Department of the TREASURY NEWS

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TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of this distinguished Committee:

It is a pleasure to appear before this Committee to discuss the important issues raised by H.R. 5665, the "Tax Restructuring Act of 1979." This bill would result in fundamental changes in our Federal tax structure. Income taxes on corporations and individuals, as well as social security taxes, would be cut by $130 billion in 1981. A Federal value added tax would offset this revenue loss. This testimony will not concentrate on the specifics of H.R. 5665, but on the basic issue which the bill raises: whether the United States should replace some of its income taxes with a consumption tax. That is, whether the Federal tax system should weigh more heavily on consumption and less heavily on saving and investment. Many believe that such a change would contribute significantly to improved capital formation, higher productivity, and a more competitive position for American business in world markets. Others express concern that a consumption tax would have only small effects on investment and would place an unfair burden on lower income families already plagued by high prices for energy, food, housing, and other basic necessities of life. Higher consumption taxes, they believe, would mean still higher prices. These hearings will serve the valuable function of focusing the discussion on these significant economic and social issues.

An important element in this discussion is the role of a value added tax in the Federal tax structure. A value added tax is a multistage tax on consumer goods and services. Unlike a retail sales tax, it is collected at each stage in the production and distribution process. But since it is levied only on the amount of value added (the difference between sales and purchases) at each stage, rather than on the full selling price, it avoids the cascade, tax-on-tax, effects of a turnover sales tax. A value added tax is similar to a retail sales tax in that the total tax paid by the consumer is equal to the final price of the product multiplied by the tax rate.

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Many European countries have value added taxes. Typically, they are imposed at a rate of about 15 to 20 percent and generate about 15 percent of a country's total national and local tax revenue. In contrast, state and local retail sales taxes raise about 7 percent of the total Federal, state, and local tax revenue in the United States. The $130 billion in value added tax revenue estimated to be raised by H.R. 5665 would be about 14 percent of total Federal, state, and local 1981 tax liabilities, assuming it is accompanied by the proposed income and social security tax cuts.

In nearly all cases, the European value added taxes replaced sales taxes, frequently of the cascade turnover type which, unlike the value added tax, taxed the full sales price at each stage, without allowing a credit for tax on previous transactions. The Europeans found the cascade tax objectionable because it discriminated against nonintegrated firms and because the export rebate and import tax could not be accurately estimated for border adjustment purposes. Thus, in the European case, the adoption of a value added tax was regarded as a reform of an unwieldy and distortionary system of indirect taxation. This characterization does not apply to the present indirect tax system in the United States. Only the United Kingdom has used the value added tax to reduce income taxes, as Chairman Ullman is suggesting for the United States.

The popularity of the value added tax is not universal. The voters of Switzerland have twice rejected it by referendum. The latest rejection was based in part on a perceived threat to local autonomy since a Federal value added tax would have replaced some of the local Swiss taxes. Most recently, Japan, largely as a result of its parliamentary elections, appears to have postponed the planned introduction of a value added tax.

For the United States, a value added tax raises a number of important questions. Would it encourage capital formation? What impact would it have on the price level? Would it improve the trade balance? Would it be regressive? No one is seriously suggesting the value added tax solely as an additional Federal tax. Consequently, the answers to these questions, as well as others, depend upon which taxes the value added tax replaces. By way of illustration, two of the proposals made by Chairman Ullman call for reducing the corporate income tax and the social security taxes.

Capital Formation

Taxes on capital income, such as the corporate income tax and the individual income tax on interest and dividends, reduce the after-tax return on savings. Put another way, an income tax encourages present, as compared to future, consumption. With no taxes, a person with $100 of income could choose between buying

$100 of consumption goods this year or saving now and buying $110 of consumption goods next year, assuming the interest rate is 10 percent. Thus, a person can consume 10 percent more next year by saving now. Similarly, with a consumption tax, which exempts the earnings from capital, a person with $100 of income could consume $50 this year and pay $50 in tax or, by saving the income this year, could consume $55 next year and pay $55 in tax. Thus, a person could still consume 10 percent more next year by saving now.

If a 50 percent income tax, rather than a consumption tax, is imposed, however, the individual, after paying the tax, can buy $50 of consumption goods this year or can save the $50 and, after paying the tax on the interest earnings, buy $52.50 of consumption goods next year. Because of the income tax, a person can buy only 5 percent, rather than 10 percent, more consumption goods next year. Because of this lower return, the individual may decide to consume now rather than save for future consumption. It is important to recognize, however, that the responsiveness of saving to more favorable taxation is an unsettled issue. If one concludes that savings will rise in response to reduced taxation, then substituting a value added tax for the corporate income tax should encourage saving.

There are other considerations in assessing the mechanism that leads to an increase in investment. First, an increase in savings must be channeled into domestic financial markets in order to lower interest rates and therefore the cost of capital. Second, producers must respond to the lower cost of capital by using more capital intensive methods of production. There probably will be some response, but its magnitude is open to discussion. Third, the mix of new investment must be considered; it may be concentrated in housing, consumer durables, or fixed business capital. Thus, the substitution of a value added tax for the corporate income tax will increase capital formation only if savings increase, the cost of capital falls, and business responds by investing in the United States.

Finally, it bears noting that the potential of the value added tax for promoting capital formation may be exaggerated by an analysis that compares a "pure" consumption tax with a "pure" income tax levied on all returns to capital. The current income tax does not apply with full force to all types of saving and investment. For example, home ownership, pension reserves, and assets eligible for the investment tax credit or the asset depreciation range receive relatively favorable tax treatment. Similarly, not all forms of consumption would be taxed the same under any likely value added tax.

In contrast to an income tax, neither the social security tax nor a value added tax applies directly to the return from saving. Consequently, substituting a value added tax for the social security tax would be unlikely to affect savings decisions.

Price Level Impact

A value added tax, by itself, will probably increase prices, since the tendency for business to pass the tax on to consumers is unlikely to be offset by an unduly restrictive monetary policy. The result would be a "one-shot" increase, not a recurrent increase, in the price level, although the subsequent price effects of adjustments in wage contracts, social security payments, and other indexed items may occur over time. In this regard, it is noteworthy that the Thatcher government's program of increased value added taxation and reduced individual income taxation has been accompanied by a significant increase in the consumer price index in the United Kingdom.

The important question, then, is whether the inflationary impact of the value added tax would be offset by reductions in other taxes. In the short run, the corporate income tax reduces the after-tax rate of return to capital, rather than increases product prices. Accordingly, prices will probably not fall as corporate income taxes are cut. Thus, substituting a value added tax for the corporate income tax is likely to increase prices. This is a serious drawback to the value added tax.

Substituting a value added tax for the social security tax may be less inflationary. Reducing the employer portion of the social security tax would tend to reduce business labor costs and possibly prices. Reducing the employee portion of the social security tax, however, would probably have no effect on the price level. Thus a value added tax, accompanied by an equivalent reduction in employer and employee social security taxes, would result in some increase in the price level. This would be particularly distressing to individuals least able to protect themselves from rising prices.

The impact of a value added tax on prices is largely independent of whether it is hidden in the price of the product or whether it is quoted separately to consumers. While it is not customary in Europe to quote the value added tax separately, this need not be the case in the United States. State retail sales taxes are quoted separately because the merchants persuaded legislators to require it, and the same could occur in the case of a United States value added tax. Furthermore, nonseparate quotation of the value added tax might be viewed as an attempt to hide the tax from public scrutiny.

Balance of Trade

Many have expressed the view that a value added tax would improve our trade balance. This is based on the observation that current international rules allow indirect taxes, such as sales or value added taxes, to be imposed on imports and rebated on exports. These adjustments are not allowed for direct taxes,

such as the corporate income or social security taxes. It is doubtful, however, that the U.S. trade balance would improve significantly from substituting a value added tax for the corporate income tax.

The impact of the value added tax on trade is closely related to what happens to prices. Quite simply, one must ask the question: will the substitution of the value added tax for some other tax increase prices? It seems likely that the immediate impact of substituting a general value added tax of 5 percent for part of the corporate income tax would be to increase prices by about 5 percent. Since the new tax would be rebated on exports, just like our state retail sales and Federal excise taxes, exports would leave the country tax free. While domestic prices would be 5 percent higher, export prices would remain unchanged. Foreign consumers, therefore, would find U.S. products no more attractive than before; there would be no increase in demand for U.S. exports.

Since imports would be subject to the value added tax their prices also would increase by about 5 percent, the same as for domestic goods and services. As a consequence, domestic consumers would find imports just as attractive as before; there would be no incentive to reduce the demand for imports. Thus, on both the export and import side, there would be little immediate impact on the U.S. trade balance if a value added tax were substituted for the corporate income tax. There might, of course, be a positive trade impact in the long run if the substitution led to an improved investment climate, enhanced capital formation, and a more productive and competitive U.S. economy.

A modest trade balance improvement might result from replacing the social security tax with a value added tax, if the price level increased by less than the value added tax. Because of the price-dampening effect of reducing the employer portion of the social security tax, this is a possibility.

Regardless of which tax it replaces, many believe that a value added tax rebate, in itself, will expand exports and that a value added tax levy will retard imports. This belief might have a positive effect on trade if it encourages businesses to compete more vigorously in international markets. This result would depend upon the importance of nonprice considerations in explaining export activity.

It is also important to recognize that other countries could restructure their own tax systems if they felt the United States was gaining an unfair trade advantage. Relative to other countries, the United States has a moderately high corporate income tax, but a low social security tax. (See Annex A.) Thus, the possibility exists that other countries might maintain their competitive position by increasing their existing value added

taxes and reducing their corporate income or, especially, their social security taxes. This outcome is by no means certain. After all, a country's tax structure is not determined solely by international considerations. Moreover, except for Japan, U.S. indirect taxes, as a share of gross domestic product, are the lowest of the major developed countries. (See Chart 1 and Annex A.) Other countries may believe that the United States should be allowed to "tilt" its tax structure to reach some "reasonable" or "average" level of indirect taxation.

This issue has been studied before. Both the President's Task Force on Business Taxation, in its 1970 review of tax policy, and the Advisory Commission on Intergovernmental Relations, in its 1973 value added tax study, considered the trade issue. Both expressed doubt over any trade benefits resulting from substituting a value added tax for the corporate income tax and both noted the possibility of foreign retaliation.

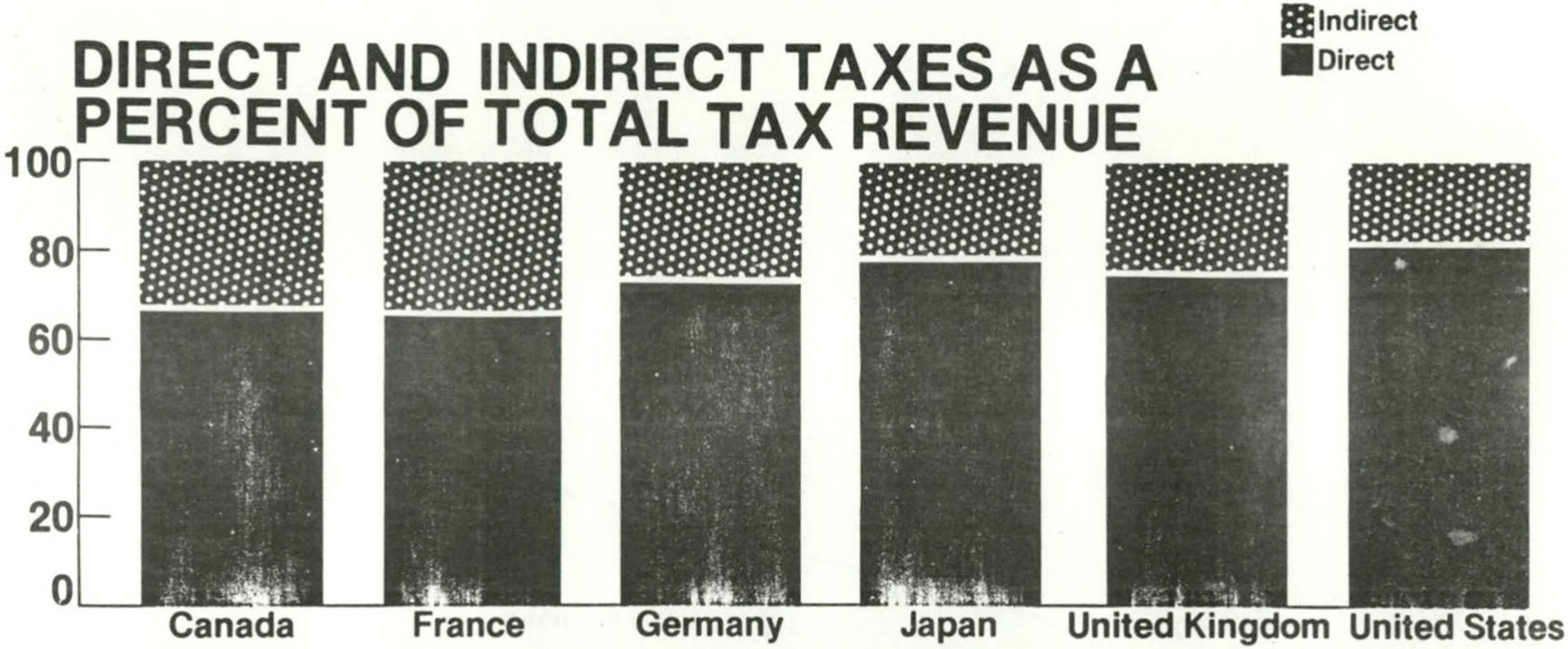
Distribution of Tax Burden

Lower income taxpayers, who must spend all their income on consumption, may find a value added tax burdensome because of its regressivity. While a value added tax, by itself, is regressive, one must consider which tax it replaces. The immediate impact of the corporate income tax is probably progressive since it falls on income from capital. Therefore, substituting a value added tax for the corporate income tax would make the tax structure less progressive. The social security tax, on the other hand, also is regressive because it is limited to the first $22,900 of wages and applies only to labor income. Accordingly, substituting a value added tax for the social security tax would not make the tax system noticeably less progressive. One regressive tax would be substituted for another. Retired individuals, however, who do not pay social security tax, would be distressed by having to pay value added tax. They could justifiably say that they already had paid for their retirement during their working years and that higher prices and taxes in retirement were unfair. Their distress might be partially assuaged by the fact that social security payments are indexed.

One way to illustrate possible distributional effects is to ask what would happen to tax burdens if a value added tax completely replaced the individual income and social security (employee portion) taxes. (See Chart 2.) The combination of the current income and social security taxes is progressive while a value added tax, even with necessities excluded, is regressive. As a share of income, the present individual income and social security taxes are only 2 percent for families with less than $5,000 in income, but increase throughout the income range to 33 percent for families with over $100,000 in income.

CHART 1

DIRECT AND INDIRECT TAXES AS A PERCENT OF TOTAL TAX REVENUE



TAX REVENUES AS A PERCENT OF GROSS DOMESTIC PRODUCT

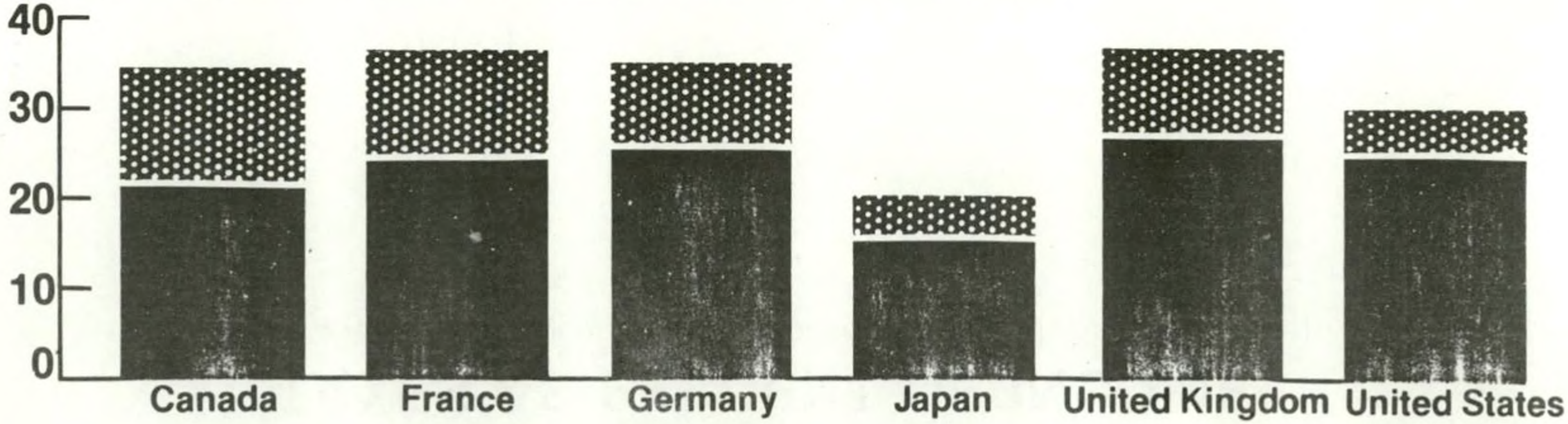
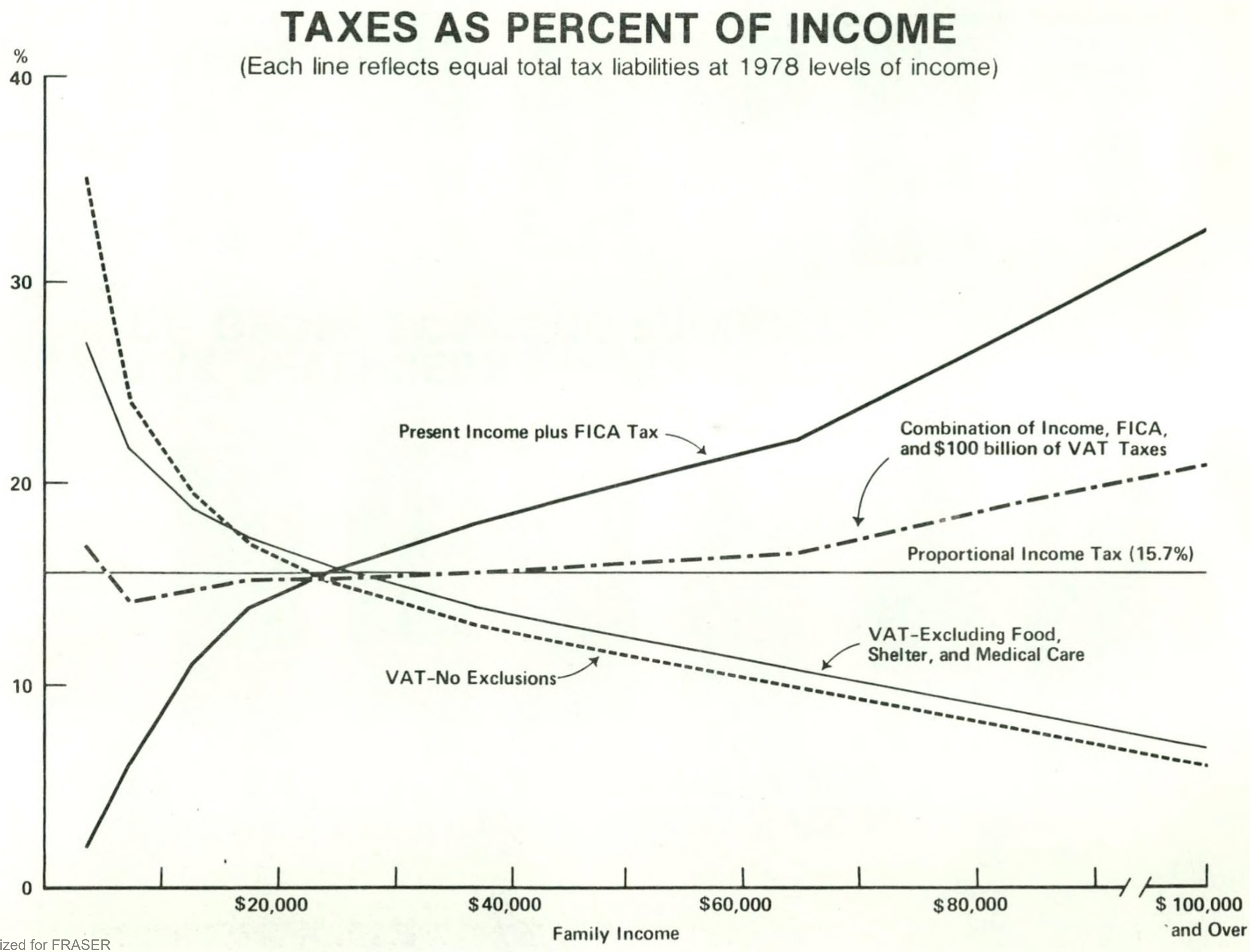


CHART 2



TAXES AS PERCENT OF INCOME
(Each line reflects equal total tax liabilities at 1978 levels of income)
%
40
30
20
10
0
Present Income plus FICA Tax
Combination of Income, FICA, and $100 billion of VAT Taxes
Proportional Income Tax (15.7%)
VAT-Excluding Food, Shelter, and Medical Care
VAT-No Exclusions
$20,000
$40,000
$60,000
$80,000
$ 100,000 and Over
Family Income

This may be contrasted with a value added tax with no exclusions at a 23.2 percent rate, sufficient to equal the revenue raised by the individual income and employee social security taxes in 1978. As a share of income, such a value added tax would be 35 percent for families with less than $5,000 in income, but fall to 6 percent for families with over $100,000 in income.

