HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

B-71 Cannon HOB ■ Washington, DC 20515 ■ 202-226-7200 ■ www.house.gov/budget_democrats

September 29, 2004

A National Retail Sales Tax: Right-Wing Dream Tax Is Wrong Tax for Most Americans

Dear Democratic Colleague:

President Bush believes that a national sales tax is "an interesting idea that we ought to explore seriously." No surprise there — Republicans have toyed with the idea of a sales tax for years. It would lower, if not eliminate, taxes on income from wealth, and while working Americans would take up the slack and pay dearly, proponents hope that the lure of ending the income tax would distract attention from the real impact of a sales tax. If people understood the true impact of a national sales tax, the vast majority would reject it outright.

Who Pays?

A sales tax would come down hard on working Americans because it would apply to almost every dollar they spend. Working families spend most of their income to maintain their standard of living. Wealthy families spend a smaller fraction of their incomes, and save the balance to build up their wealth. This fraction of their income would not be subject to a sales tax. Therefore, the wealthy would pay less; working families would pay more.

This takes the distribution of our current income tax and stands it on its head. The most basic elements of the income tax are a standard deduction for each family and a personal exemption for each family member. Because of these deductions and exemptions, moderate-income families enjoy the first dollars of their income tax-free. Low-income families enjoy income tax relief for virtually all of their incomes. This would not be possible with a sales tax; every dollar of their spending would be taxed, and the purchasing power of working family wages would suffer an instant reduction.

Tax scholars have confirmed that replacement of the individual income tax, the payroll tax, the corporation income tax and the estate tax with a national sales tax would shift a substantial burden onto working families. One research paper found that under the leading sales tax proposal (espoused by "Americans for Fair Taxation" and embodied in H.R. 25), the tax burdens of many middle-income families would increase by half, while those of the wealthy would be cut by more than half. Lower-income working families would be hurt even more. Though the precise findings are open to debate, the results are so overwhelming that there can be little doubt about where the tax burden would fall.

Advocates of a sales tax try to lighten the blow with a rebate equal to the sales tax rate times the poverty level. But these rebates, sometimes called "demogrants," would not begin to offset the combined effects for working families with children. These families would lose their Earned Income Tax Credit while paying a huge increase in sales taxes on all they consumed. Other attempts to ease the burden for working families would be equally ineffective. Exempting food or other necessities is like a dog chasing its tail. Assuming that Republicans do not want to make their deficit even larger, every exemption requires an even higher tax rate on every item that is not exempt, in order to keep revenue levels the same. As a result, tax scholars have found that exemptions or lower rates for necessities make little difference on the impact of the tax.

It is the required level of the sales tax rate that would shock most Americans. The Joint Committee on Taxation of the Congress estimated that an earlier but identical version of H.R. 25, which would replace income taxes, payroll taxes, and the estate and gift tax, would need a tax rate of 57 percent. A prominent non-governmental tax scholar has estimated that the necessary tax rate would be at least 60 percent. This tax rate is expressed the way U.S. sales-taxpayers expect; that is, if the price of an item is $1.00, and the sales tax is $0.60, the total cost of the product is $1.60. Some quote lower tax rates by upending the math; the total cost of the product is $1.60, the tax is $0.60, and so the tax rate is presented as 37.5 percent, or 60/160. With this calculation, what everyone would call a 30 percent tax rate is presented as a 23 percent rate. The former method, with which all Americans are familiar, is called the "tax-exclusive rate." The latter, which most would not understand, is a "tax-inclusive rate."

This rate contrasts sharply with the current income tax under which a working family with two children pays no tax on its income up to $40,000, and rates of 10 percent and 15 percent apply to their income above that amount. Under the national retail sales tax, every time a working parent went to the supermarket, a grocery bill of $100 would turn into $157, $160, or even more. Add those taxes up, week after week, and you can easily see why many middle-income families could pay almost twice in sales taxes what they pay now in income and payroll taxes.

Sales tax advocates claim that government cash payments to families would ease this tax burden. But this is where the impact of the national sales tax on working families becomes an administrative nightmare and a political tug-of-war. Such cash payments would have to be made to the vast majority of American households, if not all households, to make whole those with moderate or low incomes. But many Republicans are already on record as opposing the nearest analogy in our current tax system: the Earned Income Tax Credit for working families with children. What would the Republican Congress and President do if they had their way and created a national sales tax? Would they accept an even larger and more pervasive version of the

Earned Income Tax Credit? Or would they go for a national sales tax that would almost double the tax burden on many working families, so that the tax burden on the wealthy could be cut in half? Either the nation would have a vastly more complicated tax process with negative taxes for most, or working families would have a crushing new tax burden.

