rule-making to clarify its interpretation of the 1992 Supreme Court decision in INDOPCO, Inc. v. Commissioner. In INDOPCO, the Court ruled that expenses incurred by firms preparing for a friendly take over had to be capitalized rather than expensed. The IRS rules put forward categories of safe harbors under which intangible assets could be expensed rather capitalized. Many practitioners are concerned that under the IRS rules, firms are given too much leeway to expense investments rather than depreciate them over time.[23]

Moreover, proposals for greatly expanded tax-free saving accounts would push even further toward elimination of tax on capital income. The Administration has proposed two new types of individual accounts called Lifetime Saving Accounts (LSAs) and Retirement Saving Accounts (RSAs). LSAs would allow annual contributions of $5,000 per person per year. Although contributions would not be deductible, account earnings and withdrawals would be tax-free. Anyone could make a contribution to their own account or anyone else's with no income, age, or other restrictions. Withdrawals could be made at any time for any purpose. RSAs are basically Roth IRAs, but with no income limit for contributions. They would have similar features to LSAs, except that contributions could not exceed earnings and withdrawals made before age 58 (or the death and disability of the owner) would be subject to a small penalty. Over time, these proposals would allow an increasing share of the returns to wealth to be sheltered from taxation (Burman, Gale, and Orszag 2003).

Despite these similarities, the tax cuts differ from fundamental reform in both their rules and their effects. A key difference in rules between the recent tax cuts and fundamental reform involves the tax treatment of interest payments. A well-designed income tax would tax interest income and allow deductions for interest payments. A well-designed consumption tax could treat interest the same way, or it could allow for nontaxation of interest income coupled with nondeductibility of interest payments. The key point is that any well-designed tax system would treat capital income and capital expenses in a consistent manner. Yet although it is embracing proposals that reduce or eliminate the tax on interest income, the Administration has not endorsed or proposed any such restrictions on deductions for interest borrowing.

Without such restrictions, cuts in the taxation of capital income expand the opportunities for tax sheltering. For example, consider someone who borrows $100 and deposits the money in a tax-free savings account. If the individual borrows the money in a tax-deductible form (for example, through a home equity loan), the net effect is to create a tax shelter. The investment returns on the account would be free from taxation, so no tax would be owed on the income, but the individual would still enjoy a deduction for the borrowing costs. Note also that there is no net investment in the example—simply a tax-motivated asset purchase financed with debt. Gordon, Kalambokidis, Rohaly, and Slemrod (2004) argue that if "the ultimate destination of this set [i.e., the Bush Administration's] of tax reforms is a consumption tax base, then the most glaring omission from the discussion to date concerns interest deductibility."

The recent tax cuts and fundamental reform also differ in their effects. Perhaps the central reason to consider a consumption tax is the potential to raise national saving and thereby raise economic growth (Aaron and Gale 1996). It is therefore instructive to understand why many studies show that a well-designed consumption tax could raise national saving and growth while the analysis in earlier sections shows that the recent tax cuts will reduce national saving and growth.

One difference arises because the studies that show that consumption taxes raise growth examine revenue-neutral shifts in the structure of taxes (see the papers in Aaron and Gale 1996 and Zodrow and Mieszkowski 2002), whereas recent tax policies significantly reduced revenues. National saving is equal to private saving minus the government's budget deficit. A revenue-neutral switch to a consumption tax leaves the deficit unaffected and thus only needs to increase private saving in order to raise national saving. Most studies suggest that positive, albeit modest, increases in private saving would occur under a well-designed consumption tax. Thus, the deficit-financed nature of the recent tax cuts reveals one flaw in the argument that the tax cuts are helping the nation evolve in steps toward a well-designed consumption tax. The revenue costs and the limited private saving response discussed above imply that the recent tax cuts reduce national saving, exactly the opposite of a fundamental goal of a consumption tax.

A second difference is that the recent tax cuts move the nation more toward a wage tax than a consumption tax. The fundamental difference between wage and consumption taxes involves the treatment of people who own assets at the time the new tax system is enacted.[24] A wage tax does not tax assets held at the time of the transition. A consumption tax does; it provides a tax break only for new saving, not for income or consumption out of existing capital. As a result, a consumption tax actually reduces the value of existing assets to their owners.[25]

Research indicates the taxation of assets held at the time of transition to a consumption tax is the source of almost all the increase in economic growth from such taxes.[26] Thus, a wage tax, which exempts from taxation the assets held at the time of the transition, does not provide the macroeconomic benefits that a consumption tax would.

By way of comparison, the 2001 and 2003 tax cuts not only do not impose a new tax on existing capital; they reduce taxes on existing capital. The reductions in capital gains and dividends taxes, for example, provide large benefits to owners of existing stocks and hence are not well-targeted toward exempting just new saving.

In effect, from the standpoint of economic growth, a major attraction of a consumption tax is the ability to place an additional tax on existing assets at the time of the transition. Yet the 2001 and 2003 tax cuts do exactly the opposite, reducing such taxes, and hence omitting much of the potential economic gains from a consumption tax.

WILL THE RECENT TAX CUTS MAKE FUNDAMENTAL REFORM MORE LIKELY?

From a political economy perspective, tax reform always combines gain and pain. The 2001 and 2003 tax cuts do the easy part of tax reform, but ignore the difficult part. Consider the 2003 dividend tax cut. Even before the dividend tax reduction, most corporate income in the United States was not taxed twice. A substantial share was not taxed at the corporate level due to shelters, corporate tax subsidies, and other factors. And half or more of dividends were effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and non-profits (Gale 2002). The problem is that the dividend tax cut undermines the political viability of true corporate tax reform. Any such reform would have to combine the carrot of addressing the “double taxation” of dividends with the stick of closing corporate loopholes and preferential tax provisions, to ensure that corporate income is taxed once and only once—but at least once. The dividend tax cut instead just gave the carrot away.

The same problem has occurred in the taxation of capital income generally. Enacting meaningful reform will require conforming the treatment of capital income and interest deductions. Yet by reducing the taxation of capital income without also restricting the ability to deduct interest payments, legislators gave away the easy part of reform and now have little to bargain with to make the treatment of interest income and expense compatible.

SUMMARY

Tax cuts that reduce national saving, reward owners of existing capital, and retain deductions for borrowing costs while reducing the taxation of new capital income are not consistent with any sensible tax system—whether based on income, consumption, or wages. Taken to their logical conclusion, these tax cuts will not lead to a consumption tax, but rather to a system in which capital is actually subsidized (i.e., faces a negative tax rate on average) and labor income ends up bearing the full weight of supporting government services and more.

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ENDNOTES

1. Arjay and Frances Fearing Miller Chair, Economic Studies Program, and Co-Director, Tax Policy Center. The views presented are my own and should not be taken to represent the views of the Brookings Institution or the Tax Policy Center.

2. Taking exception to these statements is a group of economists who believe that an inefficient, unfair, or complex tax system makes it more difficult politically to raise revenues, which helps hold down the size of government. They argue that, on balance, a smaller government with a more cumbersome tax system is better for the economy than a larger government with a more efficient tax system (Friedman 1993 and Becker and Mulligan 1998).

3. For additional information, see Gale (1999) and Gale and Hotlzblatt (2002).

4. For a detailed analysis, see Gale and Hotlzblatt (1999). Mastromarco (1998) presents an opposing view.

5. The OECD has stated that "Governments have gone on record as saying that a retail sales tax of more than 10 to 12 percent is too fragile to tax evasion possibilities." Vito Tanzi, director of Fiscal Studies at the International Monetary Fund has said, "The general view among experts, a view obviously shared by most governments, is that 10 percent may well be the maximum rate feasible under an RST" (Tanzi, 1995, pp. 50–51). British fiscal expert Alan Tait expressed a similar view: "At 5 percent, the incentive to evade [the retail sales tax] is probably not worth the penalties of prosecution; at 10 percent, evasion is more attractive, and at 15–20 percent, becomes extremely tempting" (quoted in Tanzi, 1995, p. 51). Slemrod (1996) and others have expressed similar sentiments.

6. For additional information, see Aaron and Gale (2000) and Gale and Holtzblatt (2002).

7. Hall and Rabushka (1985).

8. U.S. Department of Treasury (1996, p. 451). This includes personal exemptions of $10,700 (single), $21,400 (married), and $14,000 (head of household), and child exemptions of $5,000.

9. Perlman (1996).

10. The impact on housing prices is controversial. Capozza, Green, and Hendershott (1996, p. 201) estimated that the flat tax would reduce the price of owner-occupied housing (the structure plus the land) by an average of 29 percent if interest rates were constant. If the flat tax led to a fall in interest rates of 2 percentage points, the estimated average fall in housing prices would be 9 percent (p. 190). Bruce and Holtz-Eakin (1998) estimate that nominal house structure prices would rise by 10 percent in the short run and 17 percent in the long run. However, Gale (1999b, pp. 6–7) shows that under consistent assumptions about price-level effects, and including land in the analysis, the Bruce and Holtz-Eakin model suggests that real housing prices would fall by 7–10 percent in the short run and by 2–6 percent in the long run, depending on how interest rates adjust.

11. Clotfelter and Schmalbeck (1996, pp. 229, 232, 234) estimate that the end of the charitable contributions deduction would reduce individual giving by 10 percent to 22 percent, corporate giving by 15 percent to 21 percent, and testamentary gifts by 24 percent to 44 percent.

12. Gruber and Poterba (1996, p. 142).

13. Dickert, Houser, and Scholz (1995); and Eissa and Liebman (1995).

14. This estimate understates the increase in rates that would be necessary because it is based on itemized deductions claimed under the personal income tax. But many taxpayers who use the standard deduction and therefore do not explicitly list such outlays as mortgage interest or charitable contributions also incur these expenses and would claim them under a flat tax if such itemized deductions were retained. Furthermore, if political pressure or policy consideration led Congress to retain itemized deductions, similar considerations might lead to the retention of such provisions as child care or education credits.

15. Representative Richard Armey and Professors Robert Hall and Alvin Rabushka, for example, have already acknowledged the need for transition relief. A commission studying tax reform chaired by former Representative Jack Kemp blandly remarked that "policymakers must take care to protect the existing savings, investment, and other assets" during a transition to a new tax system. Although the Kemp Commission did not elaborate on this seemingly innocuous statement, it has far-reaching implications for tax reform. Kemp Commission Report; http://www.flattax.house.gov/reptoc.htm [August 13, 1999].

16. See Specter (S. 488, 1995); and the Kemp Commission Report.

17. Graetz (1997) describes numerous problems in the current system that will not disappear with the flat tax.

18. Feld (1995, p. 615).

19. Slemrod (1996, p. 375).

20. Estimates of the effects on growth also depend on how the current system is characterized. Engen and Gale (1996) document that most private saving and growth now occurs in tax sheltered forms. If one recognizes this fact, the impact on saving and growth of switching to a consumption tax will be smaller than it would be if one assumes that the current system is a pure income tax.