No one, of course, is proposing the complete substitution of the value added tax for the income and social security taxes. A more realistic alternative would be to substitute a value added tax for part of the combined individual income and social security taxes. One possibility would be to reduce income and employee social security taxes by $100 billion, keeping the same degree of progressivity for these taxes as under present law, and offset the revenue loss with a $100 billion value added tax with no exclusions. The resulting distribution of tax burdens would be regressive at the lowest income levels and mildly progressive elsewhere. As a share of income, families with less than $5,000 in income would pay 17 percent in taxes, families with between $5,000 and $10,000 in income would pay 14 percent, and taxes would then increase throughout the income range so that families with over $100,000 of income would pay 21 percent of their income in taxes. The overall distribution is significantly less progressive than the present combination of income and employee social security taxes.

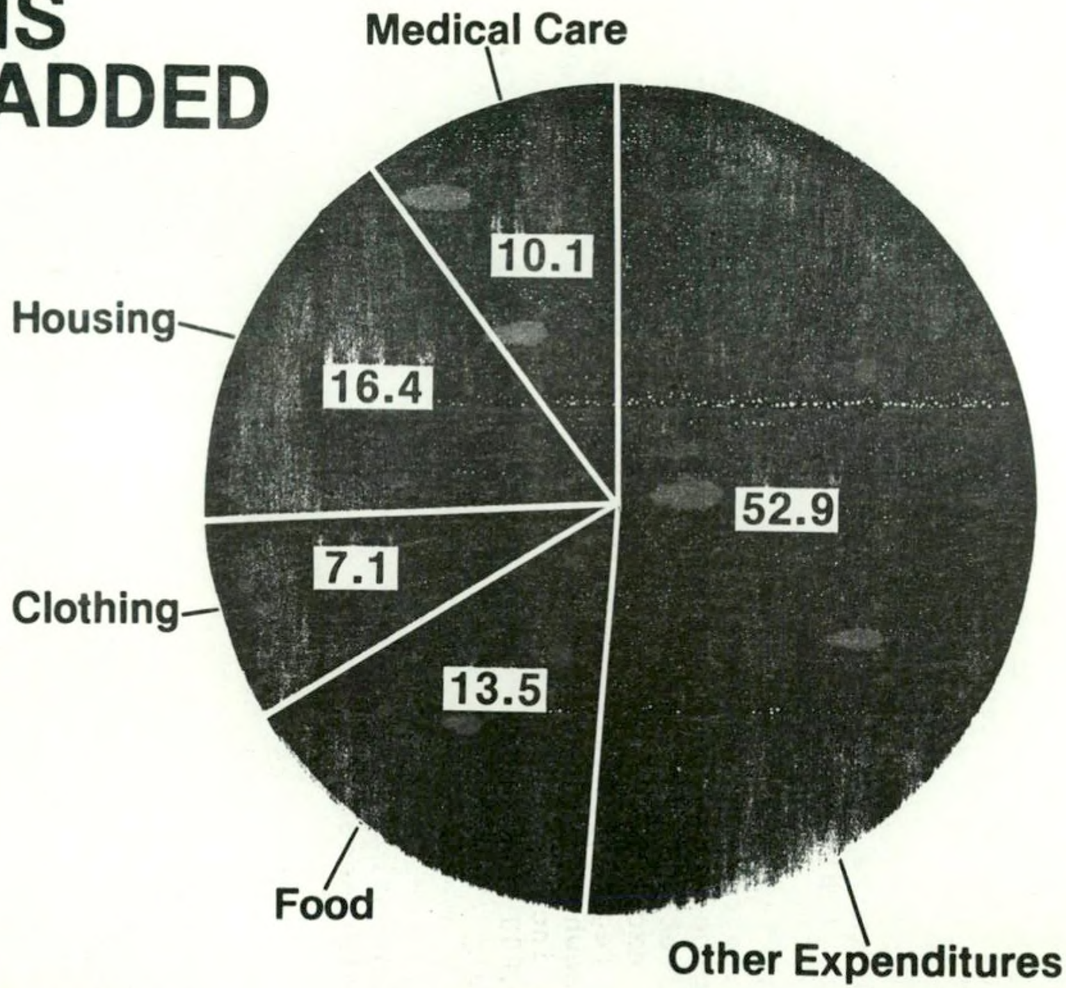
The regressivity of the value added tax can be moderated, but not eliminated, by special measures. One possibility is the use of exemptions and reduced rates for necessities, as in Chairman Ullman's proposal and in some European countries. These reduce the tax burden of the value added tax at the lowest income levels, but the tax remains regressive. Exemptions and reduced rates, moreover, create administrative problems. A tax with two, three, or four rates is more complex than a tax with one rate. The specially-taxed items must be identified. Does a lower rate for food, for example, apply to such items as chewing gum, soda pop, candy, or caviar? Experience with the income tax shows that even medical services and drugs are not easy to define. Beyond the definitional problems, total or partial exclusions erode the value added tax base and its revenue potential. (See Chart 3.)

The regressivity of a value added tax also can be reduced by a refundable income tax credit for tax paid on a necessary amount of consumption. This avoids the need to define exempt commodities and can be implemented at a lower revenue cost than a complete exemption for certain "essential" commodities. It can, for example, be phased out at increased income levels. In effect, middle and upper income groups would still pay tax on purchases of food and other necessary items. On the other hand, a refundable credit is effective only if it reaches the roughly 25 million individuals who do not appear on an income tax return. These tend to be individuals most in need of the credit, mainly

CHART 3

SUBTRACTIONS FROM VALUE ADDED TAX BASE

(Percent)



recipients of social security benefits and of transfer payments under social and welfare programs. Unlike lower rates and exemptions, if the credit was not paid until the end of the year, the consumer would have to finance the tax during the year.

Administrative and Design Considerations

Both the European value added taxes and the tax suggested by Chairman Ullman have certain basic similarities:

- they are broad based, applying to services as well as goods;

- tax liability is determined by the credit method with tax paid on purchases deductible from tax due on sales;

- they are consumption type taxes, any tax paid on capital equipment purchases is immediately deductible; and

- they extend through the retail stage.

A value added tax of this type for the United States would involve about 15 million taxpayers. This number might be reduced by 5 million if exemptions were provided for very small proprietorships and farming. But under a value added tax, nearly all transactions are taxed. Even a firm that is tax exempt on its sales will have paid tax on its purchases. If it is to receive credit for tax paid on its purchases, it either would have to file a return or the credit would have to be made available to its customers.

Even 10 million taxpayers would add about 30 percent to the number of returns filed with the Internal Revenue Service, assuming quarterly returns are required. Since the value added tax would not totally replace any other tax and would be a new tax, requiring new returns, new regulations, and a new body of case law, this would be a net addition to the work of taxpayers, the Internal Revenue Service, and the courts. This differs sharply from the typical European case where the value added tax completely replaced another sales tax.

Reporting and payment requirements for a value added tax would be similar to those for Federal excises, which require liability to be computed on a semimonthly basis with payment due 9 days later. The actual excise tax return is filed quarterly and is accompanied by the payment of any remaining balance. Liquor and tobacco excises, however, have slightly different rules. A value added tax payment system which would fit more neatly with ordinary bookkeeping would be a monthly liability period with payment due at the end of the next month. This would be similar to that proposed by Chairman Ullman.

Other Considerations

A Federal value added tax would raise a number of other issues. Forty five states and the District of Columbia impose general sales taxes, a revenue source which they tend to view as belonging exclusively to them. Sales and gross receipts taxes account for about 30 percent of state tax revenue. In contrast, excise taxes generate less than 4 percent of Federal tax collections. Nevertheless, while a Federal value added tax may make it more difficult for the states to raise their sales taxes, it should not prevent such increases. All levels of government, for example, impose income taxes. Moreover, total Federal, state, and local sales tax collections are lower in the United States than in most developed countries.

Because of likely differences in the tax bases, it is doubtful that a Federal value added tax could be coordinated with the state sales taxes. Separate taxes, admittedly, would mean higher administrative and compliance costs. Each level of government would require a collection and audit capability. Taxpayers would have to become familiar with separate tax bases and separate returns. Revenue departments and taxpayers, however, already face this problem with Federal and state income taxes. Efforts aimed at Federal-state cooperation and coordination have not been successful.

As shown by Chairman Ullman's proposal, even a broad-based value added tax may not apply to all forms of final consumption. Practical considerations may require special treatment for many items. In the area of housing, for example, homeowners and tenants should be treated equally. But if rental payments are taxed, how should homeowners be taxed? It may be difficult to value the so-called "imputed rent" on owner occupied housing. Taxing the purchase price of a home is one alternative, but this may aggravate the problems of many families already hard pressed to cope with high housing prices. The treatment of interest in the housing area also is troublesome. If it is exempt, what part of a rental payment should a landlord be allowed to exclude from the tax base? These and other problems will require careful study.

The value added tax is a very potent revenue source. At 1979 levels of consumption, a value added tax would raise roughly $10 billion in revenue for each percentage point. Thus, a 7 percent value added tax would raise about as much revenue as the corporate income tax and a 12 percent value added tax would raise as much revenue as the social security taxes. With such a powerful instrument for raising revenue, many are concerned that the value added tax eventually will be used to add to the total Federal tax burden.

Conclusion

Mr. Chairman, you are to be commended for initiating an examination of the very important, but complex, issues of how the Federal tax structure affects our national well being. This is a time of great change. It is also a time of troublesome and unfamiliar economic conditions. The combination of high inflation, slow growth, and persistent trade deficits must make us wonder if the traditional economic remedies still work. In this sense, your decision to study a broad range of new initiatives could not come at a better time. But changes of such major consequences require careful and deliberate study. We welcome the opportunity to participate with you in that study.

ANNEX A

Federal, State and Local Tax Revenues for Selected Countries as Percent of Gross Domestic Product, by Type of Tax, 1975
(Country Rankings in Parentheses)

Country	Total	Indirect Taxes	Direct Taxes							
			Social Security 2/							
		Sales and Excise 1/	Total	Employer	Employee and Self Employed	Corporate Income	Noncorporate Income 3/	Property 4/	Other 5/	Total Direct Taxes 6/
Belgium	41.43(5)	10.87(6)	13.14(5)	8.44(4)	4.70(5)	3.07(6)	13.24(4)	1.01(12)	0.10(8)	30.56(4)
Canada	33.98(9)	10.94(4)	3.22(12)	n.a.	n.a.	4.67(2)	11.32(7)	3.13(3)	0.70(4)	23.04(11)
Denmark	43.05(4)	14.71(1)	0.48(13)	0.31(12)	0.17(12)	1.37(13)	23.86(1)	2.57(4)	0.06(10)	28.34(5)
France	36.90(6)	12.44(2)	14.72(3)	10.61(2)	4.11(6)	2.00(9)	4.58(13)	1.46(9)	1.70(2)	24.46(9)
Germany (Fed Rep)	35.22(8)	9.37(8)	12.03(6)	6.60(7)	5.43(4)	1.56(12)	10.60(8)	1.09(11)	0.57(6)	25.85(7)
Italy	32.34(10)	9.34(9)	14.83(2)	11.92(1)	2.91(9)	2.04(8)	4.95(12)	1.17(10)	0.01(11)	23.00(12)
Japan	20.23(13)	3.67(13)	5.09(11)	2.63(11)	2.46(10)	3.43(4)	5.07(11)	1.94(7)	1.03(3)	16.56(13)
Luxembourg	46.74(2)	9.72(7)	14.05(4)	7.80(6)	6.25(2)	7.22(1)	12.78(5)	2.34(5)	0.63(5)	37.02(1)
Netherlands	46.90(1)	10.91(5)	17.99(1)	8.40(5)	9.59(1)	3.61(3)	12.66(6)	1.48(8)	0.25(7)	35.99(2)
Sweden	45.96(3)	11.48(3)	8.89(7)	8.47(3)	0.42(11)	1.99(10)	21.17(2)	0.51(13)	1.92(1)	34.48(3)
Switzerland	29.49(12)	5.90(11)	8.49(8)	3.05(10)	5.44(3)	2.46(7)	10.51(9)	2.13(6)	--	23.59(10)
United Kingdom	36.77(7)	9.24(10)	6.71(10)	3.75(9)	2.96(8)	1.92(11)	14.29(3)	4.54(1)	0.07(9)	27.53(6)
United States	30.31(11)	5.49(12)	7.42(9)	4.18(8)	3.24(7)	3.29(5)	9.98(10)	4.13(2)	--	24.82(8)

Office of the Secretary of the Treasury
Office of Tax Analysis

Source: Revenue Statistics of OECD Member Countries, 1965-1975.

1/ Includes general sales, value added, and specific excise taxes.

2/ Includes contributions of employers, employees, and self employed. Category is broadly defined to include all tax payments to institutions of general government providing social welfare benefits, provided they are levied as a function of pay or a fixed amount per person. Thus, for the United States this category includes contributions to the railroad retirement fund, unemployment insurance fund, workman's compensation fund, and civil service retirement program in addition, of course, to the more familiar social security-type payments made pursuant to the Federal Insurance Contributions Act (FICA).

3/ Includes income taxes on individual and unincorporated enterprise, such as proprietorships and partnerships.

4/ Includes taxes on net wealth, immovable property, estates, and gifts.

5/ Includes taxes on employers based on payroll or manpower and miscellaneous taxes which cannot be classified within a specific direct tax category.

6/ Computed by subtracting sales and excises from total.

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An important element in this discussion is the role of a value added tax in the Federal tax structure. A value added tax is a multistage tax on consumer goods and services. Unlike a retail sales tax, it is collected at each stage in the production and distribution process. But since it is levied only on the amount of value added (the difference between sales and purchases) at each stage, rather than on the full selling price, it avoids the cascade, tax-on-tax, effects of a turnover sales tax. A value added tax is similar to a retail sales tax in that the total tax paid by the consumer is equal to the final price of the product multiplied by the tax rate.

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Capital Formation

Taxes on capital income, such as the corporate income tax and the individual income tax on interest and dividends, reduce the after-tax return on savings. Put another way, an income tax encourages present, as compared to future, consumption. With no taxes, a person with $100 of income could choose between buying

$100 of consumption goods this year or saving now and buying $110 of consumption goods next year, assuming the interest rate is 10 percent. Thus, a person can consume 10 percent more next year by saving now. Similarly, with a consumption tax, which exempts the earnings from capital, a person with $100 of income could consume $50 this year and pay $50 in tax or, by saving the income this year, could consume $55 next year and pay $55 in tax. Thus, a person could still consume 10 percent more next year by saving now.

If a 50 percent income tax, rather than a consumption tax, is imposed, however, the individual, after paying the tax, can buy $50 of consumption goods this year or can save the $50 and, after paying the tax on the interest earnings, buy $52.50 of consumption goods next year. Because of the income tax, a person can buy only 5 percent, rather than 10 percent, more consumption goods next year. Because of this lower return, the individual may decide to consume now rather than save for future consumption. It is important to recognize, however, that the responsiveness of saving to more favorable taxation is an unsettled issue. If one concludes that savings will rise in response to reduced taxation, then substituting a value added tax for the corporate income tax should encourage saving.

There are other considerations in assessing the mechanism that leads to an increase in investment. First, an increase in savings must be channeled into domestic financial markets in order to lower interest rates and therefore the cost of capital. Second, producers must respond to the lower cost of capital by using more capital intensive methods of production. There probably will be some response, but its magnitude is open to discussion. Third, the mix of new investment must be considered; it may be concentrated in housing, consumer durables, or fixed business capital. Thus, the substitution of a value added tax for the corporate income tax will increase capital formation only if savings increase, the cost of capital falls, and business responds by investing in the United States.

Finally, it bears noting that the potential of the value added tax for promoting capital formation may be exaggerated by an analysis that compares a "pure" consumption tax with a "pure" income tax levied on all returns to capital. The current income tax does not apply with full force to all types of saving and investment. For example, home ownership, pension reserves, and assets eligible for the investment tax credit or the asset depreciation range receive relatively favorable tax treatment. Similarly, not all forms of consumption would be taxed the same under any likely value added tax.

In contrast to an income tax, neither the social security tax nor a value added tax applies directly to the return from saving. Consequently, substituting a value added tax for the social security tax would be unlikely to affect savings decisions.

Price Level Impact

A value added tax, by itself, will probably increase prices, since the tendency for business to pass the tax on to consumers is unlikely to be offset by an unduly restrictive monetary policy. The result would be a "one-shot" increase, not a recurrent increase, in the price level, although the subsequent price effects of adjustments in wage contracts, social security payments, and other indexed items may occur over time. In this regard, it is noteworthy that the Thatcher government's program of increased value added taxation and reduced individual income taxation has been accompanied by a significant increase in the consumer price index in the United Kingdom.

The important question, then, is whether the inflationary impact of the value added tax would be offset by reductions in other taxes. In the short run, the corporate income tax reduces the after-tax rate of return to capital, rather than increases product prices. Accordingly, prices will probably not fall as corporate income taxes are cut. Thus, substituting a value added tax for the corporate income tax is likely to increase prices. This is a serious drawback to the value added tax.

Substituting a value added tax for the social security tax may be less inflationary. Reducing the employer portion of the social security tax would tend to reduce business labor costs and possibly prices. Reducing the employee portion of the social security tax, however, would probably have no effect on the price level. Thus a value added tax, accompanied by an equivalent reduction in employer and employee social security taxes, would result in some increase in the price level. This would be particularly distressing to individuals least able to protect themselves from rising prices.

The impact of a value added tax on prices is largely independent of whether it is hidden in the price of the product or whether it is quoted separately to consumers. While it is not customary in Europe to quote the value added tax separately, this need not be the case in the United States. State retail sales taxes are quoted separately because the merchants persuaded legislators to require it, and the same could occur in the case of a United States value added tax. Furthermore, nonseparate quotation of the value added tax might be viewed as an attempt to hide the tax from public scrutiny.

Balance of Trade

Many have expressed the view that a value added tax would improve our trade balance. This is based on the observation that current international rules allow indirect taxes, such as sales or value added taxes, to be imposed on imports and rebated on exports. These adjustments are not allowed for direct taxes,

such as the corporate income or social security taxes. It is doubtful, however, that the U.S. trade balance would improve significantly from substituting a value added tax for the corporate income tax.

The impact of the value added tax on trade is closely related to what happens to prices. Quite simply, one must ask the question: will the substitution of the value added tax for some other tax increase prices? It seems likely that the immediate impact of substituting a general value added tax of 5 percent for part of the corporate income tax would be to increase prices by about 5 percent. Since the new tax would be rebated on exports, just like our state retail sales and Federal excise taxes, exports would leave the country tax free. While domestic prices would be 5 percent higher, export prices would remain unchanged. Foreign consumers, therefore, would find U.S. products no more attractive than before; there would be no increase in demand for U.S. exports.

Since imports would be subject to the value added tax their prices also would increase by about 5 percent, the same as for domestic goods and services. As a consequence, domestic consumers would find imports just as attractive as before; there would be no incentive to reduce the demand for imports. Thus, on both the export and import side, there would be little immediate impact on the U.S. trade balance if a value added tax were substituted for the corporate income tax. There might, of course, be a positive trade impact in the long run if the substitution led to an improved investment climate, enhanced capital formation, and a more productive and competitive U.S. economy.

A modest trade balance improvement might result from replacing the social security tax with a value added tax, if the price level increased by less than the value added tax. Because of the price-dampening effect of reducing the employer portion of the social security tax, this is a possibility.

Regardless of which tax it replaces, many believe that a value added tax rebate, in itself, will expand exports and that a value added tax levy will retard imports. This belief might have a positive effect on trade if it encourages businesses to compete more vigorously in international markets. This result would depend upon the importance of nonprice considerations in explaining export activity.

It is also important to recognize that other countries could restructure their own tax systems if they felt the United States was gaining an unfair trade advantage. Relative to other countries, the United States has a moderately high corporate income tax, but a low social security tax. (See Annex A.) Thus, the possibility exists that other countries might maintain their competitive position by increasing their existing value added

taxes and reducing their corporate income or, especially, their social security taxes. This outcome is by no means certain. After all, a country's tax structure is not determined solely by international considerations. Moreover, except for Japan, U.S. indirect taxes, as a share of gross domestic product, are the lowest of the major developed countries. (See Chart 1 and Annex A.) Other countries may believe that the United States should be allowed to "tilt" its tax structure to reach some "reasonable" or "average" level of indirect taxation.

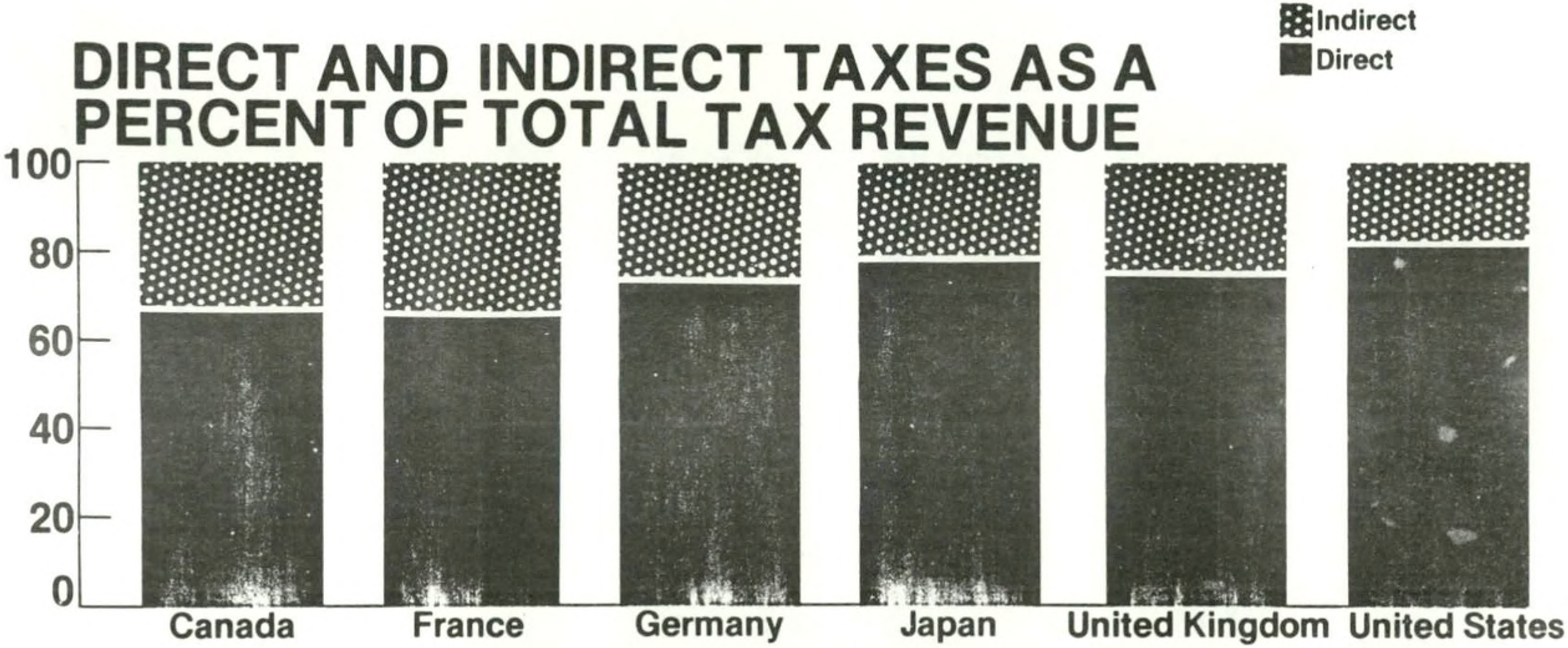
This issue has been studied before. Both the President's Task Force on Business Taxation, in its 1970 review of tax policy, and the Advisory Commission on Intergovernmental Relations, in its 1973 value added tax study, considered the trade issue. Both expressed doubt over any trade benefits resulting from substituting a value added tax for the corporate income tax and both noted the possibility of foreign retaliation.

