

**Statement of**  
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**Submitted to**  
**The Joint Economic Committee**  
**United States Congress**  
**November 5, 2003**

**Summary**

Chairman Bennett's invitation asked for my views on fundamental tax reform and simplification as well as my thoughts about the long-term endurance of any tax reform that can be enacted. In summary form, these are my views:

1. The individual and corporate federal income tax system should be replaced with a "business activities tax" that is constructed by applying rigorously the six principles discussed later in this statement. Among the benefits of such a replacement would be the following:
  - remove individuals from the tax collection and remittance processes altogether (except for those who are sole proprietors of their own businesses), thereby reducing drastically both the sources of political pressures for tinkering and the number of taxpayers needing to file returns while enhancing the ability of the IRS to audit properly;
  - eliminate the endless refinements that are enacted to shut down creative tax planning that is related to characterizing income (ordinary vs. capital gain) and to realizing income (artificial losses now vs. income later) along with the enormous complexities of depreciation/amortization/capitalization;
  - put in place a simpler and more stable tax base (the value of goods and services consumed rather than income – however it is measured);
  - provide our country with a **legal** way to remove a federal tax burden from exports while imposing it on imports; and
  - at least offer to states an opportunity to use a model that could provide benefits to their revenue systems as well.
2. If government and taxpayers can summon the political will to replace the current income tax with a clean and simple consumption-based system (recognizing that "simple" is a relative term in an economy such as ours), that may be the best safeguard against eroding reform. Statutory super majorities and Constitutional amendments may be useful, but the ability to point to the increase in the single tax rate on everyone else resulting from efforts by a few to gain favored treatment could be a far more effective deterrent to erosion than elaborate rules.

## **Background**

As a tax lawyer by training and a tax policy lobbyist for most of my career, I have studied various alternatives to the income tax for about 20 years. My views have evolved over time as I have worked with clients to understand different approaches and have worked with former Members and staffs in the development of both concepts and specific legislative drafts.

A few years ago, I was the vice chair and then the chair of the Committee on Value Added Taxes of the Tax Section of the American Bar Association. That period of service coincided with the development and adoption by the Committee of a comprehensive set of principles that should be applied if the federal government ever enacts a consumption-based tax. The Committee was comprised of law school professors, corporate tax vice presidents, policy attorneys like me and tax practitioners from large and small law firms around the country. Getting agreement on these principles from people who have studied VATs around the world, sales taxes in this country and other formulations was not automatic, but it probably was not as difficult as some of us feared when we began the project because there was a great deal of knowledge around our meeting table.

The surprise for me was that our Committee's work was adopted by the Tax Section at a plenary session in January 2000 with only one audible "no" vote among the few hundred voting members. While the ABA House of Delegates did not adopt the policy as a formal position for the whole organization, the adoption by the Tax Section of the principles and the accompanying explanatory report are akin to a "man bites dog" story because it was a statement by tax attorneys in private practice, in companies and in the academic community whose livelihoods are, to varying degrees, significantly enhanced when tax rules are complicated and perpetually changing. They understand the issues and they spoke accordingly.

Attached to this statement is the formal resolution of the Tax Section and the accompanying report. It is attached solely for your information because I am not representing the Tax Section here today. In fact, the views I express to the Committee are my own and cannot be attributed to anyone else. Also, please note that neither my Committee nor the Tax Section endorsed replacing all or part of any existing federal tax with a consumption-based tax, although I do.

## **My policy perspective**

My support for replacing the income tax is based partially on economics and partially on a desire for efficiency. I will summarize these views here just to provide context for the recommendations regarding a new system.

The economic case for replacing the income tax is, for me, obvious and strong. The federal government needs a general revenue tax to meet its general revenue needs (leaving aside at this point the Social Security taxes, gasoline taxes, etc.). The strongest possible economy should be the most reliable generator of a predictable stream of tax revenues, so a tax system should seek to extract such revenues without imposing any more drag on the private sector than is the inevitable result of removing resources from the private sector for use in the public sector.

The income tax does not meet that objective. It is a substantial burden on the very economy from which it is expected to produce revenues. I am not entering here the debate

about whether the total tax burden is too high or not or whether double taxation of corporate income is too high and so on. Instead, my point is that the income tax diverts tens and probably hundreds of billions of dollars annually from productive investments in our economy and into the incomes of tax lawyers, accountants, financial planners and other professionals who engage in tax administration and compliance as well as in perfectly legal tax planning that is based on all the carrots and sticks that have been put into the Internal Revenue Code over a long period of time to induce individuals and companies to do certain things and not to do others. These professionals earn quite good livings doing nothing more than helping clients manage their taxes. They are some of the hardest working people with some of the best business and financial minds in the country; if they were not, they could not succeed in this work. But is this a good public policy result?

Now, add to this planning, administration and compliance work the extensive efforts of all kinds of organizations and their representatives here in Washington who devote countless hours to attempting to change the Code or not to change the Code or both on different issues at the same time, and who do so year in and year out. Whether representing businesses or unions or exempt organizations or public groups or any other entities, the amounts of money paid for the services of these people and the brainpower that is not being devoted to other issues are both substantial.