21. H.R. 2060 and S. 1050, The Freedom and Fairness Restoration Act of 1995.

22. Other models, reported in Joint Committee on Taxation (1997) generate a range of results that, dropping the high and low estimates, are fairly close to the results reported in the text. See also Auerbach (1996); Engen and Gale (1996); and Fullerton and Rogers (1996).

23. See, for example, Jack Taylor, "Tax Deductibility of Business Expenses," CRS Report for Congress, RS21194, April 2002.

24. Intuitively, this result stems from the fact that, under some simplifying assumptions, future consumption can be financed from existing assets or future wages. Thus, both items are taxed under a consumption tax. If existing assets are exempted, the result is a tax on wages.

25. To see why, think of someone with $100 in the bank at the time a consumption tax is adopted. Under an income tax, the owner of the bank account could withdraw the money and spend it without being taxed. Under a consumption tax, though, the $100 would be taxed when it is withdrawn and spent. Since the $100 bank account does not buy as much, after tax, its value is reduced under a consumption tax.

26. For example, Altig et al (2001) show that a standard flat tax with a personal exemption of $9,500 would raise the size of the economy by 2.2 percent after 14 years if assets held at the time of transition were subject to the tax, as they would be under a consumption tax. But if at least partial transition relief were granted for assets held at the time of transition (by continuing to allow depreciation allowances on such assets), the economy would only be 0.5 percent larger after 14 years.

Chairman NUSSLE. Thank you, Dr. Gale.

Dr. Hall.

STATEMENT OF ROBERT E. HALL

Mr. HALL. Thank you, Mr. Chairman. I am delighted to have this opportunity to talk about tax reform.

Let me say first that, there is a very strong consensus, and Bill's remarks just now strongly conform to this, that the best type of tax system that the United States should move to is a value added tax. First of all, a value added tax is proven in practice in Europe and other countries that have been using it for half a century.

The thing I want to stress here is that the ideas I pushed in the past, and I am the Hall of Hall and Rabushka, are to institute a value added tax. We were always very clear on this point. It is called the flat tax and that was Rabushka's contribution in terms of naming, to call it the flat tax. Rabushka came to me in 1981 and said, the people want a flat tax, what is it? I said it is a value added tax but it is different from the European value added tax in one critical way. It has all the strengths of the European value added tax but it has one additional feature and that is it is progressive.

The failure of progressivity of the European value added tax model is central to why we don't want a European value added tax but we do want something you could call an American value added tax. So the real question is how can we get from here to there, especially in this town. We want to get there in steps.

The steps are pretty clear and they have been discussed in different ways today but let me tick off what those key steps are.

First of all, you eliminate the personal taxation of business income. You eliminate personal taxes on dividends, capital gains and interest. There are many ways of doing that. The simplest is to take them off the form. Another way to do it is to extend IRA type instruments and have an unlimited entitlement to IRA that is an unlimited savings allowance and that would accomplish the same thing. So there are different ways of doing that. It is up to Congress to decide which of those is going to be most successful politically.

A second step is that we have a corporate income tax but that is actually a big mistake. We should have a business income tax. We would extend the corporate income tax to be an air tight, comprehensive business tax. In that tax, we would remove the deduction for interest.

If you read Bill's testimony, he didn't express this just now but if you read his testimony, he is properly insistent on the point that the business deductibility of interest is really the central weakness of the American tax system today. The very top priority should be to remove the deduction of interest from the business tax.

That will raise the question that in parallel you would want to remove the personal deduction from mortgage interest. I recognize that is not something Congress is likely to do soon and there are various ways of working around that.

The final step, again central to the value added concept, we need a consumption tax. That is what Europe has. Economic efficiency demands a consumption tax. A VAT is a consumption tax because it allows first year write off of investment, plant and equipment. That is all it takes and that is what we want.

I want to come back to the point that a proper implementation of this idea in the American context needs to be progressive and although Rabushka named our idea the flat tax, he has given me permission to advocate the not so flat tax. I think there is a reason to do that and that is that the distribution of income and wealth in the United States has shifted dramatically since 1981 when we first started pushing this idea and we now have a very substantial economic elite who have very high levels of wealth, consumption and income. They are the tax heroes today. They pay a very disproportionate share of the income tax. We, I think, probably should retain that feature.

I don't align myself with the branch of this thinking that says everybody should have the same rate. We never said that because we have always had a zero rate bracket. It has never really been a flat tax. We could have more brackets. One thing I feel strongly about is that the top bracket shouldn't be above 30 percent. You don't actually get any tax from taxing successful people at rates above 30 percent because they always figure out a way around it.

What we really need is an air tight way of enforcing a rate, say a top rate of 25 percent and make it stick as opposed to putting on the books a higher rate. For example, for a while we have a 50 percent top marginal rate and that is a real mistake. It was a huge step forward in the 1980s when we systematically stripped away these unrealistically high rates down to the 28 percent top rate that we achieved in 1986 and it was a big mistake in 1993 when we rolled that back and put back in higher rates. We really need to stick to this principle that progressivity does mean there should be brackets but it doesn't mean that the top bracket should be an unrealistically high rate.

So a system based on these principles of centralizing the taxation of business income at the business level, taxing wages at the personal level for just one reason and that is that is the way you can most realistically make the system progressive. By taking a piece of the value added tax and moving it to the individual, you can then make it progressive because that is the right way to implement multiple brackets, in particular a zero bracket at the bottom.

It would also be possible in that framework to retain the earned income tax credit, something that has properly gotten a lot of attention here. A design in this framework that preserved the ITC and the other similar low income credits would be completely feasible. I think administratively it is the right way to do it.

Let me close by saying what we shouldn't do. I have told you what we should do and we have done some of it. For example, we have cut capital gains and dividend rates. Last year, that was a very good step forward. Let me close with what we shouldn't do.

We shouldn't just adopt a European VAT because it is not progressive. We should have an American VAT. We should be sure that it is adequately progressive. We should not expand saving incentives at the personal level, we should have a single investment incentive in the VAT at the business level. Those are the two important things not to do.

We should certainly not have a sales tax and the criticism of the administrative side of the sales tax is absolutely compelling. We need a VAT, not a sales tax and we can make the VAT progressive using the design I have discussed. Thank you.

[The prepared statement of Mr. Hall follows:]

PREPARED STATEMENT OF ROBERT E. HALL, HOOVER INSTITUTION, STANFORD UNIVERSITY

I am grateful for the opportunity to present testimony on the next steps in tax reform. My expertise is in the operation of the U.S. economy and in tax policies to achieve higher growth. I serve as the McNeil Joint Senior Fellow of the Hoover Institution at Stanford and Professor in Stanford's economics department. I am co-author, with Alvin Rabushka, of The Flat Tax, which lays out the ultimate goal of tax reform as we see it. My testimony today deals with practical steps that could be taken in the direction of that ultimate goal. I will consider improvements that could be made in the personal and corporate income taxes. I will not comment here on the other major component of the Federal revenue system, the payroll tax for Social Security.

A number of goals of tax reform command widespread support. First is simplification. The personal income tax today is ridiculously complicated. An improved tax would result in a one-page filing for every taxpayer.

The second goal is uniform, powerful incentives for capital formation. In today's tax system, entrepreneurial startups are heavily taxed while tax shelters are subsidized. Uniformity of powerful investment incentives is key to a pro-growth tax policy.

The third goal is progressive distribution of the tax burden. Today's tax system shields the poor from any income tax—a feature that should be retained—but its distribution across middle- and upper-income taxpayers is cruelly uneven. We need an airtight progressive tax.

The fourth goal is economic efficiency. Once the other goals are achieved, efficiency calls for moderate top tax rates. Experience everywhere in the world at all times has taught that tax rates above about 30 percent generate inefficiencies that far outweigh the limited revenue that they collect.

The basic structure of a tax system that could achieve all of these goals is the American value-added tax. The VAT is the backbone of the revenue system of every country in Europe. It is the essence of simplicity. It provides exactly the right incentive for capital formation, because all investment is deducted from the tax base. The VAT is efficient because its rate is in the safe zone below 30 percent. The only defect of the standard European VAT—but a serious one—is its lack of progressivity. European countries complicate their VATs by applying higher rates to luxury goods, but they have not succeeded in achieving a fair distribution of the burden of the VAT. I will show how to make a simple VAT progressive without sacrificing any of its desirable features. The result is the American VAT.

Some proponents of tax reform are pushing a Federal sales tax. In principle, a sales tax that exempts sales of investment goods has the same benefits as a VAT. But a VAT is much easier to administer than is a sales tax. In a VAT, every business pays the tax on all of its sales, whether to other businesses or to final customers. If the customer is a business, the customer deducts the purchase, so there is no double taxation. A seller does not need to keep track of whether its customers are businesses or final customers. Under a sales tax, the seller does need to make that distinction. Customers masquerade as reselling businesses when they are actually final customers. Sales taxes are notoriously leaky and cannot sustain tax rates much above 10 percent. The case against the sales tax is practical. In addition, a sales tax suffers from the same defect as a standard VAT—it is not progressive.

The following steps would take us to the progressive American VAT. The reformed tax system would meet all four of the key goals and would replace all of the current revenue of the personal and corporate income taxes:

1. Eliminate personal taxation of business income: interest, dividends, and capital gains
2. Bring all businesses under the corporate income tax, to be renamed the business tax
3. Remove the deduction for interest in the business tax and the personal deduction for mortgage interest
4. Extend depreciation of plant and equipment to first-year write-off

The result of all of these reforms would be a VAT, though its administration would be different from a standard European VAT. In Europe, the typical family does not have direct contact with the VAT. The tax is embedded in the prices the family pays, but the family does not fill out a form. That is why the VAT cannot be sensitive to the family's income level. Accordingly, the standard VAT cannot be progressive. In the American VAT, families would continue to fill out a personal tax form, but it would be simple enough to fit on a postcard. Only earnings are taxed on the form. The personal tax has a generous exemption and could have a couple of rates, say 15 and 25 percent.

In the business part of the American VAT, businesses report total revenue and deduct purchases of inputs, including the wages they pay. They also deduct purchases of plant and equipment. The business part of the American VAT is the same as the European VAT, except for the deduction of wages.

The business and personal parts of the American VAT mesh to form a standard VAT. Collecting the tax on earnings at the personal level is the secret of making the VAT fair and progressive. The American VAT is a big step forward over the European VAT because of its progressivity.

The American VAT meets all four of the key goals of tax reform. First, it is simple. Both the business and personal taxes fit on postcards. Second, it provides exactly the right incentives for capital formation, across the board, through first-year write-off. Third, it is progressive, because of the exemption and graduated rates in the personal part of the tax. Fourth, it is economically efficient because its top rate would be no more than 25 percent.