Distribution of Tax Burden

Lower income taxpayers, who must spend all their income on consumption, may find a value added tax burdensome because of its regressivity. While a value added tax, by itself, is regressive, one must consider which tax it replaces. The immediate impact of the corporate income tax is probably progressive since it falls on income from capital. Therefore, substituting a value added tax for the corporate income tax would make the tax structure less progressive. The social security tax, on the other hand, also is regressive because it is limited to the first $22,900 of wages and applies only to labor income. Accordingly, substituting a value added tax for the social security tax would not make the tax system noticeably less progressive. One regressive tax would be substituted for another. Retired individuals, however, who do not pay social security tax, would be distressed by having to pay value added tax. They could justifiably say that they already had paid for their retirement during their working years and that higher prices and taxes in retirement were unfair. Their distress might be partially assuaged by the fact that social security payments are indexed.

One way to illustrate possible distributional effects is to ask what would happen to tax burdens if a value added tax completely replaced the individual income and social security (employee portion) taxes. (See Chart 2.) The combination of the current income and social security taxes is progressive while a value added tax, even with necessities excluded, is regressive. As a share of income, the present individual income and social security taxes are only 2 percent for families with less than $5,000 in income, but increase throughout the income range to 33 percent for families with over $100,000 in income.

CHART 1


Indirect
Direct
DIRECT AND INDIRECT TAXES AS A PERCENT OF TOTAL TAX REVENUE
100
80
60
40
20
0
Canada
France
Germany
Japan
United Kingdom
United States

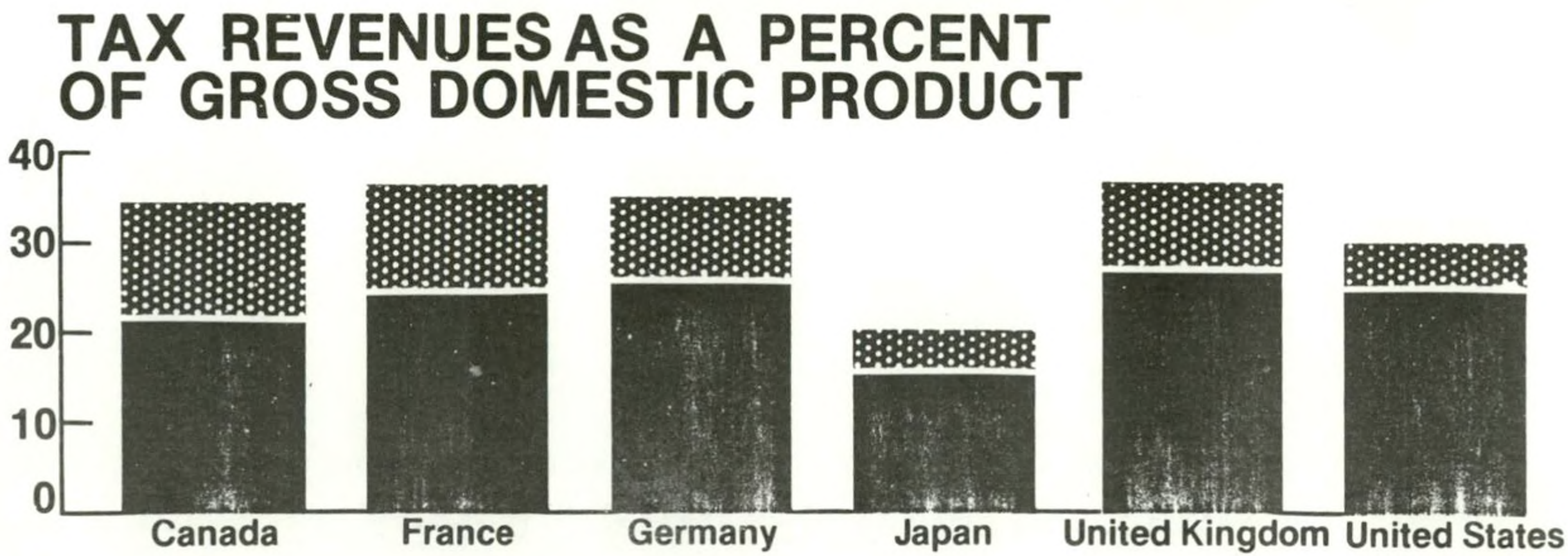
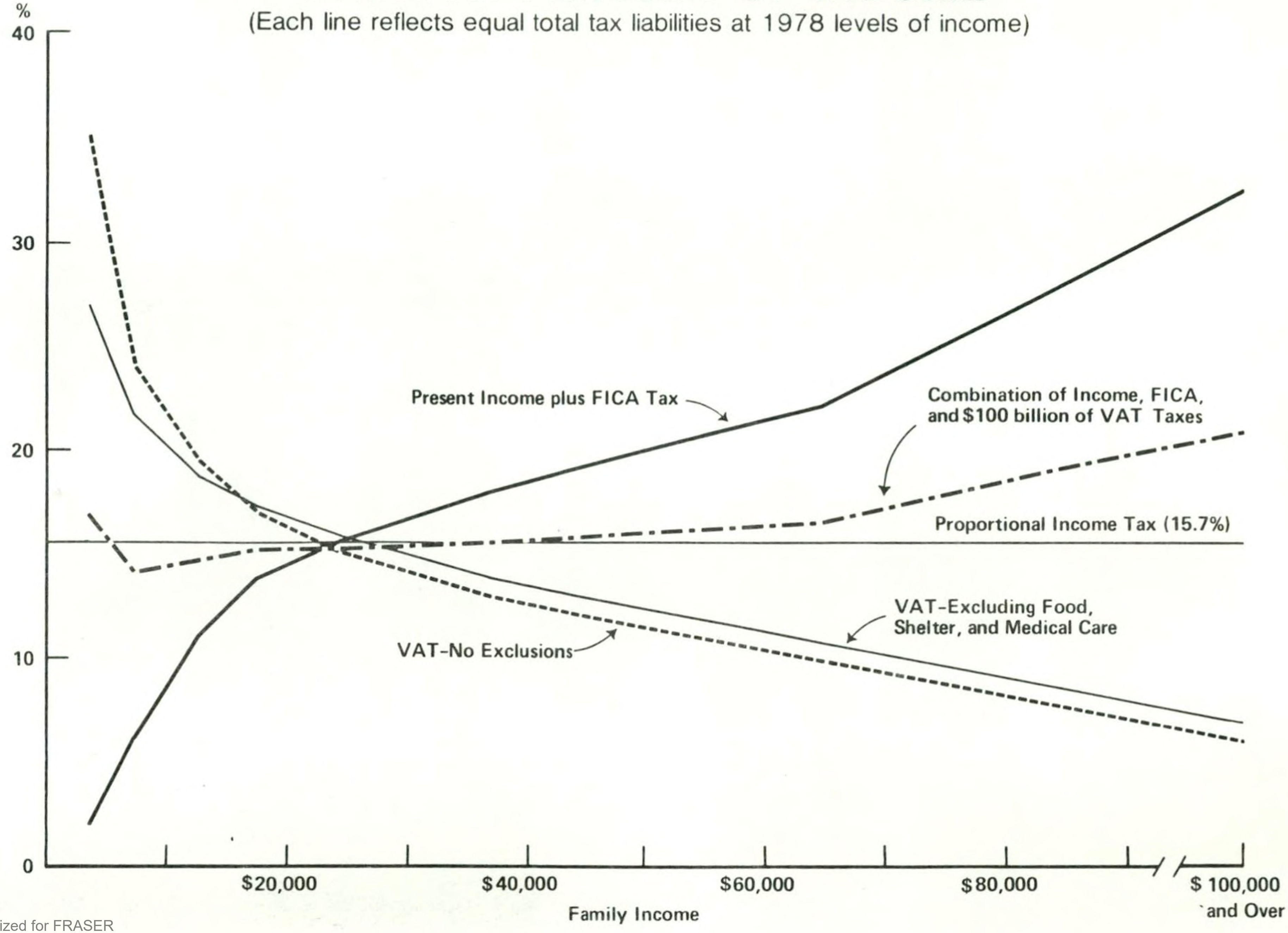

TAX REVENUES AS A PERCENT OF GROSS DOMESTIC PRODUCT
40
30
20
10
0
Canada
France
Germany
Japan
United Kingdom
United States

CHART 2

TAXES AS PERCENT OF INCOME

(Each line reflects equal total tax liabilities at 1978 levels of income)



This may be contrasted with a value added tax with no exclusions at a 23.2 percent rate, sufficient to equal the revenue raised by the individual income and employee social security taxes in 1978. As a share of income, such a value added tax would be 35 percent for families with less than $5,000 in income, but fall to 6 percent for families with over $100,000 in income.

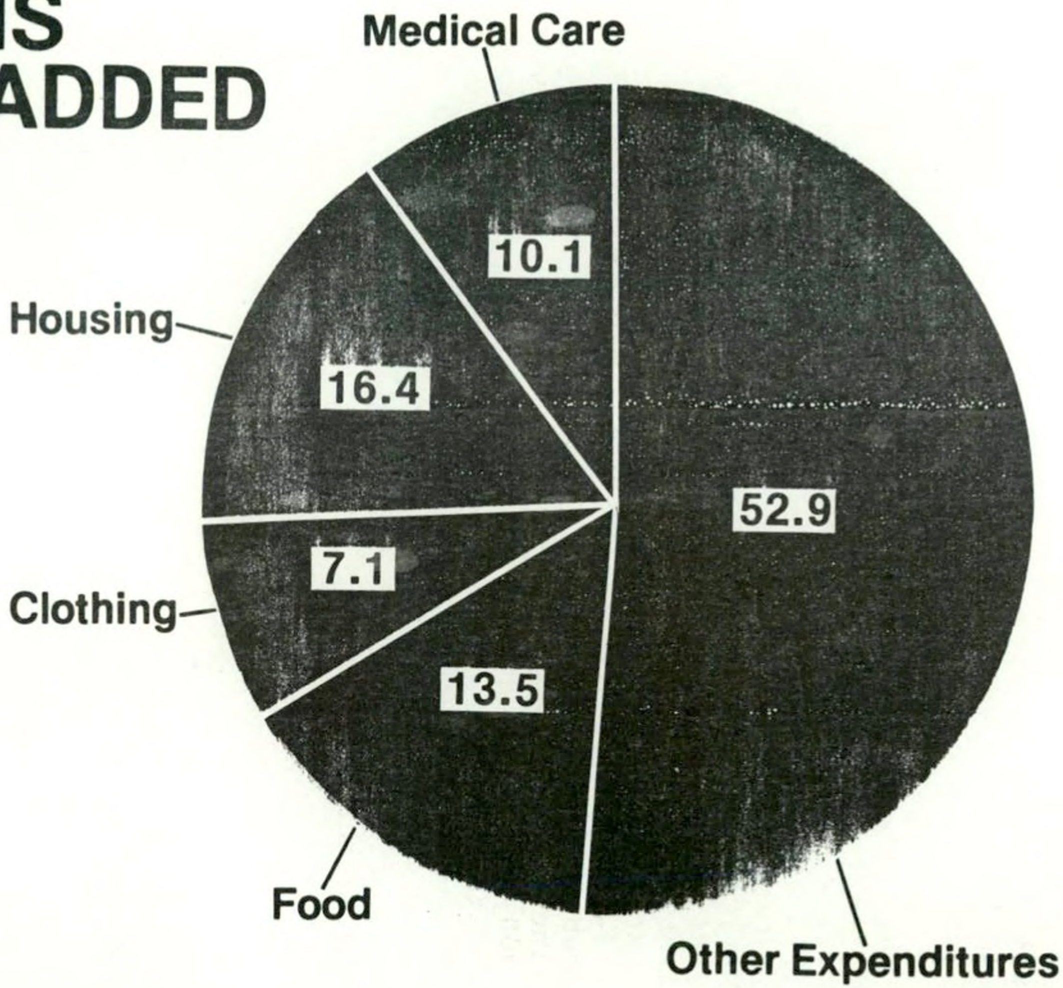
No one, of course, is proposing the complete substitution of the value added tax for the income and social security taxes. A more realistic alternative would be to substitute a value added tax for part of the combined individual income and social security taxes. One possibility would be to reduce income and employee social security taxes by $100 billion, keeping the same degree of progressivity for these taxes as under present law, and offset the revenue loss with a $100 billion value added tax with no exclusions. The resulting distribution of tax burdens would be regressive at the lowest income levels and mildly progressive elsewhere. As a share of income, families with less than $5,000 in income would pay 17 percent in taxes, families with between $5,000 and $10,000 in income would pay 14 percent, and taxes would then increase throughout the income range so that families with over $100,000 of income would pay 21 percent of their income in taxes. The overall distribution is significantly less progressive than the present combination of income and employee social security taxes.

The regressivity of the value added tax can be moderated, but not eliminated, by special measures. One possibility is the use of exemptions and reduced rates for necessities, as in Chairman Ullman's proposal and in some European countries. These reduce the tax burden of the value added tax at the lowest income levels, but the tax remains regressive. Exemptions and reduced rates, moreover, create administrative problems. A tax with two, three, or four rates is more complex than a tax with one rate. The specially-taxed items must be identified. Does a lower rate for food, for example, apply to such items as chewing gum, soda pop, candy, or caviar? Experience with the income tax shows that even medical services and drugs are not easy to define. Beyond the definitional problems, total or partial exclusions erode the value added tax base and its revenue potential. (See Chart 3.)

The regressivity of a value added tax also can be reduced by a refundable income tax credit for tax paid on a necessary amount of consumption. This avoids the need to define exempt commodities and can be implemented at a lower revenue cost than a complete exemption for certain "essential" commodities. It can, for example, be phased out at increased income levels. In effect, middle and upper income groups would still pay tax on purchases of food and other necessary items. On the other hand, a refundable credit is effective only if it reaches the roughly 25 million individuals who do not appear on an income tax return. These tend to be individuals most in need of the credit, mainly

CHART 3

SUBTRACTIONS FROM VALUE ADDED TAX BASE (Percent)



recipients of social security benefits and of transfer payments under social and welfare programs. Unlike lower rates and exemptions, if the credit was not paid until the end of the year, the consumer would have to finance the tax during the year.

Administrative and Design Considerations

Both the European value added taxes and the tax suggested by Chairman Ullman have certain basic similarities:

- they are broad based, applying to services as well as goods;

- tax liability is determined by the credit method with tax paid on purchases deductible from tax due on sales;

- they are consumption type taxes, any tax paid on capital equipment purchases is immediately deductible; and

- they extend through the retail stage.

A value added tax of this type for the United States would involve about 15 million taxpayers. This number might be reduced by 5 million if exemptions were provided for very small proprietorships and farming. But under a value added tax, nearly all transactions are taxed. Even a firm that is tax exempt on its sales will have paid tax on its purchases. If it is to receive credit for tax paid on its purchases, it either would have to file a return or the credit would have to be made available to its customers.

Even 10 million taxpayers would add about 30 percent to the number of returns filed with the Internal Revenue Service, assuming quarterly returns are required. Since the value added tax would not totally replace any other tax and would be a new tax, requiring new returns, new regulations, and a new body of case law, this would be a net addition to the work of taxpayers, the Internal Revenue Service, and the courts. This differs sharply from the typical European case where the value added tax completely replaced another sales tax.

Reporting and payment requirements for a value added tax would be similar to those for Federal excises, which require liability to be computed on a semimonthly basis with payment due 9 days later. The actual excise tax return is filed quarterly and is accompanied by the payment of any remaining balance. Liquor and tobacco excises, however, have slightly different rules. A value added tax payment system which would fit more neatly with ordinary bookkeeping would be a monthly liability period with payment due at the end of the next month. This would be similar to that proposed by Chairman Ullman.

Other Considerations

A Federal value added tax would raise a number of other issues. Forty five states and the District of Columbia impose general sales taxes, a revenue source which they tend to view as belonging exclusively to them. Sales and gross receipts taxes account for about 30 percent of state tax revenue. In contrast, excise taxes generate less than 4 percent of Federal tax collections. Nevertheless, while a Federal value added tax may make it more difficult for the states to raise their sales taxes, it should not prevent such increases. All levels of government, for example, impose income taxes. Moreover, total Federal, state, and local sales tax collections are lower in the United States than in most developed countries.

Because of likely differences in the tax bases, it is doubtful that a Federal value added tax could be coordinated with the state sales taxes. Separate taxes, admittedly, would mean higher administrative and compliance costs. Each level of government would require a collection and audit capability. Taxpayers would have to become familiar with separate tax bases and separate returns. Revenue departments and taxpayers, however, already face this problem with Federal and state income taxes. Efforts aimed at Federal-state cooperation and coordination have not been successful.

As shown by Chairman Ullman's proposal, even a broad-based value added tax may not apply to all forms of final consumption. Practical considerations may require special treatment for many items. In the area of housing, for example, homeowners and tenants should be treated equally. But if rental payments are taxed, how should homeowners be taxed? It may be difficult to value the so-called "imputed rent" on owner occupied housing. Taxing the purchase price of a home is one alternative, but this may aggravate the problems of many families already hard pressed to cope with high housing prices. The treatment of interest in the housing area also is troublesome. If it is exempt, what part of a rental payment should a landlord be allowed to exclude from the tax base? These and other problems will require careful study.

The value added tax is a very potent revenue source. At 1979 levels of consumption, a value added tax would raise roughly $10 billion in revenue for each percentage point. Thus, a 7 percent value added tax would raise about as much revenue as the corporate income tax and a 12 percent value added tax would raise as much revenue as the social security taxes. With such a powerful instrument for raising revenue, many are concerned that the value added tax eventually will be used to add to the total Federal tax burden.

Conclusion

Mr. Chairman, you are to be commended for initiating an examination of the very important, but complex, issues of how the Federal tax structure affects our national well being. This is a time of great change. It is also a time of troublesome and unfamiliar economic conditions. The combination of high inflation, slow growth, and persistent trade deficits must make us wonder if the traditional economic remedies still work. In this sense, your decision to study a broad range of new initiatives could not come at a better time. But changes of such major consequences require careful and deliberate study. We welcome the opportunity to participate with you in that study.

ANNEX A

Federal, State and Local Tax Revenues for Selected Countries as Percent of Gross Domestic Product, by Type of Tax, 1975
(Country Rankings in Parentheses)

Country	Total	Indirect Taxes	Direct Taxes							
			Social Security 2/							
		Sales and Excise 1/	Total	Employer	Employee and Self Employed	Corporate Income	Noncorporate Income 3/	Property 4/	Other 5/	Total Direct Taxes 6/
Belgium	41.43(5)	10.87(6)	13.14(5)	8.44(4)	4.70(5)	3.07(6)	13.24(4)	1.01(12)	0.10(8)	30.56(4)
Canada	33.98(9)	10.94(4)	3.22(12)	n.a.	n.a.	4.67(2)	11.32(7)	3.13(3)	0.70(4)	23.04(11)
Denmark	43.05(4)	14.71(1)	0.48(13)	0.31(12)	0.17(12)	1.37(13)	23.86(1)	2.57(4)	0.06(10)	28.34(5)
France	36.90(6)	12.44(2)	14.72(3)	10.61(2)	4.11(6)	2.00(9)	4.58(13)	1.46(9)	1.70(2)	24.46(9)
Germany (Fed Rep)	35.22(8)	9.37(8)	12.03(6)	6.60(7)	5.43(4)	1.56(12)	10.60(8)	1.09(11)	0.57(6)	25.85(7)
Italy	32.34(10)	9.34(9)	14.83(2)	11.92(1)	2.91(9)	2.04(8)	4.95(12)	1.17(10)	0.01(11)	23.00(12)
Japan	20.23(13)	3.67(13)	5.09(11)	2.63(11)	2.46(10)	3.43(4)	5.07(11)	1.94(7)	1.03(3)	16.56(13)
Luxembourg	46.74(2)	9.72(7)	14.05(4)	7.80(6)	6.25(2)	7.22(1)	12.78(5)	2.34(5)	0.63(5)	37.02(1)
Netherlands	46.90(1)	10.91(5)	17.99(1)	8.40(5)	9.59(1)	3.61(3)	12.66(6)	1.48(8)	0.25(7)	35.99(2)
Sweden	45.96(3)	11.48(3)	8.89(7)	8.47(3)	0.42(11)	1.99(10)	21.17(2)	0.51(13)	1.92(1)	34.48(3)
Switzerland	29.49(12)	5.90(11)	8.49(8)	3.05(10)	5.44(3)	2.46(7)	10.51(9)	2.13(6)	--	23.59(10)
United Kingdom	36.77(7)	9.24(10)	6.71(10)	3.75(9)	2.96(8)	1.92(11)	14.29(3)	4.54(1)	0.07(9)	27.53(6)
United States	30.31(11)	5.49(12)	7.42(9)	4.18(8)	3.24(7)	3.29(5)	9.98(10)	4.13(2)	--	24.82(8)

Office of the Secretary of the Treasury
Office of Tax Analysis

Source: Revenue Statistics of OECD Member Countries, 1965-1975.

