TRANSFORMING THE TAX CODE: AN EXAMINATION OF THE PRESIDENT'S TAX REFORM PANEL RECOMMENDATIONS

JOINT HEARING

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SUBCOMMITTEE ON RURAL ENTERPRISES, AGRICULTURE & TECHNOLOGY and SUBCOMMITTEE ON TAX, FINANCE & EXPORTS

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WEDNESDAY, FEBRUARY 1, 2006

HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON RURAL ENTERPRISES, AGRICULTURE AND TECHNOLOGY AND SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS
Washington, DC

The joint Subcommittee met, pursuant to call, at 3:01 p.m., in Room 2360 Rayburn House Office Building, Hon. Jeb Bradley [Chairman of the Tax, Finance, and Exports Subcommittee] and Sam Graves [Chairman of the Subcommittee on Rural Enterprises, Agriculture and Technology] presiding.

Members present: Representatives Kelly, Graves, Bradley, Millender-McDonald, Udall, Sodrel, Barrow, Fitzpatrick, and Lipinski.

Mr. BRADLEY. Good afternoon, ladies and gentlemen. Welcome to this committee hearing. It is a pleasure to be here. For those of you I haven't had a chance to say happy new year to, including our guests, happy new year. I would like to, obviously, welcome you all to the Joint Hearing of the Tax, Finance & Export Subcommittee and the Rural Enterprises, Agriculture & Technology Subcommittee of the House Committee on Small Business.

It is a pleasure to be working with my colleague Congressman Graves as we examine the recommendations of the President's Advisory Panel on Federal Tax Reform. I would also like to thank our distinguished witnesses and certainly thank the Minority Chair, Ms. Millender-McDonald for being here this afternoon.

In my view the current tax code is a very difficult code to navigate for members of the public that we represent. We need a simpler system which is more conducive to our economic goals and economic growth. For too long the American people have been burdened by the constraints of a complex and unfair tax system, one that is riddled with loopholes and shelters. In a time of ever-increasing globalization, these impediments to economic growth are precluding hardworking Americans from attaining their full economic potential.

Before being elected to Congress I was a small business owner myself and know firsthand the significant role that these tax difficulties play in our economy and how important it would be to

simplify them to create prosperity for our economy. We have to deal with complexities of the current code and know the need for real reform. Small businesses are the lifeblood of my state, of our American economy and we have to take away these impediments to that kind of economic growth.

[Chairman Bradley's opening statement may be found in the appendix.]

With that I would recognize Congressman Graves for an opening statement.

Mr. GRAVES. Thank you, Mr. Chairman. I appreciate it. I also, too, want to welcome everybody to this joint hearing. A lot of you, I know, traveled a long ways to be here. I appreciate your participation very much and for being a part of this.

I also want to thank Jim Housman from Housman Metal Works and Roofing for coming all the way to Washington from St. Jo to testify as a constituent of mine. I look forward to hearing some real life experiences from him and others today and appreciate again your participation.

Throughout my tenure as a Member of Congress I have traveled my district visiting with small businesses, manufacturers, and others talking about the issues that impact their business. It is almost always guaranteed that the tax code and reform in the tax code is brought up. According to the folks in my district, the current tax code is far too complex, time consuming, and cost way too much of their hard-earned money to examine it.

I support simplifying the tax code. The tax code including all the opinions and precedents is over 54,000 pages long or about 2.8 million words. To complete the form it takes on average 11 hours. I think people have much more important things to do with their time than spending that 11 hours trying to fill out or trying to navigate the complexities of this tax code.

Government shouldn't handcuff small business owners. It should work with them. I think simplifying the code helps everyone. The tax code is a major drag on the economy. In fact, according to some estimates it costs the economy one trillion dollars in lost growth each year. This represents hundreds of thousands of jobs and opportunities never created because of the tax code itself.

Americans deserve a tax code that is simple, that is fair and that promotes economic growth. It is fundamentally unfair to have a tax code that has different rules for different people. Small businesses create seven out of every 10 jobs in America. I want to make sure that we don't put a tax burden on them so heavy that there is no incentive to create those jobs.

The tax code impacts our lives in ways we rarely even acknowledge. For example, the tax code tells us when is the best time to get married, when is the best time to buy a home, to change jobs, to start saving, to have children. It tells us when is the best time to get an education and even when it is the best time to die.

According to one small business owner that testified before the President's Bipartisan Advisory Panel. The tax code affects almost every decision he makes; where to invest, when to invest, how much to invest in machinery and equipment used in production, and how to finance the investment. The complexity of the tax code is what makes it so easy for some folks with the means and the

motive to cheat the system. Closing those loopholes is not enough I believe. Closing the loopholes only adds additional complexity to the system and all too often provides a new way to cheat.

I look forward to hearing everybody. I think this is a very important subject. I think we need to do something before it even gets worse than it already is. Thank you, Mr. Chairman for allowing this joint hearing.

[Chairman Graves' opening statement may be found in the appendix.]

Mr. BRADLEY. Thank you very much, Congressman Graves. I would recognize Ms. Millender-McDonald.

Ms. MILLENDER-MCDONALD. Thank you so much, Mr. Chairman, and happy new year to you and to all of the members here on the panel and to the former member and the current members who are here with us. It is important to have all of you here. It is so important to have you here on the back of the State of the Union when the President spoke about taxes. Not necessarily small business taxes but, nevertheless, taxes. We are here today to talk about taxes where it really will impact small businesses.

It is so important, Mr. Chairman, and it is great to have this dual committee meeting today because we look at taxes with reference to rural and urban and those are the two critical areas where we need the most relief, rural business as well as urban businesses so it is important that we have come together today to talk about this.

It is good to have our old friend with us, Senator John Breaux, who serves admirably as the Vice Chair of this Committee or Commission that the president has put together, this panel along with Senator Connie Mack. Those two experienced former members certainly help to advance this issue that nobody wants to deal with but then everyone needs to talk about.

It is an interesting time for us and I am especially interested in the hearing on how these changes will impact the economic development of our nation's 23 million small businesses. Many of these firms already face a barrage of roadblocks on their path to success and the tax code should not be one of them from rising energy prices to a lack of affordable health care and the difficulty in assessing capital it is clear that America's small businesses deserve a break.

Unfortunately, inequities and complexities in the tax code continue to persist for small businesses. Statistics show that in 2002 small businesses shouldered 52.5 percent of the $194 billion and 5.8 billion hours Americans spent on tax compliance activities.

In addition, the revenue code income tax provisions have only continued to balloon between 1995 to 2001. It grew a staggering 478 percent from 172,000 words to 995,000 words. No one should have to try to grapple with that. The complexity problem clearly has serious implications for small business owners. This is why this panel has recommended a lot of changes that will no doubt help small businesses.

For an example, the recommendation to allow for more immediate expensing of new investment for small businesses is a positive step forward and one that will encourage economic growth by decreasing the complexity of expensing small business owners are

encouraged to invest in their businesses while at the same time improving their cash flow and simplifying their tax reporting.

I am happy that the panel flatly rejected a consumption of tax. I thank you so much for that. I thank you, Mr. Chairman. I will put the rest of my statement in the record with unanimous consent and thank you so much for convening this hearing.

Mr. BRADLEY. Thank you very much. So ordered on your statement.

[Ranking Member Millender-McDonald's opening statement may be found in the appendix.]

Mr. BRADLEY. I understand that Congresswoman Kelly has an opening statement. Please.

Ms. KELLY. Thank you, Mr. Chairman. Because I represent small businesses in New York's Hudson Valley I have a considerable concern regarding some of the proposals in the Presidential Tax Reform Panel. At the same time, there are some promising ideas to at least work with in terms of advancing the tax reform agenda as it relates to small business.

It is important to note that the suggestions in Plan A that would repeal the alternative minimum tax are good thinking, I believe. The AMT should never be on the backs of middle income taxpayers and small business owners. This is money that middle income families need for themselves to pay their own bills and to use for their own personal needs, most importantly to spend in small businesses.

Under Plan B there is an allowance for the immediate and full expensing of all capital investments. Such a deduction allows innovators to take more changes, hire more people at an early stage, and generally afford more of the cost of doing business.

Plan B also creates a tax system for businesses that are cash flow based. This is important, I think, to small businesses who need to be able to get a fair shake in terms of their real income, what they are actually earning and spending and taxing it only once at a lower and flatter rate than we do now. This cash flow method eliminates many of the complicated tax accounting rules that plague small businesses.

My greatest concern, however, is the portion of the recommendations that will have an inherent negative impact on small businesses and that is the proposed elimination of the home mortgage interest deduction and the state and local income tax deduction. This punishes middle income small business owners in New York's Hudson Valley severely. These individuals are already overtaxed.

When middle income citizens are punished, small businesses see losses. Elimination of these deductions takes money out of the pocket of the homeowner. These homeowners are the individuals and the families that are out there spending money in our small businesses and this plan would take money away, I believe, from valuable patriates of our small businesses.

I support a simpler tax code but not at the expense of the average Hudson Valley resident or small business owner who would stand to lose thousands of dollars in tax deductions and potential business every year. Small business owners need and their customers rely heavily on these deductions for federal tax relief every year, not just in the Hudson Valley but across America.

The thought of these crucial deductions sends a chill through the livelihood of most of the small businesses of America. Small businesses need tax relief, not tax increases. This is a tax increase. Now is the time for us to be looking for ways to bring more tax relief to America. It is not to be developing methods of taking it away. There are good ideas in these plans. I hope we can stay with the good ideas and jettison those that aren't. Home mortgage interest deduction not allowing that is a bad idea. Thank you, Mr. Chairman.

[Congresswoman Kelly's opening statement may be found in the appendix.]

Mr. BRADLEY. Thank you.

Mr. BARROW. Thank you, Chairman Bradley and Chairman Graves for holding this joint hearing to look into the findings of the President's Tax Reform Panel. I want to thank Senator Breaux, Representative Castle and Representative Garrett for taking the time to come before our Subcommittees today.

President Bush appointed the Tax Reform Panel because the current tax system is an absolute mess. It hurts business and it is a huge drain on our economy. The reason my Subcommittee was looking at this, at least in part, is because the current tax code hurts small businesses even more than big businesses. In 2004 small businesses spent an average of $1,300 per employee to comply with federal income taxes which is almost twice as much as big business has to spend.

In addition, the current system makes planning ahead much more difficult for small businesses because of Sunsets and other temporary fixes it is impossible for a small business owner to know how the tax code will affect him in the years down the road. The tax code hurts small businesses and that means it hurts the growth of our economy.

The panel's recommendations address many of these issues that make life miserable for American taxpayers. Some of the recommendations could help the American taxpayers such as simplifying our methods of saving. On the other hand, some of the recommendations could hurt such as putting a cap on mortgage deductions for homeowners. The current mortgage deduction system has helped a huge number of working Americans become homeowners. A cap on the deduction could put homeowners at risk of losing their homes and make new homes unaffordable for most Americans.

Now, the panel took a long hard look at the National Retail Sales Tax, an idea that has been floating around Washington for many years now. Their findings reinforce the conclusions of economists and tax experts throughout the country, the National Retail Sales Tax is a bad idea.

The panel refused to recommend the National Retail Sales Tax because they recognize it is just a tax shift and there would be a huge tax increase for the vast majority of Americans. A national sales tax might be easier for most taxpayers to pay but not if it cost more in the long run. Paying more in sales tax shouldn't be the price that we have to pay to get tax simplification.

Let me read you a few of the quotes from the Tax Reform Panel's report. "Replacing the current income tax with a stand-alone retail sales tax would increase the tax burden on the lower 80 percent

of American families as ranked by cash income by approximately $250 billion per year. Such families would pay 34.9 percent of all federal retail sales taxes, more than double the 15.8 percent of federal income taxes they pay today."

"Although a program could be designed to reduce the burden of a retail sales tax on lower income and middle income taxpayers by providing cash grants. such cash grants would represent a new entitlement program, by far the largest in American history and make most American families dependent on monthly checks from the Federal Government."

"Two types of Administrations would be required, one to collect the tax and another to keep track of personal information that would be necessary to determine the size of the taxpayer's cash grant."

"Even with favorable assumptions a retail sales tax on a broad base with a cash grant program would create incentives for significant tax evasion."

"The tax rate would be 49 percent. If a narrower tax base were used instead of the extended base, the rate would be even higher."

In other words, in order to break even it will cost more for most of us and the worst of it is that the IRS ain't going anywhere. What we will get is two bureaucracies instead of the current one. One to collect a huge tax that will be much harder to collect than folks realize, and the other to pay off the welfare rebate that is supposed to keep the new tax from crushing the poor, two messes to replace the current mess.

The President's Tax Reform Panel gave America a thorough, nonpartisan, and fair assessment of the National Retail Sales Tax. While the panel clearly laid out the flaws in the proposal, I am glad to see some of their other recommendations and I again thank the chairman for holding this hearing to discuss these options in greater depth.

Mr. Chairman, I ask unanimous consent to submit Chapter 9 of the Tax Reform Panel's Report for the record.

Mr. BRADLEY. So ordered.

[Ranking Member Barrow's opening statement and Chapter 9 of the Tax Reform Panel's Report may be found in the appendix.]

Mr. BARROW. Thank you, Mr. Chairman.

Mr. BRADLEY. With that, let me recognize our first panel. Senator Breaux who is the Vice Chairman of the President's Advisory Panel on Federal Tax Reform; Congressman Castle from Delaware, and Congressman Garrett from New Jersey's 5th Congressional District.

Mr. BRADLEY. Gentlemen, welcome, and I think we'll begin with you, Senator.

STATEMENT OF THE HONORABLE JOHN BREAUX (U.S. SENATE, RETIRED), PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX RETURN REFORM

Mr. BREAUX. Thank you, Mr. Chairman, Mr. Chairman and ranking members and ranking members. I am delighted to have the opportunity to be over on the House side to share some thoughts and comments. Actually, after serving 32 years in Congress this is the first time that I've been back to testify in any ca-

pacity and I'm delighted to be asked to appear before your distinguished Committees.

Actually, the way things are changing I am just happy to be able to walk into the building. I am not sure if I will be able to come back a few more months from now so this may be my first appearance and maybe my last appearance, but whatever. Thank you for having me. I think that everything that all of you have said I think is very important. I don't disagree with almost all of the conclusions that you have pointed out.

The Tax Commission, which was bipartisan, had myself and Connie Mack as the chair and the co-chair, Congressman Bill Frenzel from the House who served on the Ways and Means Committee with distinction was one of our other members. Nobody else was a political elected official and none of us were running again so we were able to do what commissions are supposed to do, to look at the tax code which we were charged with looking at, and make the best possible recommendations without the worry about what are the political implications.

That's for the administration and that's for you ladies and gentlemen to decide whether what we recommended has any political legs or is it too difficult to consider. That is the beauty about having a commission. You can always say, "The Commission recommended this and we are going to look at it and see what we can do with it."

I think it is timely. It is much more timely than some of the other efforts. We all remember the effort on Social Security. The problem with Social Security was that the country was not in any kind of agreement that it should be changed. The President has put a lot of time, a lot of effort, a lot of political capital in traveling around the country talking about reforming Social Security.

The fact was that seniors who I think should be involved in looking for positive changes were totally opposed to it. And young people who you would think may be looking for new alternatives to it were really not engaged and not supportive of it. The people who were against it were much more against it than the people who were for it. Therefore, when you have a split in national dialogue, it is very difficult to get a consensus and, as a result, nothing happened.

On tax reform and tax simplification, I would suggest that you cannot go to a rotary club. You cannot go to a town hall meeting and ask the question, "Does anybody here not think that the tax code is too complicated? Does anybody think that we should not simplify it?" It is almost an unanimous agreement among America's public, young, old, black, white, geographic across the country that a tax code is too complicated and we should do something for it.

This is, I think, a political win for both parties. I would have hoped that the President would have said, "I am charging the Congress to take the recommendations of my Commission, which was unanimous Democrats and Republicans alike, and use it as the basis to start the dialogue for simplifying the code." No one would disagree with that challenge. How we do it, of course, obviously there are a lot of challenges.

The President told us to make sure that what we did was reasonably progressive, that it was pro-growth, that we assumed that the tax cuts of 2001, '03, and '04 were made permanent, that we paid particular attention to the importance of charitable contributions and mortgage deductions, and, oh, by the way, make it revenue neutral. I would suggest that is an incredibly difficult problem to make it revenue neutral if you do all of the things that we talked about doing.

Congresswoman Kelly talked about the mortgage deduction. Someone talked about the AMT. Connie Mack's wife, incidentally, had the best comment about the AMT. She asked Connie, "Why do you all call it the Alternative Minimum Tax?" He said, "What are you talking about?" She said, "Well, No. 1, it is not an alternative. You have to pay it. And it is not the minimum tax that you paid, it is the maximum tax. Instead of calling it the Alternative Minimum Tax it should be called the Maximum Mandatory Tax."

Regardless, we recommended, like I think most of you would agree, that we do away with it. But how do you do that and pay for it? It is $1.6 trillion over 10 years to do away with the AMT. If you are going to do away with that and then provide incentives in the code like we did, you have to pay for it. That is the unpleasant thing. We can all agree that it ought to be done away with but who wants to offer the first suggestion on how we pay for it?

That is the difficult thing and we have things in there that do that. The state and local tax deduction. I can talk about why I think the people who pay more taxes for local services should not have people in other states pay for that, which we do. We talked about the mortgage deduction. With Congresswoman Kelly it is a very big concern.

The fact is if you look at our studies over 70 percent of tax filers we had records for did not benefit one nickel from the mortgage deduction that is currently under code. Only 30 percent did because of the itemization. Most people don't. Most people don't get the benefit. What we try to do is structure a recommendation that said, yes, we will keep the mortgage deduction but we recommended that we replace the current deduction with a home credit available to all homeowners whether you itemize or not.

Not just 30 percent of the taxpayers but everybody would benefit from it. We would restructure it to say it would be 15 percent of the mortgage interest that you paid on a principal residence. Not a vacation home but on the principal residence and it was limited to the average mortgage in respective areas up to $411,000 a year.

Now, if you are wondering how many people would be affected by it, between 85 and 90 percent would not lose one nickel of deduction under that plan. Those funds along with others were used to help pay for the elimination of the AMT which I think is a very important thing to do.

Let me just say, like I think I might have said, $140 billion a year in complying with the tax code. $140 billion every year is spent in complying with the tax code. The earned income tax credit for the poorest people, 65 percent of them have to hire someone to help them figure it out. These are people that don't have enough money to hire a tax account or attorney or even H&R Block.

We ended up making a recommendation that you could do all your taxes on two pages, front and back. It is a real simplification. I would hope that the Congress would pick this up as a starting point. We sent this to the Secretary of the Treasurer. They were involved in watching what we did and involved with suggestions. I think they thought it was a great idea. I don't know where it is at the White House. It must be in a closet somewhere or on a shelf somewhere. I didn't hear anything about it. This is something the American people would support.

I have up there what we do on small business and I think that small businesses are particularly at a disadvantage because they cannot obviously afford the tax attorneys like Exxon does but yet they have to comply with the same rules and regulations. We recommended that most small businesses file taxes the same way they pay their bills, with a checkbook. They would report income as cash receipts minus their cash business expenses.

Both of our panels made recommendations that allow unlimited expensing for most assets that would be purchased by businesses with less than a million dollars of income greatly simplifying it for small businesses. I think that is a real political winner and I think it makes economic sense. Thank you all very much for listening.

[The Honorable John Breaux's testimony may be found in the appendix.]

Mr. BRADLEY. Thank you.

Mr. Castle.

STATEMENT OF THE HONORABLE MIKE CASTLE (DE-AT LARGE), CONGRESSMAN, U.S. HOUSE OF REPRESENTATIVES

Mr. CASTLE. Thank you, Chairman Bradley and Chairman Graves and members of the Committees. I am delighted to be here with you. I could probably save you five minutes or so by saying that I agree with virtually everything you said in your opening statements and with Senator Breaux. And to further tell you that I struggle with tax courses over at Georgetown Law School. But being a politician I will take every bit of my five minutes and tell you what I think I know about all this and what we should do about it.

First of all, I agree with the plan. I am not going to try to go through the plan and discuss the details of it except that I agree with it. I particularly agree with something in the executive summary which read, "Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity, instability, and pose large compliance costs and can lead to an inefficient use of resources.

A rational system would favor a broad tax base providing special treatment only where it could be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers."

Obviously lofty goals well stated. I think you all sort of basically agree with it in what you stated. However, I believe that reform and simplification of the current tax system, although it is one of extreme high priority, is not going to be easy at all. As Senator Breaux said, we don't know where this report is now, which I consider to be a good comprehensive report. It seems to be collecting

dust someplace. I am delighted this Committee has dusted it off a little bit so that we can have this discussion.

I don't see a strong political viability for passing reforms. While we all sort of give lip service to it, probably do it in our town meetings or whatever, it becomes a heck of a lot more difficult when you start to determine what you can subtract and add in getting to that revenue neutral circumstance that the senator mentioned also.

We also have many names of Americans who have made investments based to some degree on the tax code which is perhaps unfortunate but it is the way it is. I am thinking primarily of long-term mortgages, other long-term pike loans, other things that one can write off depreciation or whatever it may be. That adds into the difficulty as well.

I think we do need truth in accounting. We talk about revenue neutral. We need to make sure whatever we do in Congress is revenue neutral not anticipating future expenditure cuts or tax cuts or increases or whatever it may be, but meets the circumstances of whatever we are facing from a fiscal point of view at that particular point in time.Any of this can have long-term impacts on federal deficits in trading debt for more debt because we are trying to fix the tax code would not, in my judgment, be the way to go.

I think there are problems, political problems, in dealing with the tax code. Just an excerpt from what I actually wrote that is before the Committee is, "As important as truth in accounting is restoring the faith of Americans in the Government and our ability to fairly collect the nation's revenues, the biggest challenge that I think we have in this area is the common abuse of the complex tax code to avoid paying federal taxes.

Loopholes allowing tax avoidance by individuals, and particularly corporations [not really small businesses but corporations] have proliferated in recent years those same lobbyists have created such a growth and demand for earmarks of the same type to feast on loopholes and tax bills at incredible cost to our revenue system leading to mass complexity in business decisions driven by tax consequences rather than economic benefit.