On top of what it does to the private sector, consider how much time you and your colleagues and your staffs and the professionals in the Treasury and IRS spend in refining the Code and trying to shut down the latest shelter schemes while also using the revenue system as an economic and social policy tool. Though it might be less interesting to serve on the Finance Committee and on the Ways and Means Committee, would a rational tax system improve the ability of Congress and the Administration to make decisions about how to *spend the money* that such a system produces? My personal view is “yes, if” and the “if” is important.

If we could replace the income tax with a simple and more stable consumption tax that is based on principles described below, then the change would be worth the considerable hassle of overcoming the significant obstacles between here and there – both political and substantive, such as transition rules and related spending issues and others, I’m sure. However, if the result is to replace the mess we already know with another mess that we don’t yet know, then the effort is not worth beginning.

### **Principles to apply**

Revising somewhat the principles developed by the Tax Section committee, I believe that a federal revenue system based on the value of goods and services consumed in this country should replace the federal income tax – *but only if it is enacted with a firm commitment to these principles:*

1. A tax system that is imposed on consumption should use the most comprehensive definition of “value-added” as its base, should apply only one rate of tax to that broad base and should provide no exemptions, exclusions, deductions, credits, multiple rates or other rules that grant favored treatment to or impose punitive treatment on particular sectors of the economy or on specific goods or services.
2. All businesses and organizations engaging in sales of goods or services as a business activity should be taxable without regard to their particular legal structures or profit motives.

3. The “destination principle” should be used, consistent with our international trade agreements, to prevent both double taxation and undertaxation in international activities.
4. Any efforts to offset perceived “regressivity” of a consumption tax should be created and administered outside the consumption tax system itself to assure that principles 1 and 2 above are not undermined as well as to assure that large amounts of revenues aren’t lost by providing such tax savings to tens of millions of unintended beneficiary households.
5. In those sectors for which explicitly stated prices for services are not available (financial intermediation is a prime example), alternative mechanical rules should be applied to assure that all value-added created by these sectors in their business activities is included in the overall tax base.
6. Recordkeeping and reporting rules for businesses should be as simple as possible. Arguments about administrative convenience may suggest that small business exemptions or similar devices are desirable, but these should be weighed against the likelihood of tax avoidance opportunities, competitive distortions and other possible problems.

### **Options available**

Four principal models have been developed and put into legislative drafts over the last 20 years, and my own work has led me through all of them. My personal “spectrum” of choices from least useful to the most useful is summarized below along with a few comments on why I place each one in its position from least to most useful.

#### **1. Flat tax**

Compared to retaining the income tax, enactment of a pure flat tax would be a better option, but not by much. For this purpose, a flat tax would be a split tax base system (i) with businesses taxable on the sum of receipts from sales of goods and services minus costs of goods and services purchased from other businesses minus compensation paid to employees and (ii) with individuals taxable on compensation received from the businesses for which they work. The same single rate would be applied to both businesses and individuals. In this form, a flat tax would have a lot to offer in terms of simplicity and avoiding the distortions of behavior caused by multiple tax rates and lots of deductions, credits, exemptions, exclusions, *etc.*

But flat tax proposals do not come in this form. Rather, they tend to have at least a personal exemption or household exemption that removes a substantial amount of the otherwise taxable base, thereby pushing up the rate needed to generate the needed revenues. They also come with proposals to allow some additional deductions for mortgage interest and/or charitable contributions and/or other items. By having individuals in the tax system, by attempting to offset perceived effects on households through the tax law and by providing special rules intended to favor particular activities over others, the typical flat tax proposals set the stage for recreating the system we now have. Also, even if it were “pure,” it would not permit a “border adjustable” feature for exports and imports.

So, while starting off better than the current system, the flat tax would put back into play the pressures that have brought us to the state of current law.

## **2. Sales tax**

Next would be a national sales tax. This would be a better option than the flat tax. For this purpose, the sales tax would impose a single rate on each retail sale of goods and services – meaning a sale to a person who consumes the good or service rather than using it in a business activity. It would be applicable to the retail sale of imported goods and services, and it would not be applicable to the export of goods and services to purchasers in other countries.

The sales tax has much to offer. By removing individuals from the collection and remittance process, the administration of the system will rely on a relatively small number of businesses. This also reduces the pressures that could be brought to bear under a flat tax for special provisions for particular groups of individuals. Furthermore, it can be applied with the border adjustment feature as noted.

But the sales tax also poses the greatest risk to the government that revenues will not be collected while imposing the greatest difficulties on untold numbers of businesses every day. The revenue risk arises from the fact that the tax only applies at the last possible point – namely, the sale to the ultimate consumer. When fraud occurs, the government loses the tax attributable to the full retail value of the final good or service because there has been no intermediate collection. This will place a premium on administration and enforcement by the IRS with respect to retail sellers – probably the smaller businesses and those with more cash sales than credit card sales. But the principal problem may well be faced by the honest business which must question each customer about whether the good or service being sold is going to be used by the purchaser in a business (in which case the sale is excluded from the seller's tax base) or is for personal consumption (in which case the sale is taxable). While this will not be a problem for many companies which sell only to other businesses, it will be an enormous problem for those which sell to both businesses and consumers all day every day. The resentment that is likely to set in cannot be overestimated.