1/ Includes general sales, value added, and specific excise taxes.

2/ Includes contributions of employers, employees, and self employed. Category is broadly defined to include all tax payments to institutions of general government providing social welfare benefits, provided they are levied as a function of pay or a fixed amount per person. Thus, for the United States this category includes contributions to the railroad retirement fund, unemployment insurance fund, workman's compensation fund, and civil service retirement program in addition, of course, to the more familiar social security-type payments made pursuant to the Federal Insurance Contributions Act (FICA).

3/ Includes income taxes on individual and unincorporated enterprise, such as proprietorships and partnerships.

4/ Includes taxes on net wealth, immovable property, estates, and gifts.

5/ Includes taxes on employers based on payroll or manpower and miscellaneous taxes which cannot be classified within a specific direct tax category.

6/ Computed by subtracting sales and excises from total.

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TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of this distinguished Committee:

It is a pleasure to appear before this Committee to discuss the important issues raised by H.R. 5665, the "Tax Restructuring Act of 1979." This bill would result in fundamental changes in our Federal tax structure. Income taxes on corporations and individuals, as well as social security taxes, would be cut by $130 billion in 1981. A Federal value added tax would offset this revenue loss. This testimony will not concentrate on the specifics of H.R. 5665, but on the basic issue which the bill raises: whether the United States should replace some of its income taxes with a consumption tax. That is, whether the Federal tax system should weigh more heavily on consumption and less heavily on saving and investment. Many believe that such a change would contribute significantly to improved capital formation, higher productivity, and a more competitive position for American business in world markets. Others express concern that a consumption tax would have only small effects on investment and would place an unfair burden on lower income families already plagued by high prices for energy, food, housing, and other basic necessities of life. Higher consumption taxes, they believe, would mean still higher prices. These hearings will serve the valuable function of focusing the discussion on these significant economic and social issues.

An important element in this discussion is the role of a value added tax in the Federal tax structure. A value added tax is a multistage tax on consumer goods and services. Unlike a retail sales tax, it is collected at each stage in the production and distribution process. But since it is levied only on the amount of value added (the difference between sales and purchases) at each stage, rather than on the full selling price, it avoids the cascade, tax-on-tax, effects of a turnover sales tax. A value added tax is similar to a retail sales tax in that the total tax paid by the consumer is equal to the final price of the product multiplied by the tax rate.

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Many European countries have value added taxes. Typically, they are imposed at a rate of about 15 to 20 percent and generate about 15 percent of a country's total national and local tax revenue. In contrast, state and local retail sales taxes raise about 7 percent of the total Federal, state, and local tax revenue in the United States. The $130 billion in value added tax revenue estimated to be raised by H.R. 5665 would be about 14 percent of total Federal, state, and local 1981 tax liabilities, assuming it is accompanied by the proposed income and social security tax cuts.

In nearly all cases, the European value added taxes replaced sales taxes, frequently of the cascade turnover type which, unlike the value added tax, taxed the full sales price at each stage, without allowing a credit for tax on previous transactions. The Europeans found the cascade tax objectionable because it discriminated against nonintegrated firms and because the export rebate and import tax could not be accurately estimated for border adjustment purposes. Thus, in the European case, the adoption of a value added tax was regarded as a reform of an unwieldy and distortionary system of indirect taxation. This characterization does not apply to the present indirect tax system in the United States. Only the United Kingdom has used the value added tax to reduce income taxes, as Chairman Ullman is suggesting for the United States.

The popularity of the value added tax is not universal. The voters of Switzerland have twice rejected it by referendum. The latest rejection was based in part on a perceived threat to local autonomy since a Federal value added tax would have replaced some of the local Swiss taxes. Most recently, Japan, largely as a result of its parliamentary elections, appears to have postponed the planned introduction of a value added tax.

For the United States, a value added tax raises a number of important questions. Would it encourage capital formation? What impact would it have on the price level? Would it improve the trade balance? Would it be regressive? No one is seriously suggesting the value added tax solely as an additional Federal tax. Consequently, the answers to these questions, as well as others, depend upon which taxes the value added tax replaces. By way of illustration, two of the proposals made by Chairman Ullman call for reducing the corporate income tax and the social security taxes.

Capital Formation

Taxes on capital income, such as the corporate income tax and the individual income tax on interest and dividends, reduce the after-tax return on savings. Put another way, an income tax encourages present, as compared to future, consumption. With no taxes, a person with $100 of income could choose between buying

$100 of consumption goods this year or saving now and buying $110 of consumption goods next year, assuming the interest rate is 10 percent. Thus, a person can consume 10 percent more next year by saving now. Similarly, with a consumption tax, which exempts the earnings from capital, a person with $100 of income could consume $50 this year and pay $50 in tax or, by saving the income this year, could consume $55 next year and pay $55 in tax. Thus, a person could still consume 10 percent more next year by saving now.

If a 50 percent income tax, rather than a consumption tax, is imposed, however, the individual, after paying the tax, can buy $50 of consumption goods this year or can save the $50 and, after paying the tax on the interest earnings, buy $52.50 of consumption goods next year. Because of the income tax, a person can buy only 5 percent, rather than 10 percent, more consumption goods next year. Because of this lower return, the individual may decide to consume now rather than save for future consumption. It is important to recognize, however, that the responsiveness of saving to more favorable taxation is an unsettled issue. If one concludes that savings will rise in response to reduced taxation, then substituting a value added tax for the corporate income tax should encourage saving.

There are other considerations in assessing the mechanism that leads to an increase in investment. First, an increase in savings must be channeled into domestic financial markets in order to lower interest rates and therefore the cost of capital. Second, producers must respond to the lower cost of capital by using more capital intensive methods of production. There probably will be some response, but its magnitude is open to discussion. Third, the mix of new investment must be considered; it may be concentrated in housing, consumer durables, or fixed business capital. Thus, the substitution of a value added tax for the corporate income tax will increase capital formation only if savings increase, the cost of capital falls, and business responds by investing in the United States.

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The important question, then, is whether the inflationary impact of the value added tax would be offset by reductions in other taxes. In the short run, the corporate income tax reduces the after-tax rate of return to capital, rather than increases product prices. Accordingly, prices will probably not fall as corporate income taxes are cut. Thus, substituting a value added tax for the corporate income tax is likely to increase prices. This is a serious drawback to the value added tax.

Substituting a value added tax for the social security tax may be less inflationary. Reducing the employer portion of the social security tax would tend to reduce business labor costs and possibly prices. Reducing the employee portion of the social security tax, however, would probably have no effect on the price level. Thus a value added tax, accompanied by an equivalent reduction in employer and employee social security taxes, would result in some increase in the price level. This would be particularly distressing to individuals least able to protect themselves from rising prices.

The impact of a value added tax on prices is largely independent of whether it is hidden in the price of the product or whether it is quoted separately to consumers. While it is not customary in Europe to quote the value added tax separately, this need not be the case in the United States. State retail sales taxes are quoted separately because the merchants persuaded legislators to require it, and the same could occur in the case of a United States value added tax. Furthermore, nonseparate quotation of the value added tax might be viewed as an attempt to hide the tax from public scrutiny.

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Many have expressed the view that a value added tax would improve our trade balance. This is based on the observation that current international rules allow indirect taxes, such as sales or value added taxes, to be imposed on imports and rebated on exports. These adjustments are not allowed for direct taxes,

such as the corporate income or social security taxes. It is doubtful, however, that the U.S. trade balance would improve significantly from substituting a value added tax for the corporate income tax.

The impact of the value added tax on trade is closely related to what happens to prices. Quite simply, one must ask the question: will the substitution of the value added tax for some other tax increase prices? It seems likely that the immediate impact of substituting a general value added tax of 5 percent for part of the corporate income tax would be to increase prices by about 5 percent. Since the new tax would be rebated on exports, just like our state retail sales and Federal excise taxes, exports would leave the country tax free. While domestic prices would be 5 percent higher, export prices would remain unchanged. Foreign consumers, therefore, would find U.S. products no more attractive than before; there would be no increase in demand for U.S. exports.

Since imports would be subject to the value added tax their prices also would increase by about 5 percent, the same as for domestic goods and services. As a consequence, domestic consumers would find imports just as attractive as before; there would be no incentive to reduce the demand for imports. Thus, on both the export and import side, there would be little immediate impact on the U.S. trade balance if a value added tax were substituted for the corporate income tax. There might, of course, be a positive trade impact in the long run if the substitution led to an improved investment climate, enhanced capital formation, and a more productive and competitive U.S. economy.

A modest trade balance improvement might result from replacing the social security tax with a value added tax, if the price level increased by less than the value added tax. Because of the price-dampening effect of reducing the employer portion of the social security tax, this is a possibility.

Regardless of which tax it replaces, many believe that a value added tax rebate, in itself, will expand exports and that a value added tax levy will retard imports. This belief might have a positive effect on trade if it encourages businesses to compete more vigorously in international markets. This result would depend upon the importance of nonprice considerations in explaining export activity.

It is also important to recognize that other countries could restructure their own tax systems if they felt the United States was gaining an unfair trade advantage. Relative to other countries, the United States has a moderately high corporate income tax, but a low social security tax. (See Annex A.) Thus, the possibility exists that other countries might maintain their competitive position by increasing their existing value added

taxes and reducing their corporate income or, especially, their social security taxes. This outcome is by no means certain. After all, a country's tax structure is not determined solely by international considerations. Moreover, except for Japan, U.S. indirect taxes, as a share of gross domestic product, are the lowest of the major developed countries. (See Chart 1 and Annex A.) Other countries may believe that the United States should be allowed to "tilt" its tax structure to reach some "reasonable" or "average" level of indirect taxation.

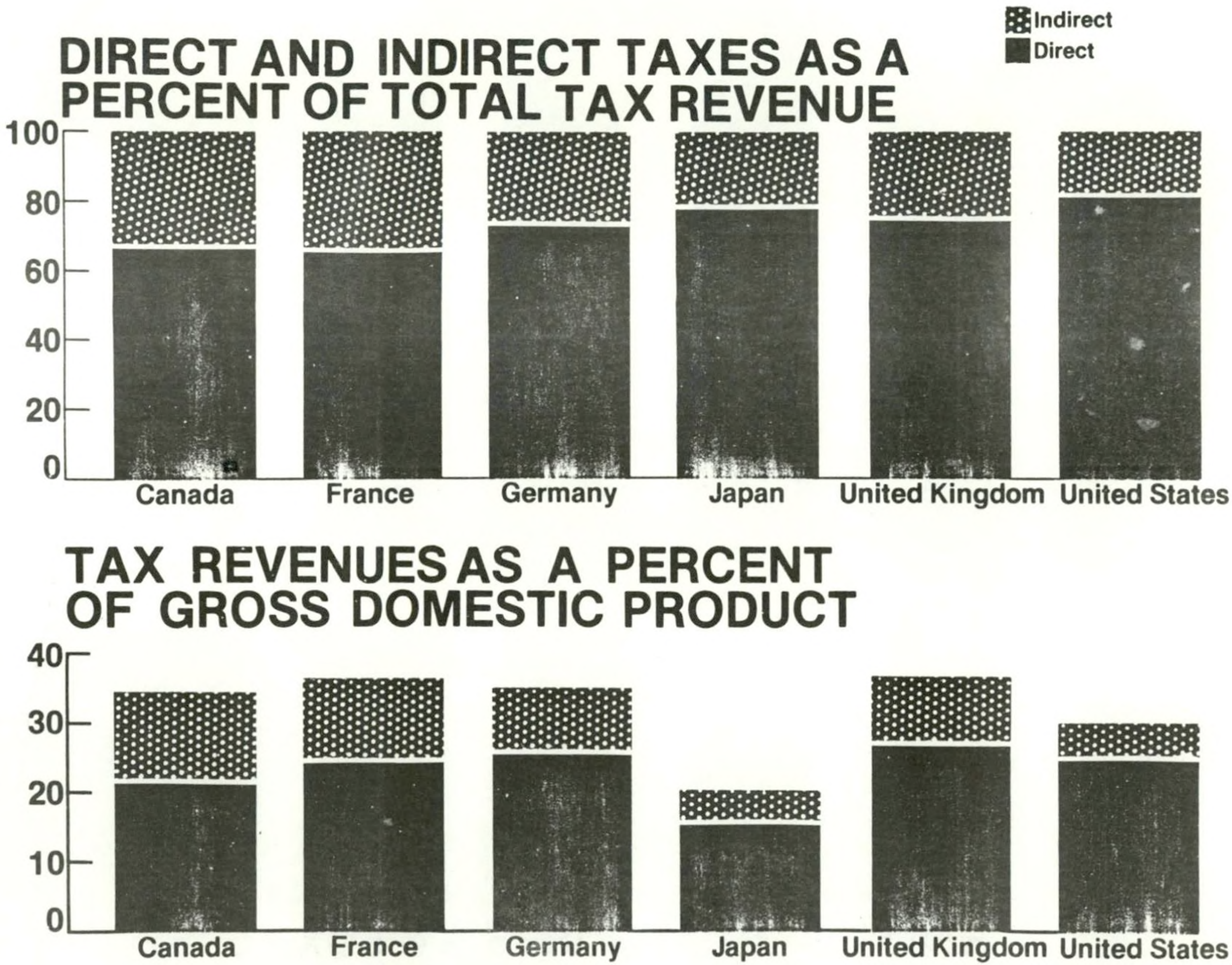
This issue has been studied before. Both the President's Task Force on Business Taxation, in its 1970 review of tax policy, and the Advisory Commission on Intergovernmental Relations, in its 1973 value added tax study, considered the trade issue. Both expressed doubt over any trade benefits resulting from substituting a value added tax for the corporate income tax and both noted the possibility of foreign retaliation.

Distribution of Tax Burden

Lower income taxpayers, who must spend all their income on consumption, may find a value added tax burdensome because of its regressivity. While a value added tax, by itself, is regressive, one must consider which tax it replaces. The immediate impact of the corporate income tax is probably progressive since it falls on income from capital. Therefore, substituting a value added tax for the corporate income tax would make the tax structure less progressive. The social security tax, on the other hand, also is regressive because it is limited to the first $22,900 of wages and applies only to labor income. Accordingly, substituting a value added tax for the social security tax would not make the tax system noticeably less progressive. One regressive tax would be substituted for another. Retired individuals, however, who do not pay social security tax, would be distressed by having to pay value added tax. They could justifiably say that they already had paid for their retirement during their working years and that higher prices and taxes in retirement were unfair. Their distress might be partially assuaged by the fact that social security payments are indexed.

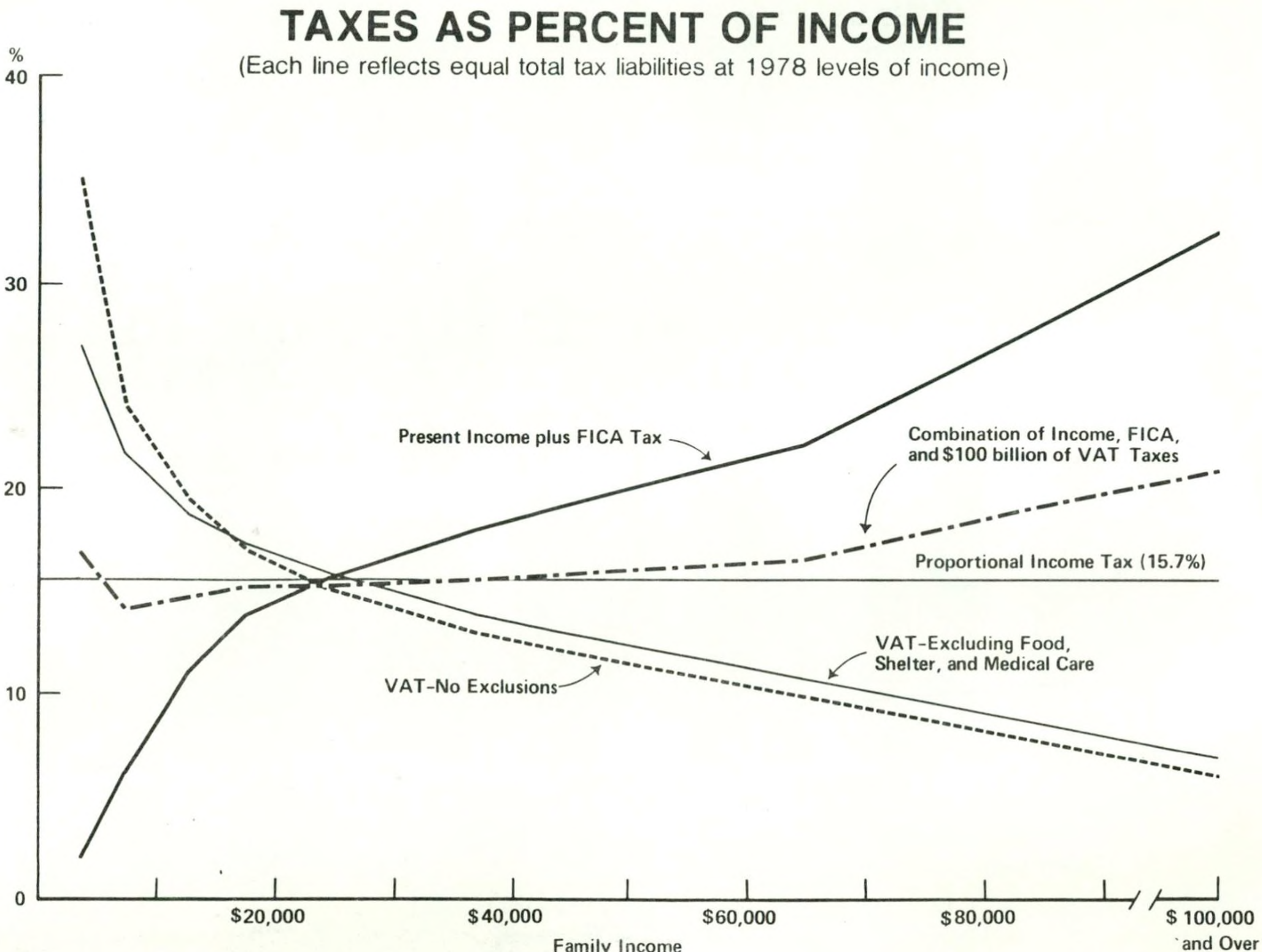
One way to illustrate possible distributional effects is to ask what would happen to tax burdens if a value added tax completely replaced the individual income and social security (employee portion) taxes. (See Chart 2.) The combination of the current income and social security taxes is progressive while a value added tax, even with necessities excluded, is regressive. As a share of income, the present individual income and social security taxes are only 2 percent for families with less than $5,000 in income, but increase throughout the income range to 33 percent for families with over $100,000 in income.

CHART 1



Indirect
Direct
DIRECT AND INDIRECT TAXES AS A PERCENT OF TOTAL TAX REVENUE
100
80
60
40
20
0
Canada
France
Germany
Japan
United Kingdom
United States
TAX REVENUES AS A PERCENT OF GROSS DOMESTIC PRODUCT
40
30
20
10
0
Canada
France
Germany
Japan
United Kingdom
United States

CHART 2



TAXES AS PERCENT OF INCOME
(Each line reflects equal total tax liabilities at 1978 levels of income)
%
40
30
20
10
0
Present Income plus FICA Tax
Combination of Income, FICA, and $100 billion of VAT Taxes
Proportional Income Tax (15.7%)
VAT-Excluding Food, Shelter, and Medical Care
VAT-No Exclusions
$20,000
$40,000
$60,000
$80,000
$ 100,000 and Over
Family Income

This may be contrasted with a value added tax with no exclusions at a 23.2 percent rate, sufficient to equal the revenue raised by the individual income and employee social security taxes in 1978. As a share of income, such a value added tax would be 35 percent for families with less than $5,000 in income, but fall to 6 percent for families with over $100,000 in income.

No one, of course, is proposing the complete substitution of the value added tax for the income and social security taxes. A more realistic alternative would be to substitute a value added tax for part of the combined individual income and social security taxes. One possibility would be to reduce income and employee social security taxes by $100 billion, keeping the same degree of progressivity for these taxes as under present law, and offset the revenue loss with a $100 billion value added tax with no exclusions. The resulting distribution of tax burdens would be regressive at the lowest income levels and mildly progressive elsewhere. As a share of income, families with less than $5,000 in income would pay 17 percent in taxes, families with between $5,000 and $10,000 in income would pay 14 percent, and taxes would then increase throughout the income range so that families with over $100,000 of income would pay 21 percent of their income in taxes. The overall distribution is significantly less progressive than the present combination of income and employee social security taxes.

