The United States would benefit greatly by reforming the national system of taxation to encourage more saving and investment. Doing so would help to achieve faster economic growth, higher levels of unemployment, and smaller budget deficits. Specifically, a savings-exempt income tax on individuals and families coupled with a companion cash-flow tax on business should replace the existing federal income taxes.
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The Savings-Exempt Income Tax
by Murray Weidenbaum

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Introduction

The United States would benefit greatly by reforming the national system of taxation to encourage more saving and investment — and thus help to achieve faster economic growth, higher levels of employment, improved standards of living, and smaller budget deficits. Specifically, a savings-exempt income tax on individuals and families and a companion cash-flow tax on business should replace the existing federal income taxes.

The Basic Idea

This proposal deals with the missing link in the budget debate. Until now, most proposals to reduce the deficit have focused either on cutting spending or raising taxes. There is a third alternative — improving the way that the tax system functions. The twin proposals made here — the savings-exempt income tax and the business cash-flow tax — would initially raise the same amount of revenue as the existing tax system with far less damage to the economy. This means that, over the years, the nation would achieve a faster growing economy. The direct benefits will be threefold: (1) more people at work, (2) lower federal outlays for unemployment payments, etc., and (3) more income to the Treasury from a growing tax base with no future change in tax rates.

All this cannot be attained by tinkering with the details of the Internal Revenue Code. Instead, the present federal income tax must be overhauled so that it exempts saving and investment, which constitute the seedcorn for economic expansion. This is not an argument for a new tax, such as a value-added tax (VAT), but a sea change in the existing income tax structure.

Going beyond the present array of detailed proposals that would modify the income tax in a piecemeal fashion, let us consider a fundamental change in the government's revenue system: abandon the whole idea of taxing income and shift to a consumption-based tax as the primary federal revenue source. Because so many people jump to the conclusion that all consumption taxes are unfair and regressive, the idea needs to be examined carefully.

Murray Weidenbaum is Mallinckrodt Distinguished University Professor and Director of the Center for the Study of American Business at Washington University in St. Louis. He is indebted to Samuel Hughes, the Frederick Deming Fellow at the Center, for extremely helpful research assistance.
There are several basic arguments that economists have offered over the years for shifting the primary base of taxation from income to consumption in an effort to achieve greater equity as well as economic efficiency. Consumption-based taxes put the fiscal burden on what people take from society — the goods and services they consume — rather than on what they contribute by working and saving, as do income taxes. Thus, under a consumption-based tax system, saving — and long-term investment — is encouraged at the expense of current consumption. Of course, over a period of time, the society is likely to achieve higher levels of saving and consumption because the added investment, by generating a faster growing economy, will lead to a bigger income “pie” to be divided among the various participants in economic activity.

Among the major industrialized nations there is a clear and positive correlation between the share of GDP going to investment and the pace of economic growth.

A constant theme voiced by tax reformers is the need for increased incentives for saving, capital formation, and economic growth. It is common knowledge that the United States saves and invests far less than other industrialized countries. In 1990, the U.S. net savings rate as a percentage of GDP was only 2.2 percent, the lowest of any Organization for Economic Cooperation and Development (OECD) member country; the OECD average net savings rate was 8.3 percent. Standing alone, this fact might not appear terribly harmful. However, among the major industrialized nations, there is a clear and positive correlation between the share of GDP going to investment and the pace of economic growth. This is not a transitory or fleeting relationship. The close fit between investment and growth shows up in the data for the past three decades (see Figure 1).

In that light, this report examines the many ramifications of consumption-based taxation and also analyzes the major alternative approaches to structuring a new consumption-based tax.
Promoting Investment and Economic Growth

Under a consumption-based tax, the basic way to cut taxes legally - is for individuals and families to save more and for companies to invest more. In contrast, to minimize tax liability under the existing tax structure, taxpayers have to earn less. This fundamental fact reduces the incentives for taxpayers to work, save, and invest. By increasing the amount that we save and invest, the proposed tax system would augment the forces that create the formation of capital.

