# Chapter 3

## THE FOUR OPTIONS

In its study of fundamental tax reform, the Treasury Department focused on four basic options: a pure flat tax; a "modified" flat tax; a consumed income tax; and a general sales tax, such as a value-added tax or a Federal retail sales tax. These four options are described and analyzed briefly in this chapter. Chapters 4 to 8 describe the Treasury Department proposal for a modified flat tax in greater detail and compare it with similar proposals that have been advanced recently by several members of Congress. Chapters 9 and 10 provide further analysis of the consumed income tax and value-added tax, two options which are not being proposed. (Volume II contains details of the Treasury Department proposal for a modified flat tax and Volume III analyzes a value-added tax in greater detail.)

### I. The Pure Flat Tax

Most pure "flat tax" proposals share two characteristics: a much more comprehensive tax base than under current law and a single low tax rate. In some flat tax proposals the tax base is consumption, rather than income. In the most extreme proposals there are virtually no deviations from a comprehensive definition of income or consumption, except for personal exemptions.

#### A. Advantages of the Flat Tax

A pure flat tax would have major advantages over current law, because of the breadth of the tax base and the low tax rate made possible by the comprehensive base. Such a tax would reduce the inequality of tax treatment of families with equal incomes, the distortions of economic decisions, the disincentives to growth, and some of the complexities that plague the current tax system. Because the present system contains many exclusions, exemptions, deductions, and credits not required for the accurate measurement of income, it requires higher tax rates than would be necessary under a pure flat tax. In addition, a uniform tax rate lessens problems inherent in steeply graduated rates, such as the bunching of income, discrimination between single persons and married couples, and incentives to shift income artificially to family members subject to lower tax rates.

#### B. Distributional Inequity of the Pure Flat Tax

These important advantages must be compared to the troublesome distributional implications of a pure flat rate tax. A single, totally flat rate, whether imposed on income or on consumption, would involve a substantial shift of tax burden from those in the highest income brackets to low- or middle-income taxpayers. Under current law families with less than $20,000 of income pay 5.5 percent of the

Table 3-1

Percentage Distributions of Individual Income Tax Liability
Under Current Law, a Pure Flat Tax and
the Treasury Department Proposal,
by Economic Income Class of Families

(1983 Levels of Income)

| Family Economic Income Class | Share of income | Share of Tax 1/ | | |
|---|---|---|---|---|
| | | Current law tax 1/ | Pure flat tax 2/ | Treasury Department proposal 3/ |
| | (percent) | | | |
| Less than $20,000 ......... | 13.7 | 5.5 | 9.5 | 5.1 |
| $20,000 to $50,000 ........ | 41.6 | 34.6 | 41.6 | 34.3 |
| $50,000 to $100,000 ....... | 30.4 | 32.7 | 32.6 | 33.1 |
| $100,000 or more .......... | 14.3 | 27.2 | 16.3 | 27.5 |
| Total ............. | 100.0 | 100.0 | 100.0 | 100.0 |

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1/ Current law applicable in 1986.

2/ A single rate of 16.8 percent applied to taxable income under the Treasury Department proposal, which essentially exempts from tax those in poverty.

3/ A three-rate graduated structure applied to taxable income under the Treasury Department proposal, which essentially exempts from tax those in poverty.

individual income tax, although they receive 13.7 percent of the income. (See Table 3-1.) A pure flat tax -- even one with liberalized personal exemptions and zero-bracket amounts designed to eliminate tax for families at or below the poverty level -- would raise the share of taxes paid by families with less than $20,000 of income to 9.5 percent of the total. This pure flat tax would sharply reduce the share of individual taxes paid by those with incomes over $50,000, from 59.9 percent under current law to 48.9 percent. Stated differently, taxpayers with incomes above $50,000 would pay about 18 percent less under a revenue-neutral flat-rate tax than under current law. (See Table 3-2.) Conversely, those with incomes between $20,000 and $50,000 would pay one-fifth more tax than under current law. Because of the massive redistribution of tax burdens a pure flat tax would produce, the Treasury Department recommends against its enactment.