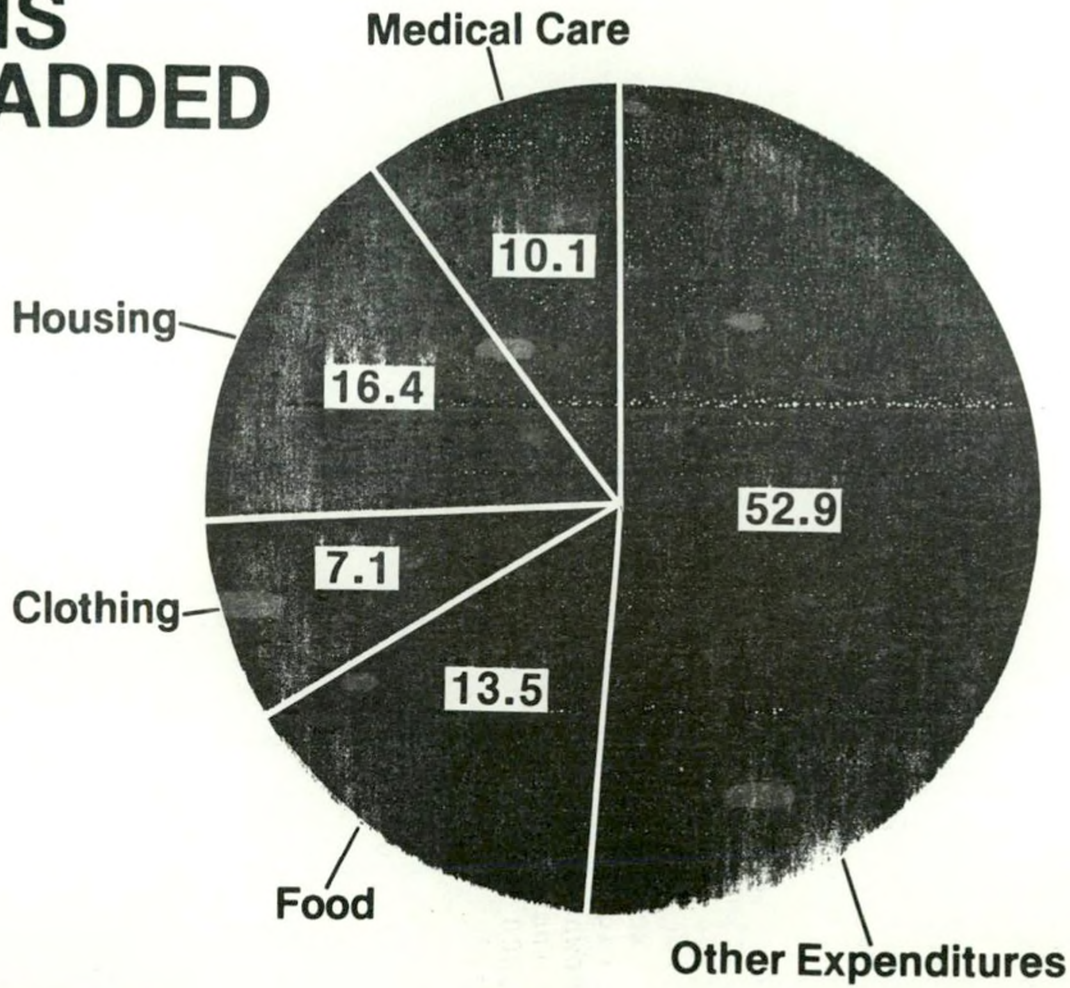
The regressivity of the value added tax can be moderated, but not eliminated, by special measures. One possibility is the use of exemptions and reduced rates for necessities, as in Chairman Ullman's proposal and in some European countries. These reduce the tax burden of the value added tax at the lowest income levels, but the tax remains regressive. Exemptions and reduced rates, moreover, create administrative problems. A tax with two, three, or four rates is more complex than a tax with one rate. The specially-taxed items must be identified. Does a lower rate for food, for example, apply to such items as chewing gum, soda pop, candy, or caviar? Experience with the income tax shows that even medical services and drugs are not easy to define. Beyond the definitional problems, total or partial exclusions erode the value added tax base and its revenue potential. (See Chart 3.)

The regressivity of a value added tax also can be reduced by a refundable income tax credit for tax paid on a necessary amount of consumption. This avoids the need to define exempt commodities and can be implemented at a lower revenue cost than a complete exemption for certain "essential" commodities. It can, for example, be phased out at increased income levels. In effect, middle and upper income groups would still pay tax on purchases of food and other necessary items. On the other hand, a refundable credit is effective only if it reaches the roughly 25 million individuals who do not appear on an income tax return. These tend to be individuals most in need of the credit, mainly

CHART 3

SUBTRACTIONS FROM VALUE ADDED TAX BASE

(Percent)



recipients of social security benefits and of transfer payments under social and welfare programs. Unlike lower rates and exemptions, if the credit was not paid until the end of the year, the consumer would have to finance the tax during the year.

Administrative and Design Considerations

Both the European value added taxes and the tax suggested by Chairman Ullman have certain basic similarities:

- they are broad based, applying to services as well as goods;

- tax liability is determined by the credit method with tax paid on purchases deductible from tax due on sales;

- they are consumption type taxes, any tax paid on capital equipment purchases is immediately deductible; and

- they extend through the retail stage.

A value added tax of this type for the United States would involve about 15 million taxpayers. This number might be reduced by 5 million if exemptions were provided for very small proprietorships and farming. But under a value added tax, nearly all transactions are taxed. Even a firm that is tax exempt on its sales will have paid tax on its purchases. If it is to receive credit for tax paid on its purchases, it either would have to file a return or the credit would have to be made available to its customers.

Even 10 million taxpayers would add about 30 percent to the number of returns filed with the Internal Revenue Service, assuming quarterly returns are required. Since the value added tax would not totally replace any other tax and would be a new tax, requiring new returns, new regulations, and a new body of case law, this would be a net addition to the work of taxpayers, the Internal Revenue Service, and the courts. This differs sharply from the typical European case where the value added tax completely replaced another sales tax.

Reporting and payment requirements for a value added tax would be similar to those for Federal excises, which require liability to be computed on a semimonthly basis with payment due 9 days later. The actual excise tax return is filed quarterly and is accompanied by the payment of any remaining balance. Liquor and tobacco excises, however, have slightly different rules. A value added tax payment system which would fit more neatly with ordinary bookkeeping would be a monthly liability period with payment due at the end of the next month. This would be similar to that proposed by Chairman Ullman.

Other Considerations

A Federal value added tax would raise a number of other issues. Forty five states and the District of Columbia impose general sales taxes, a revenue source which they tend to view as belonging exclusively to them. Sales and gross receipts taxes account for about 30 percent of state tax revenue. In contrast, excise taxes generate less than 4 percent of Federal tax collections. Nevertheless, while a Federal value added tax may make it more difficult for the states to raise their sales taxes, it should not prevent such increases. All levels of government, for example, impose income taxes. Moreover, total Federal, state, and local sales tax collections are lower in the United States than in most developed countries.

Because of likely differences in the tax bases, it is doubtful that a Federal value added tax could be coordinated with the state sales taxes. Separate taxes, admittedly, would mean higher administrative and compliance costs. Each level of government would require a collection and audit capability. Taxpayers would have to become familiar with separate tax bases and separate returns. Revenue departments and taxpayers, however, already face this problem with Federal and state income taxes. Efforts aimed at Federal-state cooperation and coordination have not been successful.

As shown by Chairman Ullman's proposal, even a broad-based value added tax may not apply to all forms of final consumption. Practical considerations may require special treatment for many items. In the area of housing, for example, homeowners and tenants should be treated equally. But if rental payments are taxed, how should homeowners be taxed? It may be difficult to value the so-called "imputed rent" on owner occupied housing. Taxing the purchase price of a home is one alternative, but this may aggravate the problems of many families already hard pressed to cope with high housing prices. The treatment of interest in the housing area also is troublesome. If it is exempt, what part of a rental payment should a landlord be allowed to exclude from the tax base? These and other problems will require careful study.

The value added tax is a very potent revenue source. At 1979 levels of consumption, a value added tax would raise roughly $10 billion in revenue for each percentage point. Thus, a 7 percent value added tax would raise about as much revenue as the corporate income tax and a 12 percent value added tax would raise as much revenue as the social security taxes. With such a powerful instrument for raising revenue, many are concerned that the value added tax eventually will be used to add to the total Federal tax burden.

Conclusion

Mr. Chairman, you are to be commended for initiating an examination of the very important, but complex, issues of how the Federal tax structure affects our national well being. This is a time of great change. It is also a time of troublesome and unfamiliar economic conditions. The combination of high inflation, slow growth, and persistent trade deficits must make us wonder if the traditional economic remedies still work. In this sense, your decision to study a broad range of new initiatives could not come at a better time. But changes of such major consequences require careful and deliberate study. We welcome the opportunity to participate with you in that study.

ANNEX A

Federal, State and Local Tax Revenues for Selected Countries as Percent of Gross Domestic Product, by Type of Tax, 1975
(Country Rankings in Parentheses)

		Indirect Taxes	Direct Taxes							
			Social Security 2/							
Country	Total	Sales and Excise 1/	Total	Employer	Employee and Self Employed	Corporate Income	Noncorporate Income 3/	Property 4/	Other 5/	Total Direct Taxes 6/
Belgium	41.43(5)	10.87(6)	13.14(5)	8.44(4)	4.70(5)	3.07(6)	13.24(4)	1.01(12)	0.10(8)	30.56(4)
Canada	33.98(9)	10.94(4)	3.22(12)	n.a.	n.a.	4.67(2)	11.32(7)	3.13(3)	0.70(4)	23.04(11)
Denmark	43.05(4)	14.71(1)	0.48(13)	0.31(12)	0.17(12)	1.37(13)	23.86(1)	2.57(4)	0.06(10)	28.34(5)
France	36.90(6)	12.44(2)	14.72(3)	10.61(2)	4.11(6)	2.00(9)	4.58(13)	1.46(9)	1.70(2)	24.46(9)
Germany (Fed Rep)	35.22(8)	9.37(8)	12.03(6)	6.60(7)	5.43(4)	1.56(12)	10.60(8)	1.09(11)	0.57(6)	25.85(7)
Italy	32.34(10)	9.34(9)	14.83(2)	11.92(1)	2.91(9)	2.04(8)	4.95(12)	1.17(10)	0.01(11)	23.00(12)
Japan	20.23(13)	3.67(13)	5.09(11)	2.63(11)	2.46(10)	3.43(4)	5.07(11)	1.94(7)	1.03(3)	16.56(13)
Luxembourg	46.74(2)	9.72(7)	14.05(4)	7.80(6)	6.25(2)	7.22(1)	12.78(5)	2.34(5)	0.63(5)	37.02(1)
Netherlands	46.90(1)	10.91(5)	17.99(1)	8.40(5)	9.59(1)	3.61(3)	12.66(6)	1.48(8)	0.25(7)	35.99(2)
Sweden	45.96(3)	11.48(3)	8.89(7)	8.47(3)	0.42(11)	1.99(10)	21.17(2)	0.51(13)	1.92(1)	34.48(3)
Switzerland	29.49(12)	5.90(11)	8.49(8)	3.05(10)	5.44(3)	2.46(7)	10.51(9)	2.13(6)	--	23.59(10)
United Kingdom	36.77(7)	9.24(10)	6.71(10)	3.75(9)	2.96(8)	1.92(11)	14.29(3)	4.54(1)	0.07(9)	27.53(6)
United States	30.31(11)	5.49(12)	7.42(9)	4.18(8)	3.24(7)	3.29(5)	9.98(10)	4.13(2)	--	24.82(8)

Office of the Secretary of the Treasury
Office of Tax Analysis

Source: Revenue Statistics of OECD Member Countries, 1965-1975.

1/ Includes general sales, value added, and specific excise taxes.

2/ Includes contributions of employers, employees, and self employed. Category is broadly defined to include all tax payments to institutions of general government providing social welfare benefits, provided they are levied as a function of pay or a fixed amount per person. Thus, for the United States this category includes contributions to the railroad retirement fund, unemployment insurance fund, workman's compensation fund, and civil service retirement program in addition, of course, to the more familiar social security-type payments made pursuant to the Federal Insurance Contributions Act (FICA).

3/ Includes income taxes on individual and unincorporated enterprise, such as proprietorships and partnerships.

4/ Includes taxes on net wealth, immovable property, estates, and gifts.

5/ Includes taxes on employers based on payroll or manpower and miscellaneous taxes which cannot be classified within a specific direct tax category.

6/ Computed by subtracting sales and excises from total.

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TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of this distinguished Committee:

It is a pleasure to appear before this Committee to discuss the important issues raised by H.R. 5665, the "Tax Restructuring Act of 1979." This bill would result in fundamental changes in our Federal tax structure. Income taxes on corporations and individuals, as well as social security taxes, would be cut by $130 billion in 1981. A Federal value added tax would offset this revenue loss. This testimony will not concentrate on the specifics of H.R. 5665, but on the basic issue which the bill raises: whether the United States should replace some of its income taxes with a consumption tax. That is, whether the Federal tax system should weigh more heavily on consumption and less heavily on saving and investment. Many believe that such a change would contribute significantly to improved capital formation, higher productivity, and a more competitive position for American business in world markets. Others express concern that a consumption tax would have only small effects on investment and would place an unfair burden on lower income families already plagued by high prices for energy, food, housing, and other basic necessities of life. Higher consumption taxes, they believe, would mean still higher prices. These hearings will serve the valuable function of focusing the discussion on these significant economic and social issues.

An important element in this discussion is the role of a value added tax in the Federal tax structure. A value added tax is a multistage tax on consumer goods and services. Unlike a retail sales tax, it is collected at each stage in the production and distribution process. But since it is levied only on the amount of value added (the difference between sales and purchases) at each stage, rather than on the full selling price, it avoids the cascade, tax-on-tax, effects of a turnover sales tax. A value added tax is similar to a retail sales tax in that the total tax paid by the consumer is equal to the final price of the product multiplied by the tax rate.

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Many European countries have value added taxes. Typically, they are imposed at a rate of about 15 to 20 percent and generate about 15 percent of a country's total national and local tax revenue. In contrast, state and local retail sales taxes raise about 7 percent of the total Federal, state, and local tax revenue in the United States. The $130 billion in value added tax revenue estimated to be raised by H.R. 5665 would be about 14 percent of total Federal, state, and local 1981 tax liabilities, assuming it is accompanied by the proposed income and social security tax cuts.

In nearly all cases, the European value added taxes replaced sales taxes, frequently of the cascade turnover type which, unlike the value added tax, taxed the full sales price at each stage, without allowing a credit for tax on previous transactions. The Europeans found the cascade tax objectionable because it discriminated against nonintegrated firms and because the export rebate and import tax could not be accurately estimated for border adjustment purposes. Thus, in the European case, the adoption of a value added tax was regarded as a reform of an unwieldy and distortionary system of indirect taxation. This characterization does not apply to the present indirect tax system in the United States. Only the United Kingdom has used the value added tax to reduce income taxes, as Chairman Ullman is suggesting for the United States.

The popularity of the value added tax is not universal. The voters of Switzerland have twice rejected it by referendum. The latest rejection was based in part on a perceived threat to local autonomy since a Federal value added tax would have replaced some of the local Swiss taxes. Most recently, Japan, largely as a result of its parliamentary elections, appears to have postponed the planned introduction of a value added tax.

For the United States, a value added tax raises a number of important questions. Would it encourage capital formation? What impact would it have on the price level? Would it improve the trade balance? Would it be regressive? No one is seriously suggesting the value added tax solely as an additional Federal tax. Consequently, the answers to these questions, as well as others, depend upon which taxes the value added tax replaces. By way of illustration, two of the proposals made by Chairman Ullman call for reducing the corporate income tax and the social security taxes.

Capital Formation

Taxes on capital income, such as the corporate income tax and the individual income tax on interest and dividends, reduce the after-tax return on savings. Put another way, an income tax encourages present, as compared to future, consumption. With no taxes, a person with $100 of income could choose between buying

$100 of consumption goods this year or saving now and buying $110 of consumption goods next year, assuming the interest rate is 10 percent. Thus, a person can consume 10 percent more next year by saving now. Similarly, with a consumption tax, which exempts the earnings from capital, a person with $100 of income could consume $50 this year and pay $50 in tax or, by saving the income this year, could consume $55 next year and pay $55 in tax. Thus, a person could still consume 10 percent more next year by saving now.

If a 50 percent income tax, rather than a consumption tax, is imposed, however, the individual, after paying the tax, can buy $50 of consumption goods this year or can save the $50 and, after paying the tax on the interest earnings, buy $52.50 of consumption goods next year. Because of the income tax, a person can buy only 5 percent, rather than 10 percent, more consumption goods next year. Because of this lower return, the individual may decide to consume now rather than save for future consumption. It is important to recognize, however, that the responsiveness of saving to more favorable taxation is an unsettled issue. If one concludes that savings will rise in response to reduced taxation, then substituting a value added tax for the corporate income tax should encourage saving.

There are other considerations in assessing the mechanism that leads to an increase in investment. First, an increase in savings must be channeled into domestic financial markets in order to lower interest rates and therefore the cost of capital. Second, producers must respond to the lower cost of capital by using more capital intensive methods of production. There probably will be some response, but its magnitude is open to discussion. Third, the mix of new investment must be considered; it may be concentrated in housing, consumer durables, or fixed business capital. Thus, the substitution of a value added tax for the corporate income tax will increase capital formation only if savings increase, the cost of capital falls, and business responds by investing in the United States.

Finally, it bears noting that the potential of the value added tax for promoting capital formation may be exaggerated by an analysis that compares a "pure" consumption tax with a "pure" income tax levied on all returns to capital. The current income tax does not apply with full force to all types of saving and investment. For example, home ownership, pension reserves, and assets eligible for the investment tax credit or the asset depreciation range receive relatively favorable tax treatment. Similarly, not all forms of consumption would be taxed the same under any likely value added tax.

In contrast to an income tax, neither the social security tax nor a value added tax applies directly to the return from saving. Consequently, substituting a value added tax for the social security tax would be unlikely to affect savings decisions.

Price Level Impact

A value added tax, by itself, will probably increase prices, since the tendency for business to pass the tax on to consumers is unlikely to be offset by an unduly restrictive monetary policy. The result would be a "one-shot" increase, not a recurrent increase, in the price level, although the subsequent price effects of adjustments in wage contracts, social security payments, and other indexed items may occur over time. In this regard, it is noteworthy that the Thatcher government's program of increased value added taxation and reduced individual income taxation has been accompanied by a significant increase in the consumer price index in the United Kingdom.

The important question, then, is whether the inflationary impact of the value added tax would be offset by reductions in other taxes. In the short run, the corporate income tax reduces the after-tax rate of return to capital, rather than increases product prices. Accordingly, prices will probably not fall as corporate income taxes are cut. Thus, substituting a value added tax for the corporate income tax is likely to increase prices. This is a serious drawback to the value added tax.

Substituting a value added tax for the social security tax may be less inflationary. Reducing the employer portion of the social security tax would tend to reduce business labor costs and possibly prices. Reducing the employee portion of the social security tax, however, would probably have no effect on the price level. Thus a value added tax, accompanied by an equivalent reduction in employer and employee social security taxes, would result in some increase in the price level. This would be particularly distressing to individuals least able to protect themselves from rising prices.

The impact of a value added tax on prices is largely independent of whether it is hidden in the price of the product or whether it is quoted separately to consumers. While it is not customary in Europe to quote the value added tax separately, this need not be the case in the United States. State retail sales taxes are quoted separately because the merchants persuaded legislators to require it, and the same could occur in the case of a United States value added tax. Furthermore, nonseparate quotation of the value added tax might be viewed as an attempt to hide the tax from public scrutiny.

Balance of Trade

Many have expressed the view that a value added tax would improve our trade balance. This is based on the observation that current international rules allow indirect taxes, such as sales or value added taxes, to be imposed on imports and rebated on exports. These adjustments are not allowed for direct taxes,

such as the corporate income or social security taxes. It is doubtful, however, that the U.S. trade balance would improve significantly from substituting a value added tax for the corporate income tax.

The impact of the value added tax on trade is closely related to what happens to prices. Quite simply, one must ask the question: will the substitution of the value added tax for some other tax increase prices? It seems likely that the immediate impact of substituting a general value added tax of 5 percent for part of the corporate income tax would be to increase prices by about 5 percent. Since the new tax would be rebated on exports, just like our state retail sales and Federal excise taxes, exports would leave the country tax free. While domestic prices would be 5 percent higher, export prices would remain unchanged. Foreign consumers, therefore, would find U.S. products no more attractive than before; there would be no increase in demand for U.S. exports.

Since imports would be subject to the value added tax their prices also would increase by about 5 percent, the same as for domestic goods and services. As a consequence, domestic consumers would find imports just as attractive as before; there would be no incentive to reduce the demand for imports. Thus, on both the export and import side, there would be little immediate impact on the U.S. trade balance if a value added tax were substituted for the corporate income tax. There might, of course, be a positive trade impact in the long run if the substitution led to an improved investment climate, enhanced capital formation, and a more productive and competitive U.S. economy.

A modest trade balance improvement might result from replacing the social security tax with a value added tax, if the price level increased by less than the value added tax. Because of the price-dampening effect of reducing the employer portion of the social security tax, this is a possibility.

Regardless of which tax it replaces, many believe that a value added tax rebate, in itself, will expand exports and that a value added tax levy will retard imports. This belief might have a positive effect on trade if it encourages businesses to compete more vigorously in international markets. This result would depend upon the importance of nonprice considerations in explaining export activity.

It is also important to recognize that other countries could restructure their own tax systems if they felt the United States was gaining an unfair trade advantage. Relative to other countries, the United States has a moderately high corporate income tax, but a low social security tax. (See Annex A.) Thus, the possibility exists that other countries might maintain their competitive position by increasing their existing value added

taxes and reducing their corporate income or, especially, their social security taxes. This outcome is by no means certain. After all, a country's tax structure is not determined solely by international considerations. Moreover, except for Japan, U.S. indirect taxes, as a share of gross domestic product, are the lowest of the major developed countries. (See Chart 1 and Annex A.) Other countries may believe that the United States should be allowed to "tilt" its tax structure to reach some "reasonable" or "average" level of indirect taxation.