According to the panel findings more than 14,000 changes have been made to the code in the past 20 years. It is because of these complications that the annual cost of complying with today's federal tax system cost taxpayers $1 in compliance cost for every $7 in federal income taxes." Ms. Millender-McDonald referenced that. Senator Breaux indicated that some $140 billion. It is a lot of money that is put into the compliance aspect of it.

I will admit that I am going to be hiring an accountant here shortly to help with my taxes this year so I am part of that expenditure that I would like to eliminate. So there are a number of problems. The major benefactors of the current tax code, in my judgment, in terms of loopholes are the more major corporations. The federal corporate tax rate is 35 percent but in 2003 corporate taxes were 7.4 percent of overall federal receipts which happens to be the lowest level in 20 years which indicates what that problem really is.

I think that any reform to simplify the tax code should include a full review of the commonly used methods that are here. Some of this is perfectly fine. Tax carryovers for businesses and corpora-

tions, I don't have a problem with that. Some of the exploitation that takes place in offshore tax havens, the corporate expatriation or inversions which occur out there, simply registering offshore with a post office address and shifting tax burdens.

As a result of that when you are an American corporation are a tremendous burden on our system here in the United States of America. It is a burden on everyone of us across the United States because somebody else is not paying taxes and we are to meet the revenue needs which are there. As those kinds of loopholes continue to be created and exploited and taken advantage of, particularly by the large corporations, it creates a tremendous problem for all of us.

We are losing out on a lot of revenue, I think virtually every individual, and I think frankly most corporations, and this is important for economic activity. So instead of having avoidance of taxation and all the effort and energy that is put into that, we could have it put into positive economic activity. But if you had a simpler flatter way of dealing with taxes and avoid the loopholes which are there, in my judgement the economic advantage of transferring that effort from tax avoidance to production would be tremendously beneficial to our country. It is something we need to get back to as soon as we possibly can.

I think that the Commission did very well when they spoke about the updates being able to encourage and reward personal investment and savings through simplification. We are getting away from savings. That is a great problem for small business people. It is a great problem for individuals in the United States of America and, unfortunately, is not particularly encouraged by what we have today.

I don't think reforms will be easy to enact but I would tell you that if we take the time to really read this report, as Ms. Kelly said, we may not agree with everything that is in the report, and I certainly probably don't agree with everything that is in the report, but the direction of the report, most of the content of the report, and the idea of the report of making a move in this direction is something that I believe that we as a Congress should be taking up as soon as we can. I don't see this as being a Republic Democrat issue. It is one of those issues which we could actually work together and have an achievement which will be beneficial to the American people. Thank you.

[The Honorable Mike Castle's testimony may be found in the appendix.]

Mr. BRADLEY. Thank you.

Mr. Garrett.

STATEMENT OF THE HONORABLE SCOTT GARRETT (NJ-5), CONGRESSMAN, U.S. HOUSE OF REPRESENTATIVES

Mr. GARRETT. Greetings and good afternoon. Before I begin, let me apologize. I was one that was screaming in excitement for the President last night so I have a touch of laryngitis so bear with me. I will probably keep my remarks briefer than I intended. Also, I should say that I also agree with around 80 percent of the opening comments, maybe even 90 percent. Make that 80.

As the Chairman indicated, I am from the state of New Jersey. Why I bring that up again is because, as you may know, my home state being where it is and the income level that it has, tax policy has a significant impact upon us. Due to the progressive nature of the system, New Jersey is one of the highest relative tax states in the union and, therefore, we are at a significant disadvantage vis-a-vis the other states. We are a donor state sending far more tax revenue to Washington than we ever get back from the Federal Government.

But so, too, is the situation for all American taxpayers having been overtaxed for too long with our federal income tax system, as indicated, overly complex and decidedly unfair. American taxpayers are taxed, taxed again, and taxed again and again on various levels of government sending the money to Trenton or capitals, Washington, all of which could be resolved with significant tax reform. That is really why I was so inspired by the President and the members of this Committee for delving into this issue and willing to take and hopefully make some of the hard choices that will need to be made.

My first impression of the panel suggestion was that it was in some ways hampered from the very beginning by some of the instructions that they had such as trying to come up with a system that was purely a revenue neutral system, and also with a more static approach to the impact of the tax changes.If seen with the impact of changing economies as the recent evidence showing us that tax relief will actually grow the economy, grow the tax base and increase revenue, therefore, changes to the tax system can do so likewise.

Next, I was dismayed that there was not a more sweeping change proposed, quite honestly, ones that would address some of the concerns that have been overly raised by the panel as far as the current tax code affecting every single aspect of our lives, although I don't think the Committee mentioned as to when we have our child, too. When we get married, when we die, but also having our children.

Since my time is limited, let me just pick and choose a couple of the aspects in the plan. I am very pleased that both plans focus on the AMT. As you probably know, New Jersey has the highest percentage of filers who fall victim to the AMT. If left unchanged, the AMT will penalize nearly 20 percent of taxpayers, nationally some 30 million taxpayers in America in total.

Both recommendations made unanimously by the bipartisan panel emphatically call for immediate repeal of the AMT. This arcane provision goes to the grave threat to middle America and small business. I am happy to indicate to this committee that I have legislation, HR 703, that would simply index AMT for inflation and allow for state and local tax deductions. I would be pleased that the panel would mimic such a proposal in their recommendations. Also important are the panel's recommendations for permanent marriage relief and improving incentives for saving and investing.

Now, the second proposal is the growth and investment tax plan. It is probably more business friendly in specifically how they deal with business investment. Tax relief to American business is key

to economic growth. Businesses need to keep more money to grow. More importantly to hire more employees. The recommendations show a step in the right direction but, again, the sweeping changes that most likely you need were not present in the proposal.

In conclusion, I think we should be inspired by the panel that they made some positive suggestions that will certainly make improvements to the overall system. As a proponent of a healthier economy, increased job growth, and a more efficient Federal Government, I want to stress every point that I can not to rule out even more significant tax reform.

I understand that such ideas as FairTax, flat tax and likewise have not had a general consensus in this country, but I think those are things that this Congress should consider to look at. A smaller Federal Government is a more efficient Federal Government, one that is able to effectively provide the services that the American people need, and a reformed system like this will provide that more efficient system.

I think, as already indicated, we can now use the President's panel's recommendation merely as a starting point and as a starting point from a bipartisan approach. Finally, again, I would just say that although there is not a consensus in our America, in the rotary clubs and the like that we go back to, as to which of the more sweeping reforms would be the better one and the more popular one, I am sure I don't remind anyone on this Committee that the role of a member of Congress is not necessarily to be popular but it is to lead and take charge. I took forward to this Committee taking that role of leadership on sweeping reform. I thank you. And I thank you for bearing with me.

[The Honorable Scott Garrett's testimony may be found in the appendix.]

Mr. BRADLEY. Thank you very much.

My first question, I think, I would direct to you, Senator Breaux.

Can you talk about, for the panel, why it is the AMT was your top priority, what harm it does to the economy? I have legislation along with Congressman Garrett similar to yours that not only indexes but raises the limits. I have been a long-term proponent of this but could you talk about the rationale for why this is so important?

Mr. BREAUX. Well, it is outdated. It was originally, as you everyone knows, intended to touch very wealthy Americans who paid nothing towards running this Government because of the various tax deductions and credits that they were entitled to legally. The country thought that, well, everybody ought to contribute something to running the country and that is where the birth of the AMT occurred.

It was never indexed and now it doesn't just touch wealthy individuals but is moving down the food chain and to people making $65,000, $70,000 a year. Now, there is a consensus it should be eliminated but the last numbers we had it is estimated to generate about $1.4 trillion so it is easy to say let us eliminate it. The question is if you do it in a revenue neutral fashion, where do you get the money to do it?

Now, if we just raised the rates to cover the AMT, you would be looking at about an 11 percent across the board rate increase. That

would offset the loss of the AMT. It is easy to do away with the AMT but it ain't easy to do it if you are going to do it and pay for it. I think there is a consensus, Democrats and Republicans, that it has outlived whatever usefulness it has had. It is a burden. It is not needed and is not necessary and should be done away with.

Mr. BRADLEY. Senator Breaux and Mr. Castle and Mr. Garrett, would you comment on why the panel didn't recommend either a national sales tax or a flat income tax and talk about the merits of those.

Mr. BREAUX. I mean, very quickly, we look at all of those and we had the option of making—the President said make one recommendation that simplifies the current code. Keep the structure of the current code and we did that. That is simplified. Then you can come up with anything else you want. We looked at a flat tax, a national sales tax, a value added tax, combination consumption and income tax together which most developed countries actually have.

The national sales tax, there is no consensus on that. The states don't like it. That is their form of collecting taxes. Municipalities collect their revenues through a sales tax and they are totally opposed to it. The estimates from IRS tell us that if you did a national sales tax, you are looking at about 33 cents on the dollar. The potential for fraud and abuse with that system is very, very high.

National flat tax, we had folks come in and talk about that and make eloquent presentations, 17 percent. How are you going to say that it is fair and it is reasonably progressive if you have a 17 percent rate on someone making $20,000 a year and a 17 percent rate on someone making $20 million a year? That is not reasonably progressive. Once you start doing things with a flat tax to make it reasonably progressive, you get right back into complicating it with exemptions, exceptions, and deductions. We decided that the value added tax, flat tax was not the way to go. We said some favorable things about the combination of the two but rejected the retail sales tax and the flat tax for those reasons.

Mr. CASTLE. Mr. Chairman, I can't respond as to why the panel did what it did. Mr. Breaux did a remarkably good job of that. But, like you, I come from a state that doesn't like taxation a whole lot. We don't have a sales tax either. I find that to be about the most annoying tax. I intentionally wait until I get back to Delaware to buy anything I am going to buy to avoid paying sales taxes in other states.

Mr. BRADLEY. You can come to New Hampshire and avoid an income tax, too.

Mr. CASTLE. That would be even better. I think the flat tax is not progressive, I agree. I agree with the reasoning of Senator Breaux completely on that. I think the lack of progressiveness really is an issue. I really feel there should be somewhat of a higher burden as you go up the income scale.

Having said that, it may be somewhat out of proportion just as I think the deductions are crazy all over the place at this point. I am delighted they actually didn't make that finding. Mr. Garrett may disagree with me here in a moment but I believe that gives us a sound basis to get something done and I think will bring more

of the political middle into actually getting something done in Congress. I think it was a good recommendation.

Mr. GARRETT. I am not an advocate. You have other members who would come clearly more forcefully today but I would just say this. It will be hard whatever we do to get through to Congress and through the President's task for reform. At the end of the day after this year, or the next session where we do all that work to try to simplify the system, however that comes down, it would be a shame to think that maybe three or four years down the road we are simply back in the same boat that we are today because the code we are operating under right now, as I understand it, when it started some 70 or 80 years ago was a very simple, easy tax code without any of those other parameters and controls on our lives that we have right now.

We may try to do some band-aid approaches in the next six months or the next year or so to try to fix it. But how long will those band-aid approaches remain in effect when we know all too well all the lobbying effect will come back just to add them all right on again and this Committee will be back to say how do we reform the reform from 2006.

Mr. BRADLEY. Congresswoman Millender-McDonald.

Ms. MILLENDER-MCDONALD. Thank you so much, Mr. Chairman. You are absolutely right. If we do a band-aid approach we won't get nowhere. But to try to do an approach that has been recommended will take a lot of political will. That is very true. As I look at and as I have heard your testimony, Senator Breaux, you spoke about most small businesses pay their bills by checkbook.

Yet, we talk about health insurance which has been a big problem with small businesses. We talk about the alternative minimum tax which you are suggesting that we repeal by virtue of your own calculation, the trillions of dollars that would be lost with that. Plus the President's request for a permanent tax cut. Where do we go? What do we do?

When we speak about state and local deductions, repealing of that, as a mayor of a city, coming from the local governments, and especially California with Proposition 13, we just don't have anywhere else to go. What do you do in this type of climate? Given all of those variables that I have just given you, I do feel we need something but how in the world do we start?

Mr. BREAUX. Well, I would start by using the Commission and saying they have looked at it for over a year. They made a nonpolitical recommendation. They have a lot of things that reduce taxes and everybody can basically or pretty much agree with that. We did a lot of things for small business in terms of expensing and the way they file their taxes. We did away with the AMT. But you had to find a way to pay for it.

Let me just make a quick comment. I understand people who—

Ms. MILLENDER-MCDONALD. That is what I am talking about.

Mr. BREAUX. I will address that. I think for people in high tax states, New York and California, started calling us while we were still writing that recommendation saying, "You are absolutely crazy." Charlie Rangel went everywhere on the thing. Here is the logic on it. Say you live in Beverly Hills or a bigger city that has

very high income constituents in it. They pay a lot of local taxes. They may have their trash picked up twice a day.

They may have 24-hour-a-day police security in their neighborhood. They may have underground sewage and underground powerlines buried so you never see them. They are paying a lot of tax for that. Why should someone in New Hampshire be helping to pay for that? Why should someone in any other state be helping to pay for a high tax community that is enjoying those benefits that only they get. Because the whole country is seeing that tax deductible, everybody else is paying more for the high-tax communities and the high-tax states.

Ms. MILLENDER-MCDONALD. But that is not the only high-scale area in this country.

Mr. BREAUX. No, it is all over the place.

Ms. MILLENDER-MCDONALD. It is one of many, yes.

Mr. BREAUX. My point is why should a Congresswoman or a Senator from the state that doesn't have those benefits have their constituents be subsidizing the high-tax states for the good things that their tax base provides them. If they want to pay the tax for all those extras, that is fine, but why should someone from Arizona be subsidizing another state's benefits that the people in Arizona don't get? By allowing it to be a deductible on their Federal income tax, every American is helping to subsidize what only a few are getting. It is not just California.

Ms. MILLENDER-MCDONALD. No.

Mr. BREAUX. New York is the same way. It is a high-tax state. They have a lot of benefits but why should the rest of the country pay for the benefits that only one state is receiving? If they want to pay that tax for those benefits, that is fine. If they don't want to, they should elect different local officials. The rest of the country shouldn't be subsidizing the high-tax benefits that other states get. That was the logic behind it. Of course, I am not running again so I can say that.

Ms. MILLENDER-MCDONALD. That is very true. Certainly flat tax proposal will not fly in the state of California. I will say that right now. But, you know, you have places like Compton, a very urban area, that really pays more taxes than Beverly Hills. So when you talk about the tax inequity, you really start talking about urban versus suburban versus all other things being either equal or unequal. So you get to that type of scenario. When you get to that, then you do not have the type of proposal that you present to us, not from California because you have other urban areas that are paying more in taxes than Beverly Hills is paying.

The other thing is the reform laid out in the report would allow for more small businesses to move toward a cash-based system by counting and allow them to write off most investments immediately. How would these changes reduce complexity and encourage investment for small firms? What was the thoughts of the panel on that?

Mr. BREAUX. Number one, you are correct in saying what we did. We simplified the record keeping for small businesses by basing it on cash receipts and expenses. Many small businesses are complying with the same rules as Exxon or any of the largest companies in America. Many of them are having to keep more than one

set of books just to keep track of all their accounting implications for everything they do.

This would allow them to have one set of books and it would be based on, as we have said, on cash receipts and expenses. I think the rule reduces compliance cost for small businesses from keeping a second or sometimes even a third set of books and allowing them to use the records that they already keep in their businesses, basically their checking accounts. The money they get and the money they spend and they can figure out their taxes on our recommendation in a much more simplified form than it was before.

Ms. MILLENDER-MCDONALD. Mr. Chairman, I am through for now.

Mr. BRADLEY. Mr. Fitzpatrick, do you have a question?

Mr. FITZPATRICK. Thank you, Mr. Chairman. Under current tax law the code makes certain provisions with respect to healthcare spending. For example, an employer that provides a healthcare plan to his employees and their families, currently that healthcare plan, I understand, is considered exempt for purposes of income taxes and payroll taxes. Did the tax advisory panel deal with the issue of healthcare?

Mr. BREAUX. Oh, yeah. I would argue that the problems with healthcare in America is not because we don't spend enough money. We as a Government spend more money on healthcare than any other country, any developed nation in the world. The latest numbers are approximately $1.5 trillion dollars in tax expenditures are spent on healthcare every year. That is about 5,000 and some odd dollars for every person in this country, man, woman, and child. About 12 percent of all Federal income tax revenues are spent on healthcare. Yet, we still have incredible problems with healthcare.

As you stated, the tax deduction is about $141 billion dollars on the deduction that an employer can have when he pays for the premiums for his employee and then the non-taxability to the employee adds up to $141 billion a year. It also takes away the connection between the employee and the cost of healthcare. There is a real incentive to buy the best plan and even more than they actually need because it is not taxable income to them. Their employer is paying for it.

The panel recommended the following. The panel recommended that employee-based health insurance continues to be the principal way of getting health insurance for our employees. What we suggested was that we have a system that employers would be able to continue to deduct the cost of their employee compensation, 100 percent of the plan they provide for their employee, whether in the form of either cash compensation they give to the employee or the health insurance premiums that the employer would pay.

Employees, on the other hand, would be allowed to receive a base amount of health insurance from their employer tax free but not everything. We will also allow even employees who do not have access to employer-provided insurance to also be allowed a new tax deduction for their health premiums. Right now you get the deduction if you are getting it from your employer. If you buy it yourself, you don't. We would allow them to be able to deduct the cost of health premiums that they pay themselves.

We have an exclusion, however. The exclusion would be for employer-provided health insurance would be limited to $11,500 for families. In other words, an employee would not have to count anything up to $11,500 in contributions from their employer is taxable income. But if it is more than that, that would be taxable income to the employee. That happens to be about the national average. That is what all of you now are paying under the Federal Employees Health Benefit Plan. That is about the value that you get for a first-class world-class health plan. But if it is more than that, you would be paying income tax on it.

Mr. FITZPATRICK. So that $11,500 is that the base amount that you referred to in your testimony? If so, is that base amount be indexed?

Mr. BREAUX. It is indexed for inflation. Yes, sir.

Mr. FITZPATRICK. Nothing further. Thank you.

Mr. GRAVES. Mr. Barrow.

Mr. BARROW. Senator Breaux, you talked about some of the problems in response to Chairman Bradley's first question about some of the reasons for not going with the national sales tax or FairTax. I want to, if I can, help you understand some of the reasons why a little bit more. Your panel felt the need to report on the so-called FairTax and refute some of the claims made by proponents.

One of the things you all went into your panel report mentioned that the Treasury Department's own figures contradict those offered by proponents of the so-called FairTax. Can you help us understand and try to put it in shirtsleeve English for us? What is behind the discrepancy between the Treasury Department's estimate and their estimates?

Mr. BREAUX. Okay. I mean, we asked that. If you replaced the current system with a national sales tax, how much would it have to be? So where did we get our figures from? We got our figures from the Department of Treasury, Republican Secretary of the Treasury, John Snow. They looked at it and if we replaced it with a national sales tax, even with favorable assumptions a retail sales tax on a broad base would require a tax rate of at least 34 percent and likely higher over time if the base erodes. That is the number. I think that the conclusion by most tax experts is you are looking for real trouble.

Number one, you get the municipalities against it and the states against it. All the retail stores don't want to be the tax collector for the Federal Government. Plus the high rate led to the conclusion that you are looking for trouble. You are looking at a lot of tax avoidance if you move in that direction.

Mr. BARROW. How about tax avoidance and evasion? I want to focus in on that for just one second more. What do you say to those folks who say that the evasion problem will be negligible because the cost of everything in the world is going to go down to match the increase in this huge add-on tax, the folks who say the embedded tax is just going to all of a sudden walk out the window?

What do you say to folks who say it is not going to be revenue neutral to have this huge add-on tax added to everything we buy but it is actually going to be cost neutral to the taxpayer because the cost revenue is going to fall to a corresponding extent? What do you all have to say about that?

Mr. BREAUX. I mean, that is simply not the information, the evidence, and the testimony that we got from the Treasury Department when they looked at it. I thought they did it in as nonpartisan a fashion as possibly you can. They looked at other states, other countries, other nation states that have gone to a National Retail Sales Tax. None of them have that now as their own method of raising revenues.

People have tried it and have done away with it. It has been a huge failure. There is no country in the world that relies on their revenues for running their governments on a National Retail Sales Tax type of plan. Those who have tried it have had to get rid of it many for the reasons that I have tried to spell out.

Mr. BARROW. I appreciate you spelling that out and for those folks who do think this is not only going to be revenue neutral but cost neutral, I have some ocean front property in north east Georgia that I would be interested in selling them.

Mr. BREAUX. I have some property in Louisiana I could sell you, too.

Mr. BRADLEY. Mr. Sodrel.

Mr. SODREL. Yes. Thank you. I guess there is no way to know where the underlying numbers came from on the 33 or 34 percent that a National Retail Sales Tax would have to be in order to be revenue neutral. I guess the first thing I would say I never taught tax preparation, never taught accounting. In fact, I haven't prepared a tax return in a whole lot of years but I have paid a lot of taxes and I have spent a lot of work hours in business trying to calculate the tax ramifications of anything we did before we did it.

The amount of work hours and management time that is spent in the United States trying to predict the impact of a business action by the tax code is unknowable. It is incalculable. I don't even know what it is. I spent too much time trying to calculate what action we were taking was going to affect our taxes and too little time trying to figure out how to operate the company. You can't know what that number is. It is literally unknowable so I am just curious.

The second question I have is which countries ever went with a national sales tax and then got rid of it?

Mr. BREAUX. I could give them to you. In fact, it is in our book. You are right on the time spent. What we found out and from testimony that Americans spent more than 3.5 billion hours doing their taxes. That is the equivalent of hiring almost 2 million new IRS employees, more than 20 times what they have now. We spent about $140 billion on complying with the tax code.

There is huge political opportunity and rightfully so in making the argument in a bipartisan fashion that this Congress, this session, will begin the process of simplifying the code. You will get almost no disagreement back home in town hall meetings from the people you speak with when you say, "I want to embark on simplifying the tax code."

How you do it obviously begins the political problems. You do away with AMT how do you pay for it? Then you get into some difficult items. Unlike Social Security there is unanimity of agreement that it should be done.

Mr. CASTLE. You know, I would just like to comment on that.

Mr. SODREL. Please do.

Mr. CASTLE. I think it is a tremendous point. I made it in my opening, too. The time spent is beyond anything we can possibly determine, as you have indicated. It is the focus on that instead of economic production. You are running a business and you are worried about how am I going to avoid a tax or how am I going to pay these taxes or what is the tax exactly. You are working with accounts and spending a lot of money.