## II. Reconciliation: The Modified Flat Tax

In order to simplify and reform the existing income tax, but avoid the massive redistribution of tax liabilities of a pure flat tax, the Treasury Department proposes that a modified flat tax on income be enacted. The proposal is broadly consistent with several modified flat tax proposals advanced by members of Congress, but it goes beyond them in the scope of its recommendations for simplification and reform.

Many believe that conflict between the goal of distributional equity, on the one hand, and the goals of simplicity, economic neutrality, encouragement of growth, and equal tax treatment of equals (horizontal equity), on the other, is inherent in any flat tax proposal, whether pure or modified. In fact, this conflict is more apparent than real. Most of the advantages commonly attributed to pure flat tax proposals result primarily from the inclusion of all income (or consumption) in the tax base and have relatively little to do with whether tax rates are flat or graduated. Conversely, the redistribution of the tax burden from high- to middle-income taxpayers that would result from application of a flat rate cannot be traced to implementation of a comprehensive definition of the tax base. It results entirely from the substitution of a flat rate for graduated rates.

Because the effects produced by a totally flat rate are quite distinct from those resulting from base-broadening, it is possible to achieve most of the base-broadening advantages of a pure flat tax without the shift in tax burdens among income classes a pure flat rate would entail. This is, in effect, the approach taken in proposals for a modified flat tax. By combining a more comprehensive definition of income than under current law with modestly graduated low rates, modified flat tax proposals are able to achieve gains in simplicity, economic neutrality, equal tax treatment of families with equal incomes, and economic growth, without sacrificing distributional equity.

Table 3-2

Changes in Tax Resulting from a Pure Flat Tax
and the Treasury Department Proposal
Distributed by Family Economic Income Class

(1983 Levels of Income)

| Family Economic Income Class | Current law tax 1/ | Pure Flat Tax 2/ | | | Treasury Proposal 3/ | | |
|---|---|---|---|---|---|---|---|
| | | Amount | Change from current law | | Amount | Change from current law | |
| | | | Amount | Percent | | Amount | Percent |
| | (.... $ billions | ..... | .....) | (. % .) | ( $ billions | ) | (. % .) |
| Less than $20,000 ..... | 14.6 | 25.0 | 10.5 | 72.1 | 12.3 | -2.3 | -15.7 |
| $20,000 - $50,000 ..... | 91.2 | 109.6 | 18.4 | 20.2 | 82.8 | -8.4 | -9.2 |
| $50,000 - $100,000 .... | 86.4 | 86.1 | -0.3 | -0.4 | 80.0 | -6.4 | -7.4 |
| $100,000 or more ...... | 71.6 | 43.1 | -28.6 | -39.9 | 66.4 | -5.2 | -7.2 |
| Total ................. | 263.8 | 263.8 | 0 | 0 | 241.5 | -22.3 | -8.5 |

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1/ Current law applicable in 1986.

2/ A single rate of 16.8 percent applied to taxable income under the Treasury Department proposal, which essentially exempts from tax those in poverty.

3/ A three-rate graduated structure applied to taxable income under the Treasury Department proposal, which essentially exempts from tax those in poverty.

A modified flat tax that includes only two or three tax rates covering a wide range of low to middle income would be indistinguishable from a pure flat tax for most taxpayers. (Of course, low-income taxpayers would pay lower rates under a modified flat tax than under a pure flat tax.) The use of flat rates over wide ranges of incomes minimizes marriage penalties and bonuses, as well as problems caused by bunching of income in one year.

## A. Questions Common to Income and Consumed Income Taxes

The term "modified flat tax" could be applied to an expanded income tax base or to a consumption tax base. The only inherent difference between these two tax bases involves the treatment of saving. Under a tax on consumed income, a deduction is allowed for net saving, whereas under an ordinary income tax it is not. This distinction is explained briefly in part B of this section and at greater length in chapter 9. Under either approach many of the issues that must be answered in defining the tax base are the same. Should fringe benefits provided by employers be taxed, or should they be exempt? How are business assets to be distinguished from private assets? Should housing receive preferential treatment? Should charitable contributions be favored? Should activities of state and local governments be subsidized through the tax system? Should a tax continue to be levied on corporations? The remainder of this section focuses on questions such as these, on suggested modifications of the present taxation of capital and business income, and on proposed deviations from the pure income tax model.