The American VAT would overcome grave inefficiencies in the current income taxes. The central problem is inconsistent incentives for capital formation that result in subsidies for some types of investment and high taxes on others. Incentives to capital formation come in two varieties. First is depreciation, including first-year write-off. Second is deduction of saving at the personal level. When both incentives are provided—as happens when a business finances investment by selling bonds to a pension fund and takes depreciation on the investment—the investment is inefficiently subsidized. This is the essence of a tax shelter. By far the best way to eliminate tax shelters is to move to a single coherent investment incentive.

Tax designers have developed a complete, coherent system based on personal deductions for saving. This is called the cash-flow consumption tax. Under such a system, businesses pay no taxes. Households file complex returns that account for all the inflows and outflows of cash—the base of the tax is the residual spent on consumption. The cash-flow tax is vastly more complicated and much harder to administer than any form of value-added tax.

The central issue in tax reform in the coming year will be the choice between evolving toward a VAT, on the one hand, or toward a cash-flow tax, on the other hand. Tax reform in recent years has taken steps in both directions, increasing the likelihood of conflicts that create tax shelters that exploit both investment and saving incentives and gain inefficient subsidies. We have been adding investment incentives and saving incentives and thus worsening opportunities for tax shelters without coordination.

In my view, we should move purposely toward the American VAT. The reductions in the dividend and capital gains taxes adopted last year were important steps in that direction. We made the right choice by reducing the personal rates on these types of income rather than reducing the corporate rates.

The next step should be the elimination of all personal taxation of dividends and business capital gains. The public needs to be educated that these types of income have already been taxed at the business level. Removing personal taxation is not a giveaway to the rich, because the tax on these types of income has already been paid, at the top tax rate, at the business level. The corporate tax is a withholding tax.

Another important step is the rationalization of interest taxation. In some ways this step is easier, because the removal of interest deductions raises more revenue than is lost from removing taxation of interest at the personal level. The decrease in business interest deductions could be offset by an increase in depreciation, as I will discuss shortly. To avoid dislocations, certain transition rules would be needed. I will not try to spell these out here.

Of course, the big issue in interest taxation and deductions is home mortgage interest. Even an ivory tower dweller like me knows that the mortgage deduction is sacrosanct. The deduction could be retained in the American VAT setting if there were a special corresponding tax on mortgage interest receipts that recaptured the tax lost from the deduction and maintained the VAT principle overall. Lenders would receive a small incentive to offer alternative mortgages at lower rates that lacked the privilege of interest deduction. The interest on these mortgages would not be taxed when received by the lender. Eventually, Americans would be weaned of deductible-interest mortgages.

At the same time that we are moving the taxation of all business income to the business and limiting personal taxation to earnings, we should phase in improvements in depreciation of plant and equipment. After a period of a decade or so, all plant and equipment should be written off for tax purposes in the year of purchase, in accord with the principle of the VAT. During the period of transition, depreciation and write-offs will be higher than normal, because we will be honoring past commitments to depreciation at the same time that new investment is written off immediately.

At the end of this process, we will have created the American VAT. The additional revenue from plugging existing loopholes will permit a top tax rate of about 25 percent for both the business and personal taxes. We will achieve the four key goals of simplification, uniform, powerful incentives for capital formation, progressive distribution of the tax burden, and economic efficiency.

Let me conclude with a few remarks about what we should not do. We should not consider a national sales tax—it is an administrative nightmare. We should not consider a European VAT—it is not progressive. We should not expand saving incentives at the personal level or make any other changes that anticipate moving to a cash-flow consumption tax—it too is an administrative nightmare. The progressive American VAT is the desirable goal of tax reform.

Chairman NUSSLE. Thank you, Dr. Hall.

Dr. Steuerle, welcome back to the Budget Committee. We are pleased to receive your testimony.

STATEMENT OF C. EUGENE STEUERLE

Mr. STEUERLE. Thank you, Mr. Chairman, and members of the committee.

I appreciate the time you are giving to us, especially given we have moved well into the afternoon. In fact, I remember one time when I was called to testify for the Senate Finance Committee and it was 11:55 a.m. Senator Moynihan was the Chair and the lone Member left in the room and he sat up there and said, “Well, it is 11:55 a.m. and I would like to end at 12 p.m." And there were five of us to go. You haven't done that to us and I appreciate it.

Let me also comment that this is one of my favorite congressional committees before which to testify because you examinine issues in-depth in ways I find commendable.

Today, the topic is tax reform, that ever elusive elf that is beginning to again charm us a bit. Because of my background as an original organizer and economic coordinator of the tax reform effort of Treasury that led to the Tax Reform Act of 1986, you have asked me to reflect on some of the lessons from that period as well as on what might make reform possible again.

I suppose if I have any basic message to you, it is probably consistent with my fellow panelists, but I am not sure it is consistent with all the previous discussion: it is that systematic tax reform is actually hard work. It is very, very hard work, requires substantial leadership and requires a well thought out vision. I have three examples that I will give you today and there are further examples in my testimony.

The first one has to with the fact that systematic reform basically creates identifiable losers. Unlike simple tax cuts or simple expenditure increases, when you do tax reform you are really systematically creating winners and losers and some of those are going to be identifiable.

The second issue is that reforming the tax system requires attention to a whole myriad of issues, housing policy, pension policy, charitable policy, wage subsidy policy. I could go on and on because all of these are in the Tax Code. Whether we want them in the Tax Code or not, we now have to deal with them.

The third point along these lines is that many taxpayers now face tax rates of 50–100 percent because they face all sorts of implicit income tax systems. Those are due largely to the phaseouts of all sorts of benefits. Some benefits are in the tax system, such as the earned income credit or education subsidies, the tax system, or the phase out of the child credit and the dependent exemption. We also phase out food stamps and TANF and other sorts of benefits. The phase-outs are all based on income, so you still have a system of income accounting and very high tax rates that apply to these taxpayers. Now to a bit more detail.

My first point was unlike simple tax cuts or expenditure increases, systematic tax reform creates identifiable losers. If you look at a couple of the figures I have attached to my testimony, the first one show phase-outs of a variety of programs. A few of them are only in the tax system; to these I have added ones that are not directly in the income tax system but rely upon income accounting to be phased out.

If you look at the educational subsidies alone, you will see that you already have three of them in the tax system. There are more that are being proposed. In trying to reform those, I think all of us agree one educational incentive or two educational incentives would be a lot better than three in the tax system and Pell Grants in the direct expenditures system. If we want to reform them and make them uniform, make them do what we think we want educational subsidies to do, we are going to create some losers along the way—these who basically got some extraordinary benefits out of that crazy quilt system we now have in place.

My second point was that reforming the tax system requires attention to an extraordinary range of issues. The simple point is that pension policy, health care policy, charitable giving policy, fiscal federalism policy toward State and local governments, education policy, as well as tax policies toward international transactions, depreciation, research and development, even local school construction, are all sitting there in the tax system. It is one thing to say we do not want them in the tax system. But if we are going to reform that tax system, we have to address every one of these items.

As coordinator of the tax reform effort back in Treasury in 1984, I divided tax issues into 20 modules and those 20 modules each had at least 10 or 12 items in them. And all of those 200 or 300 items had to be examined if you were going to do tax reform. You cannot get around the issue. Somebody could conclude, "I do not care if we cut back on this deduction or credit, I do not care if we eliminate it," but you still have to make that choice.

To give you a simple example, conversion of an income tax to a pure consumption tax would remove the incentive for pensions. In fact, you have a number of Republican as well as Democratic members who are now concerned if we go too far in making unlimited IRA deductions, for instance, whether we will have an incentive for pensions. You may agree with that choice, you may not agree with that, but it is an issue that has to be dealt with.

My third point was that high tax rates distort behavior. But if we really want to deal with high tax rates, we really have to be honest about where they are now coming from. And they are really not coming from taxes on very high income people, although they do apply to some high income people.

We have now moved down that very high tax rate system—I am talking about marginal tax rates, the tax rate that applies to the next dollar of earnings or investment—to many low and middle income taxpayer. And if you look again at Figure 2 in my graph, I show you a variety of marginal tax rates often at 50 or 100 percent of income, as people phase out of earned income credits, phase-out of educational benefits, phase out of TANF, phase out of food stamps, and have Medicaid eliminated if they earn one more dollar of income, all of these systems where we have created these implicit income taxes, have to be dealt with at the same time.

Let me turn, in my final minute, to the possibility of tax reform and the lessons that we might have from history. While it is true that tax reform is very hard work, it is equally true that opportunity is important. If one looks back historically at when we have had major systematic tax reform, there are probably three instances that stand out in the post-World War II period. Those are 1954, 1969, and 1986. Looking closely at those three efforts, what we find in every case is that there was broad bipartisan support for what took place. I will give you a couple of examples.

In 1969, the tax reform that took place under President Nixon was largely developed by the Treasury Department under President Johnson. And hardly a beat was skipped as, in a bipartisan way, the Congress and the President agreed to move on to deal with those issues.

In 1986, people may remember a little better the agreement of Chairman Rostenkowski with President Reagan: Chairman Rostenkowski would be allowed to design tax reform, that is, take up the President's proposal, and President Reagan would not criticize the Democratic House while they were undertaking that effort. Those types of bipartisan efforts are vital.

Now I cannot speak to what will lead to bipartisan consensus or cooperation today. I do see in the current laws an opportunity. One set of opportunities is just simply created by the problems we know we have to deal with, such as the growth in tax shelters. It is a different type of tax shelter, but we have to deal with it again today. The other example is the movement of tens of millions of taxpayers onto the Alternative Minimum Tax. I think both political parties are ready to recognize that we have to do something about it. Right now, they are not willing to pay the cost, but we all recognize that something is going to have to be done. It may be the reform of tax shelters and reform of the Alternative Minimum Tax that is the hearse upon which broader tax reform rides.

So, in summary, I think there are many gains in efficiency equity and simplicity that derive from systematic tax reform. However, to achieve these gains requires attention to many details. Tax reform efforts have often failed. But they have also succeeded on occasion, especially when rising problems created the opportunity and demand for reform and tough issues were tackled in a spirit of bipartisan cooperation. Thank you.

[The prepared statement and attached material of C. Eugene Steuerle follows:]

PREPARED STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, THE URBAN INSTITUTE, CO-DIRECTOR, THE TAX POLICY CENTER

Any opinions expressed herein are solely the author's and should not be attributed to any of the organizations with which he is associated.

TAX REFORM: PROSPECTS AND POSSIBILITIES

Mr. Chairman and members of the committee: Thank you for the opportunity to testify before the House Budget Committee—one of my favorite Congressional committees because of its continual efforts to examine issues in depth. Today the topic is tax reform, that ever elusive elf that is beginning to tease us again with its potential charm. Because of my background as the original organizer and economic coordinator of the Treasury's tax reform effort that led to the Tax Reform Act of 1986, you have asked that I reflect on some of the lessons from that period and on what might make reform possible again.