It is just incredible. It is true of individuals as well. It is not just small businesses. It is not just large businesses. It is true of individuals also. I am very sad in a way that the panel's report has just not been given more credence, has not been given more attention than it has either at the White House or in Congress. I hope that this meeting this afternoon will perhaps generate the beginning of something.

We are going to have to make tough decisions. I don't think you are ever going to get rid of entirely, nor should you, charitable deductions and some of the interest rates deductions and the healthcare payment deductions and some things like that. But there are a lot of things that we all know we could get rid of if we had the guts to do it. If we did it, I think the public would stand up and say, "Hurrah. You have done actually bright in the Congress of the United States and something we really appreciate."

But it can't be the band-aid approach which was discussed earlier. It has to be a full comprehensive approach. If we do that, if we can make this simpler and we can get it down to this form, half a page that you could do your taxes on, most people are going to say that is great stuff. We ought to do it.

Mr. SODREL. Congressman Garrett, did you want to comment?

Mr. GARRETT. Well, maybe just going back to my comment before. Where are we going to be today down the road? As much as we want to be optimistic, anything less than a pure significant change, which I think we need to do, will be long lasting. Just think back over the last 12 months or what have you that we have been in session and the proposals for other changes to our existing tax code, additional deductions, credits, what comes out of, with all due respect, Ways and Means all the time.

None of us can get through all that and understand everything that they are trying to change in the tax code all the time. It is making it more complicated literally as we speak. Here we sit saying we are going to come up with a proposal that is going to streamline that down to a card or what have you. I guess my recidivism or skepticism is whatever we do unless it is really broad, one of the other proposals that are out on the table, will just be nit-picked away in the years ahead in the 110th Congress and 111th Congress and 112th Congress.

Mr. SODREL. Just for the record, Mr. Chairman, this country operated on duties, excises, and imposts from 1787 from the time the constitution was written until 1913 when the constitution was amended to allow Congress to lay and collect taxes on income from whatever derived. This country operated on a flat tax from 1787 until 1913 so it can be done, was done, has been done. Thank you.

Mr. BRADLEY. Thank you. Congressman Fitzpatrick? No questions. Are there any follow-up questions quickly of the panel? See-

ing none, let me thank you for your very compelling testimony. It is great to see you again, Senator Breaux, and thank you very much Congressman Castle and Congressman Garrett. Thank you.

While the second panel is getting seated, let me start with the introductions and then I am going to turn it over to Mr. Graves for a while because I have to go to another committee meeting.

The first panelist is Mr. Todd McCracken who is the President of the National Small Business Association; Dr. Daniel Mitchell who is the McKenna Senior Fellow in Political Economy from the Heritage Foundation; Mr. David Burton, Americans for Fair Taxation; Mr. Jim Hausman, Hausman Metal Works and Roofing, Inc. from Missouri; Mr. Andy Loftis, Keller Williams Realty on behalf of the National Association of Realtors; and Dr. Leonard Burman, Senior Fellow at the Urban Institute. Welcome. With that I am going to turn it over to Mr. Graves.

Mr. GRAVES. Thank you very much, Mr. Chairman. We will go ahead and what we will do is just start out and let you give your testimony. We have a series of votes that could be called any time during this process unfortunately. What we will have to do is recess and then come back. The way the timers work is basically you have five minutes. Then there is a one-minute warning on the yellow and then it goes to red.

Don't worry about it too much. If you have something to say, please say it. I do worry a little bit about our time crunch. I want to try to get everybody in before we have to break for votes. We will start out with Mr. McCracken. Thank you for being here. I appreciate it. Look forward to hearing you.

STATEMENT OF TODD MCCRACKEN, NATIONAL SMALL BUSINESS ASSOCIATION

Mr. MCCRACKEN. Thank you, Mr. Chairman. It is good to be here today. Again, my name is Todd McCracken and I am the president of the National Small Business Association. We represent small businesses across the country now for almost 70 years. We are the oldest national small business advocacy association.

We have been very active in the field of tax policy and we were particularly excited when this Commission was appointed because our top priority is to fundamentally reform the tax system of this country. It has a profound negative impact. A lot of what we heard today is true so I won't go into all that again.

My written testimony, which I would ask to be submitted for the record, details a number of the key proposals of the Tax Reform Commission's recommendations and what we believe their impact would be on the small business community. I don't have time to go into all of those today but I would be happy to take questions on them when I am finished.

I would like instead to focus on a couple of key areas where I think there are some recommendations that the panel made that would make a pretty profound difference to the small business community in the near term even in lieu of the fundamental reform we think is so vitally necessary.This really does get at those areas where the tax code has a very profound impact on decisions, on the lives of people. That is really what we need to begin the business of doing.

First I would like to address the area of health insurance. I mean, we are very pleased that the Commission has recommended frankly both that there be a limit on the tax exclusion that health insurance receives today from employers. But also that all individuals receive equitable treatment in the tax when it comes to health insurance.

In the small business community today, as I am sure you know, half of all small companies can't afford to provide health insurance to their employees right now. They do not receive health insurance. That extends to many of the business owners themselves. This very fact that many of these millions of people are out looking for individual coverage and finding out that, "Guess what? I have to pay taxes on every nickel of that health insurance premium," is a profound inequity in our tax code. It is also regressive, I might add.

The panel's recommendations would fundamentally alter that and we think that would be a great step forward. I would also add, though, we often forget about the payroll tax when we are talking about that. We think that it is also important that health insurance for people who don't get it through an employer also be exempt from payroll taxes. That would be taken care of for the self-employed through some legislation that is also before the Congress. We would recommend you support that.

The second thing I would like to address is the area of retirement savings and pensions. This is another area where there is a profound inequity in the current code between small businesses and individuals and those who work for large companies. The 401(k) system that we have today has worked extremely well for most individuals who work for very large companies because of the substantial regulatory burdens that are within that system can be spread across large numbers of employees and there are still substantial savings for everyone.

In the very small businesses the cost of setting up and running one of these plans is enormous. It simply does not make financial sense for the smallest companies to have a traditional 401(k) plan. Therefore, they don't. Fewer than 25 percent of small businesses have a retirement plan for their employees. So what is available to those employees to save on their own? Well, not much frankly. They are largely left out of the retirement saving system that our country has devised.

Fortunately the Commission has put forth a number of recommendations that would really not totally eliminate this disparity but make it much smaller. We greatly applaud them for that. I think this is an area, again, where the Congress can take some action in the relative near term that I think can be bipartisan and make a big difference in the lives not only of millions of small businesses but also their employees.

I would like to end, though, on I guess a negative note. Our only big disappointment in the recommendations was that they did not choose ultimately to tackle big reform, fundamental reform. We do believe that a move to a sales tax is hands down the best move not only for the small business community but the nation overall. We had wished it would get a lot more attention and, frankly, a more equitable reporting in the final report of the Commission.

With that said, we think there is a lot to be said for what actually is in the report and the adoption of many of these proposals would greatly improve the good we have now. Thank you very much.

[Mr. McCracken's testimony may be found in the appendix.]

Mr. GRAVES. Thank you, Mr. McCracken.

Dr. Mitchell

STATEMENT OF DR. DANIEL MITCHELL, PH.D., THE HERITAGE FOUNDATION

Mr. MITCHELL. Thank you very much, Mr. Chairman. With your permission, I'll submit my statement for the record and then touch on a few of the highlights. What I would like to do is talk about some of the economic principles that I think the Tax Reform Panel did a good job of outlining and addressing. Even if perhaps the final recommendations were not as aggressive as I would have preferred, I thought they did a very good job in focusing on both the need to have low marginal tax rates and the need to reduce the level of double taxation of the current system.

A lot of policy makers have a very good understanding of the economics of taxation when they are talking about, say, tobacco taxes. We have very high tobacco taxes, most state governments, a lot of local governments, and those taxes are explicitly put in because policy makers say if we put the tax higher, we will discourage people from smoking.

Now whether the Government should be trying to do that, that is a separate matter but their economic analysis is absolutely correct. The higher the tax rate the more you are discouraging something that is being taxed. Even though they didn't recommend big sweeping tax rate reductions, they pointed out that marginal tax rates on work, saving, investment, entrepreneurship and risk taking have negative economic affects.

Then they also, and here is where they were more aggressive and I think did a sterling job, they talked about the damage of double taxation. By that I am referring to the fact that within our current tax system it is possible for a single dollar of income to be cycled through the tax code several times.

Particularly if you are saving and investing between the capital gains tax, the corporate income tax, the personal income tax, the death tax you actually have very high effective marginal tax rates on saving and investment which, as the panel pointed out in their analysis, it is rather self-defeating since every economic theory, I mean, even the Socialist and the Marxists, they would all agree that savings and investment, capital formation, that is the key to long-term economic growth.

If we could reduce those levels of double taxation which, of course, most of the various fundamental tax reform plans that is one of their key features, we will get more saving and investment, more capital formation which ultimately, of course, translates into more productivity for workers and more productive workers are better paid workers.

So a low marginal tax rate, getting rid of double taxation, those are two of the key principles, as well as, of course, we want to get the Government out of the sort of back door industrial policy

through the tax system. It would be great to have fewer resources needed for tax compliance. The Tax Foundation just issued a recent report that there are $265 billion of compliance cost for the current tax system. We have heard other figures that are a little bit lower.

Who knows what is really right. A lot of it depends on how you value the time that individuals themselves spend on filling out their tax returns. There are costs and those costs are very substantial. Those are costs completely independent of the economic costs, costs that are completely independent of the amount of money you are actually sending to Washington.

If we want to make sure our resources are more effectively utilized, if we want to make sure that our economy is as competitive as possible and we are worried about competing with China and India, not to mention our traditional trading partners, we live in a globalized economy where factories can be built in different places, jobs can be out-sourced, we don't want to have tax policy in effect being some sort of red flag or obstacle to job creation and entrepreneurship and economic activity inside the U.S.

Especially given the fact that we are seeing so much tax reform, so much tax rate reduction in so many countries around the world. We have literally gotten to the point now where every single European country, even ones we would consider welfare states like France and Sweden, they now have lower corporate tax rates than the U.S. Other countries are beginning to catch up and try to move tax policy in the right direction and I worry that our system might just be so high bound.

I mean, we have 96 years now of accumulated provisions in the tax system and the thought of simplification combined with the lower tax rates and the reductions in double taxation that we have in the current system I think could yield very, very immense benefits. Ultimately, we think that the prism through which tax policy should be judged is some form of low single-rate consumption based tax system. That could be a FairTax as some of the other panelists support.

It could be a flat tax which I think might be more reasonable especially since we've seen so many countries like the former Soviet bloc, adopt such a system, but as long as we are moving in the right direction. Many of the tax cuts that we saw in 2001 and 2003 do move in the right direction so incremental changes. We don't want to make the perfect the enemy of the good.

There are lots of incremental reforms and that is really what we saw in the tax reform advisory panel, a list of incremental reforms that would make our tax system better, more competitive, incremental reforms that would try to at least reduce the interference of the tax code and decision making. We want people in our economy to make decisions based on what is going to create the most wealth, the most jobs, what is going to earn the most income.

Those are the criteria that should determine our economic decisions, not what is going to be the best in terms of reducing my tax liability, what is going to make me eligible for some new tax provision. That is economic inefficiency. We have seen that countries that rely on Government planning you have much less economic efficiency, much lower levels of productivity. We do it through the

tax code where some other countries did it through central planning but the ultimate result is the same.

When decisions are based on the tax code or on the basis of political considerations instead of economic considerations, there will be a loss in economic efficiency. The tax reform panel, I think, pointed the direction that we need to go. They maybe didn't go as far as I want to but I hardily applaud that direction that they did suggest. Thank you.

[Dr. Mitchell's testimony may be found in the appendix.]

Mr. GRAVES. Next we have Mr. David Burton.

STATEMENT OF DAVID BURTON, AMERICANS FOR FAIR TAXATION

Mr. BURTON. Thank you. I am glad to be here today, Mr. Chairman, and members of the Committee. I am a partner in the Argus Group and representing Americans for Fair Taxation. I, too, would ask that my statement be made part of the record and also say that the statement basically walks through a series of 12 criteria about what constitutes good tax reform and analyzes five different plans: the FairTax, which is a national sales tax proposal, the flat tax, a business transfer tax, and the two main proposals offered by the panel. Then it summarizes it in a report card which some people might find of interest.

But I'm going to summarize that very quickly and talk about five things about the FairTax and then a number of things that people mentioned in their questions. The FairTax would be extraordinarily pro-growth. Demos pro-growth proposal being considered by the Congress. It is closely followed by the flat tax and the business transfer tax which are virtually the same.

They are all three consumption taxes. They are all three neutral toward savings and investment. They are all three dramatically reduce marginal tax rates. They will result in higher levels of employment, higher real wage rates, higher capital, higher investment, higher savings, higher productivity, and greater competitiveness. The FairTax and the business transfer tax differ from the flat tax in that they are destination principal consumption taxes.

They for the first time would place American goods and foreign goods on an equal footing. Today the income tax basically plants a sign on our shores and says, "You have to be an idiot if you make things here because we are going to tax you very heavily whether you are selling into the U.S. market or the foreign market. We are going to let foreign goods and services come into the U.S. free of any tax."

Sales taxes or business transfer taxes or value-added taxes, for that matter, the value-added tax being employed by every one of our major trading partners, are different. They tax foreign goods and U.S. goods alike. Therefore, they don't put their own industries at a competitive disadvantage. The advantage comes from replacing the income tax with the sales tax or with a BTT, not from the consumption tax itself. The consumption tax is neutral.

A sales tax would be a radical simplification. Instead of the complex morass we've heard about all afternoon so far, basically businesses that are selling to consumers have to ask the question, "How much did I sell to consumers this month at the end of the

month?" Consumers, people who are not in business, never have to file a tax return again in their life. It is hard to conceive of a simpler tax system. It is a tax system used in 45 states. It is not difficult to comply with. As small businesses what takes more time, their income tax or their sales tax return? It will always be the income tax return.

The FairTax is fair and it is fair for two reasons. It untaxes the poor, includes a rebate equal to the sales tax rate times the poverty level so no household in America is going to pay sales tax on the basic necessities of life. It also taxes similarly situated people the same. It has one uniform rate. That has certain advantages in that you cannot play one class of taxpayer off against another. You raise the sales tax rate and you are going to raise it basically on a broad part of the public.

There has been a lot of talk about evasion. The FairTax would reduce evasion. If you look at the literature there are two things that constitute the affect of evasion, the benefit from cheating and the likelihood of getting caught. The FairTax has the lowest possible marginal tax rates, and I'll get into that in a second. Also we would radically simplify the tax system and, therefore, if you hold enforcement resources constant you would increase the audit rate and the changes of getting caught would go up.

It is ridiculous the rates that have been thrown around by a number of detractors of the sales tax including the Treasury Department. The Treasury Department has not released how they came up with their numbers, Congressman. We have asked for them and so have at least a number of Senators and Congressmen I know of. I wonder why? I would be interesting to see how they did their arithmetic.

The bottom line is consumption is 85 percent of the GDP. The revenues we are replacing are about 15 percent of GDP. There is no way that replacing revenues that are 15 percent of GDP and they have a tax base that is roughly 85 percent of GDP get anywhere near the kind of numbers that our detractors are talking about. We have a lot of very fancy economists that go to a lot of fancy universities that have produced studies that show the rate is approximately 23 percent which is what it is in the legislation.

What we hear constantly from detractors is that no country has tried this. We also hear constantly from detractors lots of countries have tried this and it has never worked. Well, it can't be both ways. The bottom line is that a couple countries tried it and it worked but because those countries were in the European Union they were forced to change to that under EU directives.

A couple of quick points on the panel's report. They talk about expensing. Well, the growth and investment plan expenses and it is the best of the two proposals. The small business expensing provisions in the income tax plan are a real retrenchment because businesses that have a million dollars in gross receipts are very micro-businesses. Most restaurants, most dry cleaners will have more than that and they are only able to expense if they have under a million dollars. Otherwise, they have to go to depreciation.

Plan B in their proposal is a consumption tax but it adds on a 15 percent tax on dividends, interest, and capital gains so it is a consumption tax proposal and in that sense it is constructive.

The last thing I wanted to mention was we once co-authored a report for the National Small Business Association that details all the ways the current tax system is biased against small businesses. I would be glad to go into that. The panel does absolutely nothing to rectify a single one of those things. The law remains biased against small businesses in a host of different ways.

Lastly, Congressman Barrow mentioned ocean front real estate he was selling to sales tax supporters and I would be glad to buy it if you would be willing to send me the deeds. Thank you very much.

[Mr. Burton's testimony may be found in the appendix.]

Mr. GRAVES. Thank you, Mr. Burton.

Next we are going to have Mr. Jim Hausman who has a business there in St. Joe. Looking forward to hearing from him.

STATEMENT OF JIM HAUSMAN, HAUSMAN METAL WORKS AND ROOFING, INC.

Mr. HAUSMAN. Thank you for the opportunity to be here today. When I was asked to testify before you, my first thought was my distaste for speaking in public. However, I do have a passion to see our tax system reformed and realizing I would never have an opportunity such as this again, I jumped at the chance.

As an owner or part-owner of several small business the amount of time and money spent dealing with our present tax system is extremely frustrating and time consuming. For this discussion I will relate how this issue impacts the largest of these companies which is a sheet metal and roofing enterprise employing on average 45 to 50 employees with annual billings of $6 to 7 million.

First and foremost, I would like to expound on the estate tax which I feel is a major detriment to small business and family farms continuing into the second generation. Our firm was fortunate. In the late '80s and early '90s we spent six years transferring the stock in our company from my father and my uncle to their heirs which included my cousins, my brother, and me.

We paid approximately $110,000 to accountants, attorneys, and insurance companies to complete the transfer. The money spent to accomplish this could have been spent on trucks, new equipment, salaries, and perhaps even a bit of profit which is not a dirty word. We were fortunate to have transacted this transfer in a timely manner as a year later my uncle passed away. Our mission was accomplished but how many firms and farms are not so lucky?

Now ten years later we find our firm paying exurbanite fees every year for insurance on the four principals in order that our company might continue to operate if one of the four were to die or become incapacitated. This money could be better spent updating our facility. Ours is a small company. We jump through the hoops and pay the price to do our transfer legally but I truly believe this tax needs a death of its own.

Corporate taxes are next on my list. If GM or Ford are profitable at the end of the year they have to pay corporate taxes. If it is paid out of profits, then shareholders are paid less in dividends. My question is who pays the tax? The answer, the shareholders, not the corporation. The next year if they raise their prices on their ve-

hicles to cover the cost of the tax, then the consumer pays. If these companies cut labor or benefit cost, the employee suffers.

Our small company is no different. We collect taxes and if we are profitable at the end of the year, it comes off the bottom line which decreases dividends and/or bonuses to our owners and to the employees. In this scenario I pay one-fourth of our corporate taxes. Our firm does not buy new trucks or equipment unless our accountants are consulted. What a waste of time and money. We should be able to make decisions on these purchases on their merits, not the tax consequences.

Then comes year end. Our firm spends hundreds of hours in December verifying inventory, balancing accounts, projecting billings for the last two weeks of the year and estimating how many hours our work force will work the last couple weeks of the year, all this to project a bottom line, this just to get ready for the accountant to come in. Now we are spending more time and money sitting down with the accountants to get close to a workable number.

This year we projected our year-end numbers on December 20th with no allowance for overtime. We did not anticipate overtime work that needed to be done on Saturday, December 24th or Monday December 26th which, of course, impacted our projections greatly. Therefore, we closed our operation on Friday, December 30th so we could hit our projected number. Forty-one employees, eight hours each at $29 an hour for one day averages $9,512 we didn't put into our economy that one day.

Withholding taxes. Federal, state, FICA, Social Security, and FICA Medicare. Okay, I understand this is not the venue for state withholding. Let me start by saying I hate withholding anything out of our employee's paychecks. Our firm pays sheet metal workers approximately $30 per hour and then we withhold federal, state, Social Security, dues, 40l(k), and sometimes garnishments and child support.

We should all be responsible for payment of our own bills but when it is withheld it is as if they have never paid it. A true revolt to unions and the IRS would happen the first week that all pay was put on each employer's check. Then each employee would be responsible for writing their checks for these items just as he does his groceries and his utilities. I believe you might receive a few calls here in Washington, D.C.

Ladies and gentlemen, our tax system is unfair and burdensome. I used to feel that a flat tax was the answer but as I investigated more deeply, I feel FairTax to be a better way to go. A national sales tax on all items paid by everyone would be the fairest for all people of all socioeconomic status.

It would do away with all taxes previously described and truly stimulate our economy as never before. Please be bold. Don't allow tweaking the present system which gives breaks to and punishes a few every time it is changed which happens so often good accountants can't keep up with the changes. We need a drastic change to the system. Thank you very much.

[Mr. Hausman's testimony may be found in the appendix.]

Mr. GRAVES. Thanks, Mr. Hausman.

Next Mr. Andy Loftis will speak to us. He comes to us from Georgia.

STATEMENT OF ANDY LOFTIS, KELLER WILLIAMS REALTY

Mr. LOFTIS. Thank you, Mr. Chair. My name is Andy Loftis. I am an owner of a franchise of Keller-Williams Realty based in Athens. Currently our company employs about 40 sales agents as independent contractors. We engage in both residential and commercial sales.

I offer my testimony today as a constituent of Mr. Barrows and also as a member of the National Association of Realtors. My oral and written statements, which I ask to be received into the record, are presented on behalf of NAR and its 1.2 million members.

Real estate brokers remain decentralized local based business. Realtor interest and tax reform would be the same as any other small business and those interests include having top notch office space with good locations. The President's Advisory Panel on Tax Reform has made a series of recommendations that would if enacted be disastrous. The nation's current 69 percent home ownership rate is the highest in our history. We are puzzled that law makers would even consider, much less implement, changes that would undermine the remarkable achievement that we have accomplished.

Are there challenges facing the real estate industry? Absolutely. Would those challenges go away if Congress were to reduce or eliminate long-standing straightforward tax rules associated with real estate ownership? No. Reducing or eliminating the tax benefits that apply to existing property would cause cataclysmic disruption and would be a breach of trust for families that have relied on the current law.

Our written comments list the panel's recommendations that would affect real estate and make a number of arguments about why those recommendations are flawed. In my brief remarks I would like to focus on the role of real estate, particularly home ownership as the cornerstone of the savings and retirement plan for many, if not most, of my clients in Athens as well as around the United States.