## B. Advantages of a Comprehensive Measure of Income

A comprehensive definition of taxable income or consumption is generally conducive to simplicity and to equal treatment of equally situated taxpayers, while retreat from a comprehensive base generally involves complexity and horizontal inequity. A comprehensive tax base is also necessary for economic neutrality, since high tax rates and discrimination between various ways of earning and spending income distort economic decisions.

Omissions from the tax base generally also result in a distribution of tax liability between families with different income levels that is at least somewhat different -- and frequently markedly different -- from what the schedule of marginal tax rates suggests. Finally, any deviations from a comprehensive definition of income, unless based on widely-held views of tax equity and other generally accepted economic objectives, are likely to reduce the perceived fairness of the tax system and therefore undermine taxpayer morale.

Erosion of the tax base also has a heavy political cost. If one special interest group is allowed a deduction or credit not required for the accurate measurement of income, it becomes more difficult to resist others. Ultimately, the only way to maintain a fair tax base -- one without the many loopholes in the present tax code -- is to resist requests for special treatment. For all those reasons, the tax base should be defined as broadly as possible.

### C. Distributional Neutrality

Modification of the uniform rate contained in flat-tax proposals also involves difficult trade-offs. Fairness suggests that a single flat tax rate should not be levied at all income levels. And yet tax equity and due regard for the disincentive effects of high marginal tax rates dictate that the top marginal tax rates should not be excessive. By-and-large, the rate structure proposed by the Treasury Department, when applied to an expanded definition of taxable income, is designed to approximate the distribution of tax liabilities that prevails under current law. The primary exception is at the bottom of the income scale. Increased personal exemptions and zero-bracket amounts will ensure that most taxpayers with incomes below the poverty line will be exempt from income tax altogether.

An important feature of modified flat tax proposals is a reduction in the number of tax rates. Because rates would be constant over much wider ranges of incomes than under current law, a modified flat tax system would resemble a flat-rate system for most taxpayers. Of course, for marginal tax rates to be reduced significantly, without sacrificing revenue, it would be necessary to define the tax base much more comprehensively than under current law.

### D. Issues in Income Measurement

At a conceptual level, the proper tax treatment of many currently untaxed sources and uses of income is clear. Fringe benefits provided by employers and payments that represent wage replacement should be included in income subject to tax. Only in a few cases do problems of valuation make this ideal unattainable, as in the case of small hard-to-value fringe benefits recently determined to be tax-exempt in the 1984 Deficit Reduction Act. Taxpayers should not be allowed business deductions for what are really personal expenses, and they should not be allowed artificially to shift income between family members to reduce taxes. Preferential treatment of above-average amounts of charitable contributions is desirable, in order to maintain incentives for contributions; moreover, taxpayers making extraordinary contributions may be considered to have less taxpaying ability than others with similar incomes. The deduction of state and local taxes should be phased out, both because it is unnecessary for the measurement of income and because there is no compelling reason for the deduction. The Federal Government, through the tax system, in effect pays part of the cost of expenditures by state and local governments. Only real income should be taxed; capital gains and nominal profits that only represent inflation should not be taxed.

Special credits and deductions that are not required to measure income accurately should be repealed. These include depreciation allowances that are greater than real economic depreciation, percentage depletion allowances in excess of cost depletion, intangible drilling expenses, and various forms of preferential treatment currently accorded certain financial institutions. Particularly important is the need to deal with inconsistencies in the tax law that give rise to tax shelters. Tax shelters and the complexities, inequities, and distortions they create can be eliminated only by repealing the tax preferences that make them possible. The disparate tax treatment of corporations and partnerships should be rationalized by reducing the double taxation of dividends and by treating large limited partnerships like corporations for tax purposes.