This issue has been studied before. Both the President's Task Force on Business Taxation, in its 1970 review of tax policy, and the Advisory Commission on Intergovernmental Relations, in its 1973 value added tax study, considered the trade issue. Both expressed doubt over any trade benefits resulting from substituting a value added tax for the corporate income tax and both noted the possibility of foreign retaliation.

Distribution of Tax Burden

Lower income taxpayers, who must spend all their income on consumption, may find a value added tax burdensome because of its regressivity. While a value added tax, by itself, is regressive, one must consider which tax it replaces. The immediate impact of the corporate income tax is probably progressive since it falls on income from capital. Therefore, substituting a value added tax for the corporate income tax would make the tax structure less progressive. The social security tax, on the other hand, also is regressive because it is limited to the first $22,900 of wages and applies only to labor income. Accordingly, substituting a value added tax for the social security tax would not make the tax system noticeably less progressive. One regressive tax would be substituted for another. Retired individuals, however, who do not pay social security tax, would be distressed by having to pay value added tax. They could justifiably say that they already had paid for their retirement during their working years and that higher prices and taxes in retirement were unfair. Their distress might be partially assuaged by the fact that social security payments are indexed.

One way to illustrate possible distributional effects is to ask what would happen to tax burdens if a value added tax completely replaced the individual income and social security (employee portion) taxes. (See Chart 2.) The combination of the current income and social security taxes is progressive while a value added tax, even with necessities excluded, is regressive. As a share of income, the present individual income and social security taxes are only 2 percent for families with less than $5,000 in income, but increase throughout the income range to 33 percent for families with over $100,000 in income.

CHART 1

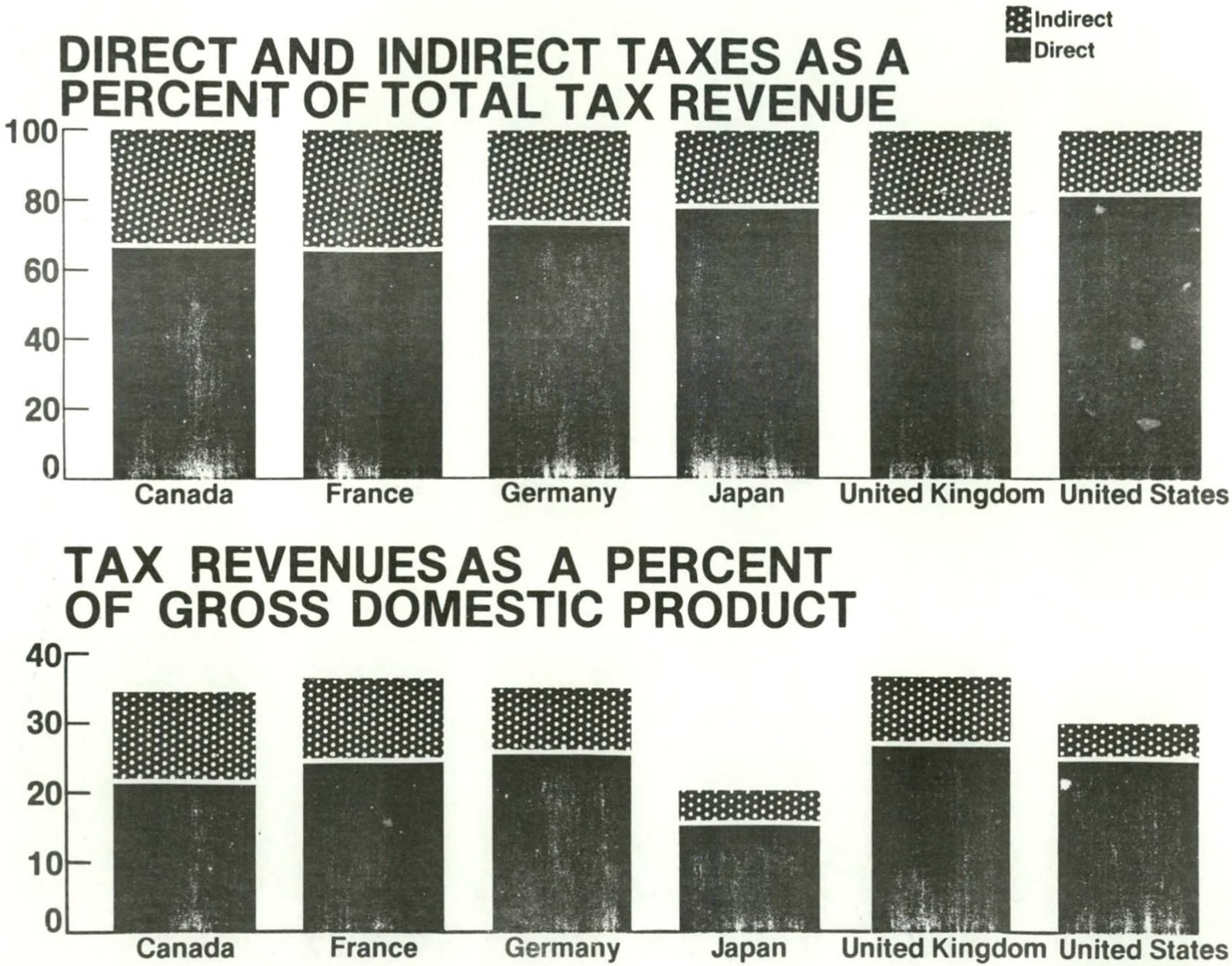
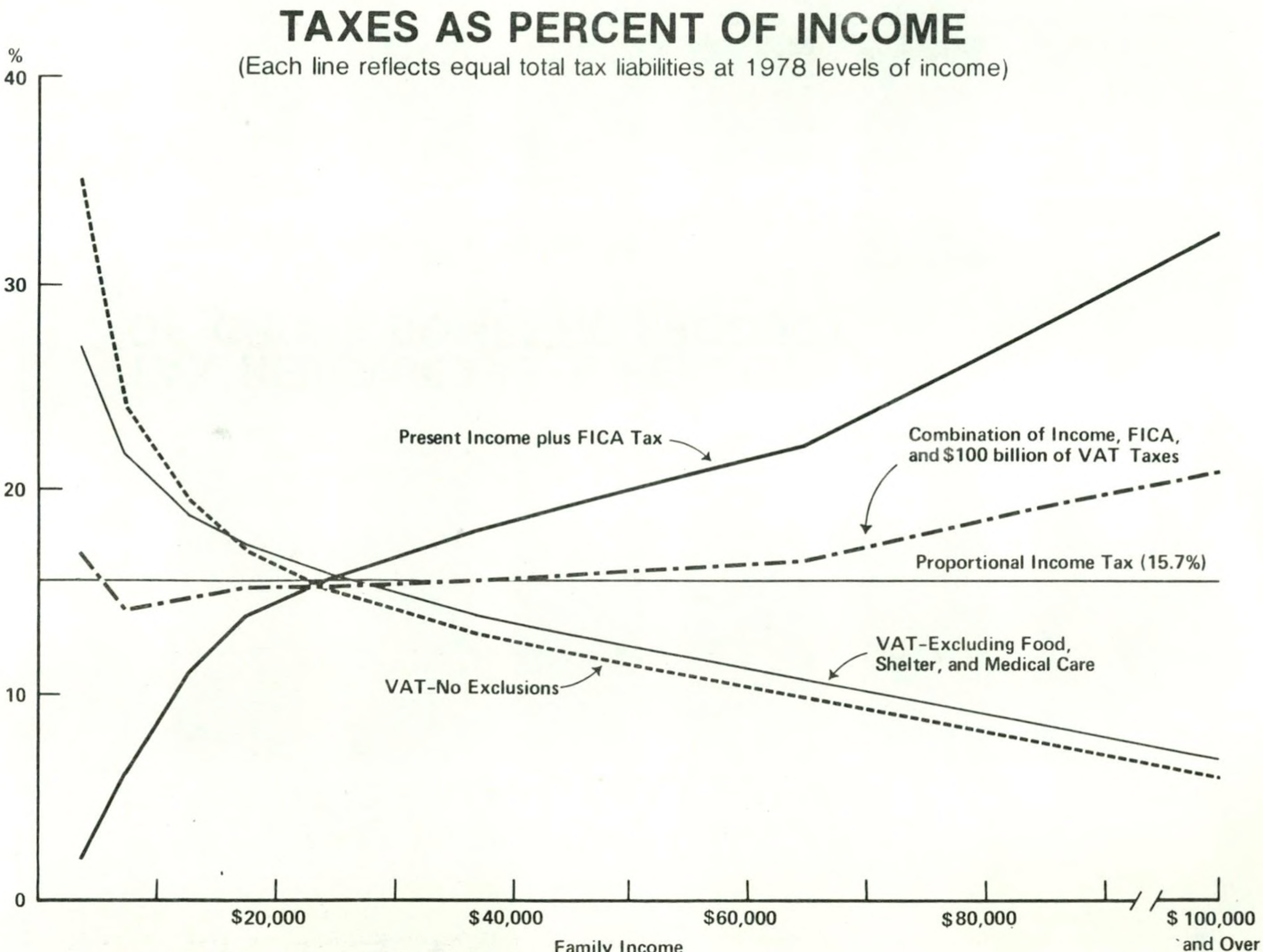

Indirect
Direct
DIRECT AND INDIRECT TAXES AS A PERCENT OF TOTAL TAX REVENUE
100
80
60
40
20
0
Canada
France
Germany
Japan
United Kingdom
United States
TAX REVENUES AS A PERCENT OF GROSS DOMESTIC PRODUCT
40
30
20
10
0
Canada
France
Germany
Japan
United Kingdom
United States

CHART 2


TAXES AS PERCENT OF INCOME
(Each line reflects equal total tax liabilities at 1978 levels of income)
%
40
30
20
10
0
Present Income plus FICA Tax
Combination of Income, FICA, and $100 billion of VAT Taxes
Proportional Income Tax (15.7%)
VAT-Excluding Food, Shelter, and Medical Care
VAT-No Exclusions
$20,000
$40,000
$60,000
$80,000
$100,000 and Over
Family Income

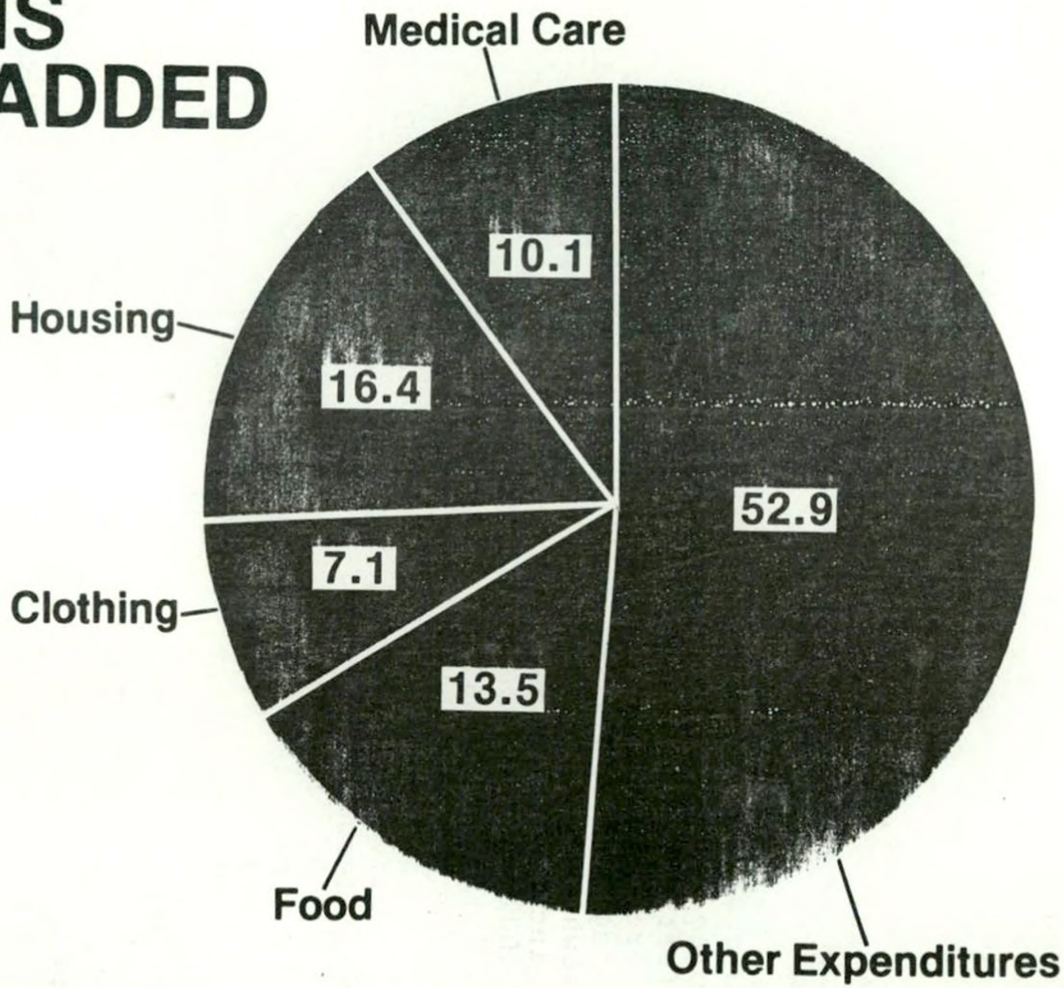
This may be contrasted with a value added tax with no exclusions at a 23.2 percent rate, sufficient to equal the revenue raised by the individual income and employee social security taxes in 1978. As a share of income, such a value added tax would be 35 percent for families with less than $5,000 in income, but fall to 6 percent for families with over $100,000 in income.

No one, of course, is proposing the complete substitution of the value added tax for the income and social security taxes. A more realistic alternative would be to substitute a value added tax for part of the combined individual income and social security taxes. One possibility would be to reduce income and employee social security taxes by $100 billion, keeping the same degree of progressivity for these taxes as under present law, and offset the revenue loss with a $100 billion value added tax with no exclusions. The resulting distribution of tax burdens would be regressive at the lowest income levels and mildly progressive elsewhere. As a share of income, families with less than $5,000 in income would pay 17 percent in taxes, families with between $5,000 and $10,000 in income would pay 14 percent, and taxes would then increase throughout the income range so that families with over $100,000 of income would pay 21 percent of their income in taxes. The overall distribution is significantly less progressive than the present combination of income and employee social security taxes.

The regressivity of the value added tax can be moderated, but not eliminated, by special measures. One possibility is the use of exemptions and reduced rates for necessities, as in Chairman Ullman's proposal and in some European countries. These reduce the tax burden of the value added tax at the lowest income levels, but the tax remains regressive. Exemptions and reduced rates, moreover, create administrative problems. A tax with two, three, or four rates is more complex than a tax with one rate. The specially-taxed items must be identified. Does a lower rate for food, for example, apply to such items as chewing gum, soda pop, candy, or caviar? Experience with the income tax shows that even medical services and drugs are not easy to define. Beyond the definitional problems, total or partial exclusions erode the value added tax base and its revenue potential. (See Chart 3.)

The regressivity of a value added tax also can be reduced by a refundable income tax credit for tax paid on a necessary amount of consumption. This avoids the need to define exempt commodities and can be implemented at a lower revenue cost than a complete exemption for certain "essential" commodities. It can, for example, be phased out at increased income levels. In effect, middle and upper income groups would still pay tax on purchases of food and other necessary items. On the other hand, a refundable credit is effective only if it reaches the roughly 25 million individuals who do not appear on an income tax return. These tend to be individuals most in need of the credit, mainly

SUBTRACTIONS FROM VALUE ADDED TAX BASE
(Percent)



recipients of social security benefits and of transfer payments under social and welfare programs. Unlike lower rates and exemptions, if the credit was not paid until the end of the year, the consumer would have to finance the tax during the year.

Administrative and Design Considerations

Both the European value added taxes and the tax suggested by Chairman Ullman have certain basic similarities:

- they are broad based, applying to services as well as goods;

- tax liability is determined by the credit method with tax paid on purchases deductible from tax due on sales;

- they are consumption type taxes, any tax paid on capital equipment purchases is immediately deductible; and

- they extend through the retail stage.

A value added tax of this type for the United States would involve about 15 million taxpayers. This number might be reduced by 5 million if exemptions were provided for very small proprietorships and farming. But under a value added tax, nearly all transactions are taxed. Even a firm that is tax exempt on its sales will have paid tax on its purchases. If it is to receive credit for tax paid on its purchases, it either would have to file a return or the credit would have to be made available to its customers.

Even 10 million taxpayers would add about 30 percent to the number of returns filed with the Internal Revenue Service, assuming quarterly returns are required. Since the value added tax would not totally replace any other tax and would be a new tax, requiring new returns, new regulations, and a new body of case law, this would be a net addition to the work of taxpayers, the Internal Revenue Service, and the courts. This differs sharply from the typical European case where the value added tax completely replaced another sales tax.

Reporting and payment requirements for a value added tax would be similar to those for Federal excises, which require liability to be computed on a semimonthly basis with payment due 9 days later. The actual excise tax return is filed quarterly and is accompanied by the payment of any remaining balance. Liquor and tobacco excises, however, have slightly different rules. A value added tax payment system which would fit more neatly with ordinary bookkeeping would be a monthly liability period with payment due at the end of the next month. This would be similar to that proposed by Chairman Ullman.

Other Considerations

A Federal value added tax would raise a number of other issues. Forty five states and the District of Columbia impose general sales taxes, a revenue source which they tend to view as belonging exclusively to them. Sales and gross receipts taxes account for about 30 percent of state tax revenue. In contrast, excise taxes generate less than 4 percent of Federal tax collections. Nevertheless, while a Federal value added tax may make it more difficult for the states to raise their sales taxes, it should not prevent such increases. All levels of government, for example, impose income taxes. Moreover, total Federal, state, and local sales tax collections are lower in the United States than in most developed countries.

Because of likely differences in the tax bases, it is doubtful that a Federal value added tax could be coordinated with the state sales taxes. Separate taxes, admittedly, would mean higher administrative and compliance costs. Each level of government would require a collection and audit capability. Taxpayers would have to become familiar with separate tax bases and separate returns. Revenue departments and taxpayers, however, already face this problem with Federal and state income taxes. Efforts aimed at Federal-state cooperation and coordination have not been successful.

As shown by Chairman Ullman's proposal, even a broad-based value added tax may not apply to all forms of final consumption. Practical considerations may require special treatment for many items. In the area of housing, for example, homeowners and tenants should be treated equally. But if rental payments are taxed, how should homeowners be taxed? It may be difficult to value the so-called "imputed rent" on owner occupied housing. Taxing the purchase price of a home is one alternative, but this may aggravate the problems of many families already hard pressed to cope with high housing prices. The treatment of interest in the housing area also is troublesome. If it is exempt, what part of a rental payment should a landlord be allowed to exclude from the tax base? These and other problems will require careful study.

The value added tax is a very potent revenue source. At 1979 levels of consumption, a value added tax would raise roughly $10 billion in revenue for each percentage point. Thus, a 7 percent value added tax would raise about as much revenue as the corporate income tax and a 12 percent value added tax would raise as much revenue as the social security taxes. With such a powerful instrument for raising revenue, many are concerned that the value added tax eventually will be used to add to the total Federal tax burden.

Conclusion

Mr. Chairman, you are to be commended for initiating an examination of the very important, but complex, issues of how the Federal tax structure affects our national well being. This is a time of great change. It is also a time of troublesome and unfamiliar economic conditions. The combination of high inflation, slow growth, and persistent trade deficits must make us wonder if the traditional economic remedies still work. In this sense, your decision to study a broad range of new initiatives could not come at a better time. But changes of such major consequences require careful and deliberate study. We welcome the opportunity to participate with you in that study.

ANNEX A

Federal, State and Local Tax Revenues for Selected Countries as Percent of Gross Domestic Product, by Type of Tax, 1975
(Country Rankings in Parentheses)

Country	Total	Indirect Taxes: Sales and Excise 1/	Direct Taxes: Social Security 2/: Total	Social Security 2/: Employer	Social Security 2/: Employee and Self Employed	Corporate Income	Noncorporate Income 3/	Property 4/	Other 5/	Total Direct Taxes 6/
Belgium	41.43(5)	10.87(6)	13.14(5)	8.44(4)	4.70(5)	3.07(6)	13.24(4)	1.01(12)	0.10(8)	30.56(4)
Canada	33.98(9)	10.94(4)	3.22(12)	n.a.	n.a.	4.67(2)	11.32(7)	3.13(3)	0.70(4)	23.04(11)
Denmark	43.05(4)	14.71(1)	0.48(13)	0.31(12)	0.17(12)	1.37(13)	23.86(1)	2.57(4)	0.06(10)	28.34(5)
France	36.90(6)	12.44(2)	14.72(3)	10.61(2)	4.11(6)	2.00(9)	4.58(13)	1.46(9)	1.70(2)	24.46(9)
Germany (Fed Rep)	35.22(8)	9.37(8)	12.03(6)	6.60(7)	5.43(4)	1.56(12)	10.60(8)	1.09(11)	0.57(6)	25.85(7)
Italy	32.34(10)	9.34(9)	14.83(2)	11.92(1)	2.91(9)	2.04(8)	4.95(12)	1.17(10)	0.01(11)	23.00(12)
Japan	20.23(13)	3.67(13)	5.09(11)	2.63(11)	2.46(10)	3.43(4)	5.07(11)	1.94(7)	1.03(3)	16.56(13)
Luxembourg	46.74(2)	9.72(7)	14.05(4)	7.80(6)	6.25(2)	7.22(1)	12.78(5)	2.34(5)	0.63(5)	37.02(1)
Netherlands	46.90(1)	10.91(5)	17.99(1)	8.40(5)	9.59(1)	3.61(3)	12.66(6)	1.48(8)	0.25(7)	35.99(2)
Sweden	45.96(3)	11.48(3)	8.89(7)	8.47(3)	0.42(11)	1.99(10)	21.17(2)	0.51(13)	1.92(1)	34.48(3)
Switzerland	29.49(12)	5.90(11)	8.49(8)	3.05(10)	5.44(3)	2.46(7)	10.51(9)	2.13(6)	--	23.59(10)
United Kingdom	36.77(7)	9.24(10)	6.71(10)	3.75(9)	2.96(8)	1.92(11)	14.29(3)	4.54(1)	0.07(9)	27.53(6)
United States	30.31(11)	5.49(12)	7.42(9)	4.18(8)	3.24(7)	3.29(5)	9.98(10)	4.13(2)	--	24.82(8)

Office of the Secretary of the Treasury
Office of Tax Analysis

Source: Revenue Statistics of OECD Member Countries, 1965-1975.