We want you to understand that real estate ownership is about the future. It is not about the tax system. The tax rules for real estate have been in place for more than 70 years. When the tax reform panel talks about them, the discussion sounds like real estate tax benefits are something for a chosen few. They are not.

Economists and possibly even the panel forget that the wish to own property has been part of the American culture since Jamestown and Plymouth Rock. The billions of tax dollars the academics focus on are in reality the individual savings of families, each saving and hoping for more, reinvesting, and eventually retiring and possibly living off the appreciation from their real estate.

When I start with a first-time home buyer in Athens I am hoping to see that person and set them on a course that by the time they bought homes and raised families they will have something tangible that is theirs and theirs alone. I work with a system sometimes where we take a first-time home buyer and we try to set them down and counsel them and show them that if they were to invest in their mortgage and pay and move probably three to four times given the rate of appreciation that has happened in our area, then they may be in a home free and clear possibly a period be-

tween 15 and 20 years versus a 30-year mortgage that sometimes happens.

The Internal Revenue Code is remarkably complex but not when it comes to home ownership. A homeowner with a mortgage receives a form 1098 from the IRS that comes from the lender that specifies to the penny how much interest was paid. The individual transfers that number to the appropriate line on the tax return and that is it. No schedules, no work sheets, no special knowledge, no appraisals are needed. Real estate ownership does not contribute to the tax system complexity. If one were designing the tax system from scratch, that system would almost certainly look very different from the one we have today but we believe the only viable tax system would continue to nurture home ownership.

Because the current tax rules affecting real estate are not complex, we see no apparent justification for revising them. Some critics point out that only about a third of taxpayers itemize their deduction. These arguments ignore the reality that overtime far more than one-third of taxpayers receive the benefits of itemizing. Mortgages get paid off, other new homeowners enter the market, and families' tax circumstances change.

Arguably, the standard deduction gives non-itemizing taxpayers a better answer than utilizing the mortgage interest deduction so it is not clear that the non-itemizers have been put at a disadvantage. As a general rule, individuals itemize only when their total deductions exceed the standard deduction, currently $10,000 on a joint return.Taxpayers who use the standard deduction thus receive a larger tax reduction than they would if they itemized.

Critics claim that the mortgage interest deduction operates as an inducement for people to buy homes. My one million plus colleagues can confirm that people do not buy homes because of the mortgage interest deduction. They buy homes to satisfy many social and family and personal goals. The mortgage interest deduction does, however, facilitate home ownership because it reduces the carrying cost of that ownership.

Some economists believe that if less money were invested in real estate more money would be invested in productive assets such as stocks and equipment. We are aware of no evidence showing that owning stocks and bonds can provide the foundation for community life, lead to development of quality public schools, lower crime rates, or contribute to the tax base of the local government.

At least one of the panelists stated that if families bought smaller houses they might buy more stock. We do not believe it is the function of the tax system to determine the size of a house for any family or its method for saving.

When former Treasury Secretary James A. Baker testified before the President's advisory panel on tax reform in 2005 he made this observation about tax reform the mortgage interest deduction. If you are going to reform the current income tax code, you will not get there if you think you are going to be able to eliminate this deduction. We could not agree more.

Secretary Baker served under President Reagan at Treasury during the arduous deliberations over what became after nearly two years of debate the tax reform of 1986. His observations about tax

reform and mortgage interest are based on experience. We underscore them for you. Thank you.

[Mr. Loftis' testimony may be found in the appendix.]

Mr. GRAVES. We do have a vote. It is going to take a little while to go through the vote. I want to go ahead and hear from Mr. Burman, if you would, and then we will recess and come back if anybody has any questions at that point. I understand if you do have to leave but I want to go ahead and let Mr. Burman get started on his testimony.

STATEMENT OF LEONARD BURMAN, URBAN INSTITUTE

Mr. BURMAN. Thank you, Mr. Chairman. I was afraid I was going to get bumped. I have a lot of say about the Tax Reform Panel's proposals. Actually, I have a lot to say about things that have been said this afternoon but I seem to be the one skeptic on this panel about National Retail Sales Tax so, given time constraints, I think that is what I would like to focus on in my oral remarks.

The President's panel rejected a National Retail Sales Tax and, in my view, they did it for a good reason. The National Retail Sales Tax called a FairTax by its proponents, is a single flat rate tax applied to an extremely comprehensive base of final retail sales. To offset the regressivity of a sales tax every household will receive cash payments from the Government equal to the sales tax owned on a poverty-level income.

Advocates claim that all federal taxes could be replaced by a single 23 percent flat-rate sales tax on a tax inclusive basis, 30 percent if you measure it the way state sales taxes are measured. But this low rate implicity 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.

The state and local government are exempt from the tax and Federal Government spending doesn't change. The 23 percent national retail sales tax would increase the deficit by $268 billion in 2005 and almost $600 billion in 2010 compared with current law. That math is spelled out in great detail in an article by Bill Gale that I cite in my testimony. I am sure that is the same kind of logic that was used by the Treasury Department. Put differently, the revenue-neutral tax rate would be 31 percent and that is under the implausibly optimistic assumptions of no avoidance, evasion, or erosion of the tax base.

In addition, the National Retail Sales Tax would undermine state tax systems. If there were no federal income tax it would be very difficult to maintain a state income tax. States benefit from the IRS' 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 the states. Taxpayers would pressure state lawmakers to eliminate their income tax. Without a state income tax states would have to increase their own sales tax rates significantly so you are looking at combined state and federal rates are quite high.

The advocates assume zero evasion and that is implausible. At the rates necessary to finance federal, state, and local governments, evasion would be rampant. The evasion would hurt compliant taxpayers and require higher tax rates. It would also trickle down to the states, which would lose a significant portion of their own 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.

Sales tax advocates also assume that almost all forms of spending will be included in the retail sales tax base including new homes, medical expenses, and financial services. Can policy makers really justify tax rates as high as 80 percent 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 the Retail Sales Tax Rates would have to be between 49 and 89 percent on a tax-exclusive basis assuming a moderate amount of evasion. Those conclusions are similar to ones that were raised by the Joint Committee on Taxation and by Bill Gale as I mentioned earlier. On top of those high federal rates, state sales tax rates would have to be quite high as well.

The Panel report also shows that adopting the National Retail Sales Tax 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 the "prebate." 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.

The proposal would hurt small businesses in my view. The Tax Reform Panel sites a well-regarded study of experience in Washington State which found the compliance cost for small firms were six and a half times as large as those for large firms. The rampant evasion would also hurt legitimate businesses which would suffer relative to the growing underground economy. It would undermine confidence in the fairness of the tax system and that would fuel still more evasion.

Enormous transition problems can also be expected as explained in my written testimony. To be clear, many of these problems are unique to the National Retail Sales Tax. 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. They raise other issues but they could be administered.

The National Retail Sales Tax is a uniquely flawed and unworkable solution. It is no wonder that no developed country has ever try this radical experiment. Thank you. I would be happy to answer your questions.

[Mr. Burman's testimony may be found in the appendix.]

Mr. GRAVES. I wish we could. I apologize for the votes. Unfortunately, I don't get to set the schedule. We always have to work around it. I understand, too, that there are a couple of people that have some flights to catch so we are going to go ahead and end the hearing at this point which is unfortunate because I have a whole bunch of questions I would like to ask. I have been doing taxation

town hall meetings for the last month and I have a lot of questions that the constituents raised.

They are good questions. I would just like to know what some of the alternatives are like a flat, like a FairTax or a consumption tax. Unfortunately, again, because of the late hours we are not going to be able to do that. I apologize but I do have some things I might send to you. If you could get a written response back to me, I would appreciate it. Thank you all.

[Whereupon, at 4:41 p.m. the Joint Subcommittee adjourned.]

Good Morning. I welcome you all to the Joint Hearing of the Tax, Finance & Export Subcommittee and the Rural Enterprises, Agriculture & Technology subcommittee of the House Committee on Small Business. I am pleased to be working closely with my colleague from Missouri, Chairman Graves, as we examine the recommendations of the President's Advisory Panel on Federal Reform. I would also like to thank our distinguished witnesses for taking the time to appear before us today.

The current tax code is broken and we are in dire need of a simpler system which is more conducive to our economic goals. For too long the American people have been burdened by the constraints of an overly complex and unfair tax system that is riddled with loopholes and tax shelters. In a time of ever-increasing globalization, these impediments to economic growth are being felt at the heart and soul of this country, and are precluding hardworking Americans from attaining their full economic potential.

This is especially true for the small business owner, who cannot compete because he is financially unable to discover the loopholes created by the mammoth number of bureaucratic regulations in place. Attempting to restrict corner-cutting by further legislation only adds to the nightmare scenario. Simplification is the way to a tax system truly favorable to growth and fairness. Trying to resolve these complex issues put in place by the onerous tax structure by chipping away at it provision by provision will get us nowhere. We need real reform now. Small businesses that could be flourishing are failing. These are people who seek to embark upon a new endeavor and it is the government's responsibility to provide them with a framework that best enables them to succeed.

Before serving coming to Washington, I was a small business owner myself. I know firsthand the significant role they play in the success and prosperity of our economy. I understand and have had to deal with the complexities of the current tax code and know the need for real reform. Small businesses are the lifeblood of this economy and we have needlessly impeded their efforts for too long. We must start anew and create a fairer system which allows endless opportunity, even for the smallest businesses.

I am looking forward to hearing the testimony from our witnesses here today and I look forward to their thoughts on this extremely important topic. However, before we do so, I'd like to recognize my distinguished colleague from Missouri for his opening statement. Mr. Graves.

Tax Hearing opening statement

GOOD MORNING AND WELCOME TO THE JOINT RURAL ENTERPRISE, AGRICULTURE AND TECHNOLOGY SUBCOMMITTEE AND THE TAX, FINANCE AND EXPORTS SUBCOMMITTEE HEARING. IT IS MY PLEASURE TO WORK WITH CHAIRMAN BRADLEY AS WE EXPLORE TRANSFORMING THE TAX CODE, AND I THANK HIM FOR ALLOWING MY SUBCOMMITTEE TO PARTICIPATE.

I ALSO WANT TO THANK JIM HOUSMAN FROM HOUSMAN METAL WORKS AND ROOFING FOR COMING TO WASHINGTON ALL THE WAY FROM ST. JOSEPH, MO TO TESTIFY. I LOOK FORWARD TO HEARING YOUR REAL LIFE EXPERIENCES, AND APPRECIATE YOUR PARTICIPATION.

THROUGHOUT MY TENURE AS A MEMBER OF CONGRESS I HAVE TRAVELED MY DISTRICT VISITING WITH SMALL BUSINESS OWNERS, MANUFACTURERS, AND OTHERS TALKING ABOUT ISSUES THAT IMPACT THEIR BUSINESS. IT IS ALMOST ALWAYS GUARANTEED THAT TAX REFORM IS BROUGHT UP. ACCORDING TO MY CONSTITUENTS, THE CURRENT TAX CODE IS COMPLEX, TIME CONSUMING, AND COST TOO MUCH HARD EARNED MONEY TO EXAMINE.

I SUPPORT SIMPLIFYING THE TAX CODE. THE TAX CODE INCLUDING ALL THE OPINIONS AND PRECEDENTS IS OVER 54,000 PAGES LONG OR 2.8 MILLION WORDS. TO COMPLETE THE FORM TAKES, ON AVERAGE, 11 HOURS. I THINK PEOPLE HAVE MORE VALUABLE THINGS TO DO WITH THEIR TIME. GOVERNMENT SHOULDN'T HANDCUFF SMALL BUSINESS

OWNERS IT OUGHT TO WORK WITH THEM. I THINK SIMPLIFYING THE TAX CODE HELPS EVERYONE.

THE TAX CODE IS A MAJOR DRAG ON THE ECONOMY. ACCORDING TO CERTAIN ESTIMATES, THE TAX CODE COSTS THE ECONOMY $1 TRILLION IN LOST GROWTH EACH YEAR. THIS REPRESENTS HUNDREDS OF THOUSANDS OF JOBS AND OPPORTUNITIES NEVER CREATED BECAUSE OF THE TAX CODE.

AMERICANS DESERVE A TAX CODE THAT IS SIMPLE, FAIR AND PROMOTES ECONOMIC GROWTH. IT IS FUNDAMENTALLY UNFAIR TO HAVE A TAX CODE THAT HAS DIFFERENT RULES FOR DIFFERENT PEOPLE. SMALL BUSINESSES CREATE 7 OUT OF EVERY 10 JOBS IN AMERICA. I WANT TO MAKE SURE THAT WE DON'T PUT A TAX BURDEN ON THEM SO HEAVY THAT THERE IS NO INCENTIVE TO CREATE THOSE JOBS.

THE TAX CODE IMPACTS OUR LIVES IN WAYS WE RARELY ACKNOWLEDGE. FOR EXAMPLE, THE TAX CODE TELLS US WHEN IT'S THE BEST TIME TO GET MARRIED, BUY A HOME, CHANGE JOBS, START SAVING, HAVE CHILDREN, GET AN EDUCATION AND EVEN WHEN IT'S THE BEST TIME TO DIE. ACCORDING TO ONE SMALL BUSINESS OWNER THAT TESTIFIED BEFORE THE PRESIDENT'S BIPARTISAN ADVISORY PANEL ON TAX REFORM THE TAX CODE AFFECTS ALMOST EVERY DECISION HE MAKES: WHERE TO INVEST, WHEN TO INVEST, HOW MUCH TO INVEST IN MACHINES AND EQUIPMENT USED IN PRODUCTIONS, AND HOW TO FINANCE INVESTMENT.

THE COMPLEXITY OF THE TAX CODE IS WHAT MAKES IT SO EASY FOR PERSONS WITH MEANS AND MOTIVE TO CHEAT THE SYSTEM. CLOSING LOOPHOLES IS NOT ENOUGH. CLOSING THESE LOOPHOLES ONLY ADDS ADDITIONAL COMPLEXITY TO THE SYSTEM AND ALL TOO OFTEN PROVIDES A NEW WAY TO CHEAT. WE NEED TO RIP THIS THING-UP AND START OVER. NO ONE IN THEIR RIGHT MIND WOULD CREATE A TAX CODE THAT COSTS SO MUCH AND ACCOMPLISHES SO LITTLE.

I LOOK FORWARD TO HEARING FROM OUR TWO PANELS REGARDING THE PRESIDENTS RECOMMENDATIONS, REFORM PROPOSALS ON THE TABLE, AND EXPERIENCES ASSOCIATED WITH THE TAX CODE.

THANK YOU MR. CHAIRMAN.

STATEMENT
of the
Honorable John Barrow, Ranking Member
Subcommittee on Rural Enterprises, Agriculture and Technology
Joint Hearing on "The President's Advisory Panel on Federal Tax Reform"
House Committee on Small Business
February 1, 2006

Thank you, Chairman Graves and Chairman Bradley, for holding this joint hearing to examine the findings of the President's Tax Reform Panel. I want to thank Senator Breaux, Representative Castle, and Representative Garrett for taking the time to come before our subcommittees.

President Bush appointed the Tax Reform Panel because the current tax system is an absolute mess. It hurts small businesses more than big businesses, and it's a huge drag on our economy.

The reason my subcommittee is looking at this is because the current tax code hurts small businesses even more than big businesses. In 2004, small businesses spent an average of $ 1,304 per employee to comply with federal income taxes, which is almost twice as much as big business. In addition, the current system makes planning ahead much more difficult for small businesses. Because of sunsets and other temporary fixes, it's impossible for a small business owner to know how the tax code will affect him just a few years down the road.

The tax code hurts small businesses, and that means it hurts the growth of our economy.

The Panel's recommendations address many of these issues that make life miserable for American taxpayers. Some of the recommendations could help the American taxpayer, such as simplifying our methods of saving. On the other hand, some of the recommendations could hurt, such as putting a cap on mortgage deductions for homeowners. The current mortgage deduction system has helped a huge number of working Americans become homeowners. A cap on the deduction could put homeowners at risk of losing their homes, and make new homes unaffordable for most Americans.

The Panel also took a long, hard look at the National Retail Sales Tax – an idea that's been floating around Washington for many years. Their findings reinforce the conclusions of economists and tax experts throughout the country – the National Retail Sales Tax is a bad idea.

The Panel refused to recommend the National Retail Sales Tax because they recognize it's just a tax shift that would be a huge tax increase for the vast majority of Americans. A National Sales Tax might be easier for taxpayers to pay, but not if it costs more. Paying more in sales tax shouldn't be the price we have to pay for tax simplification.

Let me read you a few quotes from the Tax Reform Panel's Report:

Quote: "Replacing the current income tax with a stand-alone retail sales tax would increase the tax burden on the lower 80 percent of American families, as ranked by cash income, by approximately $250 billion per year. Such families would pay 34.9 percent of

all federal retail sales taxes, more than double the 15.8 percent of federal income taxes they pay today."

Quote: "Although a program could be designed to reduce the burden of a retail sales tax on lower-income and middle-income taxpayers by providing cash grants, such cash grants would represent a new entitlement program – by far the largest in American history… and make most American families dependent on monthly checks from the federal government."

Quote: "The Prebate-type program would cost approximately $600 billion in 2006 alone. This amount is equivalent to 23 percent of projected total federal government spending and 42 percent of projected total federal entitlement program spending, exceeding the size of Social Security, Medicare, and Medicaid."

Quote: "Two types of administrations would be required – one to collect the tax and another to keep track of the personal information that would be necessary to determine the size of the taxpayer's cash grant."

Quote: "Even with favorable assumptions, a retail sales tax on a broad base with a cash grant program would…[create] incentives for significant tax evasion."

Quote: "The tax rate would be 49 percent. If a narrower tax base were used instead of the Extended Base, the tax rate would be even higher."

In other words, in order to break even it'll cost more for most of us. And the worst of it is that the IRS isn't going anywhere. What we'll get is two bureaucracies instead of the current one: One to collect a huge tax that'll be much harder to collect than folks realize, and the other to pay out the welfare rebate that is supposed to keep the new tax from crushing the poor. Two new messes to replace the current mess.

The President's Tax Reform Panel gave America a thorough, non-partisan, and "**fair**" assessment of the National Retail Sales Tax.

While the Panel clearly laid out the flaws in that proposal, I'm glad to see some of their other recommendations, and I again thank the Chairmen for holding this Hearing to discuss these options in greater depth.

Mr. Chairman, I'm submitting Chapter 9 of the Tax Reform Panel's Report for the record.

Thank you, Mr. Chairman.

STATEMENT
of the
Honorable Juanita Millender-McDonald, Ranking Member
Subcommittee on Tax, Finance and Exports
Joint Hearing on "The President's Advisory Panel on Federal Tax Reform"
House Committee on Small Business
February 1, 2006

Thank you, Mr. Chairman. I am pleased to join with Members of these two subcommittees to discuss the outcome and recommendations of the President's Tax Reform Panel.

I also want to thank Senator Breaux *(pronounce BRO)* for all of the hard work he has put into this endeavor. You and Senator Mack were charged with a difficult task of taking on an issue everyone talks about, but nobody can seem to find a solution that works. Senator Breaux, we appreciate you taking the time out of your schedule to review the panel's recommendations with the committee today.

I am particularly interested in hearing how these changes will impact the economic development of our nation's 23 million small businesses. Many of these firms already face a barrage of roadblocks on their path to success and the tax code should not be one of them. From rising energy prices, to a lack of affordable health care, and the difficulty in accessing capital – it is clear that America's small businesses deserve a break.

Unfortunately, inequities and complexities in the tax code continue to persist for small businesses. Statistics show that in 2002, small businesses shouldered 52.5 percent of the

$194 billion and 5.8 billion hours Americans spent on tax compliance activities. In addition, the Revenue Code income tax provisions have only continued to balloon – between 1995 and 2001 it grew a staggering 478 percent, from 172,000 words to 995,000 words.

The complexity problem clearly has serious implications for small business owners. The panel's recommendations include a number of changes that no doubt would help small businesses. As an example, the recommendation to allow for more immediate expensing of new investment for small businesses is a positive step forward and one that will encourage economic growth. By decreasing the complexity of expensing, small business owners are encouraged to invest in their businesses, while at the same time improving their cash flow and simplifying their tax reporting.

I was also glad to see that the panel has flatly rejected the move to a consumption tax, in the form of a national retail sales tax. A consumption tax could have devastating consequences for millions of hardworking Americans and business owners – particularly the working class poor.

However, while I do agree with many of the changes, I also have reservations about others. I am concerned about the impact of the panel's proposal to eliminate the deductibility of state and local income taxes – a measure that has the potential to create vast inequities between businesses owners, depending on the state they live in. For small businesses across the country – including an estimated 3.3 million in my own state of

California – that have contributed billions of dollars to our local and national economies, it is essential that we assess the impact of this proposal.

While I do have these concerns, I recognize that the panel was not going to please everyone with its findings. And while we may not agree on the route we must take to reform the tax code, it is certain that we must work together to craft bipartisan solutions to the issues that have a severe impact on the ability of America's small business owners to succeed. The failure to address these growing issues over the past few years has only contributed to the growing complexity of the tax code. It is clear that we need to work together to identify solutions that will truly provide relief to small business owners.

It is now up to this Congress to shape the context of the debate – which is always difficult in a politically charged environment – as we work to make tax reform a reality. Thank you.

Statement of the Honorable Sue W. Kelly
US House of Representatives
Committee on Small Business
Subcommittee on Tax, Finance, and Exports
Wednesday, February 01, 2006

Because I represent small businesses in New York's Hudson Valley, I have considerable concerns regarding the proposals of the Presidential Tax Reform Panel. At the same time, there are some promising ideas to at least work with in terms of advancing the tax reform agenda as it relates to small businesses.

It is important to note the suggestions in Plan A that would repeal the Alternative Minimum Tax (AMT). The AMT should never be on the backs of middle-class taxpayers and small business owners. This is money that middle-class families need for themselves to pay their own bills and to use for their own personal needs – and most importantly, to spend as patrons of our small businesses.

Under Plan B, there is an allowance for the immediate and full expensing of all capital investments. This would be a valuable benefit for small businesses who struggle to stay above the red ink in their first few years, by allowing them to deduct the full cost of all operating and business machinery and equipment. It would give them great advantages in being able to borrow more for less and get on stable ground faster. A deduction like this allows innovators to take more chances, hire more people at an early stage, and generally afford the cost of business.

