Chairmen Bradley and Graves, Ranking Members Barrow and Millender-McDonald, and Members of the Subcommittees:

I’m an unabashed cheerleader for tax reform. I came to Washington in 1985 on a leave of absence to work for the Treasury Department on what ultimately became the Tax Reform Act of 1986. That was so much fun that I never returned to my academic outpost. I’d love to repeat the experience—hopefully, on a reform that lasts.

Tax reform is also a national imperative. A good tax system is fair. It’s simple. It’s conducive to economic growth. And it raises enough revenue to finance government. As the President’s tax reform panel articulated well, our current tax system fails the first three criteria in numerous ways. Moreover, though the Panel was silent on this, the tax system has also failed in recent years to raise sufficient revenues to pay for government services, and, unless we change course, that problem will only get worse as the baby boomers start to retire. This is a very serious problem because, if current trends continue, our children will face stiflingly high tax rates and a government that can’t provide even essential services.

Views expressed are mine alone and do not necessarily reflect the views of any organization with which I am affiliated.
There is much to recommend the report of the tax reform panel. Either of the two plans would eliminate the unfair and pointlessly complex individual alternative minimum tax, most phase-ins and phase-outs, and many loopholes, credits, and deductions. The Simplified Income Tax (SIT) is a simpler and more comprehensive income tax, though with large new (and regressive) tax subsidies for saving. The Growth and Investment Tax is a progressive consumption tax with a small tax added on income from capital. Both plans would reduce tax burdens on capital, though the GIT calls for greater cuts.

As noted, both plans also fall short of meeting our country’s revenue needs, especially over the long run. The plans take as their baseline current law, assuming that all of the tax cuts proposed by the President are enacted. The largest of these cuts is the permanent extension of most provisions currently set to expire by 2010; that would increase the federal budget deficit by about $1.2 trillion through 2015, according to the Treasury Department. Collectively, the cuts would also make the tax system notably less progressive over time because the President’s proposed Lifetime Savings Accounts and Retirement Savings Accounts exempt a growing share of capital income (which is disproportionately realized by the wealthy). Indeed, as William G. Gale of the Brookings Institution and I have shown, the tax reform panel’s proposals would increase our budget woes even more than the President’s plan over the succeeding decades.

In addition, the plans’ baseline assumption that the President’s tax cuts will be permanent means that the wealthiest Americans will enjoy enormous tax cuts.

Of special interest to these subcommittees, the tax reform proposal would affect small businesses in many ways. I’ll address four in my oral testimony:

1. the effect of the proposed reforms on small employers’ incentives and ability to provide health insurance and retirement plans to their workers;
2. the effect of disallowing state and local tax deductions for businesses;
3. the effect of three special SIT provisions on small business owners—expensing, cash flow accounting, and special bank accounts; and
4. the road not taken—a national retail sales tax—which would be a disaster for small business owners and middle-class taxpayers and would undermine the ability of government at all levels to provide basic public services.

**Health Insurance and Retirement Plans**

Small businesses face special hurdles in providing health insurance and retirement benefits to their employees. First are the significant fixed costs of setting up such plans. These costs are easier to absorb if they may be spread among many employees (in a large firm) rather than only a few workers. In the case of retirement plans, lawmakers have recognized this problem and provided simpler alternatives and tax incentives for small employers to set up plans. But in the case of health insurance, commissions can be much larger as a share of premiums for small firms than for large ones. Moreover, a small
group pools health risks less effectively than a large one. As a result, a single sick employee can raise premiums dramatically for the whole group.

Despite these barriers, many small employers continue to offer their workers health insurance and retirement benefits. About 42 percent of workers in firms with fewer than 100 employees got health insurance at work in 2003, and 35 percent got retirement benefits. The tax reform panel’s proposal would reduce the prevalence of such benefits. The basic problem is that, under both the SIT and GIT proposals, individuals who purchased health insurance in the nongroup market could deduct the cost of their premiums (up to caps, which would also apply to employers). Similarly, individuals could save up to $20,000 per year in new tax-free “Save for Retirement” and “Save for Family” accounts, making company-sponsored retirement accounts less attractive. As a consequence, many small employers won’t provide health and retirement benefits because workers and their families can achieve similar tax savings from health insurance and tax-free savings accounts purchased outside of work. In this new tax world, small employers who continue to offer benefits will increasingly find themselves at a competitive disadvantage compared with employers who don’t, and, over the long term under either plan, it is likely that far fewer small businesses would offer health and retirement benefits. And, though the Treasury predicted that the new health tax incentives for nongroup insurance could reduce the number of uninsured, the proposal could have exactly the opposite effect—many newly uninsured employees in small firms may be unwilling or unable to purchase coverage themselves.