The United States has much lower rates of saving and business investment than our economic competitors.

To many citizens, any discussion of capital formation immediately brings to mind visions of greedy bankers, wealthy coupon clippers, and - to use what is to many a pejorative word - capitalists. Nevertheless, capital plays a pivotal role in providing the basis for the future standard of living of any society. Capital is essential for increasing productivity and thus providing the basis for rising real incomes. Increased capital formation also enhances our competitiveness in an increasingly global marketplace.

A rising stock of capital is necessary for a growing society. It is really a basic matter of how much we want to eat, drink, and be merry today, and how much we want to set aside for tomorrow. Boiled down to its fundamentals, assuring an adequate flow of saving and investment is little more than demonstrating a proper concern for the future.

A slow pace of capital formation in the United States is especially troublesome at a time of heightened global competition, when modern, state-of-the-art machinery and equipment are necessary to match foreign firms with low-wage structures. The increasingly international nature of business competition requires updating the American tax system to face up to these global realities. Unfortunately, the United States has much lower rates of saving and business investment than our economic competitors.

The reason for this shortcoming is clear: the current U.S. tax code is biased in favor of current consumption and against saving. Any doubt about this fact can be resolved quickly with a very simple example. Consider three workers, A, B, and C, each of the same age, with the same work experience and size of family, and with the same compensation. Mr. A regularly spends what he earns, no more and no less. Mrs. B, a saver, deposits a portion of her paycheck into a savings account each week. Mr. C not only spends everything he earns but also borrows to the hilt, having bought as expensive a house as he could obtain financing for.

It is interesting to compare the differential tax burden of these three workers. Clearly, Mrs. B, the saver, will have the highest tax bill, for she pays taxes on her wages as well as on the interest that she earns on her savings account. Mr. C winds up with the lowest tax bill, as he receives a tax deduction for the interest he pays on his large mortgage. Actual practice includes many variations in the tax treatment of specific financial transactions. Yet, for the average citizen, the existing personal income tax structure favors consumption over saving. In effect, the current system taxes saving twice, once when the income is earned and second when the saving generates interest, dividends, etc.

In addition, many of the government spending programs - such as welfare and food stamps - operate with a similar effect. Let us assume that A, B, and C all get laid off at the same time and that none of them obtains a new job. Mr. C, the big spender, and Mr. A, the pay-as-you-go man, will quickly be eligible to receive welfare, food stamps, and related benefits. The last to qualify for federal assistance will be Mrs. B, the big saver. Unlike the good Lord, the feds do not help those who help themselves. Clearly, the economy would benefit from the adoption of the principle that all income should be taxed only once.

Changing the Tax Structure

The United States uses consumption taxes to a far lesser degree than most other developed Western nations. In 1991, the 24 members of the OECD obtained an average 30 percent of their revenue from taxes on consumption. For the United States, the ratio was 17 percent.

The U.S. Treasury proposed a "spending tax" in 1942 as a temporary wartime measure to curb inflation. The proposal was quickly rejected by Congress. A major argument against such a tax - then and now - is that the exemption of saving would fa-
vor the rich, since they are better able to save large portions of their incomes. Some believe that this would lead to greater concentrations of wealth in the hands of a few. As we will see, proponents of a consumption tax respond that some versions can be made as progressive as desired.

The “savings-exempt income tax” is based on the current income tax, but exempts all savings. This revision would, in effect, change the income tax into a consumption-based tax. As will be shown, this form of taxation avoids many of the negatives associated with the VAT, while capturing most of the benefits. Conceptually, the base of the two types of consumption-based taxes is the same (the value of goods and services purchased) and the yields from these taxes could be very similar.

Another objection to consumption-based taxation is that such a system would favor the miser over the spendthrift, even when both have similar spending power or ability to pay. The response offered to this argument is that consumption uses up the resources available to the nation, while saving adds to these resources. Thus, people should be taxed on what they take out of the society’s pool of resources, not on what they put into it.