### E. Disparities in Effective Tax Rates

A simple example illustrates the lack of fairness and neutrality of the present income tax. The first column of Table 3-3 shows how the current tax system treats two different types of labor income, wages and salaries and fringe benefits, and two forms of capital income, interest and capital gains. Under present law, a taxpayer subject to the top statutory rate of 50 percent would actually pay effective tax rates on various forms of real income ranging from zero to 125 percent. The disparities in effective rates are less dramatic for taxpayers with lower incomes, but they are qualitatively the same.

Whereas wages and salaries are taxed at an effective rate equal to the statutory rate, certain fringe benefits are not taxed under current law. The inequity and non-neutrality of this tax treatment are obvious. Recipients of fringe benefits are treated more favorably than those who receive labor income as wages and salaries. Besides being unfair, this provides an artificial incentive for greater consumption of goods and services that can be provided as tax-free fringe benefits. Under a comprehensive definition of income, wages and fringe benefits would be taxed identically, that is, at the same effective rates.

The story is somewhat more complicated for capital income, since the effective tax rate depends crucially on the rate of inflation. The example in Table 3-3 assumes that the interest rate is 4 percent if there is no inflation, but 10 percent if the inflation rate is 6 percent. It also assumes that capital assets that have no current yield are appreciating at the rate of interest, either 4 percent or 10 percent. In the absence of inflation, interest and long-term capital gains are taxed at rates of 50 percent and 20 percent, respectively. But if the inflation rate is 10 percent, tax on nominal interest income is 125 percent of real interest income, and real long-term capital gains are taxed at an effective rate of 50 percent, despite the apparent top rate on long-term capital gains of 20 percent. At higher rates of inflation, effective tax rates on real interest income and real capital gains are even higher.

The statutory tax rate collected on interest income equals the effective rate only if there is no inflation. At inflation rates within recent experience, the effective tax rates on real interest income are much higher than the statutory rates suggest. Besides being unfair, this penalizes saving and encourages borrowing, with adverse effects on capital formation and growth. This problem can be overcome in the context of an income tax only by providing an inflation adjustment for debt.

Long-term capital gains nominally benefit from preferential tax treatment. Thus in the absence of inflation, they are taxed less heavily than wages and salaries and interest income, as shown in Table 3-3, creating both inequities and misallocations of capital. A comprehensive definition of income would not apply different tax rates to capital gains and other income. But if inflation is high and illusory capital gains are taxed, as under the current system, effective tax rates on real gains are high; inequities and distortions are magnified and invention and innovation suffer. A comprehensive definition of income that included indexing (inflation adjustment) of the basis (cost) of assets used in calculating capital gains and losses would ensure that fictitious gains are not taxed.

The second column of Table 3-3 illustrates the advantage of a comprehensive definition of taxable income. The current top statutory rate of 50 percent is used for illustrative purposes; of course, with a more comprehensive definition of income, a lower rate would be possible. For taxpayers subject to the highest marginal tax rate under current law, income from all sources would be taxed at a rate of 50 percent, regardless of the rate of inflation. Subjecting all real income to tax treats equally situated families equally and reduces tax-induced distortions of economic decisions.

## F. Simplification

Simplifying the income tax for most individual taxpayers has been an important objective of the Treasury Department study. Simplification would result from several general approaches. First, increasing the personal exemptions and zero-bracket amounts will eliminate many poor Americans from the income tax rolls. Second, several itemized deductions will be eliminated or subjected to floors. Like the floor under the current deduction for medical expenses, these floors will reduce the need for so many to keep records of deductible expenditures for extended periods of time. With the expanded zero-bracket amount and fewer deductions, about one-third fewer taxpayers will find it advantageous to itemize deductions. Third, most tax credits would simply be eliminated. The Treasury Department believes that most Americans would rather pay low taxes on all of their income than pay high taxes on part of it; doing so is simpler, as well as fairer and more neutral toward economic behavior.