1/ Includes general sales, value added, and specific excise taxes.

2/ Includes contributions of employers, employees, and self employed. Category is broadly defined to include all tax payments to institutions of general government providing social welfare benefits, provided they are levied as a function of pay or a fixed amount per person. Thus, for the United States this category includes contributions to the railroad retirement fund, unemployment insurance fund, workman's compensation fund, and civil service retirement program in addition, of course, to the more familiar social security-type payments made pursuant to the Federal Insurance Contributions Act (FICA).

3/ Includes income taxes on individual and unincorporated enterprise, such as proprietorships and partnerships.

4/ Includes taxes on net wealth, immovable property, estates, and gifts.

5/ Includes taxes on employers based on payroll or manpower and miscellaneous taxes which cannot be classified within a specific direct tax category.

6/ Computed by subtracting sales and excises from total.

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THURSDAY, NOVEMBER 8, 1979

TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of this distinguished Committee:

It is a pleasure to appear before this Committee to discuss the important issues raised by H.R. 5665, the "Tax Restructuring Act of 1979." This bill would result in fundamental changes in our Federal tax structure. Income taxes on corporations and individuals, as well as social security taxes, would be cut by $130 billion in 1981. A Federal value added tax would offset this revenue loss. This testimony will not concentrate on the specifics of H.R. 5665, but on the basic issue which the bill raises: whether the United States should replace some of its income taxes with a consumption tax. That is, whether the Federal tax system should weigh more heavily on consumption and less heavily on saving and investment. Many believe that such a change would contribute significantly to improved capital formation, higher productivity, and a more competitive position for American business in world markets. Others express concern that a consumption tax would have only small effects on investment and would place an unfair burden on lower income families already plagued by high prices for energy, food, housing, and other basic necessities of life. Higher consumption taxes, they believe, would mean still higher prices. These hearings will serve the valuable function of focusing the discussion on these significant economic and social issues.

An important element in this discussion is the role of a value added tax in the Federal tax structure. A value added tax is a multistage tax on consumer goods and services. Unlike a retail sales tax, it is collected at each stage in the production and distribution process. But since it is levied only on the amount of value added (the difference between sales and purchases) at each stage, rather than on the full selling price, it avoids the cascade, tax-on-tax, effects of a turnover sales tax. A value added tax is similar to a retail sales tax in that the total tax paid by the consumer is equal to the final price of the product multiplied by the tax rate.

M-186

Many European countries have value added taxes. Typically, they are imposed at a rate of about 15 to 20 percent and generate about 15 percent of a country's total national and local tax revenue. In contrast, state and local retail sales taxes raise about 7 percent of the total Federal, state, and local tax revenue in the United States. The $130 billion in value added tax revenue estimated to be raised by H.R. 5665 would be about 14 percent of total Federal, state, and local 1981 tax liabilities, assuming it is accompanied by the proposed income and social security tax cuts.

In nearly all cases, the European value added taxes replaced sales taxes, frequently of the cascade turnover type which, unlike the value added tax, taxed the full sales price at each stage, without allowing a credit for tax on previous transactions. The Europeans found the cascade tax objectionable because it discriminated against nonintegrated firms and because the export rebate and import tax could not be accurately estimated for border adjustment purposes. Thus, in the European case, the adoption of a value added tax was regarded as a reform of an unwieldy and distortionary system of indirect taxation. This characterization does not apply to the present indirect tax system in the United States. Only the United Kingdom has used the value added tax to reduce income taxes, as Chairman Ullman is suggesting for the United States.

The popularity of the value added tax is not universal. The voters of Switzerland have twice rejected it by referendum. The latest rejection was based in part on a perceived threat to local autonomy since a Federal value added tax would have replaced some of the local Swiss taxes. Most recently, Japan, largely as a result of its parliamentary elections, appears to have postponed the planned introduction of a value added tax.

For the United States, a value added tax raises a number of important questions. Would it encourage capital formation? What impact would it have on the price level? Would it improve the trade balance? Would it be regressive? No one is seriously suggesting the value added tax solely as an additional Federal tax. Consequently, the answers to these questions, as well as others, depend upon which taxes the value added tax replaces. By way of illustration, two of the proposals made by Chairman Ullman call for reducing the corporate income tax and the social security taxes.

Capital Formation

Taxes on capital income, such as the corporate income tax and the individual income tax on interest and dividends, reduce the after-tax return on savings. Put another way, an income tax encourages present, as compared to future, consumption. With no taxes, a person with $100 of income could choose between buying

$100 of consumption goods this year or saving now and buying $110 of consumption goods next year, assuming the interest rate is 10 percent. Thus, a person can consume 10 percent more next year by saving now. Similarly, with a consumption tax, which exempts the earnings from capital, a person with $100 of income could consume $50 this year and pay $50 in tax or, by saving the income this year, could consume $55 next year and pay $55 in tax. Thus, a person could still consume 10 percent more next year by saving now.

If a 50 percent income tax, rather than a consumption tax, is imposed, however, the individual, after paying the tax, can buy $50 of consumption goods this year or can save the $50 and, after paying the tax on the interest earnings, buy $52.50 of consumption goods next year. Because of the income tax, a person can buy only 5 percent, rather than 10 percent, more consumption goods next year. Because of this lower return, the individual may decide to consume now rather than save for future consumption. It is important to recognize, however, that the responsiveness of saving to more favorable taxation is an unsettled issue. If one concludes that savings will rise in response to reduced taxation, then substituting a value added tax for the corporate income tax should encourage saving.

There are other considerations in assessing the mechanism that leads to an increase in investment. First, an increase in savings must be channeled into domestic financial markets in order to lower interest rates and therefore the cost of capital. Second, producers must respond to the lower cost of capital by using more capital intensive methods of production. There probably will be some response, but its magnitude is open to discussion. Third, the mix of new investment must be considered; it may be concentrated in housing, consumer durables, or fixed business capital. Thus, the substitution of a value added tax for the corporate income tax will increase capital formation only if savings increase, the cost of capital falls, and business responds by investing in the United States.

Finally, it bears noting that the potential of the value added tax for promoting capital formation may be exaggerated by an analysis that compares a "pure" consumption tax with a "pure" income tax levied on all returns to capital. The current income tax does not apply with full force to all types of saving and investment. For example, home ownership, pension reserves, and assets eligible for the investment tax credit or the asset depreciation range receive relatively favorable tax treatment. Similarly, not all forms of consumption would be taxed the same under any likely value added tax.

In contrast to an income tax, neither the social security tax nor a value added tax applies directly to the return from saving. Consequently, substituting a value added tax for the social security tax would be unlikely to affect savings decisions.

Price Level Impact

A value added tax, by itself, will probably increase prices, since the tendency for business to pass the tax on to consumers is unlikely to be offset by an unduly restrictive monetary policy. The result would be a "one-shot" increase, not a recurrent increase, in the price level, although the subsequent price effects of adjustments in wage contracts, social security payments, and other indexed items may occur over time. In this regard, it is noteworthy that the Thatcher government's program of increased value added taxation and reduced individual income taxation has been accompanied by a significant increase in the consumer price index in the United Kingdom.

The important question, then, is whether the inflationary impact of the value added tax would be offset by reductions in other taxes. In the short run, the corporate income tax reduces the after-tax rate of return to capital, rather than increases product prices. Accordingly, prices will probably not fall as corporate income taxes are cut. Thus, substituting a value added tax for the corporate income tax is likely to increase prices. This is a serious drawback to the value added tax.

Substituting a value added tax for the social security tax may be less inflationary. Reducing the employer portion of the social security tax would tend to reduce business labor costs and possibly prices. Reducing the employee portion of the social security tax, however, would probably have no effect on the price level. Thus a value added tax, accompanied by an equivalent reduction in employer and employee social security taxes, would result in some increase in the price level. This would be particularly distressing to individuals least able to protect themselves from rising prices.

The impact of a value added tax on prices is largely independent of whether it is hidden in the price of the product or whether it is quoted separately to consumers. While it is not customary in Europe to quote the value added tax separately, this need not be the case in the United States. State retail sales taxes are quoted separately because the merchants persuaded legislators to require it, and the same could occur in the case of a United States value added tax. Furthermore, nonseparate quotation of the value added tax might be viewed as an attempt to hide the tax from public scrutiny.

Balance of Trade

Many have expressed the view that a value added tax would improve our trade balance. This is based on the observation that current international rules allow indirect taxes, such as sales or value added taxes, to be imposed on imports and rebated on exports. These adjustments are not allowed for direct taxes,

such as the corporate income or social security taxes. It is doubtful, however, that the U.S. trade balance would improve significantly from substituting a value added tax for the corporate income tax.

The impact of the value added tax on trade is closely related to what happens to prices. Quite simply, one must ask the question: will the substitution of the value added tax for some other tax increase prices? It seems likely that the immediate impact of substituting a general value added tax of 5 percent for part of the corporate income tax would be to increase prices by about 5 percent. Since the new tax would be rebated on exports, just like our state retail sales and Federal excise taxes, exports would leave the country tax free. While domestic prices would be 5 percent higher, export prices would remain unchanged. Foreign consumers, therefore, would find U.S. products no more attractive than before; there would be no increase in demand for U.S. exports.

Since imports would be subject to the value added tax their prices also would increase by about 5 percent, the same as for domestic goods and services. As a consequence, domestic consumers would find imports just as attractive as before; there would be no incentive to reduce the demand for imports. Thus, on both the export and import side, there would be little immediate impact on the U.S. trade balance if a value added tax were substituted for the corporate income tax. There might, of course, be a positive trade impact in the long run if the substitution led to an improved investment climate, enhanced capital formation, and a more productive and competitive U.S. economy.

A modest trade balance improvement might result from replacing the social security tax with a value added tax, if the price level increased by less than the value added tax. Because of the price-dampening effect of reducing the employer portion of the social security tax, this is a possibility.

Regardless of which tax it replaces, many believe that a value added tax rebate, in itself, will expand exports and that a value added tax levy will retard imports. This belief might have a positive effect on trade if it encourages businesses to compete more vigorously in international markets. This result would depend upon the importance of nonprice considerations in explaining export activity.

It is also important to recognize that other countries could restructure their own tax systems if they felt the United States was gaining an unfair trade advantage. Relative to other countries, the United States has a moderately high corporate income tax, but a low social security tax. (See Annex A.) Thus, the possibility exists that other countries might maintain their competitive position by increasing their existing value added

taxes and reducing their corporate income or, especially, their social security taxes. This outcome is by no means certain. After all, a country's tax structure is not determined solely by international considerations. Moreover, except for Japan, U.S. indirect taxes, as a share of gross domestic product, are the lowest of the major developed countries. (See Chart 1 and Annex A.) Other countries may believe that the United States should be allowed to "tilt" its tax structure to reach some "reasonable" or "average" level of indirect taxation.

This issue has been studied before. Both the President's Task Force on Business Taxation, in its 1970 review of tax policy, and the Advisory Commission on Intergovernmental Relations, in its 1973 value added tax study, considered the trade issue. Both expressed doubt over any trade benefits resulting from substituting a value added tax for the corporate income tax and both noted the possibility of foreign retaliation.

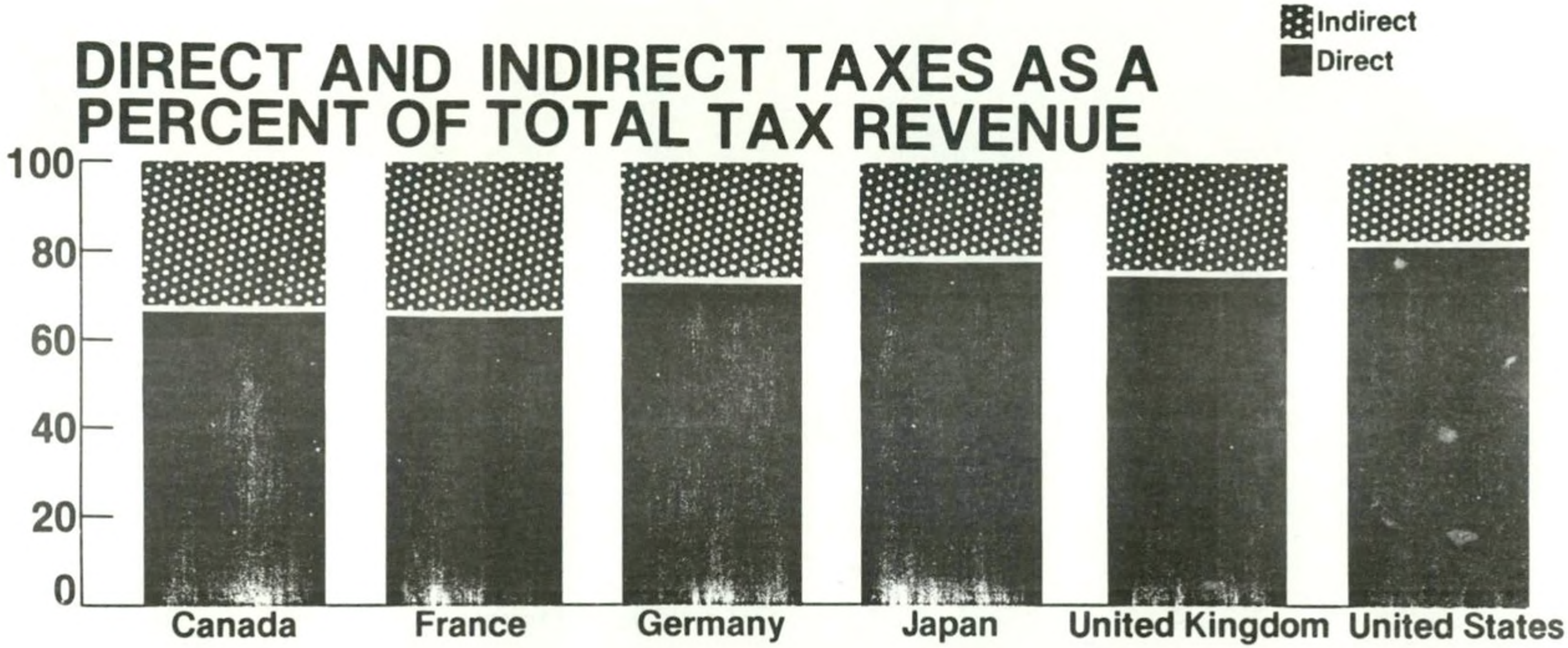
Distribution of Tax Burden

Lower income taxpayers, who must spend all their income on consumption, may find a value added tax burdensome because of its regressivity. While a value added tax, by itself, is regressive, one must consider which tax it replaces. The immediate impact of the corporate income tax is probably progressive since it falls on income from capital. Therefore, substituting a value added tax for the corporate income tax would make the tax structure less progressive. The social security tax, on the other hand, also is regressive because it is limited to the first $22,900 of wages and applies only to labor income. Accordingly, substituting a value added tax for the social security tax would not make the tax system noticeably less progressive. One regressive tax would be substituted for another. Retired individuals, however, who do not pay social security tax, would be distressed by having to pay value added tax. They could justifiably say that they already had paid for their retirement during their working years and that higher prices and taxes in retirement were unfair. Their distress might be partially assuaged by the fact that social security payments are indexed.

One way to illustrate possible distributional effects is to ask what would happen to tax burdens if a value added tax completely replaced the individual income and social security (employee portion) taxes. (See Chart 2.) The combination of the current income and social security taxes is progressive while a value added tax, even with necessities excluded, is regressive. As a share of income, the present individual income and social security taxes are only 2 percent for families with less than $5,000 in income, but increase throughout the income range to 33 percent for families with over $100,000 in income.

CHART 1

DIRECT AND INDIRECT TAXES AS A PERCENT OF TOTAL TAX REVENUE



TAX REVENUES AS A PERCENT OF GROSS DOMESTIC PRODUCT

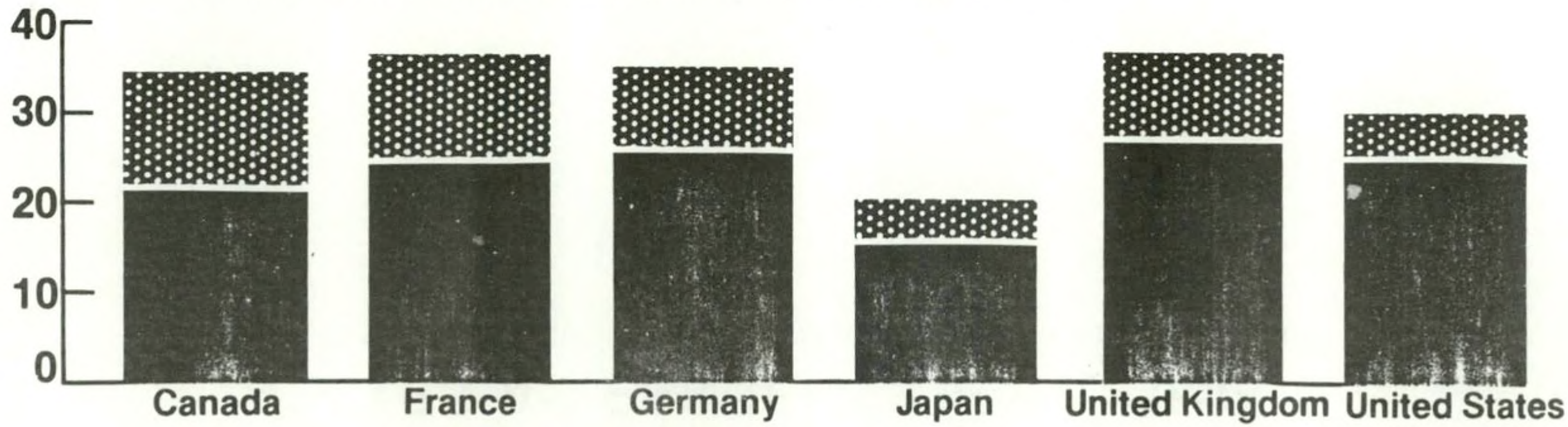
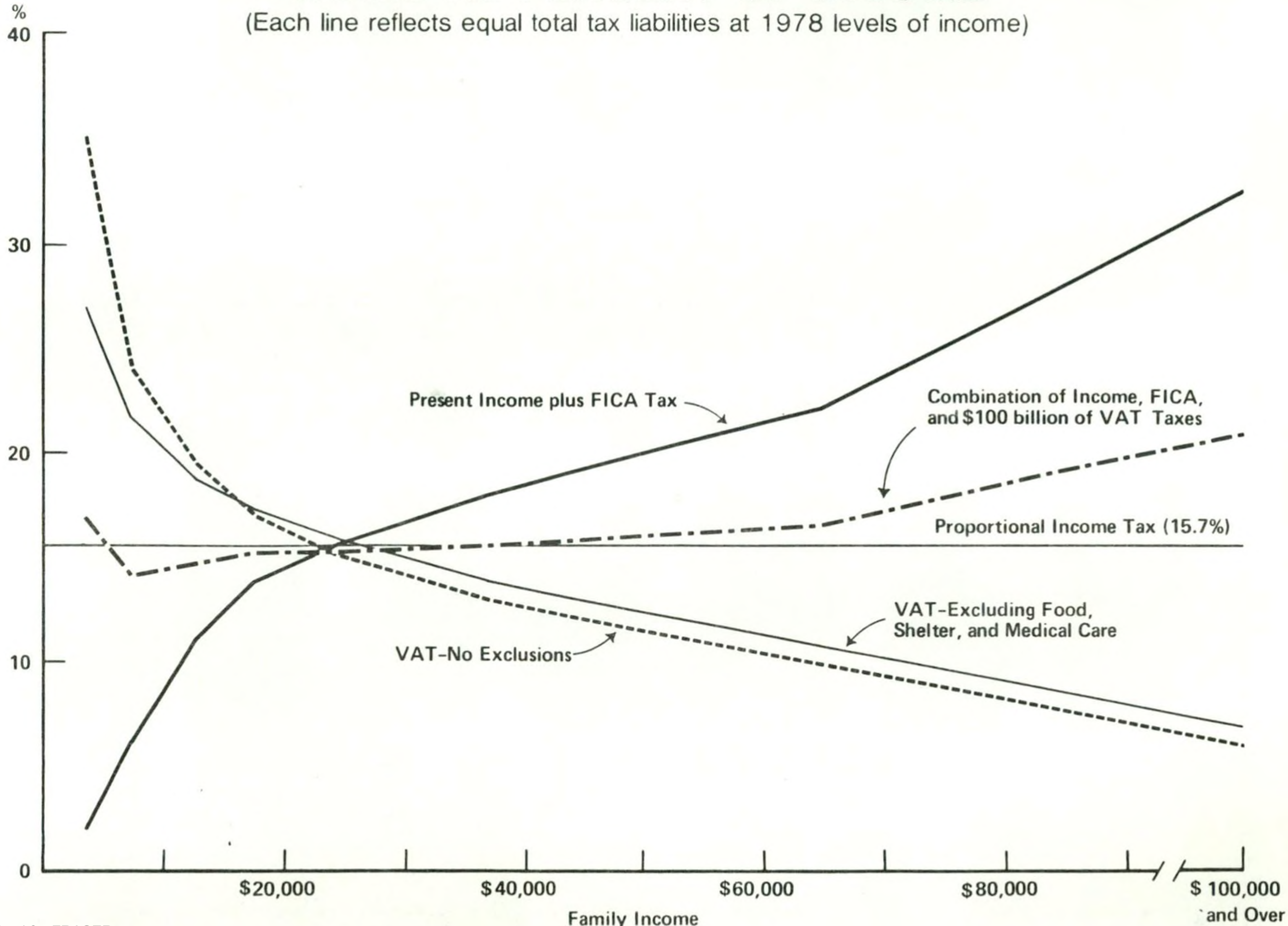


CHART 2

TAXES AS PERCENT OF INCOME

(Each line reflects equal total tax liabilities at 1978 levels of income)



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This may be contrasted with a value added tax with no exclusions at a 23.2 percent rate, sufficient to equal the revenue raised by the individual income and employee social security taxes in 1978. As a share of income, such a value added tax would be 35 percent for families with less than $5,000 in income, but fall to 6 percent for families with over $100,000 in income.