Tax experts have devised, and criticized, a variety of specific consumption-based taxes. No consensus has yet been reached on the details. It is likely that three interrelated clusters of issues will receive increased public attention in the 1990s: (1) the general desirability of a tax on consumption, (2) the specific form that it should take (“top-down” or “bottom-up”), and (3) whether it should replace or augment an existing tax.

There are two major types of consumption-based taxes. One is a “bottom-up” tax on individual purchases of goods and services. The United States provides many examples in the form of general sales taxes. In Western Europe and other industrialized areas, a variation known as a value-added tax (VAT) is customary. Like general sales taxes, a VAT is comprehensive. Essentially, value-added is the difference between a business’s sales and its purchases from other companies. The VAT is paid by each enterprise in the chain of production — manufacturer, wholesaler, and retailer. Duplication is avoided by taxing only the added value that the firm contributes to the goods or services it produces.

The second approach to consumption taxation is a “top-down” variation. This proposal, over the years, has been called an expenditure tax and a consumed-income tax. The current nomenclature is a “savings-exempt income tax.” This tax is based on the current income tax, but exempts all savings. This revision would, in effect, change the income tax into a consumption-based tax. As will be shown, this form of taxation avoids many of the negatives associated with the VAT, while capturing most of the benefits. Conceptually, the base of the two types of consumption-based taxes is the same (the value of goods and services purchased) and the yields from these taxes could be very similar.

The Value-Added Tax

A value-added tax (VAT) represents a very different way of collecting a general tax than most Americans are familiar with: It focuses on the sales of goods and services to consumers by individual companies. It is, in effect, a sophisticated and comprehensive sales tax which avoids the double counting otherwise inevitable when the same item moves from manufacturer to wholesaler to retailer. In total, a VAT should be equivalent in yield to a single-stage sales tax levied at the retail level.

Essentially, a firm’s “value-added” is the difference between its sales and its purchases from other firms. Value-added can also be estimated by adding labor and capital inputs supplied by the firm itself — represented by wages and salaries, rent and interest payments, and profit.

Reasons for Favoring a VAT

Proponents of the VAT contend that it is economically neutral, because ideally it would be levied at a uniform rate on all items of consumption. It would not distort choices among products or methods of production. In that regard, the VAT is superior to the existing array of selective excise taxes.

Advocates of the value-added tax also point out that, in contrast to an income tax, there is no penalty for efficiency — profits are taxed equally as wages — and no subsidy for waste (a dollar of expense saved becomes a dollar of profits and is taxed equally). Moreover, the VAT is neutral between incorporated and unincorporated businesses and, theoretically, also between public and private enterprises. By focusing on consumption, it avoids a double tax burden on the returns from capital. This tax starts off with no exclusions or exemptions and thus, at least initially, provides a broader and fairer tax base, one that the underground economy will have more difficulty evading. Consumption taxes such as the VAT are levied on the returns to labor (wages and salaries) equally with the returns on capital (rent, interest, and profits). Thus, shifting to a more capital-intensive and perhaps
more profitable method of production would not influence a firm's tax burden.

Another argument in favor of a value-added tax is that many other nations have adopted this form of taxation. It therefore fits in better than conventional taxes with the growing international character of production. The VAT has become one of the revenue workhorses of the world. Virtually every industrialized economy in Europe imposes the tax and it has spread throughout the Third World. The members of the European Union have used VAT taxation since the late 1960s or early 1970s. In 1989, Japan imposed a broad-based 3 percent sales tax.

However, unlike recent attempts to overhaul the United States tax code, the adoption of a tax on value-added was true reform in Western Europe. The VAT typically replaced an extremely inefficient form of consumption tax that was already in place, a cascading sales or turnover revenue system. Those latter taxes apply to the total amount of a firm's sales rather than only to its value-added. Sales taxes, thus, would be paid over and over again on the same items as they moved from firm to firm in the various stages of the production and distribution process. Such cascade-type taxes favored integrated firms (that could legally avoid one or more stages of the tax), but they severely discriminated against independent companies that operate at only one phase of the production process.