As much as I believe in this elf and the possibilities it offers for improving economic and national well-being, I am also wary about thinking about it in mystical or magical terms. I have no doubt that we can create a better tax system that can improve equity, increase economic efficiency, and simplify our lives. Nonetheless, if I have any basic message, it is that systematic tax reform—if it is to achieve true economic gains—is hard work, very hard work, requiring substantial leadership and a well-thought out vision. Here are some further reflections on that theme:

Unlike simple tax cuts or expenditure increases, systematic reform creates identifiable losers. Systematic reform recognizes important societal trade-offs, and trade-offs mean that something must be given up to achieve something better. Simple increases in expenditures or reductions in tax only hide elsewhere—often in future changes—those who pay for the initial changes. The only way to create no losers in tax and budget policy is to maintain current law. It is a fundamental law of budget economics and accounting that almost any budget change has an impact on the other side of the ledger. Systematic reform usually makes those losers more identifiable up front.

• Example. My Urban Institute colleague, Adam Carasso, and I have suggested combining the child credit and the Earned Income Tax Credit, which are needlessly separated. However, they have different maximum ages for eligibility. Taking an average maximum age would reduce the availability of the EITC for some college kids, thereby creating some losers. Alternatively, extending upward the child credit to the maximum age of the EITC makes the costs skyrocket, and these must be covered somehow, perhaps by reducing subsidies in some other part of the reform package.

• Example: There are many interactions among the three higher education incentives in the tax laws, as well as with Pell grants and other direct expenditures. Simplifying the law by combining them into one program or even two is likely to simplify taxes, as well as lead to a more efficient and productive use of educational incentives. But it is also likely to lead to some losers if no more revenue is made available since the combined program is likely to more rationally relate assistance to need (see Figure 1).

• Example: Saving incentives, if they are to work, must treat consistently both sides of the ledger: negative, as well as positive saving; interest payments as well as interest receipts. There are dozens of incentives today for making deposits that can be financed by borrowing, thus allowing taxpayers to arbitrage the tax system—to save taxes as if they had saved on net when they have not.

Reforming the tax system requires attention to an extraordinary range of policy issues. Being for tax reform is like being for expenditure reform, a level of generality that lacks enough specifics to give it any real meaning. There are literally hundreds of policies in play. When I set up the organization of the Treasury's 1984 tax reform study, I divided issues into roughly twenty different modules, each of which had to be examined by a team. Reforming taxes requires deciding upon policies for housing, pensions, healthcare (especially for the non-elderly), wage subsidies, charitable giving, fiscal federalism among national, State and local governments, and education, as well as tax policies for international transactions, depreciation, research and development, empowerment and enterprise zones, and local school construction—to mention only a few. One can't dodge these issues. Even when reform attempts to be more narrowly constructed so as to deal with only some of them, many stragglers force their way onto the agenda because they interact with the ones that are targeted.

• Example: The conversion of an income tax to a consumption tax must deal with the incentives for separately putting aside money for pensions and what retirement policy Congress wants to put into place.

• Example: Many programs, including tax subsidies and direct expenditures, use income accounting to determine eligibility for benefits. Therefore, elimination of income accounting for the direct income tax would not remove the requirements for income reporting and correct bookkeeping for many other purposes.

• Example: Congress has put in place a law that will soon provide an increase in tax subsidies of more than $25 billion annually for the employee exclusion for employer-provided health care. Existing subsidies are sufficient to encourage insurance purchase; the additional subsidies (from the uncapped preference) encourage the purchase of higher cost insurance. The encouragement to purchase high cost insurance leads to higher costs, which, in turn, discourages some employees and employers from offering or buying insurance. The net result of these additional subsidies, therefore, is to increase the number of uninsured.

High tax rates distort behavior, but they are hidden in many tax subsidies, alternative taxes, and direct expenditure programs. A few decades ago one could approximate the marginal tax rate for earning an additional dollar simply by looking at the statutory income tax rate structure. No longer. Economists now must look to the ways that alternative tax and subsidy schemes create their own implicit tax systems. Often these additional tax rates derive from the way that benefits are phased out as one's income rises.

• Example: The earned income tax credit phases out as income grows. So do many other tax subsidies, such as those for higher education. So do most transfer programs, such as food stamps. The total marginal tax rate (combining explicit and implicit taxes) for many households today, it often rises above 50 percent and frequently reaches 100 percent (see Figure 2).

• Example: Partly because of the very high tax rate on additional earnings from many tax subsidies and direct expenditure programs, most couples today face significant marriage penalties—often 10 to 20 percent, sometimes even 50 percent, of their combined income. Thus, a person making $10,000 a year could, by marrying someone making $30,000, potentially lose earned income tax credits, higher education subsidies, food stamps, housing vouchers, Medicaid, and child care allowances.

Systematic reform requires a truce from the fights over progressivity and higher statutory tax rates. Let me be clear: both progressivity and low tax rates or lean government are both worthy economic principles, even if emphasized differently on the two sides of the Congressional aisle. All families require more from their more affluent and able members, and high tax rates do distort behavior. Reform is very difficult to achieve when some advocates will fall on their swords over progressivity, and others do likewise over statutory tax rates. I am trying to make an economic, not political point: when one consideration alone is allowed to trump all others, and issues like simplicity or equal justice (equal treatment of equals) always get shoved to the side, there is a higher-than-necessary cost of taxation to the economy as a whole.

- Example: The alternative minimum tax (AMT) raises marginal and average tax rates, but few are willing to fold it into the regular rate schedule.
- Example: During the initial stages of 1984–86 tax reform process, progressivity was not an issue when deciding whether to remove, amend, or keep any particular item of tax preference. A bad preference didn't have to be kept because it was progressive, and a good preference didn't have to be removed because it was regressive. At the end of the process of choosing the tax base, Treasury would determine overall proposed progressivity of the tax system (in that case, approximating current law) by adjusting the statutory rate schedule.

THE POSSIBILITIES FOR TAX REFORM: SOME LESSONS FROM HISTORY

While it is true that reform is hard work, and equally true that opportunity is important, it is mistaken to believe that many instances of failure were due solely to the absence of opportunity. Instead, the process itself was often ill-conceived and poorly carried out. Still, while history warns us that attempts at systematic reform often failed, there are notable exceptions. For modern examples of systematic reform, tax bills enacted in 1954, 1969, and 1986 stand out. (Interestingly, if we follow that trend for significant reform about every 15 to 17 years, then we are about due right now.) The difficulties of reform I noted above should not deter us. Right before the Tax Reform Act of 1986, attempts at major reform had failed so many times that some writers were beginning to call it the impossible dream.

All three cases of significant tax reform involved both a felt need to act and bipartisan cooperation and bipartisan agreement on the need to move forward and to work together. The 1954 reform centered around codifying and simplifying the much more complex system that had grown up in World War II and its aftermath. Wilbur Mills, as chair of Ways and Means, exercised substantial leadership, Congressional support was quite bipartisan, and President Dwight Eisenhower approved the legislation. The 1969 reform, interestingly enough, began to be developed in 1968 under President Johnson and arose partly because of Treasury reports on abuses by foundations and on ways that wealthy taxpayers avoided paying any tax. Hardly a beat was missed when Treasury moved to Republican hands in the Nixon Administration; the work continued, eventually leading to the Tax Reform Act of 1969. In the efforts leading to the Tax Reform Act of 1986, a Treasury study galvanized support by at least some conservatives and some liberals, in no small part because of the growing use of the tax shelters of the day and because the poor increasingly were being made subject to income taxation. President Reagan and Dan Rostenkowski, chair of the Ways and Means Committee, reached an agreement not to criticize each other as the Democratic House took up what had now become the Republican President's proposal.

I cannot speak to what will lead to bipartisan cooperation today. I will state that one trend over the last couple of decades is disturbing: the dearth of useful published studies from the executive branch—in particular, the Treasury Department and the Office of Management and Budget—about problems that need to be addressed. But they are still good departments, so the potential is there. However, I do believe that there is current opportunity—an opportunity, if one wants, that derives, as in the past, from growing problems that need to be addressed. In this case, the complexity of the system has become even more overwhelming, and few, if any, understand what the tax system means or how it works. The scheduled movement of tens of millions of taxpayers onto the Alternative Minimum Tax is more of a political than economic problem, but the need to address it provides a catalyst for broader reform. Alternatively, the requirement to get the deficit under control also presents an opportunity to return toward base broadening (which in most cases is equivalent to a reduction in spending), as was done under President Reagan.

ONE WAY OF VIEWING TAX REFORM ISSUES

At the risk of oversimplification, tax reform issues can roughly be compartmentalized into those affecting three groups: moderate-, middle-, and higher-income taxpayers. Although there is much overlap, the issues affecting each group are often very different.

For moderate-income taxpayers, the most important tax rates derive from the phase-outs of benefit programs, including the EITC, and from the Social Security tax (which, for almost everyone for some time to come, is more than offset by the insurance value of Social Security and Medicare benefits). My work with Adam Carasso shows that many moderate- and middle-income taxpayers face combined tax rates from the phase out of EITC, Food Stamps, Medicaid and so forth of 100 percent or more for much of their earnings. Many also face enormous marriage penalties.

Some of these issues relate to provisions in the tax Code, such as the EITC and educational subsidies; some to other programs. To the extent that high tax rates distort economic behavior, it is now to the moderate-income taxpayer that we should devote our attention. Meanwhile, filing for the EITC has itself become complex, and most low-income taxpayers face more complex tax returns than many at higher income levels.

For middle-income taxpayers, combined tax rates continue to be high because of the phase-out of benefits, in this case stretching into such issues as the phase-out of educational benefits for post-secondary education programs. The middle-class gathers many benefits from dozens of exclusions, deductions, and credits in the tax system. Sometimes reformers look first to itemized deductions, but there are many other sources of preference. The number of saving incentives and retirement plan options not only adds complexity to that system; the cost of all the intermediaries—accountants, financial advisors, human resource personnel, insurance salespeople, lawyers—figuring out the tax law reduces the net return available from that saving.

For higher-income taxpayers, the issues often surround the taxation of capital income. In truth, the tax system at that income level has evolved in fitful stages, with any way to tax the rich often advocated on one side and any way to reduce their taxes advocated on the other. Much consolidation and integration could be considered, regardless of whether effective marginal tax rates are increased or reduced. An extremely important issue at higher income levels and for business is whether, for a given level of revenue collection, the tax system should favor existing wealth or new wealth. Under the Reagan tax reform, Treasury argued that lower rates were preferable to tax breaks because the latter tended to favor existing business over new business (which often couldn't generate enough taxable income to make use of special tax breaks). The alternative minimum tax started out also as a high-income tax issue but has evolved quickly downward to the middle class.

This tri-level view of the system is quite simplified and leaves to the side many issues. My main purpose in presenting it is to recognize that fixing one part often tells us very little about what to do with the other parts. One might fix up the EITC and tax rates facing low-income taxpayers without doing much about all the deductions and exclusions affecting the middle class; likewise, one might tackle those middle-class issues without considering how capital and business income is taxed, especially among those at higher incomes.