Additionally, Plan B creates a tax system for businesses that is "cash flow" based. This is also important, I think, to small businesses who need to be able to get a fair shake in terms of their real income, what they actually are earning and spending, and taxing it only once at a lower and flatter rate than they do now. But more importantly, this cash flow method eliminates so many of the complicated tax accounting rules that plague small businesses by shifting resources from building the business and succeeding, to recordkeeping. And, as we all know – this is the biggest complaint of small businesses regarding tax rules

While there does exist some proposals to work on in the overall recommendations, my greatest concern is the portion of the recommendations that will have an inherent negative impact on small business.

Specifically, I oppose the proposed elimination of the home mortgage interest deduction, as well as the elimination of the state and local income tax deduction.

Such provisions will especially punish middle-class small business owners and other residents across the country and in New York's Hudson Valley. These individuals are already overtaxed. When middle-class citizens are punished, small businesses also see losses. Elimination of these two types of deductions takes money out of the pocket of the

homeowner. These homeowners are the individuals and the families that are out there spending this money at our small businesses. Thus, this plan takes the money away from valuable patrons of our small businesses.

I support a simpler tax code, but not at the expense of the average Hudson Valley resident and small business owner who could stand to lose thousands of dollars in tax deductions and potential business each year.

In New York's Hudson Valley, both small business owners and their customers rely heavily on these deductions for much needed federal tax-relief every year. Just the thought of these crucial deductions sends a chill through the livelihood of small business owners – not just in New York, but all over America.

Small businesses need tax relief, not tax increases. And, as we work towards this relief, it is imperative that we remember the importance of reducing the current burdens on small businesses just to comply with the current tax code – not create new requirements and more paperwork.

Now is the time to be looking for ways to bring more tax relief to Americans, not to be developing methods of taking it away.

President's Advisory Panel on
Federal Tax Reform
TAXREFORMPANEL.GOV

Embargoed Until Delivery
November 1, 2005

Contact: Tara Bradshaw
202-622-0988

PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM DELIVERS TAX REFORM OPTIONS TO TREASURY SECRETARY JOHN SNOW

Senators Connie Mack and John Breaux, Chairman and Vice-Chairman of the President's Advisory Panel on Federal Tax Reform, and members of the Panel, today delivered to Treasury Secretary John Snow, their final report, *"Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System."*

Senator Connie Mack, Chair, President's Advisory Panel on Federal Tax Reform, delivered the following remarks:

Thank you Secretary Snow for having us here today. Along with Senator Breaux and the other Panel members, I am honored to be here to present our recommendations to reform the United States tax code. First, I want to thank my vice-chair, Senator Breaux, and the rest of the Panel for their hard work and dedication to this effort. I would also like to recognize the staff for a great job.

Ten months ago, we set out to examine the problems in the tax code and make recommendations to fix it. I don't think any of us realized what a challenge— and opportunity this was going to be. We worked hard to reach consensus on proposals that would be a good starting point for reforming our tax code. We wanted to make the tax system more transparent, so Americans would understand the tax system and their tax obligations. We wanted to eliminate loopholes that some taxpayers use to avoid paying their fair share.

Secretary Snow, we are pleased to present you with two options that accomplish these goals. We have labeled these options the Simplified Income Tax Plan and the Growth and Investment Tax Plan. They are very similar in their treatment of households, but differ in their treatment of businesses and investment. Both plans keep the distribution of the tax burden relatively the same as our current system and both are revenue neutral.

Both plans eliminate the alternative minimum tax, which is scheduled to raise taxes on more than 21 million people next year, if we do not abolish this stealth tax. Both plans greatly simplify the system for tax benefits. For example, instead of the current jumble of exemptions, deductions, and credits that are subject to different definitions, limitations and eligibility rules, we created a single credit, called the Family Credit. And it doesn't phase out. We also created a new Work Credit to simplify the current tax benefits for low-income workers.

And both plans restructure tax benefits for charitable giving, homeownership and health coverage and make these benefits fairer by ensuring they are available to all taxpayers – not just the 35 percent who itemize.

Importantly, our plans lower the top marginal income tax rate on individuals and businesses. This will help to encourage economic growth and stimulate investment. The Simplified Income Tax reduces the top rate from 35 percent to 33 percent for individuals and 31.5 percent for businesses. The Growth and Investment tax cuts the top rate to 30 percent for both individuals and businesses.

Both plans provide a simplified and expanded savings package. Taxpayers will be able to save tax-free with three new, flexible savings accounts: Save at Work, Save for Retirement, and Save for Family. And there is an additional Savers Credit to help low-income families save for their future.

There are many details in these plans, and I encourage everyone to read the report and study the Panel's findings and recommendations.

At the core of our efforts is a simple goal: To simplify the tax code, make it fairer, and make sure it doesn't get in the way of economic growth. We have done our best to achieve these goals, and wish you well, Mr. Secretary, in your efforts to move the ball forward.

Senator John Breaux, Vice-Chair, President's Advisory Panel on Federal Tax Reform, delivered the following remarks:

Secretary Snow, thank you for having us here today. I'd like to thank Senator Connie Mack for his leadership in guiding this Panel and the Panel members for all their hard work.

No one likes paying taxes, or even trying to figure out how to manage all the different forms, schedules and worksheets. Everyone agrees, our current tax code is a complicated mess.

I think the bipartisan proposals that we are delivering today will go a long way fixing our broken tax system. Americans deserve a simple tax system. Millions of Americans and businesses shouldn't be forced to make decisions about how to manage their money or make investments because of the tax system.

Small and large businesses are powerful engines of growth in our economy. Allowing businesses to keep more of their profits will allow them to expand their businesses and hire more employees. Encouraging investment helps companies grow—and when they grow, they create more and better paying jobs.

Cleaning up the tax code is an investment in our future—an investment in the American dream. These proposals encourage saving. These proposals encourage homeownership. These proposals encourage charitable giving.

We must all work together to reform our tax code, we can't turn our back on investing in our future, investing in our great economy, and most importantly the American dream.

-30-

Congressman Michael N. Castle
Testimony for House Small Business Committee
Response to the President's Tax Advisory Panel Recommendations
Joint Hearing of Subcommittee on Rural Enterprises, Agriculture and Technology
And the Subcommittee on Tax, Finance and Export
February 1, 2006

Before I begin, I would like to thank both Chairman Graves and Chairman Bradley for prioritizing the issue of tax reform. I appreciate the Committee inviting me to testify at this hearing today.

Reform and simplification of the current tax system is one of high priority to Congress, the Administration and many Americans. I also want to thank Senator Breaux for his leadership on the President's Advisory Panel on Federal Tax Reform. While none of the Panel's suggestions are going to be a quick or easy fix, it's very useful that we maintain a dialogue on these issues.

I strongly believe that we can and should simplify the tax code. While most reforms suggested by the panel, in either of the two recommendations are fair, well-intentioned and effective -- I don't presently see strong political viability for passing drastic reforms. For instance, proposals such as curtailing a tax deduction for home mortgage interest, eliminating a deduction for state and local taxes, and changing the taxation of imports, have all triggered strong reactions from many of our constituents across the country. Politically, it is going to be very tough to make progress.

Reform will be hard to sell because any change can feel drastic for so many who depend on the current benefits on which they depend. In any reform plan, we have to remain very mindful that millions of Americans have based many investment decisions on the current tax code. However, I firmly believe that ultimately, most would benefit from simplifying the system of paying taxes.

As I just mentioned, this will not be easy. It will take real examples of alternative tax scenarios before Americans can trust that simplification steps would actually benefit them personally. The challenge for Congress, will be translating these ideas into real life examples. Part of building this trust in any form of tax simplification is truth in accounting. I am concerned that by assuming current and proposed tax cuts are permanent, the panel's estimates for the cost of such reform are far-reaching. Accounting maneuvers, while useful for selling a certain plan for reform, can actually defeat our goal.

The biggest challenge I see for reforming the tax code is determining the long-term impacts these proposals would have on our federal deficits. A huge expense in both reform proposals is updating the Alternative Minimum Tax. While I think AMT reform is long overdue, I worry about the cost of updating it to include only those for which it was intended and how that will impact our deficits. Trading for more debt is shifting one problem to another. The Panel proposals would each add $1.8 trillion to the deficit over

the next decade. Therefore, practical assumptions should be used in the baseline to remain true to the goal of eliminating complexities.

As important as truth in accounting, is restoring the faith of Americans in our government and our ability to fairly collect the nations revenues. The biggest challenge I think we have in this area is the common abuse of the complex tax code to avoid paying federal taxes. Loopholes allowing tax avoidance by individuals and, particularly corporations have proliferated in recent years. Those same lobbyists who have created such a growth in the demand for "earmarks" are the same type that feast on loopholes in tax bills at incredible cost to our revenue stream— leading to mass complexity and business decisions driven by tax consequences rather than economic benefit. According to the panel's findings, more than 14,000 changes have been made to the code in the past 20 years. It is because of these complications that the annual cost of complying with today's Federal tax system cost taxpayers $1 in compliance costs for every $7 in Federal income taxes paid.

Major benefactors of the current tax code complications are corporations. The federal corporate tax rate is 35%, but tax credits and loopholes can dramatically shrink the actual U.S. revenue. According to the IRS, in 2003, corporate taxes were 7.4% of overall federal receipts, the lowest level in 20 years. Despite that, more than 21% of the $302 billion in tax refunds distributed last year went to corporations.

We are well aware of the two basic ways that corporations exploit offshore tax havens. The first is through corporate expatriation or inversions. By simply registering a company under a Post Office Box address, companies no longer have to pay taxes on their overseas operations. The more complicated, but also commonly utilized way that corporations exploit offshore tax havens is through the use of subsidiaries.

There are endless other ways that large U.S. multinationals can use offshore tax havens to avoid taxes. Any reform to simplify the tax code should include a full review of the commonly used methods such as *Deferred tax payments*; *Income Stripping*; and the practice of *Parking Intellectual Property Offshore.*

As the formal case against Enron executives begin, we are reminded to look far beyond the common practice of corporate expatriation to other ways that corporations use offshore tax havens to avoid paying taxes. Lindy Paull, the Chief of Staff of the congressional Joint Committee on Taxation summed it up this way: "Viewed in their entirety, Enron's structured transactions not only pushed the concept of business purpose to the limit (and perhaps beyond) but also highlight several general issues about the nature of the tax system and a corporation's attitude towards it. Enron's behavior illustrates that a motivated corporation can manipulate highly technical provisions of the law to achieve significant unintended benefits."

Recent reports from the Government Accountability Office concluded that more than 60% of all U.S. companies paid no federal tax at all during the boom years of 1996 to 2000, and in 2000 alone, 94% of all U.S. corporations paid less than 5% of their total

income in corporate taxes. And the problem isn't just American companies—the GAO found that about 70% of foreign-owned companies doing business in the United States paid no federal tax in the late 1990s.

By manipulating their corporate structures into different geographic locations and shifting their operations to take advantage of tax havens and other national differences in taxation, Americans are loosing out on a huge amount of revenue. During a time when we look to reform in our ethics and lobbying practices in Washington, I believe we should take any opportunity for reforming the tax code to finally address some of these widespread abuses that so many corporations have learned to rely on. And, frankly, I also believe most corporations would prefer to pay a flatter, lower tax and avoid the manipulation and loophole seeking which occurs now. The economic advantage of transferring effort from tax avoidance to production is also beneficial to America.

Americans should be able to understand their tax options without the use of expert analysts to navigate us through. The current tax code is muddled with preferences and disincentives, credits and deductions so those taxes burdens can vary widely even among taxpayers with equal incomes. Similarly situated taxpayers should bear similar tax burdens, regardless of ability to interpret avenues to take advantage of their options. In any reform, I would like our code updated to encourage and reward personal investment and savings in every earning bracket.

The panel's focus on fairness in the tax code is one I encourage this committee and Congress to maintain in any further discussions about simplification. Americans should be able to understand their tax options without the use of expert analysts to navigate us through preferences and disincentives, credits and deductions.

Chairmen, the President's Advisory Panel for Tax Reform identified many opportunities for reforming the nation's tax code in ways that will allow more Americans to keep more money, equalize the burden of taxes to make the system fairer, and reduce the current complexities that cost Americans billions each year. I am encouraged by the recommendations of the Panel and although I think these reforms will not be easy to enact, I also believe that the recommendations reflect several solid ideas that deserve our continued attention.

House Small Business Committee hearing -Transforming the Tax Code: An Examination of the President's Tax Reform Panel Recommendations
Wednesday, February 1, 3:00 pm – 2360 RHOB

Testimony of Representative Scott Garrett (NJ-05)

Thank you, Mr. Chairman and members of the Committee, for inviting me to testify on the recommendations of the President's Tax Advisory Panel on Federal Tax Reform. This issue has been a driving force in my career of public service and I appreciate the opportunity to share my thoughts with you today.

The Federal tax code is simply too complex. Its forms and rules are too unwieldy and long for the average taxpayer to understand. It is overburdened with special provisions, credits, and exemptions. The Internal Revenue Code is failing under its own weight.

In recent weeks, Congress has turned its eye toward reforming our appropriations process. Our spending bills have become a potpourri of local spending requests made by Members and lobbyists. Not all earmarks are bad proposals; many represent truly legitimate projects worthy of Federal funding. But, the process by which they earn that funding has led to a gross expansion of Federal authority and Federal spending.

That process, Mr. Chairman, must be more transparent and I fully endorse proposed reforms that would give Members of Congress the opportunity to scrutinize individual funding requests and amend or delete them in floor debate as appropriate.

But, we must remember that the appropriations process is not the only realm of Congressional authority that lends itself to this pork-barrel mentality. The Federal tax code is likewise accosted by such behavior. If we are to truly reform the Federal tax code, Congress must apply these same concepts of transparency and open debate to tax bills.

I am hopeful that we will consider such a proposal as we proceed with lobbying reform, thus giving Congress a leg up on tax code reform.

I am frankly inspired that the President, Congressional leaders, and this Committee are entertaining the notion of significant changes to our Federal tax system. It is long overdue and the American taxpayer deserves no less.

Overall, I was pleased with the Panel's recommendations, though I would have like to have seen more sweeping changes proposed.

Since my time is limited, let me just pick and choose aspects from the two proposals instead of addressing each separately. I am very pleased that both plans focus on Alternative Minimum Tax relief. As you may know, New Jersey has the highest percentage of filers who fall victim to the AMT. If left unchanged, the AMT will penalize nearly 20 percent of taxpayers by 2010—some 30 million Americans in total.

Both proposals, made unanimously by the bipartisan panel, emphatically call for immediate repeal of the Alternative Minimum Tax. This arcane provision poses a grave threat to middle income Americans and small businesses. Significant reform to it must be the centerpiece of any meaningful tax fix enacted by Congress in the coming months.

In fact, Mr. Chairman, I have introduced legislation, HR 703, that would index the AMT for inflation and allow for state and local tax deductions. I am pleased that the advisory panel mimicked my proposals in their recommendations.

Also important are the panel's recommendations for permanent marriage penalty relief and incentives for saving and investing.

In closing, Mr. Chairman, let me thank the President, his advisory panel, and this Committee for advancing the debate on significant tax reform. We are a long way from consensus on moving to a "flat tax" or a "fair tax," but these ideas have significant benefits to American workers and families.

We must change the mindset. It is *ok* to bring in less revenue to the Federal government. There are layers upon layers of bureaucracy and enough lines in the Federal budget of waste and abuse that you'd need an advance degree in calculus just to add them up.

Let's use the President's panel's recommendations as a starting point. Let's work with the President to improve fiscal discipline so that the government doesn't take so much from the American worker's paycheck. A fairer, simpler, less burdensome tax system and a more efficient Federal government is what every American deserves.

Again, thank you again for taking the time to delve into this important topic and thank you for inviting me to participate.

Testimony of Todd McCracken
President
National Small Business Association

Joint Hearing of the Subcommittees on Tax, Finance and Exports and Rural Enterprises, Agriculture, and Technology of the Committee on Small Business

"Transforming the Tax Code: An Examination of the President's Tax Reform Panel Recommendations"

February 1, 2006

1156 15th Street, N.W., Suite 1100
Washington, DC 20005
202.293.8830

Good morning Chairman Bradley, Chairman Graves and members of the committee. Thank you for the opportunity to testify and for holding a hearing on the vital topic of fundamental tax reform. My name is Todd McCracken and I am president of the National Small Business Association. We are the nation's oldest small business advocacy organization, representing 150,000 small business owners across the country.

The members of our organization choose our top priorities every two years at the NSBA Small Business Congress. At the most recent Congress in February 2005, their number one priority was fundamental tax reform.

Only days before last year's event, President Bush had issued a historic Executive Order convening a non-partisan panel of experts to study the current Federal Tax Code and propose alternatives. NSBA's members, while long-time supporters of tax reform, took the opportunity to stand with the President and emphasize the importance of tax reform in the small business community.

When NSBA's members voted in 2005 to make fundamental tax reform the organization's top priority, they were hoping for a plan that would fulfill three goals. The first was a tax system that would bring efficiency to the federal government's tax collection. The President's Advisory Panel on Federal Tax Reform's final report did an excellent job detailing inefficiencies in the current code. They noted the cost of compliance was unacceptable in both time and money spent preparing returns. A replacement to the current code must be more efficient.

Second, a new system must also be more equitable for small businesses. Under the current code, there are many areas where small businesses are disadvantaged. In the area of health care, the health care premiums of self-employed individuals are exposed to the self-employment tax, looking at pensions we see that small business owners and their employees who use small business friendly SIMPLE 401(k) plans can set aside $10,000 pre-tax while employees participating in traditional 401(k) plans can set aside $15,000. The list of other inequities is long and we have testified before this and other committees on inequities for small businesses in the tax code. A replacement to the current code must me more equitable for small businesses.

Finally, any new system must ease compliance. It is well known by members of this committee that small business owners start their venture's not to become experts on the tax code, file returns and learn depreciation schedules; but to earn a living, and bring needed goods and services to their local community. The payroll tax is an example of a tax that is both difficult to comply with (it is often outsourced) and a serious barrier to entry (with tax liability long before profitability) for entrepreneurs. Business owners don't start businesses to cheat the tax code. Any replacement to the current code must be easy to comply with and not be a barrier of entry into the marketplace.

Ultimately, the members of the NSBA chose a national retail sales tax, specifically the proposed Fair Tax, as the best way to replace the current code. They believe that the Fair Tax, while not perfect, is the best way to achieve the goals of efficiency, equity and ease.

While we are disappointed that the panel chose to not recommend a national retail sales tax, there is definite merit and improvements to be found in both options drafted by the president's panel.

Each proposal was evaluated from a small business point of view and compared to the current system and a system based on the Fair Tax.

The Simplified Income Tax Plan

The Simplified Income Tax Plan, or Plan A, proposed by the panel fulfilled President Bush's requirement that one option for reform be based on the existing tax code. For the small business perspective, we've broken the proposal into three parts that specifically affect the small business community: income reporting, fringe benefit treatment and paperwork requirements.

Judging proposals on income reporting is important because most business owner's earnings are taxed at the individual level. Under the current system, owners use a variety of forms—including schedule C, E, SE or K—attached to their tax return to inform the IRS about profits or losses from their business. Profits, if there are any, are then passed through the marginal income tax rates. Plan A reduces the number of tax rates from six to four, simplifying the process. Plan A also wisely eliminates the Alternative Minimum Tax. However, even though there are fewer tax brackets to compute, there is still a requirement for small business owners to file a variety of small business specific forms to comply with tax law. This requirement would not exist for the vast majority of small business owners under the Fair Tax.

Another significance is that Plan A does not address the payroll tax burden faced by small business owners. Under the current code and Plan A, employers would still be required to withhold Social Security, Medicare and Unemployment Insurance contributions from employee wages. Employers would also still be required to withhold and report income tax on employee wages. The Fair Tax would end withholding of payroll taxes.

Current inequitable treatment for small business fringe benefits is greatly improved under Plan A. Pension inequity for small businesses is addressed through the Save at Work program. These plans would level the playing field between traditional 401(k) and SIMPLE 401(k) plans while retaining the latter plan's ease of maintenance. NSBA has been a longtime supporter of President Bush's previously proposed Employer Retirement Savings Accounts which closely resemble the Save at Work plans. In comparison to the Fair Tax however, where taxes are only applied to consumption and tax free saving is automatic, both the current system and Plan A are more cumbersome.

Another fringe benefit inequity fixed under Plan A is differential treatment for health care costs between self-employed individuals and most other employees. Divorcing employment from the provision of health care and allowing all individuals, regardless of their form of employment, to pay for health insurance premiums with pre-tax funds in the same fashion eliminates an important disincentive to becoming self-employed. It would also be an important step in reforming our health care system.

Paperwork and record keeping are greatly improved in Plan A. Fifty-two percent of NSBA's members earn less than one million dollars in revenue and more than 85 percent earn less than five million dollars in revenue according to the most recent NSBA survey. We agree that most small business owners would benefit from the use of cash reporting in Plan A. Those that fell into the medium size business tier would also benefit from simplified depreciation categories and the cumulative method for calculating the depreciation benefit. While it is clear that small business depreciation is improved under Plan A, it is also true that is pales in comparison to the Fair Tax which requires no need to depreciate assets or report inventories. It should also be noted that the panel's report is vague on the topic of unifying rules for different pass through entities.

The Growth and Investment Tax Plan

The Growth and Investment Tax Plan, or Plan B, was the panel's proposal for fundamental reform. Plan B is a hybrid system that retains an income tax for individuals but imposes a subtraction method value added tax on businesses. The small business community would be split between the two systems with sole-proprietorships taxed at the individual rate and all other forms of business entity taxed at the flat 30 percent business tax rate.

Most of the improvements, and shortcomings, compared to the Fair Tax, for entrepreneurs found in Plan A are continued in Plan B. The number of income tax rates is further consolidated from six to three and improvements in fringe benefit treatment for small business owners in health care and pension plans are also carried over. The AMT is also repealed.

Administering a business under Plan B would also be an improvement over the current system. Tax liability would fall squarely on a business's cash flow, defined as receipts less the cost of materials, labor services, and purchases of business assets. Many small business owners already know the benefits of immediate expensing in the current code thanks to Section 179 expensing. Extending this common sense policy to all businesses would encourage investment and productivity and eliminate the incentive for businesses to keep old or inefficient equipment past its maximum potential to recover the depreciation. Business owners would still be required to report the cash flow calculation to the IRS and keep receipts and records for all applicable deductions—an improvement over the current system but inferior to the reporting burden under the Fair Tax.