There is one issue of fairness that makes introduction of a national sales tax particularly difficult. Typically, people save some of their earnings in their working years, and then draw upon their savings for support in retirement. Under the income tax, many retirees enjoy a drop in their taxes. They pay lower taxes when they spend their savings than they pay on their earnings during their working years. Under a new national sales tax, retirees would face a double whammy. Having paid taxes on their income as they earned and saved it, they would then have to pay taxes on that money all over again as they withdrew and spent it. Social Security benefits would be subject to tax as received and spent. So the nation would either need a costly and complicated transition relief program for retirees, or moderate-income seniors would be hit even harder by a new sales tax.

How Would It Work?

Advocates of a national sales tax play heavily on the apparent reduction in tax complexity, because working people would no longer have to file income tax returns. When those working people realize that their taxes would increase by half or more, they will be less grateful. The only way to prevent that tax impact is for the government to create some form of cash payment to working families, and because the way to qualify for and determine the amount of that payment may be for the family to file an income tax return, simplification for such families might be very limited. (For such payments to come close to holding families harmless, without losing large amounts of revenue, the payments would need to be calculated from an income tax return or similar detailed filing by each family.)

Advocates may argue that the elimination of the income tax return is a boon to small business owners. But putting aside the issue of tax returns to qualify for cash payments, the benefits for small businesses could be minimal. Small business would have to deal with the complexities of exemptions from the sales tax system, in addition to the basic paperwork needed to comply with the tax. And because small businesses would in effect become the tax collectors for the entire federal government, they could expect regular audits and closer scrutiny on their filings — which would need to be far more frequent, probably monthly, than their current annual tax returns.

Some may argue that, with a sales tax instead of an income tax, the nation could abolish the Internal Revenue Service (IRS). This is a pipe dream. The federal government would still need an IRS to collect the revenues from all of the tens of millions of business taxpayers (and probably through monthly payments, rather than annual income tax returns), as well as to dispense the tens or hundreds of millions of cash payments (if they were included in the plan) that would be needed to mitigate the heavy burden of the sales tax on working families. Even without a payroll tax, businesses would need to report wages for Social Security benefit records. And with sales tax rates at \$.57 to \$.60, businesses would have an incentive to understate sales. Tax administration still would be a challenge.

A national sales tax may hit States (and localities) that impose their own sales taxes. Forty-five States (and the District of Columbia) have sales taxes, with rates that average probably more than five percent. If the federal government were to impose a 60 percent sales tax, would the States believe that they could viably continue sales taxes of another five percent or more on top of that? Furthermore, many of the State sales taxes have unique sets of exemptions. How would small businesses cope with having a federal sales tax and a state sales tax that would differ in many important details?

States would suffer in other ways. H.R. 25 would force the States to pay sales tax on their purchases. Though this is of questionable constitutionality, if enforced, it would decimate State budgets. Furthermore, those States with their own income taxes now rely on the federal government for the tax return form and for nuts-and-bolts administration. States would find it difficult to continue income taxes without federal back-up. States that abandoned their income tax would have to increase property taxes or sales taxes to make up the lost revenues. The Democratic staff of the House Ways and Means Committee have estimated that these two factors could lead to a 235 percent increase in property taxes in my own State of South Carolina.

H.R. 25 tries to lighten the impact of the national retail sales tax by exempting, for example, sales of existing homes while taxing sales of new homes. Under such a rule, new home construction could virtually cease for a time. Sales of new cars or any other large, expensive durables would be hit hard. Because H.R. 25 would repeal income taxes, individual and corporate, payroll taxes, and estate and gift taxes as well, the consumption base to which it applies has to be all-inclusive. H.R. 25 would impose sales taxes on utility bills, gasoline, health insurance, homeowners insurance, medical care, new homes, and services as well as goods, all at a rate of about 60 percent. H.R. 25 would even tax the federal Medicare program — shortening its solvent life by ten years, from 2019 to 2009.

Conclusion

Bruce Bartlett, an economist and columnist for the *Washington Times,* credits “aggressive ignorance” for driving sales tax advocates and keeping the issue alive. Having done “a thorough review of the academic literature on this issue,” he reports that he “could not find a single article in a peer-reviewed journal that did not reject the sales tax proposal as utterly unworkable.” (“National Sales Tax Tremors,” Washington Times, August 18, 2004.)

A national sales tax will not stand scrutiny. It will lighten the tax burden on those with wealth but leave the weight of the system on working families, making the burden of taxes far heavier for low- and middle-income Americans. This is not a goal that Democrats, or most Americans, share.