An added, widely cited reason for adopting a VAT is the anticipated foreign trade benefits. Unlike an income tax, a sales-based tax can be imposed on goods entering the country and rebated on items leaving — supposedly encouraging exports and discouraging imports. Thus, at first blush, a VAT would seem to help reduce this nation's presently large deficit. However, most economists believe that fluctuations in exchange rates would largely offset these initial effects and result in little change in the balance of trade.

Reasons for Opposing a VAT

Opponents of a value-added tax offer an extensive list of shortcomings. They contend that a VAT is inherently regressive — those least able to pay face the highest rates because, on average, the higher your income the smaller proportion you spend on current consumption. That regressivity can be softened by exempting food and medicine or by refunds to low-income taxpayers, but such variations make the collection of the tax much more complicated. They also provide opportunity for people in the underground economy to avoid paying taxes.

Because the VAT is included in the price of purchases, it registers in the various price indices and, hence, exerts an inflationary force on the economy. The counterargument to this charge is that any price increases would be only a one-time effect, occurring when the tax is enacted or increased. However, there would be secondary inflation effects resulting from the operation of automatic escalators in wage and price agreements. That inflationary impact could in turn be offset by appropriate changes in monetary policy, albeit at times with an adverse effect on the levels of production and employment.

Imposition of a value-added tax in the United States would require establishing a new tax-collection system by the federal government and additional recordkeeping on the part of business taxpayers.

Opponents also charge that a VAT would invade the area of sales taxation, traditionally reserved for state and local governments. However, most states and some localities have come to rely on income taxes despite heavy use of the same tax base by the federal government.

Turning to the administrative aspects, imposition of a VAT in the United States would require establishing a new tax-collection system by the federal government and additional recordkeeping on the part of business taxpayers. This would be a vast and expensive undertaking. The Treasury Department, based on European experience, believes it would need 18 months after enactment to begin administering a VAT.

A variety of approaches has been suggested for collecting a new VAT. The simplest is the credit method (see Table 1). Under this approach, the tax is computed initially on a company's total sales and the firm is given credit for the VAT paid by its suppliers. To a substantial degree, such a VAT would be self-enforced. Each company would have a powerful incentive to ensure that its suppliers paid their full share of the tax, because any underpayment would have to be made up by the next firm in the chain of production and distribution.
Table 1
Computing the VAT Using the Credit Method

<table>
<thead>
<tr>
<th>Raw Materials</th>
<th>Producer</th>
<th>Manufacturer</th>
<th>Wholesaler</th>
<th>Retailer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales of output</td>
<td>$100</td>
<td>$500</td>
<td>$800</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less: purchases</td>
<td>0</td>
<td>100</td>
<td>500</td>
<td>800</td>
</tr>
<tr>
<td>Equals: Value-added</td>
<td>$100</td>
<td>$400</td>
<td>$300</td>
<td>$200</td>
</tr>
<tr>
<td>Tax on total sales</td>
<td>$10</td>
<td>$50</td>
<td>$80</td>
<td>$100</td>
</tr>
<tr>
<td>Credit on purchases</td>
<td>—</td>
<td>10</td>
<td>50</td>
<td>80</td>
</tr>
<tr>
<td>Equals: Tax liability</td>
<td>$10</td>
<td>$40</td>
<td>$30</td>
<td>$20</td>
</tr>
</tbody>
</table>

Note: Assumes a 10 percent VAT calculated on a consumption basis.

In practice, the collection of the VAT may not be as simple as shown here. That would be the case if certain transactions were exempted (such as food) and if nonprofit institutions and government enterprises were treated differently from business firms. Exemptions are no minor matter in terms of the administrative complexity that they generate. In France, a long and extensive debate occurred over whether or not Head and Shoulders antistaphylic shampoo was a tax-exempt medicine or a cosmetic subject to the full VAT.

The Savings-Exempt Income Tax

A new approach to a consumption-based tax has been proposed by Senators Pete Domenici (R-N. Mex.) and Sam Nunn (D-Ga.) in the form of a savings-exempt income tax.