Table 3-3

Illustration of Disparities in Effective Tax Rates

| Type of Income | Effective Tax Rate on Taxpayer in 50% Bracket: Current Law | Effective Tax Rate on Taxpayer in 50% Bracket: Comprehensive Definition of Real Income |
|---|---|---|
| Taxable wages and salaries | 50 | 50 |
| Tax-free fringe benefits | 0 | 50 |
| Interest: | | |
| No inflation | 50 | 50 |
| 6 percent inflation | 125 | 50 |
| Long-term capital gains: | | |
| No inflation | 20 | 50 |
| 6 percent inflation | 50 | 50 |

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November 25, 1984

## *III. Consumed Income Tax*

Consumption provides an alternative to income as the basis for personal taxation. A personal tax on consumption, or consumed income, would be levied by exempting all saving from tax, allowing a deduction for repayment of debt, and taxing all borrowing and withdrawals from savings. Consumed income would be reported on a form much like the present form 1040. Deductions would be allowed for deposits in "qualified accounts" similar to existing individual retirement accounts (IRAs); withdrawals from such accounts would be subject to tax. (Further details of such a tax are described in Chapter 9.)

Though a flat rate could be applied to the consumption base calculated in this way, most proposals for a consumed income tax postulate personal exemptions and graduated rate schedules. Thus, a consumed income tax could be progressive, if that were desired. Itemized deductions could also be allowed, as under the existing income tax.

### A. Administrative Advantages

The current income tax is based on the principle that income should be taxed annually as it is realized. It represents a practical compromise between administrative feasibility and the objective of taxing income as it accrues. Conceptually, accrued income can be defined as the amount a taxpayer could consume without reducing his or her net wealth, that is, as the total of what the taxpayer actually consumes plus the change in his or her net wealth. Many practical difficulties plague application of this conceptual ideal as the basis of an income tax. Compromise between achieving the ideal, on the one hand, and avoiding complexity, on the other, produces a system that departs significantly from the conceptual ideal. Examples of compromise include taxation of capital gains only when they are realized, commonly by sale of an asset, rather than as they accrue. Compromises such as this can allow tax on large amounts of income to be postponed indefinitely, or even avoided altogether, as when appreciated property is transferred at death. On the other hand, efforts to administer the tax on an accrual basis, by levying tax before realization occurs, can introduce significant complexity and hardship. For example, if tax were levied on unrealized gains on closely-held business, valuation would be difficult; payment of tax, moreover, could frequently be required even though there is no cash flow with which to pay the tax.

Because it avoids the problems inherent in accrual taxation, a tax on personal consumption is simpler in many respects than an income tax. The consumed income tax is simpler because all costs of investment are deducted immediately ("expensed"), rather than depreciated over the life of assets; because all costs of creating inventories are expensed, rather than being recognized only as goods are sold; and because capital gains are not taxed, as such. A corporate income tax is not an essential part of an ideal tax system based on consumption; if retained, it would serve only as a withholding device.

The consumed income tax has another major administrative advantage over the income tax. Under the present income tax, the measurement of income is commonly distorted by inflation. Because consumption inherently occurs in dollars of the current year, the measurement of the base of the consumed income tax cannot be distorted by inflation. Since depreciable assets and inventory investments are expensed, inflation cannot erode the value of future deductions because there are none. Interest is not taxed, unless spent on consumption, and thus the inflation premium is not taxed. Purely inflationary capital gains are not taxed, because there is no tax on capital gains, per se.

## B. Economic Advantages

Advocates of a consumed income tax argue that it is preferable to the ordinary income tax on conceptual and economic grounds, as well as on administrative grounds. First, an income tax penalizes saving by inducing taxpayers to consume rather than save for future consumption. By comparison, under certain circumstances, a tax on consumption does not distort the choice between consuming now and saving for future consumption. This is a major attraction of any tax on consumption.

Second, seen from a lifetime perspective, a tax on consumed income is said to be more equitable than an income tax. A taxpayer's total tax burden under a tax on consumed income does not depend on when income is earned or spent, at least under fairly restrictive simplifying assumptions. By comparison, an income tax imposes a heavier burden on those who earn income relatively early in life or spend it relatively late.

Despite the manifest attractions of the tax on consumed income, the Treasury Department does not propose it as either a replacement for, or a supplement to, the income tax. Several defects and difficulties of a consumed income tax lead to this conclusion.