Sincerely,
/s
John M. Spratt, Jr.
Ranking Democratic Member

Why the Sales Tax Rate Must Be as High as 60 Percent

Americans for Fair Taxation (AFT) proposes to replace individual and corporate income taxes, payroll taxes, and estate and gift taxes with a sales tax at a 30% rate (billed as a tax-exclusive rate of 23%). Their proposal is spelled out in H.R. 25. AFT claims that its sales tax would replace fully the revenues raised by these taxes, but their calculation of the necessary tax rate includes errors and optimistic assumptions. The Congressional Joint Committee on Taxation estimates the necessary rate at 57%. William G. Gale, Co-Director of the Tax Policy Center at Brookings, in "The Required Tax Rate in a National Retail Sales Tax," dated May 1999 and updated in August 2004, finds that if government spending is held constant, and 20% is allowed for avoidance, exemptions, and evasion, **the tax exclusive rate is 60.7%.** Here is why the tax rate has to be so high, according to Gale and the House Budget Committee Democratic Staff:

Government expenditures: AFT and the sponsors of H.R. 25 assume that the federal government would collect a sales tax on its own expenditures for goods and services. But if the federal government collected a tax, it also would have to pay the tax. If the government levied a 30% percent tax on its own purchases, it would have to increase spending on goods and services by 30%. That portion of federal government transfer payments not currently subject to taxation would also have to be increased 30% to maintain after-tax purchasing value. The sponsors assume that the federal government would collect the sales tax on state and local government purchases also. Leaving aside constitutional issues, those governments obviously would expect to be made whole. Merely maintaining the purchasing power of the government's budget would increase the tax rate by more than 12 percentage points.

The tax base, avoidance, and evasion: The sponsors of H.R. 25 assume that the government would tax virtually all goods and services, including housing and the imputed consumer income from unpriced services (like free checking accounts). Thus, they assume that the sales tax could be collected on consumption equal to 63 percent of GDP. The value-added taxes in Europe have a consumption tax base equal to only about 41 percent of GDP, because of exclusions from the tax base necessary for practical and political reasons. The sponsors assume that there will be little tax evasion, but experience elsewhere in the world, and the opportunities for evasion, suggest otherwise. Taxpayers will also have opportunities to exploit legal loopholes, such as entrepreneurs making personal purchases through their businesses and claiming business tax rebates, and extended families claiming separate demogrants for each nuclear family. Even tax leakages that are less than those in similar situations around the world would raise the necessary tax rate by more than 15 percentage points.

Current low tax receipts: The 30% tax rate claimed by the sponsors of this proposal purports fully to replace current tax receipts. However, federal tax receipts are at their lowest level in half a century (16.2% of GDP). The Administration's budget plan assumes that tax receipts will rise substantially. If they do not, deficits will only be deeper and more intractable. Increasing the tax yield to equal the Congressional Budget Office's projected average for the next ten years, plus corrections for the problems noted above, leaves the necessary tax rate at **60.7 percentage points.**

These corrections are conservative. Receipts could easily fall short at a 60.7 percent tax rate.