The distinction in Plan B between sole proprietorships and all other forms of business entity also presents interesting questions. Under current law, business owners that operate pass-through entities (S-corporations, LLC, partnerships) are taxed on profits or losses at the individual income tax rates. Plan B would continue this practice for sole-proprietors, currently 20 percent of NSBA's members, but tax all others at a level equal to the top marginal income tax rate of 30 percent, regardless of income. This split treatment of business owners could create difficult decisions for those just starting their business who wanted the benefits of limited liability or partnership options found in some current pass-through entities but did not want to immediately jump into the top tax bracket.

Plan B is a step in the right direction towards a consumption tax, and an improvement over the current code, but its retention of individual income tax reporting, payroll and income tax withholding and taxation of capital gains and dividends make it less desirable than the Fair Tax.

Conclusion

In summation, the President's Panel on Tax Reform did an excellent job making the case for why our current system is broken and harmful to economic growth. The National Small Business Association fully agrees that the system needs to be replaced with one that is efficient, equitable and eases compliance.

Both Plan A and Plan B are improvements over the current tax code. Both would cut paperwork burden, reduce non-economically sound business decisions and encourage entrepreneurship. However, from a small business point of view neither is as good as the Fair Tax.

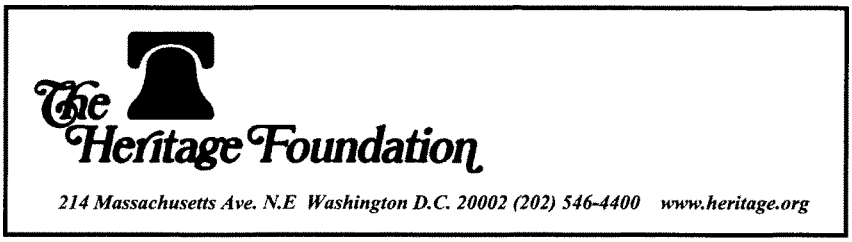
Our members choose the Fair Tax because it is the most efficient and least intrusive form of taxation. It would relieve small business owners from their current role as proxy federal tax collector for income taxes and payroll taxes. Those retail locations that did collect and remit sales taxes to the government would see their overall net tax paperwork burden vastly reduced.

The Fair Tax would treat all forms of small business entity the same by eliminating the need for business owners to make the complex and costly choice of business entity for tax purposes.

By eliminating the need for specialized tax advantaged savings vehicles for pensions, health care and other fringe benefits; small business owners would see equal access to these goods in their own lives and be better able to compete in a tight labor market with their larger competitors.

We appreciate the efforts of the tax reform panel and their hard work on proposing reforms. We disagree with their dismissal of a national retail sales tax and will continue to advocate for it as the best possible alternative for small businesses.

I sincerely appreciate the opportunity to testify before the panel today and look forward to any questions you may have.



CONGRESSIONAL TESTIMONY

The Impact of Federal Tax Reform on Small Business

Testimony before the Subcommittee on Tax, Finance, and Exports and the Subcommittee on Rural Enterprises, Agriculture, and Technology of the Small Business Committee United States House

February 1, 2006

Daniel J. Mitchell
McKenna Senior Fellow in Political Economy
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My name is Daniel Mitchell. I am McKenna Senior Fellow in Political Economy at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Tax reform should seek to accomplish the following goals. These include:

- **A lower marginal tax rate on work and entrepreneurship**. The ideal tax system has a single tax rate set at the lowest possible level. This minimizes the tax penalty on labor and increases incentives to earn more income.

- **A lower marginal tax rate on saving and investment.** The ideal tax system eliminates all forms of double-taxation, such as the capital gains tax, the death tax, and the extra layers of taxation on dividends and savings. This minimizes the tax penalty on capital and increases incentives to earn more income.

- **Fewer resources needed for tax compliance**. The ideal tax system minimizes the complexity of the tax code and thus reduces the need for expensive lawyers, accountants, and software to fill out tax returns. Equally important, these resources now are available for productive uses.

- **A more efficient allocation of resources**. The ideal tax system eliminates all the distortions in the tax code by implementing a system that taxes all economic activity equally at one low rate. Resources thus are allocated on the basis of creating wealth rather than minimizing tax liability.

- **Improved international competitiveness**. The ideal tax system makes a country much more attractive to international investors. Direct and indirect investment will significantly increase, and the nation will become a magnet for skilled labor and entrepreneurs.

Achieving these goals would be good for all taxpayers. Small businesses, however, would be among the biggest beneficiaries since they are especially victimized by the current tax system. Small business owners face several challenges, and the internal revenue code is high on the list of obstacles to entrepreneurial success. There are a number of problems with the tax code, including:

1. High tax rates – Most small business file personal tax returns rather than corporate tax returns, meaning that they face the tax rate schedule associated with the IRS 1040 form. A reasonably successful small business is therefore likely to face the onerous 35 percent top tax rate on its income. And if Medicare payroll taxes and state taxes are added to the equation, it is quite likely that a small business is going to face a marginal tax rate on productive activity of more than 40 percent. The marginal tax rate determines the "tax price" that government imposes on additional increments of productive behavior. According to the scholarly literature, marginal tax rates of 20 percent or less are thought to have

minimal effects on productive behavior. Marginal tax rates between 20 percent and 30 percent begin to discourage work, saving, and investment. And marginal tax rates of more than 30 percent are quite punitive and discourage a large amount of economic activity.

2. Bias against saving and investment – Capital is the lifeblood of small business. Unfortunately, the internal revenue code is biased against income that is saved and invested. Between the capital gains tax, the corporate income tax, the personal income tax, and the death tax, it is possible for a dollar of income to be taxed four different times. This means that the effective marginal tax rate can be much higher than the statutory tax rate. According to academic research, this onerous effective marginal tax rate reduces capital formation. This is a perverse policy since all economic theories – even Socialism and Marxism – agree that capital formation is the key to long-run growth and rising living standards.

3. Complexity – The United States has a terribly complex tax code. Compliance costs exceed $265 billion annually, and most of that cost – nearly $150 billion – is imposed on the business community. Small businesses bear the brunt of this compliance cost. The Tax Foundation has estimated that small companies have compliance costs seven times larger than large companies when measured against sales. And unlike large companies, small businesses do not have large legal and accounting divisions.

4. IRS harassment – The internal revenue service explicitly targets small businesses. IRS publications explicitly assume that the small business community is a major reason for the so-called tax gap (the difference between actual tax revenues and the amount the IRS claims should be paid). For small businesses unfortunate enough to get swept into the IRS's audit web, this means – at best – a huge additional cost burden.

The President's Advisory Panel on Tax Reform sought to address many of the problems with the current tax code. But because of constraints – primarily the decisions to use static revenue scoring and to include the alternative minimum tax in the baseline, the Panel could not fix all the problems in the tax system.

While it is perhaps an over-simplification, the Panel chose to address the "tax base" rather than dealing with tax rates. In other words, the Panel's main focus was to reduce the current system's bias against saving and investment.

The Panel actually proposed two plans – the Simplified Income Tax and Growth and Investment Tax. The GIT plan is more aggressive than the SIT plan, but both share the same broad characteristics. Both plans reduce the level of double-taxation, meaning that the tax bias against saving and investment is lowered. But neither plan makes much progress on tax rates. Moreover, both plans scale back some existing loopholes in the tax code, and both eliminate the alternative minimum tax.

When grading the Tax Reform Panel's recommendations, it is important to recall that the Panel begins with the assumption that the Bush tax cuts will be made permanent. This means that some tax reforms that are very important to the small business community – such as death tax repeal – are part of the baseline.

Borrowing from the old Clint Eastwood move, the Panel's report can be broken into three categories: The Good, the Bad, and the Ugly.

- The Good – Both the SIT and GIT plan expand IRA-type policies, meaning that there will be less double-taxation of saving. Both the SIT and GIT plans make modest reductions in the double-taxation of investment – particularly capital gains. And the GIT plan takes the important step of seeking to replace the current tax system's punitive depreciation policy with immediate deduction of all business investment costs – a policy known as expensing. The two plans also eliminate the personal AMT, a reform that is important for many of the small business taxpayers who file using the personal income tax. Moreover, some undesirable loopholes, such as the deduction for state and local taxes (which encourages a larger burden of government at the subnational level), are abolished.

- The Bad – The Tax Reform Panel does not propose any bad policies, but there are "sins of omission." On the procedural level, the panel chose to rely on the discredited practice of static revenue estimating. This was a puzzling choice, particularly since the report included estimates showing how much bigger the economy would be if the reforms were adopted. Yet if the economy is bigger, this means a bigger tax base. Needless to say, this supply-side effect should have been included – at least as a revenue-scoring option – in the report. Shifting to policy, neither of the plans includes a meaningful reduction in tax rates. It is even possible that some segment of taxpayers will be hit with higher tax rates since the static revenue losses associated with reduced double-taxation will have to be offset elsewhere and it does not appear that the loophole-closers are sufficiently large.

- The Ugly – There is only one potential ugly aspect of the Panel's recommendations. One of the Panel members, former Clinton IRS Commissioner Charles Rossotti, is a big advocate of giving the IRS unlimited and automatic access to the personal financial information of small business owners. His radical proposal – based on the IRS's long-held bias that small business owners are tax cheats – would require that a copy of bank statements and credit card statements automatically be sent to the IRS. This sweeping assault on privacy and evisceration of Constitutional liberty should be rejected. Indeed, Congress should affirmatively condemn this proposal as being incompatible with a free society.

Ideally, the Panel should have proposed to scrap the entire tax system and replaced it with a simple and fair flat tax (or other form of single-rate, consumption-base regime). Under a flat tax, small businesses would benefit from the following policies:

- **Full expensing each year.** Instead of complicated depreciation, under a flat tax all investments are given an immediate first year write-off. This will lead to dramatic simplification and lower the tax penalty on investments.
- **No alternative minimum tax.** The AMT disappears under the flat tax. No longer would businesses be forced to calculate their tax liabilities two separate ways and then pay the larger of the two amounts.
- **No estate tax.** Family-held businesses will be much more stable with the elimination of the estate tax, which destroys capital and imposes an unjustifiable additional tax on income that already has been taxed at least once.
- **No double tax on dividends.** By taxing corporate income just one time and at the source, the flat tax eliminates the current code's bias against corporate investment.
- **No double tax on interest income.** The flat tax eliminates the present practice of taxing income when it is first earned and then a second time if it is invested and earns a return. Eliminating this anti-savings bias will increase the pool of capital for business.
- **No foreign tax provisions.** The flat tax is a strictly territorial system. Income earned in other countries will be taxed by other countries, but there will be no need to go through the ridiculously complex process of reporting that income to the IRS.
- **A single, low rate.** The one low tax rate under a flat tax will give businesses the proper incentive to invest in income-generating activities.
- **No capital gains tax.** Instituting a flat tax will end one of the most pernicious forms of double taxation: the capital gains tax. More specifically, elimination of the levy will end the bias against new investment or business earnings that are reinvested.
- **Simplification.** Businesses will realize significant savings because complying with the tax code under the flat tax will be so simple. Talented lawyers, accountants, and financial planners will be able to shift their abilities to projects that help increase the company's earnings and the nation's wealth.
- **Faster economic growth.** Even the economic forecasts put together by critics of the flat tax show that it will increase economic growth. The consensus is that the economy will grow somewhere between 5 percent and 14 percent within five years. For businesses other than bankruptcy law, this will mean more income and higher profits.[7]
- **Lower interest rates.** Interest income will be taxed at the source under a flat tax, with interest payments made non-deductible for the payer but non-taxable for the recipient. This approach, which is the same as giving all interest the tax treatment now reserved for municipal bonds, will mean lower interest rates (i.e., the tax

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Testimony of

David R. Burton

on behalf of

Americans for Fair Taxation

before the

House Committee on Small Business

February 1, 2006

Mister Chairman and Members of the Committee,

My name is David Burton. I am a partner in the Argus Group, a small public policy firm based in Virginia. I have a particular interest in, and awareness of, the problems of small businesses for a number of reasons. I worked for many years in my family's furniture and pool table manufacturing business stopping only once I was well into law school. I worked as the CFO and general counsel of a small 80 employee multinational manufacturing company. I also regard small businesses and farmers as the greatest source of dynamism, innovation, upward mobility and community strength in this country.

I appear today on behalf of Americans for Fair Taxation, also known as Fairtax.org. It is the nation's largest grass roots citizens' organization dedicated to fundamental tax reform. We appreciate the opportunity to present our views regarding the proposals offered by the President's Advisory Panel on Federal Tax Reform and on fundamental tax reform generally.

With the exception of tax lawyers, tax preparation firms, tax software firms and more than a few tax professors, almost everyone supports tax reform. However, without establishing criteria describing what constitutes genuine and constructive tax reform, it is impossible to assess the relative merits of the various plans or even to decide whether a plan would be constructive. This testimony sets forth criteria we believe that policy-makers should adopt for purposes of assessing fundamental tax reform plans, including the Tax Panel's proposals. These criteria are not exhaustive but they are the most important.

In general, a reformed tax system should be fair and should minimize the adverse economic impact of raising the revenue that Congress decides is necessary to fund the federal government. A tax reform plan that meets the following twelve specific criteria will accomplish the twin goals of being fair and maximizing the economic prosperity of the American people. The FairTax best meets these criteria and, indeed, was designed to do so. Assuming the Tax Panel's proposals were enacted as proposed, they would constitute only a modest improvement over current law and would likely degenerate quickly into something barely distinguishable from the present system.

The Criteria for Fundamental Tax Reform

Prosperity Criteria

1. The plan should not be biased toward consumption and against savings and investment but rather it should be neutral between different types of consumption, savings and investment.
2. The plan should have the lowest possible marginal tax rates, removing to the greatest extent possible the disincentive to work, save and invest and providing the greatest opportunity for upward mobility.
3. The plan should be neutral between whether to produce in the U.S. or abroad; it should not provide an artificial incentive to move jobs and production overseas.
4. The plan should impose the same tax burden on all forms of productive activity and should tax each activity at a uniform rate.
5. The plan should treat human capital formation and physical capital formation alike.
6. The plan should dramatically reduce the administrative and compliance burden on the public.

Fairness Criteria

1. The plan should exempt the poor from tax and allow everyone to meet the necessities of life before paying tax.
2. Once the necessities of life have been met, however, the plan should treat people equally with favoring one set of taxpayers over another and by taxing the same proportion of goods and services they purchase for their own personal use.
3. The plan should not play favorites or reward the politically powerful or well connected.

Civic Criteria

1. The plan should be transparent and understandable so the public understands the tax system; it should not hide the true tax burden or obfuscate.
2. The plan should be politically stable, so that the reform will last
3. The plan should have a manageable transition

The prosperity criteria are those that will maximize economic growth and prosperity. The fairness criteria are those that we believe most Americans accept. The civic criteria are those that promote a healthy body politic and improve our political process.

The Plans

This testimony will consider:

1. The Tax Panel's Simplified Income Tax Plan (chapter six of the report)
2. The Tax Panel's Growth and Investment Plan (chapter seven of the report)
3. The FairTax (H.R. 25, S. 25)
4. A business transfer tax (BTT)
5. The flat tax (of the Hall-Rabushka type)

The FairTax has been introduced in the House and the Senate. It replaces the individual and corporate income tax, all payroll taxes and the estate and gift tax with a 23 percent national retail sales tax on all consumption of goods and service without exception. A rebate would be provided monthly in advance to all households equal to the poverty level times 23 percent. An extra amount is provided to married couples to prevent a marriage penalty.

The Business Transfer Tax is a subtraction method value added tax. The overall tax base is the value of all goods and services produced minus investment. It is collected from businesses using administrative means similar to the corporate tax. It is border adjusted. It has the same tax base, in principle, as a retail sales tax.

The flat tax is a form of value added tax where the tax on capital value added is taxed at the business level and labor value added is taxed at the individual level. Since investment is expensed and savings are accorded Roth IRA type treatment, it is a form of consumption tax. It is, like the income tax, an origin principle tax; thus imports are exempt from tax and exports are taxed. The administrative means used to collect the tax is similar to the current tax system.

Neutrality Between Consumption and Savings

Capital formation promotes greater productivity and output, higher rates of economic growth, and improved competitiveness. More capital per worker, embodying the latest technical innovations means more output, greater competitiveness and higher real wages. The current tax system, however, is very biased against savings and investment, often taxing the returns to savings or investment three or four times. This results in slower economic growth, reduced competitiveness and lower real wages. The solution is to adopt a tax system that is neutral toward savings and investment. The FairTax, the flat tax, a business transfer tax would address this issue decisively. In all three plans, labor and capital output is taxed equally and one time. In the flat tax and BTT this is accomplished by expensing capital investment and treating all savings effectively as if they were in Roth IRAs. In the FairTax, this result is achieved simply by taxing only final consumption and not taxing business inputs. Unlike in most state sales taxes, the FairTax does not hide taxes and impose a tax on a tax. It taxes goods and service once when sold to consumers.

The Tax Panel's Growth and Investment Plan reduces the bias against savings and investment. However, the imposition of an extra 15 percent tax -- over and above the 30 percent business tax -- on dividends, interest and capital gains and the retention of the estate and gift tax constitutes a significant bias against investment and savings. The Simplified Income Tax Plan reduces the double taxation of corporate income but otherwise retains much of the bias against savings and investment inherent in current law.

Lowest Possible Marginal Tax Rates

High marginal tax rates reduce the incentive to work, save and invest and therefore reduce the amount people choose to work, to save and to invest. As tax rates are raised, overall economic output declines. Conversely, reducing marginal tax rates has dramatic positive economic effects.

The FairTax has the lowest marginal tax rates of any plan and is the most pro-growth of any plan considered. It has the broadest possible consumption tax base and a single tax rate. The FairTax

base is equal to that of the BTT. It is larger than the flat tax, primarily due to the fact that the U.S. current imports dramatically more than it exports. The FairTax is unique in that it replaces the 15.3 percent payroll tax and since the FairTax base is broader than the payroll tax base, it reduces marginal tax rates further than any tax plan being considered.

When comparing the FairTax to other tax plans it is important to remember that the FairTax repeals the 15.3 percent payroll taxes (both Social Security and Medicare employment taxes and self-employment taxes). A flat tax with a rate of 17 or 20 percent, for example, is really a 32.3 or 35.3 percent tax on labor or self-employment income. Similarly, the Tax Panel's two proposals have top tax rates on labor income of 45.3 percent. In some cases, the Tax Panel's plans raise marginal tax rates. In most, the reductions are quite minor.

Neutrality Between U.S. and Foreign Producers

The current tax system imposes high income and payroll taxes on U.S. producers and workers whether they are selling in the U.S. market or abroad. The current tax system imposes little or no tax on goods imported into the U.S or services provided to U.S. consumers from abroad. Compared to our OECD trading partners, this places American producers at a roughly 18 percent competitive disadvantage, courtesy of the U.S. tax system.

It is no wonder that firms that remain in the U.S. find it difficult to compete. It is no wonder that manufacturing output and employment have fallen roughly since our competitors started adopting border adjusted taxes. Even our agricultural surplus has largely disappeared. The U.S. government, through its tax policy is telling American firms that they are idiots to continue producing in the U.S. since the U.S. government will tax them heavily if they produce goods here but impose no tax on goods purchased abroad.

In contrast to the U.S., every other significant trading country in the world raises a large part of its revenue from destination principle, border adjusted consumption taxes. Most use the value added tax but some (for example Canada) rely to some extent on sales taxes. These taxes are not levied on exports from those countries to the U.S. but are imposed on U.S. goods imported into their country.

The FairTax would by the very nature of a sales tax remediate this problem by taxing foreign and U.S. goods alike when sold at retail. It would, for the first time, eliminate the advantage accorded to foreign producers by current federal tax policy. A BTT would also address this issue by excluding exports from its tax base and by imposing the tax on imports. The Tax Panel's Growth and Investment Plan would also be border adjusted. However, since the WTO only allows indirect taxes to be border adjusted, it is doubtful whether the Tax Panel's plan, which is structured like a direct tax, would survive a challenge at the WTO. Sales taxes are explicitly permitted under WTO rules. Neither the flat tax or the Simplified Income Tax Plan would address the problem. Even the Tax Panel itself recognized that its proposal would probably fail WTO scrutiny.

Neutrality Between Different Types of Productive Activity

The FairTax treats all goods and services alike. Thus, it does not distort the marketplace and allows businesses to adopt the most efficient economic means to meet consumer wants. A plan

that taxes economic activity uniformly will promote the most efficient, productive economy. The flat tax and BTT would also do this (except, as mentioned below, as to labor income because of the retention of the payroll tax). Although the Tax Panel's plans would reduce these distortions, they retain major distortions in the marketplace, including the health care, housing and investment markets.

Neutrality Between Human Capital and Physical Capital

Human capital is a critical element in productivity and innovation. The FairTax is the only tax reform plan to grant human capital parity with physical capital. The FairTax accomplishes this result by not taxing tuition or job training or educational wages in either the government or private sector. This is appropriate since the primary reason most people pursue an education is to increase their future earnings capacity and the expenditures generated by those future earnings will be taxed. Tuition and job training are an investment in human capital.

The flat tax does not address this problem. Education is treated like a consumption good and must be purchased with after flat tax and after payroll tax dollars. The Tax Panel's proposals do not really address this issue; all they do is afford some savings for educational purposes consumption tax treatment.

Reduce the Compliance Burden on the Public

The current tax system has major tax evasion problems notwithstanding billions of tax and information returns filed each year, roughly 6 billion hours spent figuring out the tax due, and an army of tax preparers, tax accountants, tax lawyers and IRS personnel. We waste nearly $300 billion annually complying with the current tax system. The time spent figuring our taxes is more people than the hours spent working in the auto industry, the computer manufacturing industry, the airline manufacturing industry and the steel industry combined.

The Tax Panel's proposals would reduce this waste slightly. The flat tax would reduce it substantially, at least until the political process turned it back into something similar to what we have today. However, the flat tax does require all Americans to file tax returns and would retain withholding and payroll taxes rules.

The FairTax would radically reduce these costs and the complexity of the system. Individuals who were not in business for themselves would never need to fill out a tax return again. Moreover, the FairTax compensates businesses for the time required to fill out sales tax returns with a credit equal to ¼ of one percent of the sales tax remitted.