Also, the sales tax is subject to the pressure to apply multiple tax rates, as is the case in the states today, and/or to exempt certain items altogether. When the sale of food, for example, is taxable at a lower rate than clothing, the rate on clothing and all other goods and services must rise. An equally troubling problem is the fact that such distinctions will set off sustained efforts to have particular goods or services placed into ever-growing lists of what is subject to the lower rate (or exempt altogether). For example, how much fruit juice must a beverage contain to be treated as nontaxable food vs. a taxable beverage? When does an elective medical procedure move from being a reduced rate medical service to a standard rate “vanity” procedure?

While a sales tax would offer benefits compared to both the flat tax and current law, the risks are high that the system would be troubled by fraud and increasing complexity within a short time.

## **3. European-style VAT**

Next in the line of improvements would be the European-style VAT that is used in most other industrialized countries. This would offer considerable improvements over both current law and a flat tax while lessening considerably the revenue loss from fraud under the sales tax

and avoiding altogether the customer-by-customer inquiries that the sales tax makes inevitable. For this purpose, the VAT would be imposed on every business on every sale of goods and services by that business. The VAT rate would be applied to the price and be paid by the customer at the time of the purchase. At the end of the tax reporting period, the business adds up the VAT amounts on all of its sales and then adds up the VAT it has paid on all of its purchases. The aggregate amount of VAT paid is credited against the aggregate amount of VAT on its sales, and the business remits the net VAT to the government.

The merits of the VAT are many. Like the sales tax, it removes individuals from the system. But unlike the sales tax, the VAT minimizes the risk of revenue loss from fraud by imposing the tax on each stage in the production and distribution of goods and services rather than waiting until the last possible moment – the retail sale – to generate revenue. Even if retail sales are the subject of evasion, the earlier stages are likely to have generated a significant portion of the tax that would otherwise be lost under a sales tax. The VAT also eliminates the need for the business to quiz the customer about whether the purchased good or service will be used in a business or be consumed. Since the business is taxable on its own value-adding activities, the nature of the customer is irrelevant. If the customer is a business purchaser, it will in turn credit the VAT paid against the VAT it collects from its own customers. If the customer is the ultimate consumer, no credit will be available to it. Also, the VAT is subject to border adjustments, meaning it can be applied using the destination principle that imposes it on imports and does not impose it on exports.

But the VAT also carries one significant weakness that is identical to the sales tax – namely the ability to using differing rates and exemptions to provide preferential and punitive treatment, with all of the complexities that such variations produce. In fact, the history of the VAT in other countries demonstrates this weakness clearly. I know of no countries that have imposed a single rate on the broadest possible tax base. The tendency to turn a VAT into a very complicated system with perpetual arguments and lobbying to affect definitions of particular categories of goods and services is evident around the world.

So, while offering substantial benefits over current law, the flat tax and the sales tax, the VAT still comes up short.

#### **4. Business activities tax**

The final option is the one that I believe is the best – the business activities tax. For this purpose, the business activities tax looks very much like the familiar VAT but it is computed somewhat differently. Rather than applying the tax rate to each sale to each customer and then “crediting” aggregate purchase VATs against aggregate sales VATs, this system simply requires the business to add up sales revenues, subtract the costs of its purchases, apply the tax rate to the difference and remit the tax to the government. This “subtraction method” tax applies to the same tax base as the VAT and the sales tax; only the computation is different.

But that computation is a significant substantive difference. While presenting all of the merits of the VAT such as multi-stage taxation, no need to quiz each customer about the use of the purchased item, being border adjustable and so on, it does not present the VAT’s great weakness – namely, the ability to impose varying rates of tax (including the zero rate) on particular goods and services. While multiple rates are possible under the VAT because each sale is subject to the applicable VAT rate which is then recorded, the business activities tax cannot be administered in that way. Only aggregate sales data are required, so attempting to

break down that data into sales of widgets at one rate and wadgets at another rate and wudgets at yet another rate just doesn't work.

While the computation of tax using the subtraction method is not an iron-clad guarantee of success, the business activities tax does provide the best combination of features from the principles that need to be used. If we find the will to make a change, we should seek to make the change that offers the best results and the best prospects for remaining in place. I believe that the business activities tax offers both.

One additional observation needs to be made. There are a host of conceptual and technical issues that would need consideration when developing any one of these four basic alternatives, so I do not intend to suggest that the factors I have mentioned are the only important ones. For example, the "visibility" or "invisibility" of a tax inspires passionate debate, but a sales tax or a VAT or a business activities tax can be required to show up on every invoice or sales receipt or it can be invisible to the customer by imposing a lower rate on a higher grossed-up price. Once basic decisions are made on questions like this, statutory drafting can produce a wide range of details to flesh out the few factors I have covered here.

## **Conclusion**

For decades, we have debated the question of ***how much we tax ourselves*** in this country. Important as that is, we need now to give serious attention to ***the way in which we tax ourselves***.