## C. Transition Problems

First, the current existence of substantial wealth, much of which has been accumulated from after-tax income, poses difficult transition problems. Taxing all consumption financed from such wealth would constitute a cruel trick on those who did not expect it -- especially those who have saved after-tax dollars for retirement. Nor would complete exemption of consumption financed from existing wealth be satisfactory. Such an exemption would either be enormously expensive in terms of lost revenue or entail extremely high tax rates during the transition period. Worse, it would allow wealthy taxpayers to escape taxation for many generations if they consumed only old wealth and saved all current income.

On equity grounds, a compromise between complete exemption and full taxation of consumption from existing wealth would be necessary. Such a compromise might allow each taxpayer above a given age to enjoy a given amount of tax-free consumption during his or her lifetime.

But phasing in a consumed income tax in this way would involve transition rules that could complicate the tax system for ordinary taxpayers for a generation.

A different type of transition problem would result from the possibility of avoiding taxes by hoarding money before the effective date of the new tax. After the effective date the taxpayer could either deposit the hoarded funds in a qualified account in order to get a tax deduction for saving or use them to meet living expenses without paying tax. Alternatively, pre-effective date investments in foreign banks could be liquidated after the effective date and reinvested as tax-deductible saving. Even though this would be a temporary problem of transition, it would undermine both the revenue yield and fairness of the tax during that period.

### D. Perception Problems

Even though a taxpayer's standard of living, as reflected by his level of consumption, may be considered by many to be an appropriate base for taxation, the consumed income tax suffers from an important perception problem. Taxpayers presumably would welcome the opportunity to postpone taxes on amounts saved, paying tax only when dissaving and consumption occurs; such is the tax treatment currently accorded saving in qualified pension accounts. But to be consistent, it would also be necessary to tax amounts borrowed and allow a deduction for repayment of loans. This treatment of saving and dissaving would create a pattern of tax liabilities over the lifetime of the taxpayer that might be perceived to be unfair. Relative to experience under current law, tax liability would be greater during early adulthood and during retirement -- periods when financial resources are commonly strained. Tax would be relatively lower during middle age, the time when many taxpayers receive most of their income. The fairness of including amounts borrowed in taxable consumption might be questioned, and this tax treatment might even require a constitutional amendment.

### E. Complexity for Individuals

A consumed income tax would be more complicated than the existing income tax for many individual taxpayers. Under the present income tax, amounts withheld on wages and salaries roughly offset tax liabilities for many taxpayers who have only modest amounts of income from capital. Relatively few taxpayers must worry about estimating liabilities and paying significant amounts of tax in addition to amounts withheld. Under the consumed income tax the situation could be quite different. Withholding might be required on borrowing and withdrawals from savings; if so, "reverse withholding" would be appropriate when a loan is paid off. Even then, far more taxpayers might need to file estimated returns than now, because it would be difficult to adjust withholding rates on financial transactions to the personal circumstances of taxpayers. Moreover, many young adults and retired individuals are not required to file or pay tax under an income tax, but would be required to file and pay tax under a consumed income tax.

Owner-occupied housing would not be treated as an item of consumption, to be taxed in full in the year of purchase. Rather, inclusion of the purchase price in taxable consumption would be spread over the lifetime of the home, in effect, by requiring taxpayers to pay tax as their mortgages were paid off. This could be accomplished through special treatment of mortgages outside of qualified accounts. But purchases of homes from amounts saved in qualified accounts could require special averaging features that would complicate compliance for taxpayers. Ironically, individual taxpayers would, in a sense, be asked to keep accounts resembling depreciation accounts at the same time that such accounts were eliminated for businesses.

### F. The Dilemma of Gifts and Bequests

The proper treatment of gifts and bequests under a tax on consumed income is a fundamental issue. Under one view such transfers would not be taxed to the person making the gift or bequest; they would only be taxed when consumed by the recipient. Under a very different view, transfers would be taxed to the donor, as well as when consumed by the recipient. Advocates of this second approach argue that taxing gifts and bequests is necessary in order to realize fully the beneficial equity and efficiency effects of a consumption-based tax. They refer to this type of tax as a tax on lifetime income, to distinguish it from the conventional tax on annual income. The distributional differences in the two ways of treating gifts and bequests are, of course, substantial. The first approach would allow great fortunes to be passed from generation to generation without tax, whereas the second would subject transfers to tax.