**Disallowance of State and Local Tax Deduction for Businesses**

The plans would disallow deductions for state and local income, property, and sales taxes. For individuals, this policy has some merit. Arguably, state and local taxes are simply payments for services provided by governments and should be no more deductible than other goods and services. Even if the federal government wanted to subsidize services provided by state and local governments, the tax deduction is a peculiar instrument to deliver the subsidy since it is worth the most to high-income taxpayers and thus most helps states with the highest-income (most robust) tax bases. A better option would be direct revenue sharing with states based on need.

However, it makes no sense to disallow a state and local tax deduction for businesses. Services provided by government are simply costs of doing business and should be deductible as other input costs are.

**Simplified Small Business Rules under SIT**

The SIT would allow small businesses (those with gross receipts less than $1 million) to apply so-called simplified cash accounting for all business purchases and investments except buildings and land. This change would lower taxes for businesses that make investments ineligible under current expensing provisions (section 179) and would simplify compliance because small firms would not need to track basis in assets from year to year. Accounting for inventories on a cash basis would also be far simpler than under current law.
Medium-sized businesses (those with gross receipts between $1 million and $10 million) could continue using cash basis accounting for inventories unless they are in certain inventory-intensive industries. These businesses would have to depreciate capital investments, but subject to a much simplified accounting scheme compared with that under current law.

Large businesses would be required to incorporate and would be subject to a flat 31.5 percent tax. To reduce double taxation, dividends paid out of domestic income would be tax free to shareholders and capital gains on corporate stock would be subject to a 75 percent exclusion.

But what happens to small firms as they grow under the SIT? Generally, firms become subject to less generous tax rules as they move up to the next category, and once a firm moves up the size ladder, it cannot step back down. (SIT calls for a three-year averaging rule to prevent firms from being catapulted into a higher category by a single year of unusually high sales.) This “no going back” rule prevents firms from picking the tax status that suits them best each year, but it might also create counterproductive incentives. Some small firms, for example, may choose to spin off components as they grow to avoid the more complicated and onerous rules that apply to larger firms.

The SIT proposal would also require small business owners to maintain separate bank accounts for business purchases. Intended to simplify taxes and aid compliance, this requirement could increase complexity with respect to mixed personal and business expenditures. For example, business owners can allocate a portion of housing costs and utilities to a home office under certain circumstances. Would they be required to pay a portion of mortgage payments out of the registered business bank account and a portion out of a personal account? It is not entirely clear that this new regime will be workable in practice.

A number of other issues arise, which my colleague, Eric Toder, will address in a forthcoming Tax Policy Center analysis. Suffice it to say that, while many interesting ideas relating to small businesses can be found in the Tax Reform Panel’s proposals, numerous technical details would need to be worked out to make the proposals practical.

**National Retail Sales Tax**

The Tax Reform Panel rejected a National Retail Sales Tax (NRST) as an option. A NRST, called the FairTax by its proponents, is a single flat tax rate applied to an extremely comprehensive base of final retail sales. To offset the regressivity of a sales tax (low-income people spend much more of their income on consumption than those with higher incomes do), every household would receive cash payments from the government equal to the sales tax owed on a poverty-level income. Advocates claim that all federal taxes could be replaced by a single 23 percent flat-rate NRST on a tax-inclusive basis (30 percent on the more conventional tax-exclusive basis against which other sales taxes are
typically measured). However, this low tax rate implicitly assumes that all federal, state, and local government expenditures are in the tax base and that nominal government spending doesn’t change. In other words, the FairTax proponents’ math only works if real (after-tax) government purchases are cut by 23 percent across the board. William G. Gale has calculated that if state and local governments are exempt from the tax and federal government spending doesn’t change, the 23 percent NRST would increase the deficit by $268 billion in 2005 and almost $600 billion in 2010 compared with current law. Put differently, the revenue-neutral tax rate would be 31 percent on a tax-inclusive basis (44 percent if tax-exclusive), and that is under the implausibly optimistic assumptions of FairTax supporters: no avoidance, evasion, or erosion of the tax base.

In fact, even those high tax rates vastly understate the combined federal and state sales tax burdens, for numerous reasons. First, even if it were feasible to include purchases by state and local governments in the tax base (as assumed by FairTax advocates), doing so would require state governments to collect even higher taxes, so the combined state and federal tax rates would have to be much higher than assuming unchanging state tax rates. Moreover, as the report notes, taxing state and local government purchases would be problematic at best in our federal system of government.