Taxes on Individuals and Families

As we have seen, the VAT suffers from a number of possible complications, such as inflation, regressivity, and administrative burden. In contrast, a savings-exempt income tax would be collected much as income taxes currently are. It would be levied directly on the taxpayer. The annual taxpayer return would continue to comprise the heart of the collection system, containing exemptions and deductions, as at present. However, one fundamental change would be instituted: the portion of income that is saved would be exempt from taxation.

A savings-exempt income tax is essentially the equivalent of a universal but simplified IRA, using an amended rate table.

This type of tax has been known by a variety of names, a fact that can unnecessarily complicate policy debates. Many prefer to call it a consumption tax, for the intent is to tax what people spend, not what they save. Another frequent name is expenditure tax. The most recent congressional label attached to this proposal (and the name that this report uses) is the savings-exempt income tax.

Figure 2 illustrates a hypothetical example of a "short form" version of a savings-exempt income tax return. It shows how the difficult bookkeeping requirement to tally all consumption outlays could be structured. The illustrative tax form is based on the notion that income equals consumption plus saving. Thus, consumption can be readily estimated, indirectly but accurately, merely by deducting saving from income — and taxpayers are used to developing estimates of their incomes. That new schedule of saving during the year would include changes in bank balances and in holdings of bonds, stocks, and similar investment assets.

To a typical taxpayer, a savings-exempt income tax is essentially the equivalent of a universal but simplified IRA, using an amended rate table. Each of us would decide how much to save and in what form. Many benefits would result. Take the current tax treatment of housing: a bigger down payment, and thus lower interest payments, gives one a smaller tax break. But why should tax policy discourage investing in a home? Under a savings-exempt income tax, down payments and payments of principal would be fully deductible (as would a limited amount of interest on the mortgage). After all, building equity — in a home or busi-
Figure 2

Savings-Exempt Income Tax
Illustrative Tax Return

<table>
<thead>
<tr>
<th>Income and Other Receipts</th>
<th>Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Wages, salaries, tips, etc.</td>
<td></td>
</tr>
<tr>
<td>2. Dividends</td>
<td></td>
</tr>
<tr>
<td>3. Interest</td>
<td></td>
</tr>
<tr>
<td>4. Rents and royalties</td>
<td></td>
</tr>
<tr>
<td>5. Pensions and annuities</td>
<td></td>
</tr>
<tr>
<td>6. Net receipts of sole proprietorships</td>
<td></td>
</tr>
<tr>
<td>7. Withdrawals from partnerships</td>
<td></td>
</tr>
<tr>
<td>8. Receipts from:</td>
<td></td>
</tr>
<tr>
<td>a. sales of financial assets</td>
<td></td>
</tr>
<tr>
<td>b. gifts and bequests</td>
<td></td>
</tr>
<tr>
<td>c. insurance</td>
<td></td>
</tr>
<tr>
<td>9. Net decrease (if any) in bank accounts</td>
<td></td>
</tr>
<tr>
<td>10. Total (add lines 1 through 9)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Saving</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>11. Purchases of financial assets</td>
<td></td>
</tr>
<tr>
<td>12. Capital contributed to partnerships</td>
<td></td>
</tr>
<tr>
<td>13. Net increase (if any) in bank accounts</td>
<td></td>
</tr>
<tr>
<td>14. Other investments (equity in a home)</td>
<td></td>
</tr>
<tr>
<td>15. Total (add lines 11 through 14)</td>
<td></td>
</tr>
<tr>
<td>16. Net Income</td>
<td></td>
</tr>
<tr>
<td>(subtract line 15 from line 10)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deductions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>17. A. Itemized deductions or B. Standard deduction</td>
<td></td>
</tr>
<tr>
<td>18. Exemptions</td>
<td></td>
</tr>
<tr>
<td>19. Total deductions (add lines 17 and 18)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax Base</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>20. Taxable Income (subtract line 19 from line 16)</td>
<td></td>
</tr>
<tr>
<td>21. Tax from rate table</td>
<td></td>
</tr>
</tbody>
</table>

ness — is a form of saving and investment. Home equity loans that tap into this investment would not be rewarded with tax deductions, as they are under current tax law.