Just consider the primary stories in the tax press in recent memory -- tax shelters, corporate inversions, replacing the ETI provisions to avoid European Union trade sanctions, tax credits to subsidize various alternative energy sources. Controversies over these and many other issues have arisen from the evolution of the income tax from a small revenue source 90 years ago to a major tool for changing government policy priorities that is also expected to generate huge amounts of general revenues. These controversial issues are natural results of clinging to the income tax for both the revenue and policy purposes. As long as we insist on sticking with it, such problems will only continue to divert brainpower and private sector dollars into activities that don't do all that much for the economy as a whole.

Surely it is time to consider scrapping the income tax and putting something clean, efficient and simple (relatively speaking) in its place. Tax shelters won't be a problem when "income" is not the tax base. Corporate vs. non-corporate forms of business would no longer be important. Elaborate depreciation rules and other timing devices become irrelevant when the only question is "when did you buy it?". Domestic vs. foreign operations would not be treated differently because only the destination of the goods and services you sell would be important. Squabbles with trading partners over our illegal export subsidies won't be a problem under a business activities tax.

All of this being said, I have no illusions about what would be required. In an economy as large and complex as ours, no consumption tax is going to be "simple" in the absolute sense. Financial services, international transportation, governments and "exempt entities" selling goods and services -- these are some of the matters that would require detailed rules under a consumption tax. But a good one -- particularly the business activities tax with the recommended principles in action -- would be *simpler* and much less of a drag on the economy.

Attachment

## Attachment

***Note: The following resolution and the accompanying explanatory statement are attached to this statement solely as reference documents with respect to the views of the Tax Section of the American Bar Association. The resolution was not adopted by the ABA House of Delegates as a formal policy statement of that organization.***

***Cliff Massa III***

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June 1, 1999

### AMERICAN BAR ASSOCIATION SECTION OF TAXATION REPORT TO THE HOUSE OF DELEGATES

RESOLVED that the American Bar Association recommends that a new tax that is applied to a personal consumption base should generate revenues efficiently, avoid distorting private sector activities and not be used to implement other policy objectives; that a tax that is constructed on the following principles can achieve these results; that principles 1 and 2 are the fundamental rules; and that subsequent principles address particular situations and activities that require variations from or elaboration on the two basic principles.

FURTHER RESOLVED that the American Bar Association affirms that this policy statement is a resource for providing guidance to federal policy makers who may consider a new tax imposed on consumption; that it is not a recommendation that a new consumption-based tax be considered either as an additional tax or as a replacement for an existing tax system; and that it is not intended to provide principles applicable to the income tax.

FURTHER RESOLVED that the American Bar Association adopts the following principles for the purposes stated above:

1. A tax system that is imposed on personal consumption, whether all at once (such as under a retail sales tax) or in increments (such as under the VAT, flat tax and business activities tax proposals), should use the most comprehensive definition of "value-added" as its base and should apply only one rate of tax to that broad base. No exemptions, exclusions, deductions, credits, multiple rates or other rules should either grant favored treatment to or impose punitive treatment on particular sectors of the economy or on specific goods or services.
2. Under a consumption-based tax, all persons and entities engaging in sales of goods or services for consideration in a business activity should be taxable without regard to their particular legal structures or profit motives.
3. As long as the national consumption taxes imposed by our major trading partners continue to apply the destination principle, a U.S. consumption-based tax system should apply this principle under rules which are consistent with our international



trade agreements to prevent both double taxation and undertaxation in international or other interjurisdictional contexts.

4. If the political process seeks to create any offsets to perceived “regressivity” of a consumption tax, such offsets should be created and administered outside the consumption tax system itself to assure that principles 1 and 2 above are not undermined.
5. Explicitly stated prices which would normally be used in computing tax liability under a consumption tax often are not available with respect to the sales of goods and services by financial intermediaries, gaming businesses, government entities and income tax exempt organizations. In such situations, alternative mechanical rules should be developed and applied to assure that all value-added created by these sectors in their business activities is included in the overall tax base.
6. If a consumption-based tax increases federal tax collection and remittance obligations of businesses, its recordkeeping and reporting rules should be as simple as possible. Administrative convenience may suggest that dollar sales thresholds or other mechanisms be used to exclude the smallest businesses from the tax net. The extent to which these mechanisms are used should be weighed against the risks of avoidance planning opportunities, competitive distortions and other possible problems.
7. The following principles should apply to collateral issues which are not directly related to the operation of a new federal consumption tax itself.
  - a. Both a transition period and potential transition rules should be constructed with great care at the same time the tax is being developed.
  - b. Any federal personal consumption tax should be constructed so that state and local governments can either adopt a new system or revise their existing systems to “piggyback” on the new federal tax.
  - c. The United States should honor its treaty obligations and should require treaty partners to do the same. All countries should avoid double taxation, prevent discrimination, minimize tax avoidance and prevent evasion of continuing tax obligations while assisting each other in enforcing their consumption taxes.

## **DISCUSSION**

### **The Purpose and Structure of this Policy Statement**

The policy statement has been adopted to provide substantive guidelines which the Section of Taxation of the American Bar Association can use when it is asked to comment on the development of any new federal tax that is to be applied to a consumption base. The statement does not represent and may not be used to suggest that the Section of Taxation takes a position regarding either the desirability of enacting such a tax or the use of such a tax as either an additional tax or a replacement tax.