SUMMARY

In summary, the gains in efficiency, equity, and simplicity from systematic tax reform could be substantial. However, to achieve those gains requires attention to many details. Tax reform efforts have failed often, but they have also succeeded, especially when rising problems created the opportunity and demand for reform, and tough issues were tackled in a spirit of bipartisan cooperation.

Chairman NUSSLE. Thank you. Mr. Spratt.

Mr. SPRATT. Let me direct your attention, first, to the sales tax. And Mr. Gale, if you could amplify a couple of things you touched upon that would be helpful. For example, let me just take the basics. Because the advocates of H.R. 25, the Americans for Fair Tax, propose to repeal the individual income tax and the corporate income tax, and the payroll tax, and the gift and estate tax, they have got a huge amount of revenue to make up with the sales tax. Consequently, they have to have a very substantial and inclusive tax base upon which to apply the sales tax.

Am I reading your article and their description of the bill correctly to state, first of all, that State and local expenditures would be among the things that would be subject to taxation?

Mr. GALE. Yes. The bill would tax State and local government spending, which would be a source of revenue for the Federal Government. That is essentially placing an unfunded mandate on State and local governments that runs into a couple hundred billion dollars a year.

Mr. SPRATT. Now, are you taking this at face value when you try to derive what you believe the correct rate must be in order to replace the revenues repealed? Are you simply assuming this tax will be levied and collected on all State and local expenditures?

Mr. GALE. There are two issues here. One is that if you look at total personal consumption expenditures in the national income accounts, it includes State sales taxes. So if you buy something for $1 and you pay a 5 cent sales tax, that is $1.05 of personal consumption. I take out that 5 cents.

So I calculate this Federal sales tax on the dollar itself, and I do not include State and local purchases in the tax base. I also do not include Federal purchases in the tax base for the simple reason that the Federal Government cannot raise money on a net basis by taxing itself, and that is another misconception in the whole H.R. 25 world.

Mr. SPRATT. Let me go back to the beginning. First of all, they acknowledge that the tax rate that most ordinary citizens would consider the understandable rate is 30 percent.

Mr. GALE. Right.

Mr. SPRATT. That means that if I buy a shirt for $10.00, I will pay $13.00 for it; therefore the tax is 30 percent.

Mr. GALE. Right.

Mr. SPRATT. The 23 percent rate is derived by treating the tax, the $3.00, as a percent of the end price with tax included.

Mr. GALE. Right.

Mr. SPRATT. And what you are say is when you are looking at the revenues derived from this system, if they include State and local property taxes, you are treating this as 30 percent of the tax base? The 30 percent of State and local expenditures would be included in Federal Government's tax take?

Mr. GALE. No. My 60 percent calculation is based on the assumption that the Federal sales tax does not include State sales tax in the base.

Mr. SPRATT. State expenditures?

Mr. GALE. And that it does not include State expenditures.

Mr. SPRATT. OK. So you have to make up for it by raising the rate?

Mr. GALE. Right.

Mr. SPRATT. OK. Do you think that is impractical, unconstitutional?

Mr. GALE. I do not know about the Constitutional aspects of it. I am certain a Constitutional challenge would be raised somewhere along the way. But in terms of the plausibility of the tax base, there is already going to be two issues. One is that the States are going to feel impinged upon, because historically sales taxes have always been their province and they do not want the Federal Government moving in on them.

The other thing is that if we eliminated the Federal income tax and create a sales tax, the States are going to have no choice but to switch over and create a sales tax as well. So the total sales tax that people are going to face is the Federal tax, the 60 percent, plus existing State sales taxes, plus the cost of converting existing State income taxes into sales taxes. So the combined Federal-State rate would be something like 80 percent rather than 60 percent. And that is the thing that has to get collected on a voluntary basis with no cross reporting.

Mr. SPRATT. Yes. And in addition to levying a tax on State and local government expenditures in their proposal, their proposal will also levy the same sales tax on all Federal expenditures, which you just mentioned. So you have the oddity of the Federal Government collecting taxes with one hand and spending the money with the other hand. It is a wash and you have questions why you even put yourself to the effort.

But as it turns out, you have detected a major mathematical miscalculation which grossly understates the rate because of the way they treated the collection and dispersement of that tax. Could you explain that a little more completely than you did in your testimony?

Mr. GALE. Sure. Normally, we look at revenue neutral tax plans. If we were going to take out the income tax and put in a flat tax, we would look at a revenue neutral tax plan. That is fine in that case because the flat tax taxes at the same point in the economic process as the income tax does. The sales tax, though, does not. It taxes at a different point. It puts a tax on the retail sale.

So, there is an issue about what happens to the price level when you switch to a retail sales tax. Therefore, a consistent plan has to be both revenue neutral and budget neutral. And the reason it is an issue is because the price has changed and Federal spending has to change.

So you have to make some assumption about what happens to the price level, and you have to make the same assumption when you look at how much money the Government is going to raise from the tax and how much spending the Government is going to have to do to maintain the real value of the services that it currently provides. And they did not do that.

When they calculated how much revenue they needed, they assumed the price level would stay constant. When they calculated how much spending the Government would have to do, they assumed the price level would fall. That is a big difference. If you think of spending as two or three and a half a trillion dollars, you are talking about 20 or 25 percent of that, that is a half a trillion dollars.

Mr. SPRATT. How big a difference is this discrepancy of treatment?

Mr. GALE. In terms of the sales tax—well, it depends on what you assume about all the other things. But that alone is basically 5 to 10 percentage points in the sales tax rate.

Mr. SPRATT. Now, do you correct for this, when you restate the rate, do you correct for this by assuming that the Government would be paying the unadjusted price level, that it would be collecting the tax on the unadjusted price level and buying at that level also?

Mr. GALE. You get the same answer whether you assume that prices are constant in both cases or prices fall in both cases. As long as you make a consistent assumption, it does not affect any of the results, like the required tax rate, the distributional effects, et cetera. The only issue is you cannot make an inconsistent assumption or you are basically cheating.

Mr. SPRATT. We had some charts earlier that showed that there were no exemptions. Are there any exemptions in H.R. 25?

Mr. GALE. Right. Just to clarify that chart, I am sure it referred to product exemptions, not to personal exemptions. H.R. 25 and the numbers in there had demogrants built into them.

Mr. SPRATT. Which are rebates.

Mr. GALE. Rebates, right. H.R. 25 has a limited number of exemptions. Education is one of them. Some portion of foreign travel is another. But I think education is the biggest. And there is some consensus that to the extent that education is an investment and not consumption, it is appropriate to exempt it from a retail sales base.

Mr. SPRATT. One of the attractions here is that allegedly you get rid of the Internal Revenue Service. And in our view, one of the ways that you would lure attention away from the real distribution of this tax is by holding out the phenomenal prospect of wiping out the Internal Revenue Service. Actually, there is a fair amount of complexity in what superficially seems a simple bill.

As I understand it, first of all, America's shopkeepers, merchants would become the tax collectors for this tax. We are talking about a couple trillion dollars. So they would have to be policed pretty carefully in the reporting and transmission of the tax to the Government. Secondly, as I understood it from reading your article, not theirs, a business would pay a tax on intermediate or component goods and materials, not end prices or end goods, but on intermediate goods and then apply for a rebate of that tax, which would be a complication.

And then, of course, you have got demigrants and who qualifies for it. You may have, as you point out in one of your articles, two families living in the same household, you may have a mother-in-law or someone who is older who claims that she is a separate entitlement to the demigrant. You have got that complication. Politically, there are bound to be exemptions. And then you have got the layer of different sales taxes all over the country. Different municipalities and States have certain exemptions.

So all of those complications bedevil this particular tax and make it a lot more complex than it does seem on its label. Would you agree with that?

Mr. GALE. Absolutely. If the demogrant is based only on the poverty thresholds, every single married couple in the country would face a marriage penalty.

Mr. SPRATT. It would require also some kind of report or some kind of an application, would it not?

Mr. GALE. That is right. Yes. Administering a demogrant for 270 million people is not a simple thing. The States, by the way, do not have demogrants because they are complicated to administer. Family circumstances change. I was surprised to learn a couple years ago when I wrote a paper with a Treasury Department employee, Janet Holtzblat, about how complicated it is to keep track of family arrangements for tax purposes. And that would be an issue with the demogrant. The fact that no agency does this worldwide is telling.

Mr. SPRATT. Tells you why, yes. Here is the chart that we showed earlier which indicates the differential in sales taxes paid as opposed to previously paid income taxes, according to what your consumption level is. This assumes no exemptions, but it does assume a demogrant?

Mr. GALE. Yes.

Mr. SPRATT. A demogrant but no exemptions. And as you can see, for a taxpayer in a household consuming in the range of $27,000 to $36,000, the sales tax increase would be 59 percent more than the income taxes paid; 38 percent for the next income bracket. Really, you have got to get about over $135,000 in total consumption before this tax gets to be an advantage to you. Is this consistent with your understanding and what you have done also in distributional analyses?

And I put that as a final question to the whole panel. Is this consistent with your own perception of what a sales tax like H.R. 25, or the American Fair Tax proposal, what its impact and instance would be?

Mr. GALE. It is certainly consistent with mine. Let me just note, this study bases it on annual consumption, so it is not subject to the criticisms of looking at annual income. The second thing to note is this study was actually particularly funded by Americans for Fair Taxation. Now that I am sitting up here I can see the source. The Feehberg, Matussi, Poterba article was partially financed by the Americans for Fair Taxation, which is the group that is pushing this tax proposal. This study shows that the sales tax is regressive relative to the current system. The estimates that I have done using the Tax Policy Center model are not quite at as a developed stage as the Feeberg, Matsussi, Peterba estimates, but they generate relatively consistent results.

Mr. SPRATT. Dr. Steuerle, Dr. Hall, any comments you would care to make?

Mr. STEUERLE. Mr. Spratt, I think the panel here, the three of us, would be in uniform agreement on if one wants to move toward a consumption tax, two things. One is there are ways to do it, or move partially toward it, that could retain progressivity. However, a pure flat tax, particularly a national retail sales tax, would not achieve that goal. And the type of distributional effect you see here would occur. Treasury, including Republican Treasuries have testified to that effect.

I guess there is one other comment I would like to make. Since my colleagues on this panel talked about the national retail sales tax in-depth, I did not include a lot in my testimony, but we are all in agreement as well as to the very difficult issues regarding administration, regardless of progressivity. One administrative issue that has not even come up here is the extent to which we would require customs officials to be enormously empowered to deal with cross-border transactions. Whereas, we have moved somewhat in the opposite direction in recent years by trying to reduce the requirements on customs officials lean toward collecting customs and more toward trying to get at illegal——

Mr. SPRATT. What you are touching upon here is what Dr. Hall touched upon in his testimony. Once your rate gets above 10 percent on a sales tax, there is an enormous opportunity, first, for legal avoidance, if you can possibly construe your transaction that way, and then second, just for tax evasion.