The first reaction by many people to a savings-exempt income tax is that it is unfair because it must be regressive. If this were true, poorer people would pay a larger share of their income in taxes than would wealthier Americans. However, the savings-exempt income tax need not be regressive at all. Like the existing income tax, each taxpayer would face a rate table that could be made as progressive as desired. Under the revenue-neutral shift from the traditional income tax contemplated here, the average taxpayer experiences no change in tax burden. However, at each income level, above-average savers would pay less than they do now and below-average savers would pay more.

The basic idea is that the new tax structure would raise as much federal revenue as the existing system (that is known as being “revenue neutral”). In the longer run, the savings-exempt income tax could generate more revenue — or permit rate reductions — to the extent that the added savings stimulate economic growth which, in turn, increases the tax base while it reduces the demand for unemployment benefits and other government spending.

Most importantly, the savings-exempt income tax is not a new or an added tax: it is a simple change in the existing IRS tax collection system. Current restrictions on IRAs, Keogh accounts, and other specialized forms of investment would be eliminated. All savings would be exempt from taxes. Thus, the savings-exempt income tax does not suffer from the administrative burden associated with a VAT, which would require setting up a new tax collection system and new recordkeeping, causing overhead costs to rise in both the public and private sectors. From the viewpoint of the taxpayer, the current bookkeeping and administrative requirements would actually be reduced under a savings-exempt income tax system.

For example, the Nunn-Domenici version of the savings-exempt income tax does not differentiate among different income sources: wages, salaries, interest income, capital gains, and dividends are all treated equally. We may never again achieve the level of simplicity offered by the original 1913 income tax: its 1040 form was three pages long, accompanied by one page of instruction, and filed by only one percent of the population. However, the savings-exempt income tax is still a drastic simplification of the current individual tax code that is estimated to cost taxpayers $50 billion in compliance costs annually.
Because the savings-exempt income tax is not a new tax, it will not generate an added source of income for the U.S. Treasury. Thus, its enactment would not encourage the further expansion of the public sector. A VAT, by contrast, is a new tax that would be an addition to the current array of taxes levied by the federal government.

For a while, the United States was moving toward a form of savings-exempt income tax, albeit indirectly and in modest steps. The establishment of individual retirement accounts (IRAs) enabled many federal taxpayers to defer paying taxes on amounts saved and invested in an IRA (up to $2,000 a year). Also, the first $100 of dividends per taxpayer was exempt from income taxation. The 1986 tax law, however, sharply cut back on IRAs and eliminated the dividend credit.

The Business Cash-Flow Tax

Tax incentives to promote saving do not suffice in responding to the desire for more rapid economic growth. A larger amount of new investment is also necessary. To accomplish this, a business counterpart to the savings-exempt income tax should replace the current corporate income tax and provide greater stimulus to investment. Two current congressional proposals would replace the corporate income tax with a cash-flow tax: the Boren-Danforth Business Activities Tax (BAT) and the Business Tax in the Nunn-Domenici plan.

The Business Tax proposed by Senators Nunn and Domenici would levy a flat 10 percent tax on the cash flow (total sales minus purchases) of most businesses: very small businesses — a group that files the majority of business tax returns, but pays only a small fraction of the total tax collected — will probably be exempted from the cash-flow tax altogether, as will most nonprofit organizations. The earnings of unincorporated businesses are not taxed until the money is withdrawn for personal use. Export sales are excluded from the tax base and a tax equal to the Business Tax rate is levied on imports entering the country. This tax treatment is designed to provide a “level playing field” for products sold within the United States.