The principles in the policy statement – particularly principles 1 and 2 – are well supported by scholarly studies, but here they are based on simple common sense that is reinforced by decades of experience with foreign value-added taxes (“VATs”) and domestic sales tax systems which have not applied such principles. The first two principles are the fundamentals which should guide the development of a consumption-based tax. Subsequent principles elaborate on issues that require particular attention.

The policy statement might be characterized as proposing an ideal tax rather than providing realistic guidance to policy makers who will be subject to a range of political pressures to deviate from the ideal. However, it is the responsibility of the Section of Taxation to make recommendations for achieving the best possible tax system. It is the policy makers – not the Section – who will make the political decisions after considering the substantive advice that is given to them.

Even in this context, the policy statement expands on the strong “ideal” recommendations presented in the first two principles by elaborating on them in principles 3 and 4 and by proposing more flexible rules for certain situations in principles 5 and 6 and, finally, by calling attention in principle 7 to issues which require attention even if they are not directly linked to the substance of a new tax itself. All together, these principles are a comprehensive set of guidelines which take into account that achieving the ideal tax for the economy as a whole will require some administrative flexibility and careful attention to the handling of collateral issues.

With this overall purpose and structure in mind, the following discusses the preamble and each of the seven principles in the policy statement.

### **The Overall Concept**

The mutual interest of both taxpayers and government can be well served by a tax system which produces the desired revenues from the maximum level of voluntary self assessment with the least amount of government administrative cost, of private sector compliance costs and of disruption of the economy which actually produces the resources from which taxes are paid. Enthusiastic support for any tax may be an unrealistic objective, but adequate public support is essential if a tax is to produce these optimal results.

Public support for a new tax can weaken as the tax expands to fill countless pages of statutes, regulations and rulings which even government administrators and private sector specialists have difficulty understanding in their entirety. A complicated tax also is more

susceptible to suspicions that it provides special benefits to those capable of paying for tax avoidance advice or to whole groups/economic sectors with significant political clout or, generally, to lots of people other than “me.” Put bluntly, the concern is that the complications must be hiding something for someone; otherwise a simpler set of rules would apply to everyone.

A federal proposal for a tax based on consumption will provide an opportunity to develop a system which serves only the essential but relatively simple purpose of generating a desired amount of revenue. There are many examples of foreign VATs and of domestic state and local sales taxes, but these generally are poor models to follow. With few exceptions, these systems are very complex as a result of attempts to achieve purposes which are not related to raising revenues. Such complexities create substantial amounts of work for government administrators and for tax professionals in the private sector while creating numerous problems for consumers, businesses and other organizations.

The policy statement constitutes a strong recommendation that enactment of any new tax applied to a consumption base be taken as the opportunity to confirm a simple and clear philosophy for federal taxation – namely that a general tax should be drafted to achieve its revenue-raising purpose with minimal impact on the private sector. A tax which does not seek to alter economic behavior can provide a more stable and predictable tax base for the government’s revenue needs because it does not distort economic decisions within the private sector which generates those revenues.

### **Principle 1**

The taxes covered by this policy statement are often described as “consumption taxes” because the tax base is the aggregate amount of personal consumption in the economy. Labels such as “sales tax,” “VAT” and “flat tax” can be useful as shorthand descriptions of the mechanics of a particular tax, but the tax bases are essentially the same. Each tax is applied to the total amount of economic value embodied in the goods and services that are consumed in the country.

For example, “retail sales tax” generally describes a system which imposes a tax on the sale of goods and services to the retail customer who uses them for personal consumption rather than for resale or for another business activity. The final retail sales price equals the total amount of value that has been added to the goods and services being consumed. “VAT” is the acronym often used to describe a tax on consumption that is collected from each business in the economy based on the increments of value they have added to goods and services (computed as the excess of their sales over their purchases to avoid multiple taxation of the same value-added); in the aggregate, these increments equal the final retail sales price. “Flat tax” is the label for a system which also imposes a tax on value that is added in increments, but the tax is divided between businesses and their employees. Flat tax proposals begin with a VAT-like computation by a company and then deduct the wages/salaries component of such value-added; the wages/salaries component is taxable to the employees, while the profit, interest and benefits components of value-added are taxable to the company.

A system which applies one tax rate to the broadest possible tax base is highly desirable because it virtually eliminates the possibility that some sectors will be given a tax-induced preference over others. Absent such preferences, there is no tax-induced reason to change behavior, to spend resources in an attempt to get into a preferred category or to alter an

economic activity which otherwise makes sense on its own. One of the lessons learned from studying foreign VATs is that it is impractical to seek to limit preferences to just one or two special rules or reduced rates. Once accepted, the use of such preferences expands, and the resulting complex system no longer serves its revenue function with minimal cost and disruption. Common sense confirms the conclusion that principle 1 is a fundamental rule. Research and conversations with those who administer and comply with most foreign VATs reinforce the principle. Studies by both the Government Accounting Office and the Internal Revenue Service further reinforce the view that multiple rates and exemptions would increase dramatically the costs of a consumption-based tax.