Mr. STEUERLE. We have also got the issue of how to deal with goods versus services, which is a problem that the States have right now. There are issues having to do with how to deal with intermediate goods versus final goods, and when a particular good is consumption versus whether it actually used for production purposes. All of these issues do come into play.

Mr. SPRATT. It is not simple. Dr. Hall.

Mr. HALL. I would say two issues here. One is, it is just purely an administrative issue whether to structure something as a national sales tax or a value-added tax. The value-added tax is the proven principle for collecting what has exactly the same substantive effects as a sales tax; that is, it is a consumption tax. The other issue is, how do you design a system that is adequately and fairly progressive? The problem with H.R. 25 is that it has a very small demogrant and it has only a single bracket which applies to everybody. The result inevitably is going to be, as this picture shows, a shift in the distribution, probably a politically and morally unacceptable shift.

You need to design a better system. You can do that, especially in the value-added setting, and especially if you connect the zero bracket to people's earnings, which is what we have always done traditionally and it is the administratively practical way to do it. So you could take H.R. 25 and make some relatively small changes in it that would make it an effective consumption tax and one that was fair. It would not be a flat tax because it would have multiple brackets. But it would have all the other efficiency advantages and it would be administratively feasible. So, H.R. 25 has the right philosophy but it needs some fine tuning, I would think. One is to get away from the sales tax principle and back to the value-added principle. And the other is to make it more progressive.

Mr. SPRATT. Any further comments from the panel? Mr. Gale, do you have a reaction to that, that you could fine tune H.R. 25?

Mr. GALE. Well, I guess it is a matter of judgment whether it is fine tuning or——

Mr. SPRATT. Complete revamping.

Mr. GALE. Yes. Dumping it and starting over. But Bob is right, the economic structure of a sales tax and a value-added tax are the same, but the administrative stuff is completely different. And the administrative issues are the central issue with the national retail sales tax.

Mr. SPRATT. Thank you very much, all three of you.

Chairman NUSSLE. Mr. Brown, do you have questions? Mr. Brown is recognized.

Mr. BROWN. Thank you, Mr. Chairman. We have gone through three different panels now, so we have gotten I guess three different ideas of how the process might work. I guess if we look at a different method to collect taxes from the citizens, which I guess is our primary goal, under the current system, I believe we collect tax from about anywhere from 53–57 percent of our population today. And so if we went to some flat tax or some value-added tax or sales tax, we would shift some of that tax burden back to I guess the poorest people. Is that a correct assumption?

Mr. HALL. Not in a system that I would design. See, there are two separate issues. One is the structural issue of what kind of a tax you have. Is it a sales tax, is it a value-added tax, is it an income tax. You can take what I think, and I think this panel agrees, is the superior form; namely, the value-added tax, and then it is a policy decision that Congress would make as to who bears the burden of that.

If you wanted to retain the feature today which is that a significant fraction of the population either pays no tax or actually gets a credit back, that is important to understand, that could be built in and that would affect the rate. That is a design issue. There is nothing about adopting an efficient tax system like a value-added tax that prevents having it be as progressive as you want it to be. So that is something that you would decide. It is not something built in to this choice about tax reform. You can have tax reform and a highly progressive result in tax. That is the important message.

Mr. BROWN. Go ahead.

Mr. GALE. Just to add a little bit. The issues are you are moving from an income to a consumption tax, which is an inherently regressive move if you keep the rate structure the same. You are moving from a progressive rate to a flat rate, which is an inherently regressive move if you keep the tax base the same. Now having gone from a progressive income tax to a flat consumption tax, you are very likely to end up with a less progressive or a more regressive system. What Bob is saying is, in principle, you could take changes to restore that progressivity. But even if you do that, you will probably be hard-pressed to get the top 1 or 2 percent paying the same share as before. That is, because the value-added tax and the sales tax have a flat rate, it is very difficult to reach back up into the very top of the distribution and capture what they are paying, at least according to the estimates that I have read.

Mr. STEUERLE. Mr. Brown, in my testimony—I did not comment on it orally but it is in my written testimony—I had another way of dividing up these tax issues into what I am going to call moderate, middle, and high income tax issues. That, I think, helps a little bit. It is somewhat of a simplification. But a lot of the high income tax issues have to do with how progressive do we want the system to be and what do we want to collect from them. It also has to do with whether we could tax them, since a special portion of their income is in the form of capital income. If you decide you want to tax consumption more and income less, how can you retain progressivity. And those are the issues which we have actually talked about.

At the middle income levels, a lot of the issues have to do with deductions and exclusions and credits. It used to be that a lot of those applied more at high income levels. Now they are very much of a middle class type of issue. And a lot of reform proposals have as part of their implicit structure trying to get rid of all of those subsidies in the system, some of which I, personally, would get rid of, some of them I probably would not. But there is that set of issues.

At the bottom end, the issue is not so much how much do we tax the rich. It is the many ways we redistribute to those who are low or moderate income. The earned income credit even in the budget itself is actually treated for the most part as an expenditure. It is actually treated as a direct expenditure to the extent it exceeds tax liability. Thus, it really is a spending program administered by the IRS. Now there are reasons you probably want to administer that particular spending program by the IRS. That is largely because it depends on the wage statement of the employer. And so there is some efficiency in having the IRS do some of the administration. Regardless of its problems, it would be hard for HHS to administer it.

With low income issues, it is not even clear to me that one wants to be dealing only with the tax system itself. Most of the issues there are really spending issues. I realize that the subject at hand is tax reform. But at some level, when you start talking about redistribution, it is hard to just sit over here and only talk about a tax system and not also include earned income credit, which is a spending issue, or the educational subsidies, which are spending issues.

I do not know if that helps. But sometimes dividing the world into those three compartments helps us to realize that we have got to deal with all of them. You could solve the capital income issues perhaps to everybody's delight and not solve the middle income deduction issues. You could solve those middle income deduction issues and not solve the issue of whether you are redistributing what you really want to low and moderate income wage earners.

Mr. BROWN. Thank you. I think my time has expired.

Chairman NUSSLE. Mr. Scott.

Mr. SCOTT. Just following up on that. If you believe in a progressive tax system, is it fair to just assume that all of these will be a step backwards?

Mr. STEUERLE. No.

Mr. HALL. No.

Mr. GALE. Definitely not.

Mr. SCOTT. Which ones of these, in the likely way it would probably be enacted, it seems to me that all of them—you saw the chart up there with one of them—that all of them are going to be worse from a progressivity point of view than what we have. That is not true?

Mr. GALE. I think if you are looking at the range of realistic options, a move from a progressive income tax to a flat consumption tax is going to end up being less progressive than is currently.

Mr. SCOTT. Is anything we have discussed today more likely to be more progressive than what we have got?

Mr. GALE. No. I refer back to the discussion where Mr. Linder was saying you could add the EITC back in separately. OK. Obviously, you could do that in a sales tax. You could also expand it in an income tax. You could always add on more spending programs.

Mr. SCOTT. Or you could just leave things as they are.

Mr. GALE. That is right. My sense is that all of these programs will turn out less progressive than the current system.

Mr. SCOTT. Let me ask a couple of direct questions. On the flat tax, all the ones I have seen exclude capital gains, interest, and dividends. Is that right?

Mr. HALL. No. They are taxed at the business level. Representative Armey explained how that works. You have a business tax and you tax it at the source, at the business. When it flows to the individual, it is like——

Mr. SCOTT. Suppose you have a personal savings account and draw interest. Is that taxed under the flat tax since it is interest, unearned income?

Mr. HALL. Yes. Because the interest is no longer deductible at the business level. So it is taxed at the business level. We correct a big problem in the current tax system——

Mr. SCOTT. Wait a minute. I understood the flat tax not to include capital gains, interest, and dividends. If you have a savings account and get interest——

Mr. HALL. No. Congressman, that is not correct. There are two parts to it. There is a business tax and there is a personal tax. Under the personal tax, it is not taxed because it has already been taxed under the business tax. But there are two pieces to it. There is a business and a personal tax.

Mr. SCOTT. So, interest would be taxable. Is that what you are saying?

Mr. HALL. At the business level. It would no longer be deducted——

Mr. SCOTT. A personal savings account interest.

Mr. HALL. It would be taxed before it got to the savings account. The flow of income to the savings account would have tax already withheld from it before it got to that account. The holder of that account would not have to pay again because the tax would already have been paid.

Mr. SCOTT. A personal savings account, interest generated from a personal savings account would be taxed but would not be taxed?

Mr. HALL. It would be taxed at the business level, as I explained, before it got to the account.

Mr. SCOTT. OK. I made the cash in the business account. But once I stick it into the personal savings account and draw interest on that account, the interest would not be taxed or would be taxed?

Mr. HALL. It would be taxed at the business that generated that income in the first place.

Mr. SCOTT. The personal savings account——

Chairman NUSSLE. Use a bank as an example. OK? So it is a bank. You have a personal account at your bank. The bank pays the tax before the money goes into your account.

Mr. SCOTT. If I have a 4 percent——

Chairman NUSSLE. I am not arguing for it, I am just——

Mr. SCOTT. If I have, well, right now I guess it is about 2 percent savings account at the credit union and they pay me my little 2 percent, is that taxable?

Mr. HALL. It is not taxable to you because the tax has already been paid.

Mr. SCOTT. OK. Thank you. Under the national sales tax, you pay sales tax on the new house but not the old house, the new car but not the old car, used car, right? What about rent, do you pay tax on rent?

Mr. GALE. Renters would pay tax on their monthly rental payments.

Mr. SCOTT. So if the rent is $500 a month, what is the tax if this thing passes? Is it 60 percent?

Mr. GALE. If it replaces the whole Federal system, right.

Mr. SCOTT. My rent would go up from $500 a month to $800?

Mr. GALE. Yes.

Mr. SCOTT. Dr. Hall.

Mr. HALL. Please understand, Congressman, that I am not remotely an advocate of sales tax, and I have not done the calculations that Dr. Gale has done. So you might better address these questions to him. I am not prepared at this point to talk about a system that I do not believe in.

Mr. SCOTT. If you have a corporation that is subject to the alternative minimum tax for corporations and, in fact, did not pay any taxes and paid dividends out of cash flow because the generating cash flow would have so many deductions, loopholes, and everything else, the effective rate for the business of course would have been zero. They paid dividends. That would be zero, too. Is that right?

Mr. HALL. Do you mean under the current tax system?

Mr. SCOTT. No, under the flat tax.

Mr. HALL. Under the flat tax that would not exist because the situation you describe is generated by interest deductions and they would no longer be allowed.

Mr. SCOTT. Or depreciation?