Under the FairTax, the question a business or auditor would need to answer is how much was sold to consumers. This is a simple question not that different from line 1 on a tax return today. Under the FairTax, that would effectively be that. All of the major sources of complexity today would be repealed. Gone would be payroll and income tax withholding, 1099 reporting, inventory tax accounting (including the uniform capitalization rules), tax depreciation accounting and recapture rules, tracking tax basis, the alternative minimum tax, qualified plan rules (including top-heavy, participation and vesting rules), international tax rules, capital gains rules, passive loss limitations, estate and gift tax planning and a host of other rules.

Small businesses are disproportionately harmed today by the large compliance burden imposed by the current tax system. They would disproportionately gain from implementation of the FairTax.

Exempt the Poor

It does not make a great deal of sense to impose taxes on poor people. Neither, however, does it make sense to hide from them the cost of government. The poor cannot even meet their basic needs and are receiving financial assistance in many ways. Yet today, they pay significant taxes. Part of those taxes are the payroll taxes imposed on the working poor. But the poor also bear the burden of paying higher prices for the goods they buy because of the taxes imposed on businesses and the cost incurred by businesses to comply with the tax system. Businesses, after all, must recover all of their costs, including taxes, in the price of the goods they sell. If they do not, they will quickly go out of business.

Because of the rebate, the FairTax is progressive. The effective tax rate climbs as expenditures climb. The effective tax rate is negative or zero for the poor, it is quite low for the lower middle class. The effective tax rate for a married couple with two children with taxable spending of $51,320 would have been 11 ½ percent in 2005. The very rich would pay nearly 23 percent on their spending.

The FairTax is the only plan that entirely untaxes the poor. It accomplishes this by providing every household in America with a rebate paid monthly in advance equal to 23 percent of the poverty level (plus an extra amount in the case of married couples to prevent a marriage penalty). This, in effect, protects every household in America from paying any tax on spending up to the poverty level which means that no poor person is paying any sales tax and that no household is paying sales tax on the necessities of life.

By repealing the payroll tax, the FairTax eliminates the greatest burden on the working poor and reduces the cost of hiring new, entry level workers. By repealing business taxes, hidden taxes that must be recovered by businesses in the price of goods sold are repealed.

All other plans keep the payroll tax, which is the largest tax paid by poor Americans. No other plan is structured to ensure that no poor person will pay any tax. No other plan ensures that all households may meet the necessities of life without paying tax.

Equality of Treatment

The FairTax treats people equally on spending over the poverty level. It does not favor one set of taxpayers over another or one type of producer over another. It taxing everyone at a uniform rate on goods and services they purchase for their own personal use.

The flat tax moves in the right direction but retains the payroll tax which taxes labor income at different tax rates depending on the level of their income and does not tax capital income. The Tax Panel's proposals retain many tax preferences and treat people differently depending on the degree to which they are willing to structure their lives in a way approved of by government. In addition, the Tax Panel retains graduated tax rates which punish people who choose to work hard, study hard, save and invest.

Should Not Play Favorites

It is unfair for the government to play favorites, rewarding certain politically powerful and well-connected interests over others that do not have the same political pull. The tax system *should* be about do what is right and just rather than what will help fill campaign coffers and satisfy interest groups. The FairTax treats everyone alike and does not exempt any person, any good or any service from tax. The rules are simple and clear and apply to everyone.

The Tax Panel's proposals continue the practice of rewarding certain interests, although the proposals do reduce the scope of tax preferences compared to current law. The flat tax would largely eliminate the favoritism of current law. It does, however, retain on major favorite. Foreign produced goods are favored over U.S. produced goods. A BTT would not play favorites either and would treat foreign and U.S. produced goods and services alike.

Transparency and Comprehensibility

The FairTax is the easiest of any tax reform plan to understand. That is its virtue and its vice. It is a simple sales tax with a single tax rate.

It does not divide up the public's tax burden among four or five "low" tax rate taxes, some of which are hidden from view, that add up to very high tax rates. The FairTax has one very transparent tax rate which, in reality, is the lowest marginal tax rate by far of any tax reform plan. Yet because the FairTax is honest and transparent and the current tax system is anything but honest and transparent, FairTax detractors are able to obfuscate, demagogue and confuse by misrepresenting the facts.

Who knows who pays the corporate tax? Most people – small businesses and self-employed people being obvious exceptions – do not even know about the massive employer payroll taxes that drive their wages down. Most people have only the vaguest idea of what they pay in income taxes today and why since the taxes are withheld and, as often as not, they used paid preparers or software to figure their tax.

The Tax Panel's plans are complex and retain most of the complexity of the current system. The flat tax is relatively simple, yet even many of its most vocal proponents seem to think it is an income tax rather than a consumption tax. They do not even understand their own proposal.

Only the FairTax is simple and can be easily understood by anyone. Under the FairTax, people will understand for the first time in their lifetime how the federal government is actually paid for and who is paying for it.

Political Stability

If the flat tax is kept as it is but with graduated rates, it becomes what is often called the X-tax, a graduated rate consumption tax. The flat tax can be easily changed by to an income tax. Starting with the flat tax, if we depreciate capital rather than expense it, make inventory purchases deductible when the inventory is sold rather than when purchased, make interest taxable and deductible, then we have largely converted the flat tax into an income tax. Add a few special

interest deductions, credits and exclusions and when are very nearly back to where we started. That is a very real problem with the flat tax. It is very easy to corrupt its design and eliminate many of the gains to be had from adopting the proposal in the first place. The entire administrative apparatus of the income and payroll tax system is retained and it would be very easy to go back. Attempts to do so would start immediately.

If the FairTax were enacted, it would much more difficult to go back to an income tax system. The entire massive and expensive administrative apparatus built up over nine decades would be dismantled. It is doubtful that people would want to go back. It is doubtful that they would want to invest the massive resources necessary to do so. The FairTax, then, is a stable reform. There will, of course, be the necessity to fend off those who want to exempt one category or another of goods or services. But if the rebate system is in place, the most commonly used line of argument (we need to help the poor) will fall flat. There will always be better ways to help the poor than exempting some category of goods.

Transition

The flat tax sidesteps transition issues. It is, however, unlikely that in the final analysis Congress will force businesses to lose trillions of dollars of basis on capital assets if the income generated by those assets remains subject to tax. To do so would amount to wealth loss for existing capital owners of well over a trillion dollars to American businesses. Addressing this transition issue, will force the flat tax rate (or a BTT rate) to climb considerably.

There is no need to be concerned with basis per se in the FairTax since income streams are no longer subject to tax. Businesses will not get far complaining that their tax rate has been reduced to zero. The analogous problem in the FairTax is the sale of goods subject to FairTax that were not deducted for income tax purposes. Collecting sales tax and failing to allow an income tax deduction would effectively be double taxation. The FairTax legislation addresses this issue by providing a credit to businesses selling inventory held on the changeover date to prevent the double taxation.

There is a general danger, however, when considering transition to want to compensate every loss. In fact, in most cases where there are losses, there is someone experiencing an equal and offsetting windfall gain on the other side of the transaction. These gains should be taxed to compensate losses (if they exist) because if the loss is unjust then so is the unexpected and windfall gain at another's expense. Moreover, many of the claimed losses on capital assets will in reality be illusory because assets price will in general increase due to according consumption tax treatment to investment.

Some Specific Notes on the Impact on Small Businesses and Farms

The current system has a disproportionately adverse impact on small businesses because of the high compliance costs that consume a relatively large share of small business income and because of the many ways the current system singles out small businesses for discriminatory tax treatment.

The FairTax addresses this issue by radically simplifying the tax law, reducing compliance costs and compensating businesses for their time complying with the system. The FairTax also repeals

payroll taxes, which have a disproportionately negative impact on small businesses both because of administrative cost, the self-employment tax and the increased cost of labor. Finally, the FairTax will help small manufacturers and farmers compete against foreign goods in U.S. or foreign markets by taking the taxes out of exports and by taxing U.S. and foreign goods alike in U.S. markets. Many larger U.S. companies have already outsourced a huge portion of their manufacturing or are planning to do so. Small companies located here do not really have the option of outsourcing their manufacturing since they do not generally have both manufacturing and distributional divisions.

No other plan addresses these needs of small businesses as directly and effectively as the FairTax. BTT proposals tend not to address payroll tax issues. The flat tax does not address either payroll tax issues or level the playing field with imports. The Tax Panel's proposals would only moderately improve the current system.

Grading the Plans

The analysis above demonstrated that the FairTax is the most pro-growth and most Fair tax plan being considered in Congress. It showed that the Tax Panel's proposals were seriously deficient. It showed that the BTT and the flat tax would constitute a significant improvement over current law. The chart below is a summary of these findings.

Tax Reform Report Card

Criteria	Tax Panel Income Tax	Tax Panel Growth	Flat Tax	Business Transfer Tax	FairTax
P1. Neutral Toward Savings and Investment	C	C+	A	A+	A+
P2. Low Marginal Tax Rates	C	C	B+	A-	A+
P3. Neutral Between Foreign and U.S. Producers	F	A	D	A+	A+
P4. Taxing Economic Activity Uniformly	C+	C+	A-	A-	A
P5. Neutral Between Human and Physical Capital	F	F	F	F (usually)	A
P6. Reduce Compliance Costs	C-	C	B	B	A+
F1. Poor Untaxed	B	B	B-	B-	A+
F2. Equal and Uniform Taxation	D	D+	B	B+	A+

Criteria	Tax Panel Income Tax	Tax Panel Growth	Flat Tax	Business Transfer Tax	FairTax
F3. No Favorites or Special Exceptions	D	D	A-	A-	A+
C1. Transparency and Understandability	C	C	B	B-	A+
C2. Politically Stable	F	D	C	B	A
C3. Manageable Transition	A	A	B	B	B+
Overall Grade	D	C	B	B+	A+

Conclusion

The proposals offered by the President's Tax Panel are a major disappointment. They represent modest progress compared to present law. But the progress they offer is quite small and unlikely to last very long given the nature of the political process.

The flat tax is a highly constructive proposal, but compares unfavorably where it differs from either a sales tax or a BTT. Moreover, because it retains the administrative apparatus of the income and payroll tax, it is likely to revert back toward an income tax. Finally, by retaining payroll taxes, its rates on labor income are unnecessarily high and the tax burden on poor and lower middle income persons is higher than the FairTax.

The FairTax is the best plan being considered. It is extremely pro-growth. It would cause dramatically higher investment, large productivity gains and higher real wages. It would improve the competitiveness of U.S. producers. It would improve the well-being of the average American dramatically. It would dramatically reduce the vast amount wasted each year on compliance costs. It would untax the poor and be progressive. It would tax people based on what they consumed for themselves rather than what they invested in the community or gave to charities. It would get the government out of the business of playing favorites and rewarding politically powerful interests. It is transparent and understandable. It will lead to a more just and more prosperous America. It is the best plan.

We urge you to cosponsor the legislation and to work with your colleagues to enact it into law so that the American people can, at last, have the tax system they deserve.

THANK YOU FOR THE OPPORTUNITY TO BE HERE TODAY.

WHEN I WAS ASKED TO TESTIFY BEFORE YOU, MY FIRST THOUGHT WAS MY DISTASTE FOR PUBLIC SPEAKING. HOWEVER, I DO HAVE A PASSION TO SEE OUR TAX SYSTEM REFORMED AND REALIZING I WOULD NEVER HAVE ANOTHER OPPORTUNITY SUCH AS THIS TO EXPRESS MY VIEWS, I JUMPED AT THE CHANCE.

AS AN OWNER OR PART OWNER OF SEVERAL SMALL BUSINESSES, THE AMOUNT OF TIME AND MONEY SPENT DEALING WITH OUR PRESENT TAX SYSTEM IS EXTREMELY FRUSTRATING AND TIME CONSUMING. FOR THIS DISCUSSION, I WILL RELATE HOW THESE ISSUES IMPACT THE LARGEST OF THESE COMPANIES WHICH IS A SHEET METAL AND ROOFING ENTERPRISE EMPLOYING ON AVERAGE 45 TO 50 WITH ANNUAL BILLINGS OF 6 TO 7 MILLION.

FIRST AND FOREMOST, I WOULD LIKE TO EXPOUND ON THE ESTATE TAX WHICH I FEEL IS A MAJOR DETRIMENT TO SMALL BUSINESSES AND FAMILY FARMS CONTINUING INTO THE SECOND GENERATION. OUR FIRM WAS FORTUNATE. IN THE LATE 80'S AND EARLY 90'S WE SPENT SIX YEARS TRANSFERRING THE STOCK IN OUR COMPANY FROM MY FATHER AND UNCLE TO THEIR HEIRS WHICH INCLUDED TWO COUSINS, MY BROTHER AND ME. WE PAID APPROXIMATELY $110,000.00 TO ACCOUNTANTS, ATTORNEYS AND INSURANCE COMPANIES TO COMPLETE THE TRANSFER. THE MONIES SPENT TO ACCOMPLISH THIS COULD HAVE BEEN SPENT ON TRUCKS, NEW EQUIPMENT, SALARIES AND PERHAPS EVEN A BIT OF PROFIT (NOT A DIRTY WORD). WE WERE FORTUNATE TO HAVE TRANSACTED THIS TRANSFER IN A TIMELY MANNER AS A YEAR LATER MY UNCLE PASSED AWAY. OUR MISSION WAS ACCOMPLISHED BUT HOW MANY FIRMS AND FARMS ARE NOT SO LUCKY?

NOW TEN YEARS LATER WE FIND OUR FIRM PAYING EXHORBITANT FEES EACH YEAR FOR INSURANCE ON THE FOUR PRINCIPALS IN ORDER THAT OUR COMPANY MIGHT CONTINUE TO OPERATE IF ONE OR MORE WERE TO DIE OR BECOME

INCAPACITATED. THIS MONEY COULD BE BETTER SPENT UPDATING OUR FACILITY. OURS IS A SMALL COMPANY – WE JUMPED THROUGH THE HOOPS AND PAID THE PRICE TO DO OUR TRANSFER LEGALLY BUT I TRULY BELIEVE THIS TAX NEEDS A DEATH OF ITS OWN.

CORPORATE TAXES ARE NEXT ON MY LIST. IF GM OR FORD ARE PROFITABLE AT THE END OF THE YEAR, THEY HAVE TO PAY CORPORATE TAXES. IF IT IS PAID OUT OF PROFITS, THEN SHAREHOLDERS ARE PAID LESS IN DIVIDENDS. MY QUESTIONS IS, WHO PAYS THE TAX? THE ANSWER: THE SHAREHOLDERS – NOT THE CORPORATION. THE NEXT YEAR PRICES OF THEIR VEHICLES ARE RAISED TO COVER THE COST OF THE TAX – THEN THE CUSTOMER PAYS. IF THESE COMPANIES CUT LABOR OR BENEFIT COSTS, THE EMPLOYEE SUFFERS.

OUR SMALL COMPANY IS NO DIFFERENT. WE COLLECT TAXES AND IF WE ARE PROFITABLE AT THE END OF THE YEAR, IT COMES OFF THE BOTTOM LINE WHICH DECREASES DIVIDENDS AND/OR BONUSES TO OUR OWNERS AND KEY EMPLOYEES. IN THIS SCENARIO, I PAY ONE FOURTH OF OUR CORPORATE TAXES. OUR FIRM DOES NOT BUY NEW TRUCKS OR NEW EQUIPMENT UNLESS OUR ACCOUNTANTS ARE CONSULTED. WHAT A WASTE OF TIME AND MONEY. WE SHOULD BE ABLE TO MAKE DECISIONS ON THESE PURCHASES ON THEIR MERIT, NOT THE TAX CONSEQUENCES. THEN COMES YEAR-END. OUR FIRM SPENDS HUNDREDS OF HOURS IN DECEMBER VERIFYING INVENTORY, BALANCING ACCOUNTS, PROJECTING BILLINGS FOR THE LAST TWO WEEKS OF THE YEAR AND ESTIMATING HOW MANY HOURS OUR WORKFORCE WILL WORK THE LAST WEEK AND A HALF FOR A PROJECTED PAYROLL COST TO OUR BOTTOM LINE. THIS IS JUST TO GET READY FOR THE ACCOUNTANT TO COME IN. NOW WE ARE SPENDING MORE TIME AND MONEY SITTING DOWN WITH THE ACCOUNTANT TO GET CLOSE TO A WORKABLE NUMBER FOR THE MAGIC DATE OF DECEMBER 31ST. THIS YEAR WE PROJECTED YEAR END NUMBERS ON DECEMBER 20TH WITH NO OVERTIME ALLOWANCE. WE DID NOT ANTICIPATE OVERTIME WORK THAT NEEDED TO BE DONE ON SATURDAY, DECEMBER 24TH, OR MONDAY, DECEMBER 26TH WHICH OF COURSE IMPACTED OUR

PROJECTIONS GREATLY. THEREFORE, WE CLOSED OUR OPERATION ON FRIDAY, DECEMBER 30TH SO WE COULD HIT OUR PROJECTED NUMBER. 41 EMPLOYEES, 8 HRS EACH AT $29.00 AVERAGE = $9,512.00 WHICH WAS NOT IN OUR ECONOMY THAT ONE DAY.

WITHHOLDING TAXES: FEDERAL, STATE, FICA, SOCIAL SECURITY AND FICA MEDICARE. OK, I UNDERSTAND THIS IS NOT THE VENUE FOR STATE WITHHOLDING. LET ME START BY SAYING I HATE WITHHOLDING ANYTHING OUT OF OUR EMPLOYEE'S CHECKS. OUR FIRM PAYS JOURNEYMEN SHEET METAL WORKERS APPROXIMATELY $30.00 PER HOUR. THEN WE WITHHOLD FEDERAL, STATE, SOCIAL SECURITY, DUES, 401K, AND SOMETIMES GARNISHMENTS AND CHILD SUPPORT. WHY DOES OUR FIRM HAVE TO DO THE ACCOUNTING FOR 50 EMPLOYEES AND TWO GOVERNMENT ENTITIES. WE SHOULD ALL BE RESPONSIBLE FOR PAYMENT OF OUR OWN BILLS BUT WHEN IT IS WITHHELD IT IS AS IF THEY NEVER HAD IT. THEN MY EMPLOYEES TELL ME THEY AREN'T MAKING ENOUGH MONEY. A TRUE REVOLT TO UNIONS AND THE IRS WOULD HAPPEN THE FIRST WEEK THAT **ALL** PAY WAS PUT INTO EACH EMPLOYEE'S CHECK. THEN EACH EMPLOYEE WOULD BE RESPONSIBLE FOR WRITING CHECKS FOR THESE ITEMS JUST AS HE DOES FOR HIS GROCERIES AND UTILITIES. I BELIEVE YOU MIGHT RECEIVE A FEW CALLS HERE IN WASHINGTON, D.C.

LADIES AND GENTLEMEN, OUR TAX SYSTEM IS UNFAIR AND BURDENSOME. I USED TO FEEL A FLAT TAX WAS THE ANSWER BUT AS I HAVE INVESTIGATED MORE DEEPLY, I FEEL THE FAIR TAX TO BE A BETTER WAY TO GO. A NATIONAL SALES TAX ON ALL ITEMS PAID BY EVERYONE WOULD BE THE FAIREST FOR ALL PEOPLE OF ALL SOCIO-ECONOMIC STATUS. IT WOULD DO AWAY WITH ALL TAXES PREVIOUSLY DESCRIBED AND TRULY STIMULATE OUR ECONOMY AS NEVER BEFORE.

PLEASE BE BOLD. DON'T ALLOW TWEEKING THE PRESENT SYSTEM WHICH GIVES BREAKS TO AND PUNISHES A FEW EVERY TIME IT IS CHANGED WHICH HAPPENS SO OFTEN GOOD ACCOUNTANTS CAN'T KEEP UP WITH THE CHANGES. WE NEED A DRASTIC CHANGE TO THE SYSTEM.

TRANSFORMING THE TAX CODE: AN EXAMINATION OF THE PRESIDENT'S PANEL ON TAX REFORM RECOMMENDATIONS

House Committee on Small Business

Joint Subcommittees on Tax, Finance & Exports and Rural Enterprises,

Agriculture and Technology

February 1, 2006, 2360 Rayburn HOB

Mr. Chairman: My name is Andy Loftis. I am an owner of a Keller-Williams Realty of Greater Athens in Athens, Georgia. Currently our company employs about 40 sales agents. We are engaged in both residential and commercial real estate sales and development. I am speaking here today as a constituent of Mr. Barrows and also as a member of the NATIONAL ASSOCIATION OF REALTORS®. (NAR) My oral and written statements are presented on behalf of NAR and its 1.2 million members.

The President's Advisory Panel on Tax Reform has made a series of recommendations that would, if enacted, be disastrous for the real estate industry and for the entire economy. The Nation's current 69% homeownership rate is the highest in our history. We are puzzled that lawmakers would even *consider*, much less implement, changes that would undermine that remarkable achievement. Are there challenges facing the real estate industry? Indeed, there are. Would those challenges go away if Congress were to reduce or eliminate longstanding, familiar and straightforward tax rules associated with real estate ownership? On the contrary, reducing or eliminating the tax rules that apply to existing property would cause cataclysmic disruption.

Tax Reform Recommendations that Affect Real Estate: The Panel proposes the following:

- Convert the mortgage interest deduction to a tax credit
- Limit the deduction to interest expense on a principal residence (i.e., no deductions for interest on second homes)
- Reduce the current law cap on allowable indebtedness (currently $1 million of debt, secured by as many as two residences) by as much as $800,000 by conforming the cap to FHA loan limits

- Repeal the mortgage interest deduction for home equity loans
- Repeal the deduction for state and local property taxes
- Allow purchasers of investment real estate to deduct the cost of acquiring the property and eliminate any interest expense deductions associated with the purchase – OR –
- Require real estate investors to recover the cost of investment real estate over approximately 33 years (residential property) or 45 years (non-residential property).

As a practical matter, the NATIONAL ASSOCIATION OF REALTORS® opposes each of these changes. While our comments will mostly describe the negative impact of reducing the mortgage interest deduction, note that similar arguments would apply to most of these proposed real estate taxation changes. We choose to emphasize the mortgage interest deduction because it is among the most familiar provisions in the entire Internal Revenue Code.