### G. International Aspects

No country has a tax on consumed income, although Sweden and the United Kingdom have considered it, and India and Sri Lanka (then Ceylon) attempted to impose the tax for a brief period following World War II. Any country imposing a consumed income tax would be very much out of step with its trading partners, all of which employ income taxes, and would face the task of renegotiating its foreign tax treaties.

## IV. Sales Tax

The fourth option considered by the Treasury Department in its study of fundamental tax reform was a general sales tax, such as a value-added tax or retail sales tax. Chapter 10 of this volume examines sales taxes in greater detail, and Volume III contains an even more detailed analysis, especially of the value-added tax.

Serious consideration was given to only two forms of sales tax: a single-stage retail sales tax and a value-added tax extending through the retail level. Alternatives such as a gross receipts or turnover tax, a general manufacturer's tax, and a value-added tax that excludes the retail level contain fundamental defects that render them inappropriate for use by a developed country such as the United States. These defects are described in greater detail in Chapter 10.

Though the value-added tax (VAT) is now familiar throughout Europe and much of the rest of the world, it is new and unfamiliar in the United States. Americans therefore are likely to have difficulty appraising its economic effects. The kind of VAT most likely to be considered seriously in the United States is best seen as a particular way to administer a sales tax with economic effects very similar to those of a retail sales tax. Thus, in what follows, the discussion of the effects of a "sales tax" applies to both a VAT and a retail sales tax.

General sales taxes have the advantages of not penalizing saving and investment, as income taxes do, and of being fairly neutral between ways of earning and spending money. Because their base is very large and they are collected in small increments on billions of transactions, they can efficiently and relatively painlessly raise large amounts of revenue to finance federal spending or to take pressure off the income tax. Some advocates of a national sales tax believe this to be a disadvantage and propose that any tax of this kind should be accompanied by constitutional limits on the tax rate or on Federal spending, as a percent of GNP.

The following points also argue against use of a sales tax: it would involve some shift of tax liability to low-income groups; it would probably cause a one-time increase in prices; its implementation would require substantial administrative resources; and it would involve Federal intrusion on a revenue base long thought to be the fiscal preserve of state and local governments. Of these, the regressivity problem is probably the greatest.

Regressivity could be eliminated, or at least reduced, by exempting from tax sales of certain goods such as food, housing, and medical care, or by taxing them at reduced rates. However, exemptions and differential rates increase complexity and require higher general rates of tax. Alternatively, regressivity could be redressed by establishing a comprehensive system of refundable credits under the income tax, or by adjusting transfer payments and providing non-refundable credits. The slight tendency toward regressivity higher up the income scale should not be addressed by application of differential rates to "luxury" consumption. European experience indicates clearly that administrative costs far outweigh any benefits of such an approach.

A value-added tax would be preferable to a retail sales tax, despite the greater familiarity of the latter. A Federal retail sales tax, when combined with the retail sales taxes levied by most states, would provide irresistable inducement to tax evasion at the retail level. By comparison, the VAT would involve collection of about two-thirds of revenue before the retail stage. Moreover, a VAT would contain self-enforcement features that, while easily overstated, are quite important.

An additional reason for preferring the VAT over a retail sales tax is its treatment of capital goods and intermediate products and of goods in international trade. Under a VAT, exports, capital goods, and other intermediate inputs are automatically freed of tax. By comparison, under a retail sales tax this desired result is only approximately achieved; under many state sales taxes it is not even sought.

Total substitution of a sales tax for the current income tax was rejected because of the distributional inequity of such a policy. In a revenue-neutral reform package, revenues from a sales tax could be used to reduce the income tax. This would have the advantage of shifting some of the burden of taxation from income to consumption and of allowing lower income tax rates, taking pressure off the definition and measurement of taxable income. It would have the disadvantage of reducing the progressivity of the tax system. Given the considerable administrative costs implementing a sales tax would entail, however, it probably should not be imposed merely as a replacement for part of the income tax.