Mr. HALL. Possibly. But then that is all done on a carry forward, carry backward basis. There is no business that it does not face the tax if the tax is uniform on business.

Mr. SCOTT. If you do not have a deduction for interest and the business has to pay interest, then they lost money.

Mr. HALL. Well, that is how a value-added tax works. There is no promise in a value-added tax that you—it is not a profit tax.

Mr. SCOTT. How do you have different brackets in a value-added tax if that is kind of a sales tax? How would you have different brackets?

Mr. HALL. By splitting the value-added tax into two pieces. You have got the business tax, on the one hand, and a personal tax, on the other. The two mesh together and form a value-added tax. But because the range part of it is put on the individual, then it can be sensitive to the individual's actual level of earnings. And that is how it is made progressive. This is the essential new idea in the original Howard Buskha plan and in a progressive non-flat tax version of it.

Mr. SCOTT. I yield back.

Chairman NUSSLE. Mr. Moran, do you have questions?

Mr. MORAN. Thank you, Mr. Chairman. I would like to explore this just a bit further with Mr. Hall. First of all, what tax would you pay on profit from investment in capital goods?

Mr. HALL. At the business or personal level?

Mr. MORAN. Well, both.

Mr. HALL. OK. The taxation of all business income is centralized in the business tax. So the base for the business tax is revenue minus cost, including wage costs, and minus investment in plant equipment. And what is left over is the base for that tax. Then with that tax collect, the flow of business income to the personal level is after tax income. It is not taxed again. That is the central idea here, is to get rid of the double taxation that currently exists. And you centralize it all at the business level. So you make sure that all business income is taxed exactly one. We get rid of the fact that lots of the business income is not ever taxed at all because of the interest deduction. And we get rid of the problem that some business income is taxed twice; first at the business, and second as dividends. We iron out all those problems and come up with a coherent tax exactly once system, which is the efficient system.

Mr. MORAN. It is efficient. My concern is the distribution of the tax burden. You would expect that of the Democratic Party. But it does seem as though it is the working class that are going to be paying a higher proportion than they are now. You do not think so?

Mr. HALL. No. That is a question of design. I am a life-long Democrat, Congressman, first of all, and I share your concern about the distribution. The distributional effect of this is something that you can design. When you pass a bill that gives us a value-added tax, you can decide who bears the burden of it. You can say that nobody under $75,000 a year pays any tax. You could make it a tax only on people above $75,000. Now the rate would have to be high, of course. But that is a decision that you make. It is not built into the system. That is a decision made right here. It is a design of the tax. You could, in particular, give the burden of the value-added tax across individuals, make it approximately the same as it is now. That would require keeping the earned income tax credit, for example, it would require keeping the features that basically excuse about half the population from paying any significant income tax. You could reproduce that. That is doable. There is nothing about tax reform that requires that you shift the burden of taxation. You can separately choose what that burden is.

Mr. MORAN. Both staff and I on our side want to know what the effective rate on income from capital would be if you take into account the fact that investment is expensed in your plan. I do want to ask Mr. Steuerle, can I get a short answer on that before the time expires.

Mr. STEUERLE. It is slightly complicated. The simple answer is, if you expense all business equipment, the tax on capital income is zero. However, there are ways of doing it where the zero tax essentially applies to what economists call the normal return as opposed to the extraordinary return; that is, if one gets an extraordinary return and you are taxing consumption tax, those people who get that extra layer of consumption would pay some additional tax. I realize that is a complication. The simple answer is you are moving closer to a zero rate of tax on the capital income.

However, to the extent you start at the nova, at the beginning, the basic argument for a consumption tax, which I think has legitimacy on both sides of the aisle, is the following: if you take a wage earner who saves, and you take a wage earner who does not save, and they both earn exactly the same amount of income and you tax them equally, but then the one who saves you start taxing again and again, you have taxed the saver more than you have the other. I think that is a perfectly legitimate argument.

The issue that comes up, and it is a difficult issue, I think, revolves around progressivity. We end up having in society a lot of people who are very big winners. We do not think they are winners because they have been saving and putting money in passbook accounts and earning 3 or 5 percent. They have often leveraged up people or dollars or have just been very lucky. In a winner-takes-all society, they have gotten there ahead of somebody else and they have made very, very large gains, often measured as capital income. Sometimes we do not know whether it is capital income or wage income. Now how do we tax those people at the same time. That is the difficulty. There is a fundamental equity argument for a consumption tax. But it seems to me there is a fundamental equity argument for taxing more some of the big winners in society. And that is what we are trying to grapple with.

Mr. MORAN. I do not think there is any of us that does not want a simpler, more understandable system, one that is less prone to evasion and to disproportionately benefitting based upon how much you can pay your accountants and tax lawyers and so on. But while we want simpler tax systems, we do not want systems that are not going to do a better job of distributing wealth.

We had a session last night, it was a Town Hall meeting, and there were several hundred people there who live in northern Virginia, where we live, Gene, and I do not know about the other panelists, but it was on home ownership. The reality is that if you do not own a home, you are never going to be economically self-sufficient. You cannot acquire economic self-sufficiency in this society unless you have an appreciating asset. Our tax laws are geared toward that. If you own a home, you get a mortgage deduction, you can borrow money, you can use it as collateral, et cetera. These folks, until they can afford a $400,000 home, they are swimming upstream. And we have got to find a system that is fairer to the working class. I do not think that the flat tax or the sales tax is going to accomplish that objective, not without a whole lot of manipulation. I guess we do not have enough time to explore that further, Mr. Chairman. They are well-meaning proposals. In reality, the net effect is not going to give us the kind of fairer society that we are looking for.

Mr. STEUERLE. May I just have a very short answer to that?

Mr. MORAN. Please.

Mr. STEUERLE. In both the case of home ownership and pensions, which are the main ways our current tax system actually favors an ownership society, we have had a great deal of difficulty in getting those incentives down to moderate income taxpayers. I could show you how the way the current system works for homeowners is to provide higher tax breaks to people who are upper-middle to higher income taxpayers. But particularly for some lower income taxpayers, it could raise housing prices enough and give few enough tax benefits that they actually come out behind. And this gets, as I said earlier, to the whole expenditure side of the budget. Because I could argue with you that the way we set up rental vouchers actually discourages home ownership.

So, this gets back to a point in my testimony, which was that if we want to deal with housing policy, we have got a lot of issues we have to address. I do not think Professor Hall or Dr. Gale would disagree that if you want to get into housing issues, you want to get into pension issues, you want to get into charitable contribution issues, we have a lot of work to do to figure out how we want to design each of those systems. There is no one reform fix that is going to make those problems magically go away.

Mr. MORAN. In our society, it is virtually impossible to become economically self-sufficient on earned income. You have got to have income that is in addition to your wage. It has got to be income off of investments or asset ownership, I agree. But let me look at your testimony more closely, Gene. I thank all three panelists for their thoughtful consideration of a very important issue.

Chairman NUSSLE. I thank the gentleman. And we will take more time. This has been a good discussion today and we will take more time. I think this has been a worthwhile discussion today and debate.

Picking up on the gentleman from Virginia's last comment, and I think it is the reason why so many are tempted by the national sales or consumption-based tax is exactly the point that the gentleman made, and that is, you are not going to get wealthy or you are not going to be more than just at some level of subsistence unless you are doing something more than just earning. I think that is the reason why they are looking at something that encourages more than just earning, and that is consumption. I wanted to ask the question, as economists, because I think, for me at least, it is a fundamental question, and that is, what is the best way to determine wealth? Or who should bear the burden, income or consumption? What is the best determinant on that? From an economic standpoint, how would you address that kind of a debate or that kind of a question? I will just throw it open. Dr. Gale, do you want to try and tackle that?

Mr. GALE. Sure. If you forget about bequests given and bequests received, the difference between income and consumption is just a timing issue. Your lifetime income will equal your lifetime consumption. Now, when I say just a timing issue, you know, the difference between life and death is just a timing issue, too.

I think in relatively standard but simple models, you will come out with the conclusion that consumption is the best measure of someone's lifetime ability to pay. Those models depend heavily on both a fully rational consumer and the absence of any constraints on people to borrow and lend money over time. When you start building in more realism, the fact is people cannot borrow across time the way they might like to. So they are sort of constrained by their current circumstances. They may not have the foresight, in fact, the whole pension system is based on the notion that they do not have the foresight to do planning on their own. The whole Social Security system is based on that notion. When you work those in, then you can get I think a reasonable argument that current income is also a useful indicator.

So my view is that it is not a clear-cut case either way and that, frankly, it makes sense to tax on the basis of both consumption and income for a variety of reasons, not just this underlying question, but general equity issues and general administrative issues. So I do not think it is a black and white issue. I am familiar with economic models and textbooks that say it is a black and white issue and that consumption is the measure of lifetime ability to pay. But I think in the real world it is a little more complicated and some combination of income and consumption is a reasonable measure.

Chairman NUSSLE. Dr. Hall, evidently you are my witness here today, and then I heard you are a lifetime Democrat, and I am shocked that I had the audacity to invite you here today. But barring that one oversight, let me ask you the same question.

Mr. HALL. I do not actually strongly disagree with what Bill said, except that I would put more enthusiasm on consumption. I think as a practical matter, when you get done, the best way to measure how someone is faring in this economy is by how much they have available to spend on all the different things they choose to spend on. That is not just an implication of our economic models. I think it has got a lot of common-sense. When you think about the wealthy, either wealthy because they have lots of wealth or wealthy because they earn a lot, they also consume a lot. And so I think that we would be well guided by a general philosophy, with some exceptions, but a general philosophy which says we can identify who the winners are in our society by those who consume a lot. And that is why I believe in a progressive consumption tax.

Chairman NUSSLE. Dr. Steuerle.

Mr. STEUERLE. Well, once again I think you are going to have fairly uniform agreement among the members of the panel. I think ideally my preferential way to tax would be on the basis of ability. Unfortunately, we cannot measure ability very well. Income or consumption are rough approximations we sometimes use. A case in point where neither works very well right now, in my view, is the extraordinary encouragement we have in our current tax and transfer system to retire people for the last third of their adult lives when we desperately need their productive capability to maintain our revenue base. And neither an income tax nor a consumption tax is fully getting at that issue.

So in the end, I guess if we cannot measure ability perfectly, it ends up that we often end up having to go to some sort of hybrid system. Even the people who advocate consumption taxes, I think, would say that when you get to all the implicit tax systems, they still would use income as a base. We are not going to give a millionaire's spouse food stamps, for instance, if her consumption is low.

So we say, no, we will phase out food stamps. Or forget about a millionaire with a low-earning spouse, just take any family. If their consumption is low, we say, no, we are going to have an asset test or we are going to have some sort of way of phasing out their benefit on the basis of income, not just consumption. So we are going to have these income tests in the system one way or the other—whether we are talking about low income people and phasing our their transfers, or whether we are trying to measure the ability of high income people.