## **Principle 2**

Applying one tax rate to a comprehensive tax base is essential, but a tax on consumption also should be applied uniformly to all individuals and entities which engage in selling goods in a business activity. The federal income tax distinguishes among different entities -- C corporation, S corporation, partnership, limited liability company, sole proprietorship -- and the rules for applying the income tax to profits vary from entity to entity. There is no need for such distinctions under a consumption tax; if an entity sells goods or services, the presumption is that it is subject to the tax.

While this rule will avoid many of the complexities created within the income tax, there must be a comprehensive definition of what constitutes the business activity which will subject any entity to the system. An individual or entity generally comes within a consumption tax regime if it engages in regular sales of goods or services (without regard to a profit motive). Clarifying exclusions may be useful (e.g., non-recurring sales by consumers such as resale of the personal residence, yard sales, estate sales and other situations where used items are being disposed of by consumers), but even these should be subject to scrutiny. (For example, routine yard sales may actually be a functioning flea market business.)

The parenthetical reference above to a profit motive is important. Many entities which do not have a profit motive nonetheless regularly engage in value-adding activities and sales (particularly sales of services). Examples include (i) the membership organizations which provide a wide range of goods and services for members who pay dues or direct charges or both, (ii) colleges which provide educational services/rooms/meals to students who pay tuition/room/board and (iii) cooperatives which sell goods and services to their own members -- just to name three. Some of these and other entities may be wholly or partially "charitable" and actually give away their goods and services, in which cases special rules may be needed. But the presumption should be that an entity which provides goods and services is subject to the system unless its activities are clearly excluded.

Government sales of goods and services generally should be included in a consumption tax base when there is a charge for acquiring them. This rule should be applied in a way which excludes essential government services such as the courts, police, fire departments and numerous other functions. But it should also be applied to include many utility services (water, electricity, etc.) and other goods and services which are sold, particularly if they compete with substitutable services provided by the private sector. Government purchases also should be subject to tax.

Many foreign VATs do not tax certain goods or services while requiring their providers to pay VAT on their own purchases that relate to these untaxed goods or services. This

“exemption” treatment may actually increase prices and tax revenues over what would otherwise occur if the goods or services themselves were taxed. One example is financial intermediation services rendered to taxable businesses.

### **Principle 3**

The federal government can utilize one of two principles when determining the jurisdictional scope of a consumption-based tax. These are referred to as the “origin principle” and the “destination principle.”

In general, the origin principle allows the taxing jurisdiction to apply its tax to value-added produced within its own borders, regardless of whether the goods or services are consumed domestically. Goods and services produced overseas and imported into this country would not be subject to the U.S. tax. In other words, the country of origin (not necessarily the country of consumption) is the jurisdiction that is allowed to tax the value-added. The flat tax as proposed is an origin principle tax.

The destination principle allows the taxing jurisdiction to apply its tax to the consumption of goods and services within its borders without regard to their country of origin. In this situation, the foreign goods that are imported into this country are taxed at import at the same rate of tax as goods produced and sold here. Stated another way, the destination principle is used to impose a tax on all domestic consumption, which enables the government to determine the level of tax paid on its citizens’ consumption.<sup>1</sup>

Either principle can produce a rational international system of consumption taxation. But use of the destination principle is the only one that allows each country to tax at its own rate all consumption occurring within it, and only that consumption. The substantive case for applying the destination principle to any such tax is strongly reinforced by the fact that more than 100 other nations -- including all of the major trading nations<sup>2</sup> -- already utilize federal/national consumption taxes based on the destination principle. While economic theory holds that in the long run trade, in a world of flexible exchange rates and relative wages, will be unaffected by the choice between the destination principle and the origin principle, it is clear that short-run and sectoral effects, as well as effects on wages and exchange rates, would be quite different under the two systems. For all these reasons, any federal consumption tax should be based on the destination principle.<sup>3</sup>

But the use of the destination principle would still require agreements among the U.S. and countries with similar taxes to assure that certain international transactions are not double taxed or undertaxed. Transportation services are one such activity. Telecommunications services are another. Development of a clear statutory guideline in these and other areas should be used to develop both U.S. regulations and reciprocal agreements with other countries.

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<sup>1</sup> By applying a “zero” percent tax rate to exports, the destination principle under the familiar VAT does not violate principle 1 above regarding a single rate of tax. Instead, this is just the mechanism for removing all exported goods and services from the tax base.

<sup>2</sup> As of February 1999, Australia’s government has proposed but not yet enacted a VAT.

<sup>3</sup> The “border adjustments” of some U.S. consumption tax alternatives may be questioned under our World Trade Organization obligations.

## **Principle 4**

Both foreign VATs and domestic sales taxes routinely violate principle 1 by providing lower rates or zero rates for a wide range of goods and services. In general, these preferential rules are provided to sellers of an array of goods and services that are often described as “necessities;” some combination of food, medical care, housing and clothing are usually found here. The generally stated purpose for such preferences is the desire to reduce the impact of the VAT or sales tax on lower income consumers who generally spend a larger share of their available incomes than higher income individuals while also devoting a higher proportion of that spending to the “necessities” which are taxed at a lower or zero rate.

When first described, the purpose for these “regressivity” offsets can be widely appealing. But this broad mechanism is at best a wasteful and inefficient means for achieving its desired end. At worst, it creates significantly more problems than it solves.