Another problem for the states is that, if there were no federal income tax, it would be very difficult to maintain a state income tax. States benefit from the IRS’s information collection and auditing procedures, which would no longer exist. The compliance burden of state income taxes would be very high relative to the comparatively small amount of revenue collected by states, and taxpayers would pressure state lawmakers to eliminate their income taxes. (If they didn’t, many of the simplification gains from eliminating the federal income tax would evaporate since taxpayers would still have to deal with income tax complexity at the state level.) But without a state income tax, states would have to increase their own sales tax rates significantly.

The report assumes zero evasion, which is implausible. At the rates necessary to finance federal, state, and local governments, evasion would be rampant. This evasion would hurt compliant taxpayers and require still higher rates. It would also trickle down to the states, which would lose a significant portion of their tax bases. As a result, the required combined federal and state tax rates would be exorbitant. As a practical matter, government at all levels would have to be much smaller.

NRST advocates also assume that almost all forms of spending will be included in the federal retail sales tax base—including new homes, medical expenses, and financial services (which are notoriously hard to measure). Can policymakers really justify 40 to 50 percent sales tax rates?

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2 As the Panel’s report points out, sales taxes can be represented on a tax-inclusive or tax-exclusive basis. Ordinarily, sales taxes are measured as a percentage of the pre-tax sale price of a good. Income taxes, however, are usually measured as a percentage of income including taxes. A 30 percent sales tax on a tax-exclusive basis would equal 23 percent of the after-tax price (0.30/1.30 = 0.23). The Panel report presents sales tax rates on a tax-exclusive basis to make them readily comparable with other sales taxes.

80 percent tax rates on insulin? Would such a tax on new home sales be politically feasible? If it isn’t, the tax rates would have to be higher still.

The Tax Reform Panel concluded that NRST rates would have to be between 49 and 89 percent on a tax-exclusive basis, assuming a moderate amount of evasion, depending on how broad the tax base is. The Joint Committee on Taxation, as reported by Martin A. Sullivan, and William G. Gale reached similar conclusions.\(^4\) On top of those high federal rates, state sales tax rates would have to be 10 percent or more in many states.

The Panel report also shows that adopting the NRST would shift the tax burden significantly onto the middle class. Low-income people would pay lower taxes than under current law because of the cash subsidy, or “prebate,” and high-income people would pay much less because consumption is such a small share of their income. Thus, to raise the same amount of revenue, taxes would have to increase dramatically on the middle class. What’s more, the prebate would be “by far the largest [entitlement program] in American history.”\(^5\)

There would also be problems in distinguishing final (taxable) from intermediate (nontaxable) sales (e.g., PCs). But taxing intermediate sales, as many states do, creates cascading rates (taxes applied on both inputs and outputs), which distorts investment decisions. And there could be problems in coordinating across states since state tax bases differ from each other and from the federal tax base.

Finally, the proposal would impose a disproportionate compliance burden on small businesses. The Tax Reform Panel cites a well regarded study of experience in Washington State, which found that compliance costs for small firms were 6.5 times as large as those for large firms.

The rampant evasion would hurt legitimate businesses, which would suffer relative to the growing underground economy. It would also undermine confidence in the fairness of the tax system (which would fuel more evasion).

Enormous transition problems can also be expected. If businesses can’t deduct unused depreciation, they would suffer an immediate and large capital loss. But if they are permitted to take those deductions, the NRST rate would have to be larger still to make up the lost revenue. Moreover, absent intervention by monetary authorities, prices would rise by the amount of the tax. Those higher prices would immediately erode the savings of elderly Americans. (Social Security benefits would be maintained in real terms because they are indexed to changes in the price level.) If instead prices were held fixed by monetary policy, then the tax would effectively be borne by stockholders (in the form of capital losses) and workers (in the form of lower wages). Again, retirees, whose stock portfolios would be devalued, would suffer disproportionately.


To be clear, many of these problems are unique to the NRST. Other forms of consumption tax, such as a VAT, flat tax, or X-tax, would likely be no more difficult to administer than the current income tax and would not undermine compliance with state sales taxes.\(^6\)

But the NRST is uniquely flawed and unworkable. No wonder that no developed country has ever tried this radical experiment.

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With your permission, I’d like to include an article Bill Gale and I wrote on the Tax Reform Panel report into the record as part of my written testimony.\(^7\)

Thank you. I would be happy to answer any questions.

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\footnote{They would share other drawbacks with a NRST. They would tend to shift the tax burden away from those most able to pay and would create similar transition problems. Moreover, a flat tax or X-tax may not be border tax-adjustable under WTO rules, as noted by the Tax Reform Panel in its discussion of the GIT (which is based on the X-tax).

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