The Sales Tax Hits the Working Family

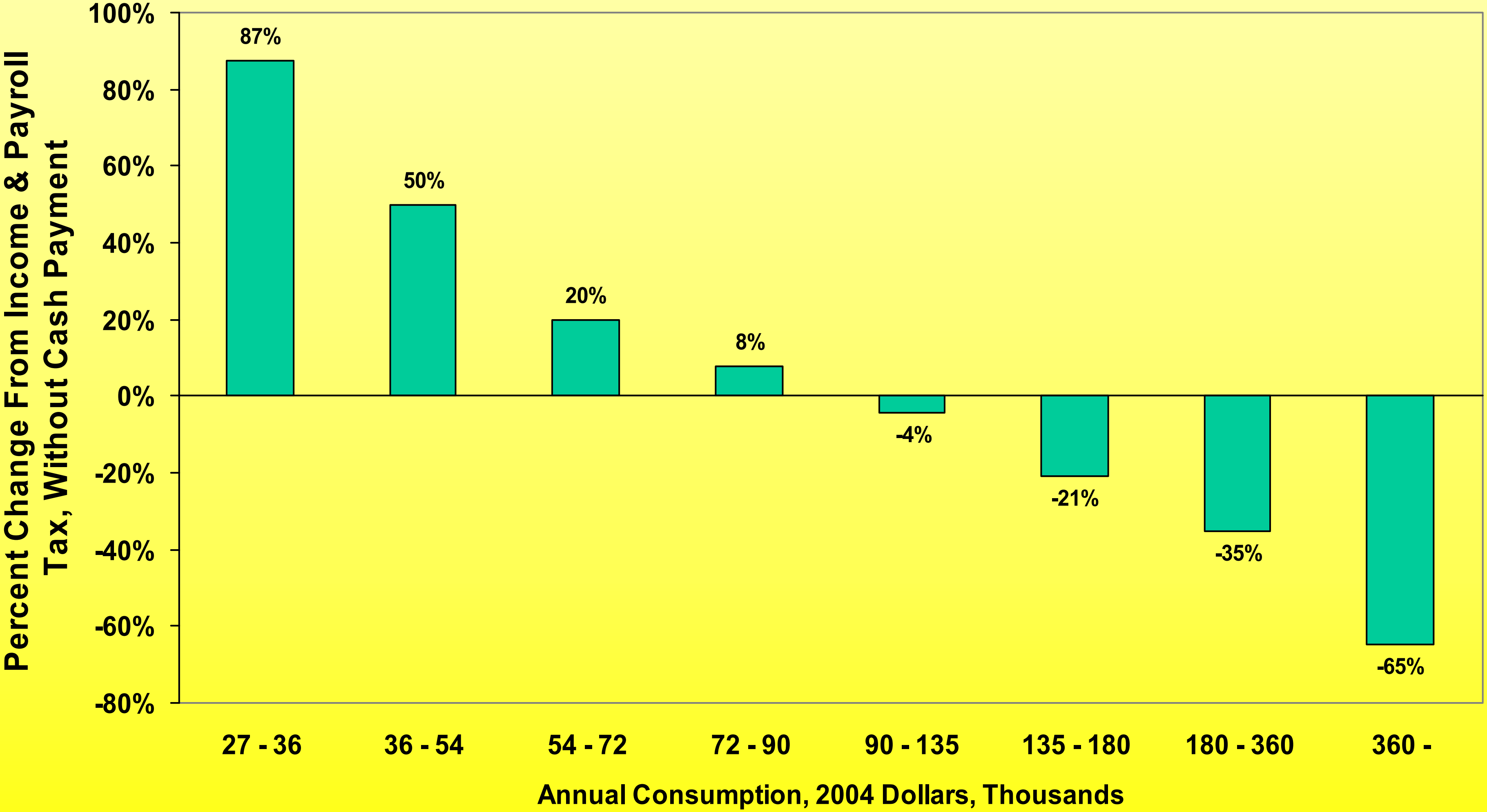
A retail sales tax would bite into every dollar of a working family's spending. An income tax, on the other hand, offers exemptions, deductions and credits that shelter much of that family's income. Here is how much more typical working families would pay in sales taxes, based on a study by Feenberg, Mitrusi, and Poterba, entitled "Distributional Effects of Adopting a National Retail Sales Tax."

A sales tax that exempts food, housing, and medical care would still almost double the taxes of families that consume between $27,000 and $36,000 per year. Those with lower annual spending would face even larger tax increases. (See the first attached chart. This study was completed in 1997, based on 1991 data; the House Budget Committee Democratic staff has adjusted the figures to 2004 dollars. Because the study's authors presented these figures in terms of annual consumption, the corresponding income classes would be significantly higher.) Families with somewhat higher consumption would also be hard hit; those with annual consumption of as much as $90,000 would be net losers. Those with annual consumption of over about $360,000, however, would be big winners; they would save more than half their annual taxes.

The sales tax just described would not provide any cash payment, or "demogrant," to offset the effect of the sales tax. By contrast, H.R. 25 would provide a demogrant equal to the amount of sales tax that would be paid by a family at the official poverty threshold. The same recent study estimated the effect of the same sales tax with such a demogrant, however; but the outcome changed very little. The reason is that the sales tax rate has to be increased to offset the cost of the demogrant, and thus families must pay even more sales tax. Families with annual consumption of between $27,000 and $36,000 per year have their tax bills increased by half. (See second chart.) Tax increases remain substantial at somewhat higher spending levels. Even families with consumption as high as $135,000 per year are net losers. But those with annual spending of over $360,000 still have their tax burdens cut by more than half.

Thus, even with a demogrant, the sales tax would hurt typical working families, while providing those who need help the least with enormous relief. If sales tax advocates want to hold all families roughly harmless, they would need to create a much more complex payment mechanism tied more closely to annual income. To accomplish that, they would need to have families file something very much like the current income tax return, and this return, along with the additional sales tax returns required of all businesses, would leave the administrative tax-collection burden not reduced but much increased.