Consider the simple mathematics of removing up to 40% of the tax base when all of the categories of necessities are subject to a zero rate of tax. One effect is to increase the rate applicable to all other sectors by two-thirds in order to generate the same amount of revenue from the smaller base. Another effect is the substantial amount of foregone revenue from the middle and upper income households which are not the intended recipients of the benefits. Economic data confirm the common sense conclusion that the farther up the household income scale you go, the more money the households tend to spend on their food, medical care, housing, clothing, *etc.* Taking both effects into account, it is likely that these attempts to reduce the burden of a VAT or sales tax on lower income households in fact raises the tax attributable to all other goods and services they purchase (thereby offsetting much of the intended benefit) while foregoing several times as much revenue from households that are not among the intended beneficiaries.

Additional problems are likely to arise if multiple tax rates, exclusions and other preferential rules are used. First will be the difficulties with interpreting what is and is not covered by the preferential rules. Foreign VATs are subject to extensive interpretive guidelines and litigation for this reason. Simple questions such as “what is medical care” and “what is food” will give rise to substantial complexities for both tax administrators and businesses. Then, with such rules firmly in place, businesses will try to expand them to cover more goods and services, and both lobbying and litigation will increase considerably.

For these reasons, principle 4 states the high desirability of addressing all regressivity concerns outside of the consumption tax system itself. By leaving the tax system free of such preferences and resulting distortions in behavior, it is likely that a more stable and predictable revenue base can fund other mechanisms to achieve the desired result, such as providing support directly to the intended beneficiaries. While social spending in response to a new tax may present its own complexities, such programs are more effectively administered through systems dedicated to their objectives than through a tax system dedicated to the objective of revenue collection.

These are practical reasons for avoiding preferential rules, but the same result is supported generally by economic commentators as well. In the 1950s when European VATs were being introduced, noted economist John Kenneth Galbraith in his book *The Affluent Society* said the following:

“The relation of the sales tax to the problem of social balance is admirably direct. The community is affluent in privately produced goods. It is poor in public services. The obvious solution is to tax the former to provide the latter - by making private goods more expensive, public goods are made more abundant. Motion pictures, electronic entertainment and cigarettes are made more costly so that schools can be more handsomely supported. We pay more for soap, detergents and vacuum cleaners in order that we may have cleaner cities and less occasion to use them. We have more expensive cars and gasoline so that we may have more agreeable highways and streets on which to drive them. Food being relatively cheap, we tax it in order to have better medical service and better health in which to enjoy it.”

John Kenneth Galbraith, *THE AFFLUENT SOCIETY* (Boston, Houghton Mifflin Co., Fourth Edition, 1984), p. 238. (See same wording in first edition: Cambridge, MA, The Riverside Press, 1958, pp. 315-316).

The best modern brief statement of this policy comes from the Fiscal Affairs Department of the International Monetary Fund which advises foreign governments which are considering this question:

“Fiscal policy - taxation and spending - is a government’s most direct tool for redistributing income, in both the short and the long run. However, the effect of redistributive tax policies, especially in the face of globalization, has been small. Policymakers should focus on developing a broadly based, efficient, and easily administered tax system with moderate marginal rates. Although the primary goal of the tax system should be to promote efficiency, policymakers also need to consider how to distribute the burden of taxation so the system is seen as fair and just.

“The expenditure side of the budget offers better opportunities than the tax side for redistributing income. The link between income redistribution and social spending - especially spending on health and education, through which governments can influence the formation and distribution of human capital - is particularly strong, and public investment in the human capital of the poor can be an efficient way to reduce income inequality over the long run.”

Excerpt from “Should Equity Be a Goal of Economic Policy?” by staff of IMF’s Fiscal Affairs Department, 35 Finance & Development #3 September 1998, pp 2-5, quotation from p. 4.

A broad-based, low, flat rate tax will not distort production and consumption choices. Applied uniformly, it can be a stable revenue source from which the political process can then determine how to design and implement any direct benefit programs for those considered adversely affected by the tax system as a whole.

## **Principle 5**

A tax system which applies to a consumption base uses the prices charged for goods and services in its computation. These sales prices less purchases from other taxable businesses represent the value-added that has been created by companies through each point of the production and distribution of goods and services. For the vast majority of sales transactions, there is an explicit price used in computing the tax base. But there are situations in which there are no explicit prices charged for goods and services or the taxable value-added cannot be calculated in the manner described above. In these situations, a consumption tax will need to apply alternative mechanical rules to assure that the seller’s tax base is computed appropriately.

One such situation is common in the financial services sector. While many financial services are provided for an explicit fee (e.g., brokerage commissions, financial planning services, safety deposit boxes, printing of checks along with many others), the fees for “financial intermediation services” generally are not separately stated by the company and separately remitted by the client. Instead, the service provider is paid from the flows of funds which it handles in its role as an intermediary. One example is a simple bank loan in which the bank’s role is to pool the funds of its depositors and to loan such funds to individuals and businesses. The intermediary does all of the work for depositors and borrowers who otherwise would be required to find each other and to engage in all the work needed to undertake direct loans. The bank’s fee for this service is not separately stated; instead, the bank is compensated by retaining a portion of the interest paid by the borrower before paying the depositor an amount of interest as a return on the deposit. An insurance company which pools the risks of many insureds, manages the premiums and pays claims is also a financial intermediary which is compensated from the flows of funds which it handles among policyholders. In these situations, the tax system will need an alternative set of mechanical rules which allows the value-added created by the intermediaries to be included in their tax bases without reference to an explicit price because that generally will not exist.