Having said that, I made the case earlier, there is a strong equity argument for not double taxing the wage earner who happens to put money aside in savings. My difficulty in the current political context is that for the most part we tend to apply the consumption tax arguments to higher income people where it seems to me the issues are much more complex in terms of measuring their ability as opposed to moderate and middle income people where we could move much more toward a consumption tax base, give them that equity benefit if they save, and help them out better.

So the bottom line answer to your question is, I, too, think that we probably end up in some sort of hybrid system.

Chairman NUSSLE. The interesting thing about your answers—and I am not trying to argue with you, it is more just an observation—the interesting thing about your answers is that you all tend to, what I am hearing is that you tend to suggest and agree and suggest there are many who agree that consumption is a better way to determine somebody's ability to pay or as a determination of their burden in the overall community or society or Nation.

And yet two of you, in particular, I think, and maybe I am misunderstanding you, Dr. Hall, but my thought was you were trying to determine, even though you say it is consumption-driven, it is based off income, it is not based off consumption, it is based off your income.

And if that is true, then you say it is fairer—I guess I am trying to be a little bit argumentative here—but you say it is fairer to determine someone's burden by consumption. And yet Dr. Gale said it is a non-starter to determine a consumption-based tax as a starting point. And I hear at least Dr. Hall suggesting that the multiplier is income. So how do you rationalize those two points?

Mr. HALL. A value-added tax is just like a sales tax. It is a way of collecting tax revenue from the act of consumption. But the way I think about this is you start with a sales tax. That is obviously a consumption tax, everyone agrees on that. Then it is just an administrative change, it does not change the economic substance to go to a value-added tax. Then, to make a value-added tax progressive by using a wage-based system for creating an exemption and for creating brackets, you move it back another stage to the actual wage earner.

But it is very important to understand as a matter of economics, this is still a consumption tax. It is still taking advantage of the principle that you start off, and it is obvious in a sales tax, that even if you cannot measure people's consumption, you can tax consumption. You can tax consumption because you can just have people every time they buy something pay a tax. The value-added tax is just a different way to administer that.

Fundamentally, this whole consumption tax approach is based on this nice idea that you can tax consumption even if you cannot measure it at the individual level, which I would agree with. It is very hard to measure consumption at the individual level. It is easy to tax consumption without measuring it. That is the neat thing about a sales tax or a value-added tax, because you can tax it just by the fact that by choosing to consume, you choose to pay the tax. So it is a very neat principle.

Mr. GALE. I love simple tax systems on paper because they are so easy to understand and they look like they work just right. But in practice, if we try to tax income, a goodly portion of income is going to slip through. If we try to tax consumption, I think a goodly portion of consumption is going to slip through. So there are many advantages to having a system that taxes both, both from an administrative perspective and from an equity perspective. I tried to say that I think both are legitimate bases for taxation, consumption and income, and not that consumption was the measure and income was not.

Chairman NUSSLE. Do any of you want to try and tackle the issue of accuracy? Dr. Gale, you have in suggesting that there is a $500 billion error. What time period are you suggesting?

Mr. GALE. Per year.

Chairman NUSSLE. That is a year. OK. What other accuracy issues in scoring something that would be revenue neutral, so to speak, how accurate is the ability to call this revenue neutral, whether it is Joint Taxation, CBO, OMB, you, anyone else? And I am not trying to quibble with you. I am just asking, generally speaking, if we are going to make a change like this, how certain can we be about the ability for us to replace the revenue over a period of a year, a couple years, 5 years, et cetera?

Mr. GALE. The problem with doing that, the certainty in the sales tax, the bias is sort of all one direction. That is, you are likely to overstate how much revenue you would get, especially if you go with the assumptions in H.R. 25. The reason is, what H.R. 25 does is look at aggregate consumption in the national income and product accounts and says, basically, we are going to tax that.

We are going to subtract out education, we are going to subtract out something else, but we are going to tax that. Well, that is not a taxable concept. There is no form anyone fills out right now that is consumption. In contrast, the flat tax is based on actually understandable, used, current concepts. You can look at tax forms and see what people's taxes would be if you taxed wages, pensions, Social Security benefits. You can recalculate firms' tax returns if you have their—all the information needed on the flat tax is already reported on the tax form, is what I am saying. So there is a behavioral issue.

But you could get the purely static estimate in the flat tax in a fairly straightforward basis. There is no basis for doing that in a sales tax because people do not report aggregate consumption. What would happen is that a big chunk of what is reported as aggregate consumption would just not show up on any of the forms. And that is an uncertainty and it would make the required rate go up.

Chairman NUSSLE. Dr. Steuerle, do you want to tackle that?

Mr. STEUERLE. I would just add that I am a firm believer that if the questions are asked the right way, we have enormously talented staff at your Congressional Budget Office and at the Joint Committee on Taxation and at the Treasury who can help you answer the questions. It is not just a question of accuracy of revenues, it is also the accuracy of claims as to progressivity. These things can be measured. I am not saying there is one pure measure. But I think in terms of accuracy, these staffs can do a fairly good job.

Chairman NUSSLE. OK. Dr. Hall, do you have anything you want to add to this?

Mr. HALL. I think only that there is sort of a consensus in this panel that you cannot have a sales tax rate much above 10 percent. That is just illustrative of the fact that predicting what would actually happen with a sales tax is that actual revenue would be very disappointing relative to projected revenue.

Chairman NUSSLE. Not only the base, but also what the behavior would be?

Mr. HALL. Right. It is so difficult to get a sales tax to work because it is so easy for a buyer who is actually a final consumer to misrepresent themselves as an intermediate purchaser. The value-added tax has a built-in way of solving that problem. The sales tax does not. That is why Europe has value-added taxes. It is not sort of arbitrary, it is practical experience. And that is experience that we need to harness.

Mr. SPRATT. Mr. Chairman, could I ask one final question of Mr. Gale?

Chairman NUSSLE. Mr. Spratt.

Mr. SPRATT. Since your report of the miscalculation in the rate of the H.R. 25 sales tax in 1999, as I recall, in an article you published, have the Americans for Fair Taxation made any effort to correct for that in their architecture of the proposed tax or in their calculation of what the actual rate has to be?

Mr. GALE. Not that I am aware of. I do not check their website on a regular basis. But if they are still talking about a 23 percent sales tax, then no adjustment has been made.

Chairman NUSSLE. Do our witnesses want any final comments? I gave that to the other panels and I would offer the same as well. Dr. Steuerle?

Mr. STEUERLE. Mr. Chairman, I would just like our discussion of fundamental tax reform not to distract us from issues of more basic tax reform. We can disagree on whether we want an extra retail sales tax or a consumption tax or a value-added tax, we can think about many of these big issues.

But, to me, tax reform is like expenditure reform. There are a lot of items where we can do things a lot better. That is, there are principles we might disagree on and we might have to reach for a balance, but there are some items where we I think would all agree they just do not belong in the tax system.

We really do not need ten different capital gains tax rates. We really do not need three different educational subsidies in the tax system adding on to a couple in the direct expenditure system that confuse everybody and lead to real losses in the economy. We do not need three or four different types of child benefits: earned income credits, child credits, and dependent exemptions all flying off loosely on their own and not being coordinated. There are a lot of things in the tax system that we can do to make it better and we should not let fundamental tax reform distract us from the job we all agree we have at hand.

Mr. MORAN. Mr. Chairman, could I ask them, as they respond, if they have any comments related to the globalization of our economy and trade overseas. I know it benefits the value-added tax because it is more compatible with other systems. But if they have any comments on that, they might add it in to their summary.

Chairman NUSSLE. Let us do that. In your summaries, if you would just take a couple of minutes and wrap us up here and give us the benefit of your wisdom on these things, and also, as Mr. Moran asked, if there is any comment you would like to make about that. We will go in reverse order. I think we will start then with Gene. Do you have anything else you would like to add in closing?

Mr. STEUERLE. I think I pretty much made my summary. Just to respond to Mr. Moran, I quite honestly do not think that most changes in the tax system, whether they are the ones being discussed today or even the ones that are being discussed in the campaign, fundamentally change the dynamics of international mobility of capital and labor. Such mobility is often motivated by much more powerful factors, including differential wage rates among countries.

I do not think that one undertakes fundamental tax reform driven by some notion that one is going to be able to, fundamentally shift jobs either to this country or to other countries. That is, you undertake to create the type of tax system that you think is right in the first place. That is the best guideline. There are exceptions, but for the most part, I do not think international mobility of labor and capital is going to be driven by the types of tax changes we are talking about. There are other things that adjust, wage rates, price levels, and other items that tend to mitigate tax-induced labor mobility.

Chairman NUSSLE. Thank you. Dr. Hall.

Mr. HALL. Well, there is global competition in tax systems. I think it is very important to recognize that. The rest of the world relies very heavily on consumption taxation. That is, the effective tax rate on capital, as we discussed before, is low or zero. And I think we need to recognize that to stay competitive we need to have a similar system, because it is a good system.

And you see that competition all over and I do not think we should ignore it. I think that it is a factor in decisions about the location of important types of economic activity. We need to be competitive in that respect and that means following the rest of the world to consumption taxation.

Chairman NUSSLE. Dr. Gale.

Mr. GALE. Thanks. Four very brief points. One is to end where I started, which was to focus on realistic reforms is absolutely crucial rather than fantasy taxes. The second is to think about tax reform in the context of the longer term fiscal gap. We cannot think of it as structure and the revenue level as separate issues anymore. That is actually useful because consumption taxes can help us solve the longer term fiscal issues.

As far as globalization is concerned, I agree with what Bob just said. I just want to add that one of the factors in tax changes that we do not often consider is how other countries respond. So if we cut our capital income taxes, we expect to get a big capital inflow coming in. But if other countries then cut theirs, the capital is going to go right back out. So there is an interesting issue about how effective capital income tax cuts are if other countries respond and then you get this race to the bottom.

The last point to talk about relating to capital income is that some of the tax reform or tax proposals on the table now are justified with sort of a bow toward fundamental tax reform. Glen Hubbard said the other day the goal is to cut the tax rate on capital income to zero. Regardless of the merits of that proposal, I want to stress something that Bob Hall mentioned, is you cannot treat the capital income side without treating the interest deduction side too. And if you reduce the taxation of capital income to zero but you still allow deductions for interest payments like we currently have, you have created an enormous loophole and basically you have created not just a wage tax, but a wage tax that only applies to poor people. So you can screw up the system worse than it currently is, believe it or not. And going to a system that treats capital income and expense even more differently than they are currently treated would be a big step in that direction.

Chairman NUSSLE. We appreciate all three of you being here today and remaining for the entire hearing for this discussion. We appreciate your advice and wisdom and I hope that it will continue as we move this discussion and debate forward.

So, with that, if there is nothing further to come before the committee, we will stand adjourned for this session of Congress.

[Whereupon, at 2:48 p.m., the committee was adjourned.]

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