One important feature of the Nunn-Domenici proposal is its treatment of the current employer payroll tax. All firms are required to pay a 10 percent tax on their cash flow, including the amounts paid to employees as salaries and wages. However, firms are given a full credit for their payment of the 7.65 percent employer payroll tax for social security. This reduction of their payroll tax liability is designed to help offset the new tax on labor inputs and other cash flow.

In computing the cash-flow tax, each firm would add up all its sales during the year, and then deduct the cost of any purchases it makes from other businesses during the year (i.e., plant and equipment, outside services, parts). The remaining cash flow is the tax base, which would then be taxed at the designated rate (see Figure 3 for a hypothetical computation of the Nunn-Domenici cash-flow tax). Remaining after-tax cash is available for payments of wages and salaries, dividends, interest, or otherwise reinvested in the business.

A cash-flow tax would drastically simplify the current business tax structure, allowing firms to devote fewer resources to complying with tax regulations and more resources to productivity-increasing investment.

The key characteristics of the Nunn-Domenici cash-flow tax are:

1. The cash-flow tax applies to all businesses, regardless of their legal form: corporations, partnerships, individual proprietorships, etc. Unincorporated firms currently taxed under the individual collection system will, instead, pay the business cash-flow tax. This eliminates the incentives for companies to structure themselves in ways that are less productive just to take advantage of tax differentials.

2. Because it is a tax on cash flow, capital purchases are treated in the same way as other expenditures: they are deducted in full at the time of purchase (i.e., “expensed”). Because of this, firms have strong incentives to invest in productivity-enhancing capital equipment. Furthermore, there are no onerous accounting requirements for depreciation, estimates of an asset’s useful life, or the other arcane complications required by the current tax system.

3. The current tax advantage afforded to borrowed capital compared to equity — because interest payments are now tax deductible but dividend payments are not — is eliminated.
Hypothetical Computation of Cash-Flow Tax

Total Sales
Deduct: Exports
Equals: Domestic Sales

Deduct:
  Purchases from other firms
  Capital outlays
Equals: Cash flow

Calculation of cash-flow tax:
  Cash flow times the tax rate
Equals: Gross tax

Deduct: Employer paid social security tax
Equals: Cash-flow tax liability

Note: Cash flow covers employee compensation, dividend and interest payments, and retained funds.

This type of cash-flow tax is superficially similar to a VAT: both taxes use the same tax base of sales minus purchases. However, the cash-flow tax differs from the VAT in several important respects. First, the cash-flow tax is intended as a replacement to the corporate income tax, not as an additional sales tax. Second, the cash-flow tax lacks the administrative complexities of a VAT, which requires firms to track on an invoice-to-invoice basis the amount of tax attributable to each transaction.

Indeed, a cash-flow tax would drastically simplify the current business tax structure, allowing firms to devote fewer resources to complying with tax regulations (and on devising creative methods to minimize their tax burden), and more resources to productivity-increasing investment. For example, the cash-flow tax would eliminate bizarre, complicated tax provisions such as the “amortization of intangible expenditures,” a procedure that depreciates purchases of patents, licenses, and other intangibles. Such complicated law contributes to the high costs of tax compliance: the Tax Foundation estimated that business tax compliance costs in 1990 totaled $112 billion, a sum nearly equal to 75 percent of federal corporate income tax collections. The simplifications offered by a cash-flow tax would particularly aid small business.

The second congressional proposal to replace the corporate income tax — the Boren-Danforth Business Activities Tax (BAT) — is similar to the Nunn-Domenici cash-flow tax, but with important differences. Under the BAT, firms would be taxed at a flat rate of 14.5 percent on the sum of:

- Labor services (wages, salaries, benefits)
- Capital services (interest to creditors, profits to owners)

Small businesses (those with less than $100,000 in gross yearly sales) would be exempt from the tax. Like the Nunn-Domenici plan, certain non-profit businesses (schools, charities, medical institutions) are exempted from the BAT, as are most governmental agencies except enterprise-type activities. Unincorporated businesses (such as partnerships and sole proprietorships) would pay taxes only on income distributed to owners, and not on income retained within the business.