Other situations also will require flexibility. Government entities which sell goods and services may not do so for an explicit price, or the explicit price may not reflect the actual amount being paid by the purchasers. Casinos mix bets and cash paid to winners, so the general definition of the taxable value of a sale does not work. Barter transactions may involve a cash price which does not fully state the price paid, even though goods and services are being sold. These and other situations in which goods and services are being sold but without a stated price (or where the price may be described in other ways such as “dues” to membership organizations) should be included in the system using a workable set of alternative rules which seek to meet the expectations of principles 1 and 2 that all sales of goods and services are in the tax base and subject to the same rate of tax.

## **Principle 6**

While any federal tax system necessarily imposes some administrative and compliance costs, a consumption-based tax which is structured using these recommended principles can be relatively simple and inexpensive for both government and taxpayers. The key word is “relatively” because an economy as large and complex as the U.S. economy probably cannot be subject to a tax which is “simple” in the absolute sense. Principle 5 recognizes that one large sector of the economy – financial intermediation services – will require alternative rules which may be more complicated than the rules applied to businesses generally. Nonetheless, any of these taxes can be much simpler than the more familiar income tax because most of the more complicated accounting rules (such as depreciation and inventory capitalization) and classifications (such as ordinary income vs. capital gain) are not needed.

All of the consumption-based taxes place substantial reliance on businesses to be the collectors and remitters of taxes. The sales tax and value-added tax formats do this exclusively, and the flat tax format does so substantially (particularly if businesses are required to withhold the flat tax on individuals’ wages and salaries). So the role of businesses in the tax collection process is likely to be increased to some degree. The administrative efficiency of relying on fewer entities to remit taxes should not result in any unnecessary burdens on those businesses.



For example, the government's need for a steady revenue flow should be weighed against the private sector's need for a reasonable reporting period.

There is a case to be made that very small businesses should be excluded from a consumption tax to reduce further the numbers of taxpayers and to avoid imposing the compliance costs of a new tax on such businesses. But this case should be weighed against possibilities that sales thresholds or compliance cost deductions or other mechanisms create strong incentives to "break up" businesses (particularly personal services businesses) into entities with sales close to or even below the threshold. Further, the case may vary depending upon the form of tax chosen and upon whether other taxes are replaced by the new tax.

## **Principle 7**

The three components of principle 7 are, in a sense, corollary issues rather than issues which must be addressed in the drafting of a consumption tax itself. However, they are sufficiently important to the process of implementing any new tax that they should be considered carefully and perhaps at the same time as the drafting of a new tax is being considered.

### **a. Transition**

Whether or not a consumption tax is used as a complete or partial replacement for an existing tax or as an additional tax, a series of "transition" issues will arise. Depending on the situation, one or more of the following categories will require consideration. For businesses, these can include (i) the impact of post-effective date sales of goods or services which are wholly or partially produced prior to the effective date because the value-added base will include amounts created before the tax takes effect; (ii) the impact of unrecovered costs of capital goods and inventories; and (iii) the effects of possible financial accounting rules governing the new tax and the continuing or replaced taxes. For individuals, these can include post-effective date taxation of consumption of pre-effective date income which has been subject to an income tax.

Historically, transition rules generally are not addressed until after "big picture" legislative goals have been decided. However, given the magnitude of a possible consumption tax and potential changes in other taxes, transition issues should be identified early and considered carefully and objectively. Also, policy makers should seek as much objective analysis as possible regarding the effects of a new consumption tax and possible changes in a current federal tax before drafting any transition rules. There is a tendency to base transition rules in the income tax on the rather narrow consideration of how changes in a particular provision will affect specific taxpayers. The impact of a new consumption tax is likely to be so pervasive that it will not be realistic to simply assume that particular effects will arise.

### **b. State and Local Taxes**

The form of a federal tax may affect the administrative and compliance costs of operating such a tax alongside state and local taxes. States will be affected by federal legislation that implements a consumption tax, particularly if it replaces all or part of the federal income tax which they use as the base for their own tax structures. Implementation of a significant national sales tax can impact a state sales tax, both with respect to the rate and the base of the tax. Therefore, the federal government should develop any new consumption tax with an awareness that the entire legislative package will affect the states.

**c. Treaties**

If the U.S. income tax were wholly or partially replaced with a consumption based system, this would have a substantial impact on tax treaties which address income tax issues. If there were little or no residence taxation of interest and dividends (and little or no withholding taxes on such items paid to foreigners), the reciprocity of U.S. bilateral income tax treaties would be altered fundamentally. Treaty partners may balk at continuing to provide relief from their withholding taxes when the U.S. would not even tax the income in question. The viability of treaty protection related to income taxes for U.S. taxpayers with foreign source income needs careful consideration.