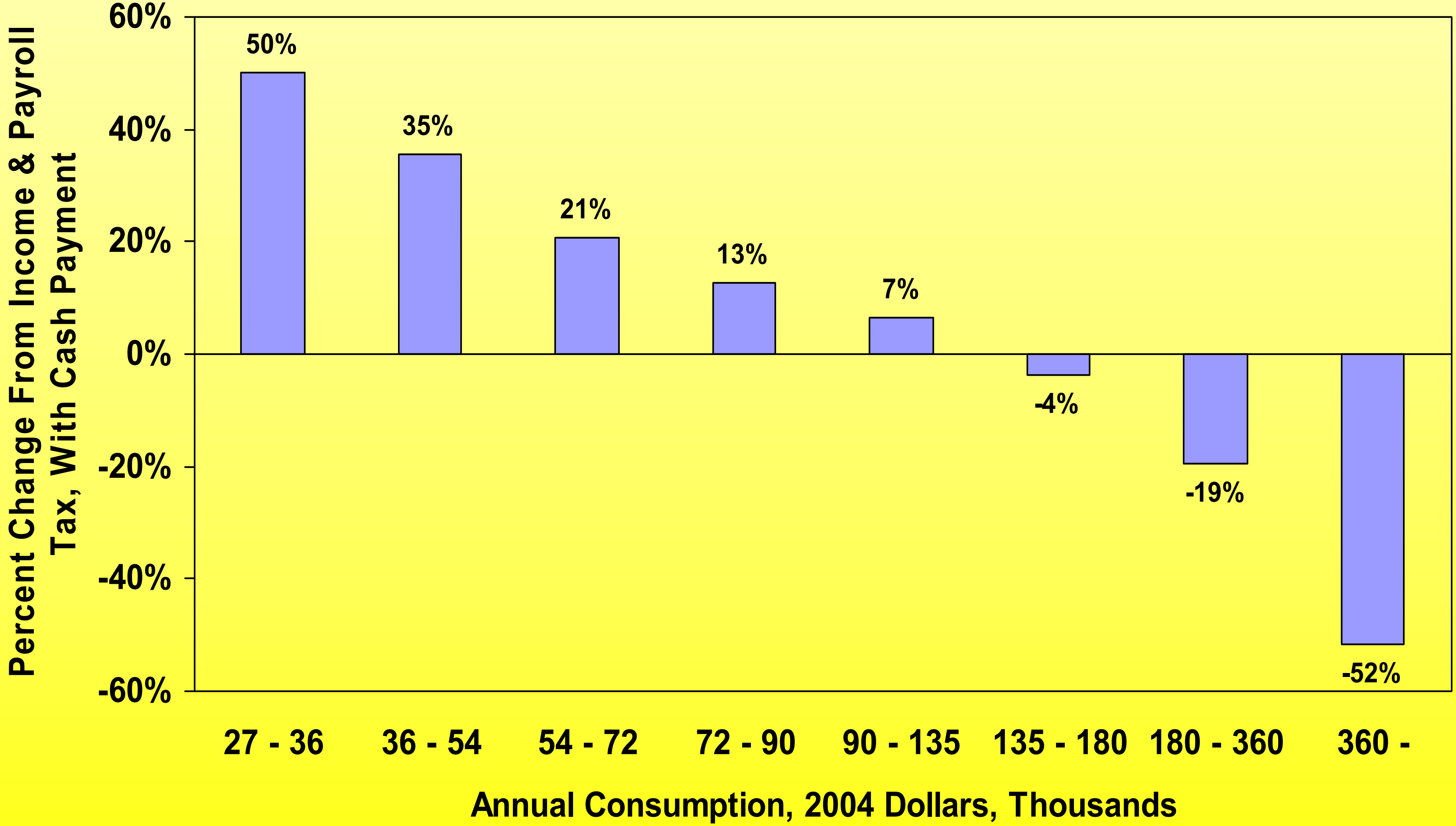
National Sales Tax Would Shift Burden From Well-Off To Middle-Class



Source: Feenberg, Mitrusi & Poterba,"Distributional Effects of Adopting a National Sales Tax," Table 12. 1991 dollars inflated to 2004 levels.

Prepared by the House Budget Committee Democratic Staff 08/09/04

National Sales Tax Would Shift Burden From Well-Off To Middle-Class



Source: Feenberg, Mitrusi & Poterba,"Distributional Effects of Adopting a National Sales Tax," Table 12. 1991 dollars inflated to 2004 levels.

Prepared by the House Budget Committee Democratic Staff 08/09/04