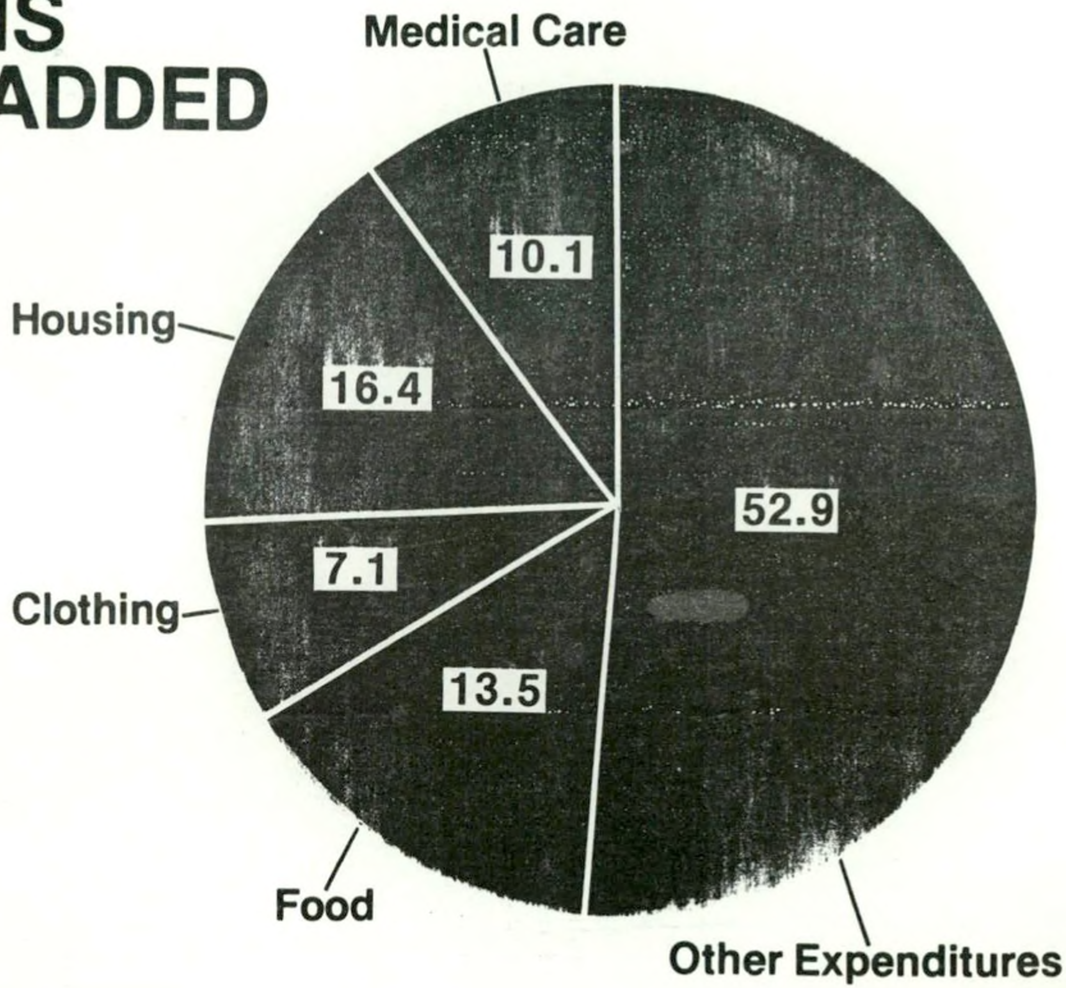
No one, of course, is proposing the complete substitution of the value added tax for the income and social security taxes. A more realistic alternative would be to substitute a value added tax for part of the combined individual income and social security taxes. One possibility would be to reduce income and employee social security taxes by $100 billion, keeping the same degree of progressivity for these taxes as under present law, and offset the revenue loss with a $100 billion value added tax with no exclusions. The resulting distribution of tax burdens would be regressive at the lowest income levels and mildly progressive elsewhere. As a share of income, families with less than $5,000 in income would pay 17 percent in taxes, families with between $5,000 and $10,000 in income would pay 14 percent, and taxes would then increase throughout the income range so that families with over $100,000 of income would pay 21 percent of their income in taxes. The overall distribution is significantly less progressive than the present combination of income and employee social security taxes.

The regressivity of the value added tax can be moderated, but not eliminated, by special measures. One possibility is the use of exemptions and reduced rates for necessities, as in Chairman Ullman's proposal and in some European countries. These reduce the tax burden of the value added tax at the lowest income levels, but the tax remains regressive. Exemptions and reduced rates, moreover, create administrative problems. A tax with two, three, or four rates is more complex than a tax with one rate. The specially-taxed items must be identified. Does a lower rate for food, for example, apply to such items as chewing gum, soda pop, candy, or caviar? Experience with the income tax shows that even medical services and drugs are not easy to define. Beyond the definitional problems, total or partial exclusions erode the value added tax base and its revenue potential. (See Chart 3.)

The regressivity of a value added tax also can be reduced by a refundable income tax credit for tax paid on a necessary amount of consumption. This avoids the need to define exempt commodities and can be implemented at a lower revenue cost than a complete exemption for certain "essential" commodities. It can, for example, be phased out at increased income levels. In effect, middle and upper income groups would still pay tax on purchases of food and other necessary items. On the other hand, a refundable credit is effective only if it reaches the roughly 25 million individuals who do not appear on an income tax return. These tend to be individuals most in need of the credit, mainly

CHART 3

SUBTRACTIONS FROM VALUE ADDED TAX BASE
(Percent)



recipients of social security benefits and of transfer payments under social and welfare programs. Unlike lower rates and exemptions, if the credit was not paid until the end of the year, the consumer would have to finance the tax during the year.

Administrative and Design Considerations

Both the European value added taxes and the tax suggested by Chairman Ullman have certain basic similarities:

- they are broad based, applying to services as well as goods;
- tax liability is determined by the credit method with tax paid on purchases deductible from tax due on sales;
- they are consumption type taxes, any tax paid on capital equipment purchases is immediately deductible; and
- they extend through the retail stage.

A value added tax of this type for the United States would involve about 15 million taxpayers. This number might be reduced by 5 million if exemptions were provided for very small proprietorships and farming. But under a value added tax, nearly all transactions are taxed. Even a firm that is tax exempt on its sales will have paid tax on its purchases. If it is to receive credit for tax paid on its purchases, it either would have to file a return or the credit would have to be made available to its customers.

Even 10 million taxpayers would add about 30 percent to the number of returns filed with the Internal Revenue Service, assuming quarterly returns are required. Since the value added tax would not totally replace any other tax and would be a new tax, requiring new returns, new regulations, and a new body of case law, this would be a net addition to the work of taxpayers, the Internal Revenue Service, and the courts. This differs sharply from the typical European case where the value added tax completely replaced another sales tax.

Reporting and payment requirements for a value added tax would be similar to those for Federal excises, which require liability to be computed on a semimonthly basis with payment due 9 days later. The actual excise tax return is filed quarterly and is accompanied by the payment of any remaining balance. Liquor and tobacco excises, however, have slightly different rules. A value added tax payment system which would fit more neatly with ordinary bookkeeping would be a monthly liability period with payment due at the end of the next month. This would be similar to that proposed by Chairman Ullman.

Other Considerations

A Federal value added tax would raise a number of other issues. Forty five states and the District of Columbia impose general sales taxes, a revenue source which they tend to view as belonging exclusively to them. Sales and gross receipts taxes account for about 30 percent of state tax revenue. In contrast, excise taxes generate less than 4 percent of Federal tax collections. Nevertheless, while a Federal value added tax may make it more difficult for the states to raise their sales taxes, it should not prevent such increases. All levels of government, for example, impose income taxes. Moreover, total Federal, state, and local sales tax collections are lower in the United States than in most developed countries.

Because of likely differences in the tax bases, it is doubtful that a Federal value added tax could be coordinated with the state sales taxes. Separate taxes, admittedly, would mean higher administrative and compliance costs. Each level of government would require a collection and audit capability. Taxpayers would have to become familiar with separate tax bases and separate returns. Revenue departments and taxpayers, however, already face this problem with Federal and state income taxes. Efforts aimed at Federal-state cooperation and coordination have not been successful.

As shown by Chairman Ullman's proposal, even a broad-based value added tax may not apply to all forms of final consumption. Practical considerations may require special treatment for many items. In the area of housing, for example, homeowners and tenants should be treated equally. But if rental payments are taxed, how should homeowners be taxed? It may be difficult to value the so-called "imputed rent" on owner occupied housing. Taxing the purchase price of a home is one alternative, but this may aggravate the problems of many families already hard pressed to cope with high housing prices. The treatment of interest in the housing area also is troublesome. If it is exempt, what part of a rental payment should a landlord be allowed to exclude from the tax base? These and other problems will require careful study.

The value added tax is a very potent revenue source. At 1979 levels of consumption, a value added tax would raise roughly $10 billion in revenue for each percentage point. Thus, a 7 percent value added tax would raise about as much revenue as the corporate income tax and a 12 percent value added tax would raise as much revenue as the social security taxes. With such a powerful instrument for raising revenue, many are concerned that the value added tax eventually will be used to add to the total Federal tax burden.

Conclusion

Mr. Chairman, you are to be commended for initiating an examination of the very important, but complex, issues of how the Federal tax structure affects our national well being. This is a time of great change. It is also a time of troublesome and unfamiliar economic conditions. The combination of high inflation, slow growth, and persistent trade deficits must make us wonder if the traditional economic remedies still work. In this sense, your decision to study a broad range of new initiatives could not come at a better time. But changes of such major consequences require careful and deliberate study. We welcome the opportunity to participate with you in that study.

ANNEX A

Federal, State and Local Tax Revenues for Selected Countries as Percent of Gross Domestic Product, by Type of Tax, 1975
(Country Rankings in Parentheses)

Country	Total	Indirect Taxes	Direct Taxes							
			Social Security 2/							
		Sales and Excise 1/	Total	Employer	Employee and Self Employed	Corporate Income	Noncorporate Income 3/	Property 4/	Other 5/	Total Direct Taxes 6/
Belgium	41.43(5)	10.87(6)	13.14(5)	8.44(4)	4.70(5)	3.07(6)	13.24(4)	1.01(12)	0.10(8)	30.56(4)
Canada	33.98(9)	10.94(4)	3.22(12)	n.a.	n.a.	4.67(2)	11.32(7)	3.13(3)	0.70(4)	23.04(11)
Denmark	43.05(4)	14.71(1)	0.48(13)	0.31(12)	0.17(12)	1.37(13)	23.86(1)	2.57(4)	0.06(10)	28.34(5)
France	36.90(6)	12.44(2)	14.72(3)	10.61(2)	4.11(6)	2.00(9)	4.58(13)	1.46(9)	1.70(2)	24.46(9)
Germany (Fed Rep)	35.22(8)	9.37(8)	12.03(6)	6.60(7)	5.43(4)	1.56(12)	10.60(8)	1.09(11)	0.57(6)	25.85(7)
Italy	32.34(10)	9.34(9)	14.83(2)	11.92(1)	2.91(9)	2.04(8)	4.95(12)	1.17(10)	0.01(11)	23.00(12)
Japan	20.23(13)	3.67(13)	5.09(11)	2.63(11)	2.46(10)	3.43(4)	5.07(11)	1.94(7)	1.03(3)	16.56(13)
Luxembourg	46.74(2)	9.72(7)	14.05(4)	7.80(6)	6.25(2)	7.22(1)	12.78(5)	2.34(5)	0.63(5)	37.02(1)
Netherlands	46.90(1)	10.91(5)	17.99(1)	8.40(5)	9.59(1)	3.61(3)	12.66(6)	1.48(8)	0.25(7)	35.99(2)
Sweden	45.96(3)	11.48(3)	8.89(7)	8.47(3)	0.42(11)	1.99(10)	21.17(2)	0.51(13)	1.92(1)	34.48(3)
Switzerland	29.49(12)	5.90(11)	8.49(8)	3.05(10)	5.44(3)	2.46(7)	10.51(9)	2.13(6)	--	23.59(10)
United Kingdom	36.77(7)	9.24(10)	6.71(10)	3.75(9)	2.96(8)	1.92(11)	14.29(3)	4.54(1)	0.07(9)	27.53(6)
United States	30.31(11)	5.49(12)	7.42(9)	4.18(8)	3.24(7)	3.29(5)	9.98(10)	4.13(2)	--	24.82(8)

Office of the Secretary of the Treasury
Office of Tax Analysis

Source: Revenue Statistics of OECD Member Countries, 1965-1975.

1/ Includes general sales, value added, and specific excise taxes.

2/ Includes contributions of employers, employees, and self employed. Category is broadly defined to include all tax payments to institutions of general government providing social welfare benefits, provided they are levied as a function of pay or a fixed amount per person. Thus, for the United States this category includes contributions to the railroad retirement fund, unemployment insurance fund, workman's compensation fund, and civil service retirement program in addition, of course, to the more familiar social security-type payments made pursuant to the Federal Insurance Contributions Act (FICA).

3/ Includes income taxes on individual and unincorporated enterprise, such as proprietorships and partnerships.

4/ Includes taxes on net wealth, immovable property, estates, and gifts.

5/ Includes taxes on employers based on payroll or manpower and miscellaneous taxes which cannot be classified within a specific direct tax category.

6/ Computed by subtracting sales and excises from total.

11016

GWM

ACTION

Date: OCT 23 1979

MEMORANDUM FOR: SECRETARY MILLER

From: Donald C. Lubick
Assistant Secretary (Tax Policy)

Subject: Outline of Value Added Tax Testimony

Attached is our proposed outline of your value added tax testimony for November 7 before the Ways and Means Committee. A copy is also attached of the Ullman plan. It calls for a value added tax, generally at 10 percent, in exchange for substantial social security, individual, and corporate rate cuts, along with reduced taxation of savings. Because tax reductions of such magnitude would not be possible without a new substitute tax, I assume you would like your testimony to concentrate on the desirability of a sales tax, like VAT, rather than on the tax reduction elements of the Ullman proposal.

If so, I suggest a comprehensive statement that would discuss the major economic and administrative issues associated with a VAT. It would not conclusively endorse or reject the VAT, but would aim to shape and focus the future debate on this tax.

Attachments

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname	X-LUBICK					
Initials / Date	/	/	/	/	/	/

Form OS-3129
Department of Treasury

OUTLINE OF
SECRETARY MILLER'S TESTIMONY
ON VAT

I. INTRODUCTION

A. Brief description of VAT and characterization as a sales tax.

B. Statement of issues whether U.S. should replace direct taxes on income with a sales tax on consumption and, if so, whether VAT is superior to retail sales tax?

C. Statement that testimony will review the issues and argumentation on both sides and welcome hearings to receive public testimony on issues.

II. ECONOMIC ISSUES

A. PRO

1. VAT would enhance capital formation. You would acknowledge this as the strongest argument for a VAT, but caution that it depends on what taxes the VAT replaces and on the response of saving and investment to lower taxation. Economists can give us little assurance whether the rate of savings responds to tax reduction. You also would note that our current income tax treats some types of saving (home ownership, pension reserves) and investment (assets eligible for the investment tax credit or ADR) preferentially.

2. VAT would improve our trade balance. You would contend that, aside from psychologically, this is an economically dubious argument. It assumes a VAT would not be inflationary and that our trading partners would not retaliate by increasing their VATs. Either assumption, you would observe, is possible, but quite unlikely.

3. Other advantages. In lesser detail, you would note that some feel that our social security and income taxes are too high and that a VAT offers relief from them.

B. CON

1. VAT would be inflationary. You would stress this as a strong argument against the VAT at this time. Although it depends on which taxes are cut, most observers agree that a VAT would increase prices. Although this would be a "one-shot" increase, rather than a recurrent annual increase, in the price level, you would note that this is a bad time for any more inflation.

2. VAT would be regressive. You would characterize this as a significant, but not fatal, criticism. For one thing, the impact of taxes on various income groups should be viewed in terms of the entire tax structure, not one particular tax. More importantly, the potentially-harsh impact of a VAT on the poor can be alleviated by tax credits or different rates. You would note that our states do this for sales tax purposes. You would note that the Ullman proposal is quite regressive.

3. Other objections. In lesser detail you would note the concern of the states over a Federal incursion into the sales or consumption tax area and of others that the VAT, with its enormous revenue potential, would ultimately mean a net Federal tax increase. You would also discuss the fact that VAT involves not inconsiderable complexity and compare the use of a retail sales tax. You would note that an additional tax source could lead to an increase in overall tax levels, and that essentially VAT for the Europeans is the margin of excess over our rate of taxation.

III. ADMINISTRATIVE AND DESIGN ISSUES

A. General design would be a broad-based consumption-type VAT. You would state that European experience and our own analyses leads us to conclude that the tax should:

-- be broad based;

-- be a consumption-type VAT;

-- provide for tax liability to be calculated by the credit method; and

-- extend through the retail stage.

B. Number of taxpayers. A VAT of this type would encompass about 15 million taxpayers, but farming and small proprietorship exemptions could reduce that by about 5 million taxpayers. In either case, this would be a net addition to the work of both taxpayers and the Treasury. Even 5 million taxpayers filing quarterly returns would constitute a roughly 15 percent increase in the number of returns filed with the IRS.

C. Offset regressivity by tax credits. You would favor this method as being cheaper and administratively preferable to lower rates or exemptions. To illustrate the point, you might question what food items would be eligible for Chairman Ullman's reduced rate. Chewing gum? Soda pop? Candy? Caviar? You would acknowledge that if tax credits are used care would have to be taken to reach the roughly 25 million individuals not covered by an income tax return.

D. Reporting and payments requirements would be similar to excise tax rules. You would describe briefly the current excise tax rules and note the VAT rules would be similar, but perhaps not identical. If the generous payment rules proposed by Ullman were adopted, it is likely that pressure would build to provide similar rules for other excises and this would involve a substantial one-time revenue loss.

E. Special problem areas. Even if one accepts the concept of a broad-based VAT, there will be problem areas. You would highlight the problems:

1. Housing. Should imputed rent on owner occupied housing be taxed?

2. Consumer interest. Should mortgage interest be taxed? Interest paid by tenants?

F. Should the tax be hidden? Should the tax be separately stated and disclosed or buried in the price? Disclosure would impose fiscal discipline. Failure to separate the tax would mean state sales taxes would be imposed on a larger base than the actual price.

INFORMATION

Date: OCT 15 1979

MEMORANDUM FOR: SECRETARY MILLER

From: Donald C. Lubick DCL
Assistant Secretary (Tax Policy)

Subject: Chairman Ullman's Grand Plan

I understand that Chairman Ullman next Wednesday will reveal his plan for a major restructuring of the American tax system. He plans to begin holding hearings on November 5. It is anticipated that you will be the leadoff witness for the Administration and that Chairman Volcker will appear on Tuesday, November 6.

On a confidential basis, the broad details of the Ullman plan have been given to us on the understanding that we will not discuss them with outsiders until the proposal is actually released.

The elements of the Ullman plan are as follows:

Revenue increases		1981 Revenue Impact ($Billions)
1. VAT -- a 10% rate except a 5% rate for food, shelter, and medical expenses. Zero rating on 501(c)(3) organizations, farmers, fishermen, and mass transit		$130

The impact of the exemptions are as follows:

10% rate without exemptions	$197
less increase in cost of Federal purchases due to introduction of VAT	-10
less food exemptions	-17
less housing exemption	-22

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname	XA-Sunley					
Initials / Date	EMS / 10/15	/	/	/	/	/

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less medical expense deduction	-5
less increased social security payments due to indexing of benefits	-8
less zero rating for 501(c)(3) organizations, farmers, fishermen, and mass transit	-5
	$130

Revenue decreases

1.	Social security -- rate reduced 2.15% for both employers and employees. 1981 rate would be 4.5%.	$52
2.	Individual	
	--50% maximum rate	5
	--Low income relief -- earned income credit extended to childless couples, rate increased to 15 percent, and credit phased out at $12,000; credit for elderly made refundable; and increase in AFDC payments	5
	--Rate reductions and higher zero bracket amount	37
3.	Savings incentive	
	--Current limit on IRAs increased to $2,000 and anyone not qualified for an IRA can set up one with a $1,000 limit. Deferral of tax on income of qualified savings accounts for up to $1,000 a year of additional savings. Income will be exempt until withdrawn; it is assumed that deferred income withdrawn first, then principal. Rollover permitted within the account and taxpayers permitted to switch to another trustee without triggering taxation	2

--Pickle's dividend reinvestment plan with a $1,500 limit per taxpayer 1

4. Business reductions

--Reduce 46% rate to 36% and increase the brackets at the low end of the corporate rate schedule so that the top rate of 36% is reached at a $160,000 of taxable income (compared to $100,000 under current law). 22

--Increase ADR variance from 20 to 40% and permit small business to elect ADR without all the bells and whistles. Investment credit liberalized to 6% for assets with useful lives of 3 to 4 years and 10% for assets with useful lives of 5 years or more. 6

$130