Miscellaneous Provisions

The BAT attempts to deal with the concern over regressivity by using some of its proceeds to triple the individual standard deduction and to expand the earned income credit (both are provisions used mainly by low income taxpayers). Under the BAT, social security taxes paid by employers and employees are cut in half. The Nunn-Domenici approach provides a full tax credit for the employer contribution. In addition, lower-income families (perhaps those with combined earnings less than $25,000) would also receive a tax credit for some portion of their contributed payroll taxes. This credit would be phased out for mid-income families (earnings of $25,001-$50,000), while high-income families (those earning more than $50,000) would receive no payroll tax credit.

The Nunn-Domenici plan also expands the earned income tax credit by about 30 percent and exempts households with low incomes from the savings-exempt income tax altogether. For example, a family of four might not pay any federal taxes on their first $25,000 of consumption. A graduated tax schedule provides
further assurance that the savings-exempt income tax is a pro-
gressive tax.

The Boren-Danforth proposal excludes exports from a firm's
taxable receipts. Moreover, deductions are allowed for the pur-
chases of inputs that produce these exports. Therefore, firms
that primarily export their products or services would typically
receive tax refunds, as their purchases exceed their taxable gross
receipts. While acknowledging the desire to promote exports from
the United States, rewarding exporters with cash refunds from
the government is, in essence, a disguised federal subsidy.

The short-run complications caused by these
major changes in the tax system are likely to be far
more than offset by the long-run advantages.

Both the Boren-Danforth and Nunn-Domenici proposals are
designed to be revenue neutral. They do not initially provide the
federal government with additional funds. Thus, they are not new
taxes, but are instead designed to be more efficient replacements
for the current corporate tax. As with any major change in the
tax system, in the period of transition from the old to the new, a
variety of short-term adjustments will be necessary. The short-
run complications are likely to be far more than offset by the long-
run advantages.

Conclusion

A “top-down” savings-exempt income tax would achieve many
of the same budgetary and economic benefits associated with a
VAT while avoiding its many shortcomings. Converting the cur-
rent income tax to a savings-exempt income tax — unlike adopt-
ing a new tax on value-added — does not require setting up an
additional collection system. Nor is it regressive or inflationary.
In contrast, a value-added tax becomes extremely complicated if
an effort is made to soften its inherent regressivity by exempting
certain categories of expenditures or taxing them at lower rates
(e.g., food and medicine). Unlike a VAT, a savings-exempt income
tax does not provide the federal government with a new revenue
source. Therefore, the public sector has no special temptation to
grow more rapidly.

It is not surprising that politicians in many countries favor
sales-type taxation on the assumption that, politically, the best
tax is a hidden tax. “Bottom-up” sales taxes such as a VAT are
rarely identified separately, as the purchaser merely pays a com-
bined product-plus-tax price. Therefore, that type of tax forces
business firms to act as the middlemen (or women) between gov-
ernment and the consumer. Many companies marketing con-
sumer products fear that the higher prices resulting from the im-
position of a VAT would reduce their sales and earnings.
Conversely, companies selling capital equipment and business
services tend to take a more sympathetic attitude toward this
form of government revenue, which would lighten the tax burden
on their customers and, hence, tend to expand their markets.

The impact of the comprehensive savings-exempt income tax,
in contrast, would not be shielded from the knowledge of the tax-
payer and would not be likely to generate the differential reactions
that flow from the VAT. In any event, a shift in emphasis in U.S.
taxation from income-based to consumption-based should on bal-
ance generate positive results, especially in helping to move the
economy to a more rapid expansion path and, thus, enable the
American people to enjoy a higher living standard while reducing
the federal budget deficit.

The combination of a savings-exempt personal income tax and
a companion business cash-flow tax would initially be revenue
neutral compared to the income tax system that it displaces.
However, over the years, it would generate more revenue for the
U.S. Treasury. This is likely because such a tax system encour-
ages more saving to finance additional investments in a growing
economy. The tax reform proposed in this report is one of the few
pain-free ways of reducing the federal budget deficit.