As we talk about the mortgage interest deduction, do understand that the negative fallout of changing longstanding tax rules would extend beyond homeownership. A little known fact is that, according to Federal Reserve data, American families *in every income category* own investment real estate. These investments can range from the smallest cottage or condo to an interest in a magnificent skyscraper. Notably, the IRS has not identified any pervasive or abusive tax avoidance within either the residential or investment real estate sector. Since the early 1990s, real estate investment deals have generally been based on their economic merit and not generated as part of an elaborate tax shelter scheme. The current law caps on mortgage interest deduction have been in place since 1987 and have not been indexed for inflation. We are therefore shocked that the Panel would recommend punitive new tax rules in light of the satisfactory rates of tax compliance in all sectors of the real estate industry over recent years.

Real estate investments, both in both homes and commercial property, build savings and individual wealth, provide tax revenues for local governments, and stimulate growth in all real estate-related industries. Indeed, we believe that *America was built on real estate*. Over the past

several decades, about fifteen to eighteen percent of Gross Domestic Product is associated with real estate ownership and services.

Because they are so widely dispersed throughout our economy, real estate investments and homeownership are hardly a *special* interest: they are the *common* interest. We would therefore ask the Committee to focus on three main aspects of real estate ownership and investment today. These remarks will describe the role of real estate in the small business sector, make observations about how the tax reform goals of "fairness and simplicity" are reflected today in the real estate sector and assess the importance of real estate as a mechanism for savings for so many Americans.

The Role of Real Estate in the Small Business Sector: No matter how large or small the size and operations of a firm, most business activities take place in offices, retail space, warehouses, industrial parks and similar developed real estate settings. Thus, business owners have every interest in assuring that their place of business is maintained and operated in a manner that supports their goals and objectives and that projects the image that the business owner wishes to convey to the public.

All small business owners, no matter what their line of business, have a stake in maintaining a vibrant real estate economy. A vibrant real estate economy assures that business properties are maintained properly, that rent levels are both fair and competitive and that necessary improvements and upgrades are made on a timely basis. Moreover, in each community, a vibrant real estate market assures that locations and facilities remain attractive, well-maintained and desirable places to do business. In addition, many small businesses support real estate operations, including local printers, local newspapers, paint stores, home furnishing stores and similar endeavors.

Real estate businesses themselves are generally small businesses. NAR's survey of Realtor firms indicates that, notwithstanding increased consolidation, about half of all real estate brokerage firms are independent, non-franchised companies. More than 90% of all residential real estate brokerage firms have only one office. Among that group, more than 90% have fewer

than 10 sales associates. Thus, real estate brokerage remains a decentralized, local business. As firms, therefore, Realtor interests would be the same as any other small businesses – and those interests include having top notch office space with good locations.

A Simple and Fair Tax System: Tax Reform Goals and Real Estate: The Internal Revenue Code is remarkably complex – but not when it comes to homeownership. A homeowner with a mortgage receives a form (IRS 1098) from the lender that specifies, to the penny, the amount of interest (and usually the amount of taxes) paid. The individual transfers the number(s) to the appropriate line(s) on the tax return. That's it. No complexity, no schedules, no worksheets, no special knowledge and no appraisals required. Real estate ownership does not contribute to the tax system's complexity.

If one were designing a tax system from scratch, that system would almost certainly look very different from what we have today. Taken as a whole, the current system is overloaded with complexity and with inconsistent and sometimes odd provisions. Nonetheless, sweeping tax-law changes create both winners (who end up paying less tax) and losers (who end up paying more). If the Reform Panel's real estate recommendations were to be adopted, residential, commercial and investment real estate would all be big losers. Because the current tax rules affecting real estate are not complex, we see no apparent justification for revising them.

The goal of "fairness" in a tax reform debate is to assure that similarly-situated taxpayers are treated "the same." Some critics point out that only about one-third of taxpayers itemize their deductions. Accordingly, they reason, the rules are not "fair," as not all homeowners (and few renters) receive the tax benefits associated with itemizing deductions. While only about one-third of taxpayers itemize deductions in any particular year, the critics' arguments about "fairness" ignore the reality that, *over time*, far more than one-third of taxpayers receive the benefits of itemizing. Mortgages get paid off, other new homeowners enter the market and family tax circumstances change.

Arguably, the standard deduction gives non-itemizing taxpayers a "better" answer than utilizing the mortgage interest deduction, so it is not clear that non-itemizers have been put at a

disadvantage. As a general rule, individuals itemize their deductions when the total of allowable deductions exceeds the standard deduction. Taxpayers who utilize the standard deduction thus receive a greater reduction of their taxes than they would if they itemized because the total of their allowable deductions is *less* than the standard deduction. Notably, every year the IRS reports that some taxpayers who would be eligible to itemize choose rather to use the standard deduction. This underscores the utility of the standard deduction as an important simplification component of the tax system.

IRS Statistics of Income data show that the taxpayers across all income categories use the mortgage interest deduction (MID). In 2002, more than one million of the 36 million itemized tax returns with a mortgage interest deduction reported an adjusted gross income of less than $20,000. A little more than 60 percent of the families who claim the mortgage interest deduction have household incomes between $60,000 and $200,000. While it is true that in any particular year only about one-third of taxpayers itemize, it is notable that of the taxpayers who *do* itemize deductions, more than 60% utilize the MID. Their deductions account for about 80% of all mortgage interest paid.

Savings and Wealth: Homeownership and the Tax System: Critics claim that the mortgage interest deduction (MID) operates as an inducement for people to buy homes. Realtors can confirm that people don't buy homes *because* of the MID. They buy homes to satisfy many social, family and personal goals. The MID *does*, however, *facilitate* homeownership because it reduces the carrying costs of ownership. Homeownership is the cornerstone of a healthy community, the basis for positive community involvement and a family's first step on the ladder to wealth.

Despite dramatic growth in homeownership over the past 5 years, a gap persists between the homeownership rates of Caucasian Americans as compared with African Americans, Hispanics and other minority groups. We believe that any elimination or reduction of the mortgage interest deduction would exacerbate this ownership gap. In recent years, minority groups have comprised the largest share of first-time homebuyers. This is a trend that should continue. Changes to the MID could erode our progress.

Some economists believe that if less money were invested in real estate and owner-occupied housing, more money would be invested in "productive" assets such as stocks and equipment. In fact, the Panel has articulated this perspective. *We are aware of no evidence showing that owning these financial assets can provide the foundation for community life, lead to the development of quality public schools, foster lower crime rates or contribute to the tax base of the local government.*

The purchase of a home symbolizes an investment in the future and a commitment to a community in ways that no other asset can. Note, too, that so-called "productive" business and investment activities associated with stocks and equipment take place in some sort of developed real estate space. Clearly real estate is fundamental to a "productive" economy.

Moreover, it is not a foregone conclusion that individuals who purchase residences for their families would necessarily have the requisite skills to choose and purchase stocks or other securities. Similarly, no family is likely to acquire manufacturing equipment as a means to improve their community or schools. At least one Panelist stated that if families bought smaller houses they might buy more stock. *We do not believe it is the function of the tax system to determine the size of a house for any family or its method of saving.*

We do know that some portion of a real estate asset's value is based on its favorable tax treatment. No one knows just how to quantify how tax rules affect property values, but it is beyond dispute that when tax benefits are taken away from existing properties, those properties lose value. In 1986, the Tax Reform Act took away numerous benefits associated with ownership of investment real estate. This loss of tax benefits was, in effect, applied retroactively, because it applied not only to new acquisitions, but also to existing properties.

Between 1987 and 1993, the value of the national portfolio of investment real estate fell by 30%. Certainly other non-tax factors contributed to the slide in values, but there is no dispute that the loss of tax benefits for existing property caused the lion's share of the decline. Thus, no matter how generous any transition rule might be, reducing tax benefits for existing property also

reduces property values and thereby reduces the value of the equity and savings associated with ownership.

NAR preliminary estimates suggest that if the Panel's mortgage-related proposals were enacted, the value of existing homes would decline by at least 15%, and even more in high-cost areas and second home markets. The loss of deductions increases carrying costs for both residential and commercial property. When carrying costs increase, value either decreases or the pace of growth in value slows. The report of the President's Tax Reform Advisory Panel acknowledges this reality and provides a 5-year transition rule to phase out the mortgage interest deduction for mortgages that are in effect when (if ever) a diminished mortgage interest provision might be enacted. The experience of 1986, however, demonstrates that *no matter how "generous" a transition rule might be, all existing properties will lose value.*

The housing market, while large, is a fragile, delicate instrument. For more than five years, housing has been the most lively and vibrant sector in the economy and fueled much of the 2001 – 2002 economic recovery. Observers will likely find it ironic that, in today's era of low savings, a change to the tax laws could sharply erode the equity savings of homeowners. *We can identify no justification for diminishing the savings families have in their homes.*

Conclusion: When former Treasury Secretary James A. Baker III testified before the President's Advisory Panel on Tax Reform in 2005, he made formal comments and also responded to questions about "political realities." In that context, he made this observation about tax reform and the mortgage interest deduction: "[I]f you're going to reform the current income tax code, you will not get there if you think that you're going to be able to eliminate that deduction." (See transcript of hearings held on March 3, 2005, at page 43, posted at www.taxreformpanel.gov.)

We couldn't agree more. Secretary Baker served President Reagan at Treasury during the arduous deliberations over what became, after nearly two years of debate, the Tax Reform Act of 1986. His observations about tax reform and mortgage interest are based on experience. We underscore them for you.

We have been hard-pressed to make any connections between the President's directive that the Advisory Panel "recognize[e] the importance of homeownership … in American society" and the recommendations the Panel made relative to homeownership. The Panel recommends that the mortgage interest deduction be changed to a tax credit, that it not apply to second homes and that the deduction be tied to a cap that, for some, would cut allowable deductions by more than two-thirds. With these proposals, the Panel strikes a blow *against* homeownership – as well as America's families and communities.

Embargoed until 3pm
February 1, 2006

Statement of Leonard E. Burman[1]

Senior Fellow, the Urban Institute
Codirector, the Tax Policy Center
Visiting Professor, Georgetown Public Policy Institute
www.taxpolicycenter.org

Before the Subcommittees on
Tax, Finance, and Exports,
and
Rural Enterprises, Agriculture, and Technology
House Committee on Small Business

Transforming the Tax Code: An Examination of the President's Tax Reform Panel Recommendations

February 1, 2006

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.

[1] 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).[2] 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.[3] 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

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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.

[3] William G. Gale, "The National Retail Sales Tax: What Would the Rate Have to Be?" *Tax Notes*, May 16, 2005, pp. 889–911.

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.

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[4] See Martin A. Sullivan, "The Rise and Fall of the National Sales Tax," *Tax Notes*, November 15, 2004, pp. 916–21; and Gale, "The National Retail Sales Tax."

[5] The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth* (Washington, DC: U.S. Government Printing Office, 2005), p. 208.

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.

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]

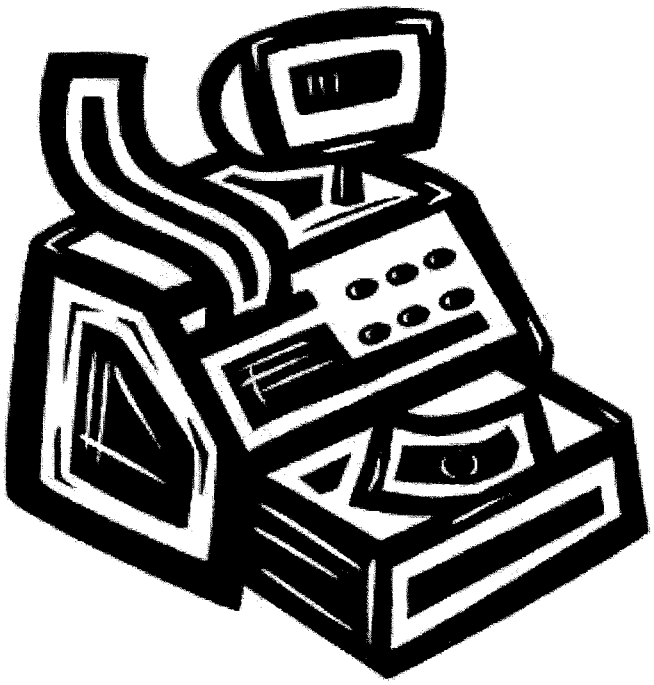
Thank you. I would be happy to answer any questions.

[6] 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).

[7] Leonard E. Burman and William G. Gale, "A Preliminary Evaluation of the Tax Reform Panel's Report," *Tax Notes*, December 5, 2005, pp. 1349–68.

Chapter Nine

National Retail Sales Tax



The Panel considered a number of proposals to reform the income tax, including replacing the entire income tax system with a broad-based national retail sales tax. A retail sales tax is perhaps the most obvious form of consumption tax because it is imposed on the final sales of goods and services to consumers. Like other consumption taxes, the retail sales tax does not tax normal returns to saving and investment and thus may lead to greater economic growth than our current tax system.

After careful evaluation, the Panel decided to reject a complete replacement of the federal income tax system with a retail sales tax for a number of reasons. Two considerations were particularly important to the Panel's decision:

- Replacing the income tax with a retail sales tax, absent a way to ease the burden of the retail sales tax on lower and middle-income Americans, would not meet the requirement in the Executive Order that the Panel's options be appropriately progressive.

- Although a program could be designed to reduce the burden of a retail sales tax on lower-income and middle-income taxpayers by providing cash grants, such cash grants would represent a new entitlement program – by far the largest in American history. Adjusting the distribution of the burden of the retail sales tax through a cash grant program would cost approximately $600 billion to $780 billion per year and make most American families dependent on monthly checks from the federal government for a substantial portion of their incomes. The Panel concluded that such a cash grant program would inappropriately increase the size and scope of government.

The Panel also had additional concerns with replacing the current tax system with a retail sales tax:

- Even with favorable assumptions, a retail sales tax on a broad base with a cash grant program would require a tax rate of at least 34 percent, and likely higher over time if the base erodes, creating incentives for significant tax evasion. A discussion of the range of potential estimates of the tax rate is provided later in this chapter.
- The federal administrative burden for a retail sales tax may be similar to the burden under the current system. A federal agency, such as the IRS, would be required to administer the tax in order to ensure adequate collection of federal revenues and uniform enforcement of the rules and regulations underlying the tax. Indeed, two types of administrations would be required – one to collect the tax and another to keep track of the personal information that would be necessary to determine the size of the taxpayer's cash grant.
- Taxpayers likely would continue to file state income tax returns, which would limit the potential simplification gains from replacing the federal income tax system with a retail sales tax.

Box 9.1. Comparing "Tax-Exclusive" and "Tax-Inclusive" Rates

The 34 percent tax rate mentioned in the introduction to this chapter is a tax-exclusive rate. Sales tax rates are typically quoted on a tax-exclusive basis, while income tax rates typically are quoted on a tax-inclusive basis. If a good costs $100 and bears an additional $34 sales tax, the tax-exclusive sales tax rate is 34 percent. The tax-inclusive rate is 25 percent – $34 (the tax paid) divided by $134 (the total amount the consumer paid). An individual who earns $134 and pays $34 in income taxes would think of themselves as paying approximately 25 percent ($34/$134 = 0.254) of their income in taxes.

Although tax-exclusive and tax-inclusive rates are both valid ways of thinking about tax rates, the easiest way to compare the retail sales tax rate to the state sales taxes paid by most Americans is to consider the tax-exclusive rate. On the other hand, it is appropriate to compare the retail sales tax rate with current income tax rates by utilizing the tax-inclusive rate. For ease of understanding, this chapter uses tax-exclusive rates unless otherwise specified in the text. Tax-inclusive rates are provided in the Appendix.

As explained in Chapter Three, the retail sales tax and the VAT represent similar ways to tax consumption of goods and services. A VAT and a retail sales tax that share the same tax base, tax rate, and compliance rates would generate the same amount of tax revenue. The Panel, therefore, analyzed a full replacement VAT at the same time it considered a full replacement retail sales tax. Although the Panel concluded that the full replacement VAT might mitigate some of the compliance challenges encountered with a retail sales tax, the Panel's primary objections to a retail sales tax applied equally to a full replacement VAT. As a result, the Panel does not recommend the full replacement VAT as a tax reform option.

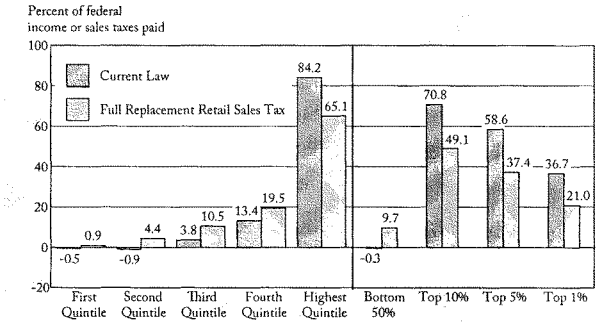
Retail Sales Tax with No Cash Grant

Forty-five states and the District of Columbia currently have retail sales taxes. Many states use multiple sales tax rates and exempt many goods and services from tax. The Panel, however, considered a single-rate tax that would be imposed on a broad tax base because such a tax would be simpler to administer and create fewer economic distortions. The Panel's broad tax base would apply to sales of goods and services to consumers, but, to prevent multiple taxation or "cascading," it would not apply to purchases of goods or services by business that are used to produce other goods or services for sale to households.

The Panel initially evaluated the federal retail sales tax using the broad tax base described by advocates of the "FairTax" retail sales tax proposal. That tax base (the "Extended Base") would exempt only educational services, expenditures abroad by U.S. residents, food produced and consumed on farms, and existing housing (or what economists refer to as the imputed rent on owner-occupied and farm housing). The long-term likelihood of maintaining this broad tax base is addressed later in this chapter.

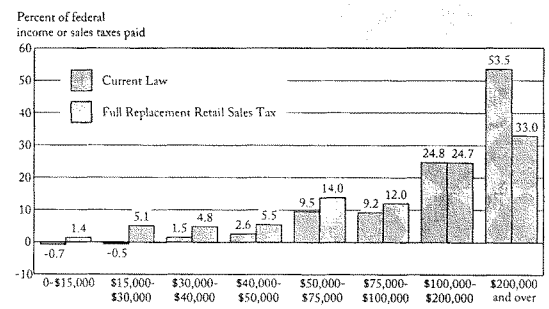
Using the Extended Base and assuming low rates of evasion, the Treasury Department calculated that the tax rate required to replace the federal income tax with a retail sales tax would be 22 percent on a tax-exclusive basis. This tax rate, however, does not include a program designed to ease the burden of the tax on lower-income Americans. Moreover, unless the states repealed their existing sales taxes, most consumers would pay both federal and state sales tax on many goods. The weighted average state and local sales tax rate is approximately 6.5 percent on a tax-exclusive basis. Thus, for sales subject to both federal retail sales tax and state and local sales taxes, the weighted average combined tax-exclusive sales tax rate would be approximately 28.5 percent.

Figure 9.1. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.2. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.1 and 9.2 compare the current distribution of federal taxes paid with the distribution that would exist under a "stand-alone" retail sales tax at a 22 percent tax rate. Adopting this retail sales tax would impose a larger tax burden on lower-income households than the current system because a retail sales tax is imposed directly on

consumption and does not provide deductions, exemptions, or credits to reduce the tax burden on lower-income Americans. Replacing the current income tax with a stand-alone retail sales tax would increase the tax burden on the lower 80 percent of American families, as ranked by cash income, by approximately $250 billion per year. Such families would pay 34.9 percent of all federal retail sales taxes, more than double the 15.8 percent of federal income taxes they pay today. The top 20 percent of American taxpayers would see their tax burden fall by approximately $250 billion per year. Such families would pay 65.1 percent of all federal retail sales taxes, compared to the 84.2 percent of federal income taxes they pay today.

Lower- and middle-income families would be especially hard hit by a stand alone retail sales tax. For example, the Treasury Department estimates that a hypothetical single mother with one child making $20,000 per year currently pays $723 in total federal taxes (including both the employee and employer shares of the Social Security and Medicare taxes). Under the stand-alone retail sales tax, her tax bill would go up to $6,186 – a tax increase of over 750 percent. A hypothetical married couple with two children making $40,000 per year would pay an additional $6,553 in taxes, an increase of more than 110 percent of total federal tax liability. In contrast, a hypothetical married couple with two children and $300,000 of income currently pays about $89,000 in total federal taxes. Under the stand-alone retail sales tax, this hypothetical family would pay about $72,000, a tax cut of 19 percent. Further discussion of the Treasury Department's hypothetical taxpayer analysis appears in the Appendix.

The Panel concluded that the distribution of the tax burden under a stand-alone retail sales tax would not meet the requirement in the Executive Order that the Panel's tax reform options be appropriately progressive.

Retail Sales Tax with a Cash Grant Program

Universal Cash Grant Program

Retail sales tax proposals generally recognize the distributional effects of a stand-alone retail sales tax. For this reason, such proposals usually include a cash grant program to relieve the burden of the retail sales tax on lower and middle-income families.

The Panel considered the cash grant program advocated by proponents of the FairTax. This program (sometimes called a "Prebate") would provide a monthly monetary grant to all U.S. citizens and residents. The goal of the program would be to provide families with cash sufficient to pay retail sales tax on all their spending up to the poverty level. The program would not be income based so there would be no need to have a federal agency to keep track of personal income. Nevertheless, it would require a federal agency to keep track of family characteristics, such as family size, on which the cash grant would be based.

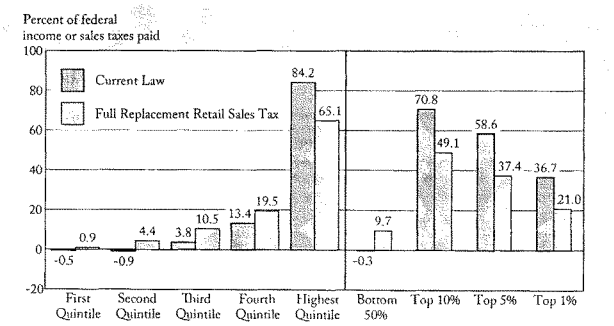
This cash grant program would be expensive, and would require raising the retail sales tax rate. To pay for the cash grant program and remain revenue-neutral, the required

tax rate, assuming evasion rates somewhat lower than those under the income tax, would be 34 percent. Using a higher evasion rate assumption, discussed further below, the tax rate would be 49 percent. If a narrower tax base were used instead of the Extended Base, the tax rate would be even higher.

How would the cash grant program work? The federal government would be required to send monthly checks to every family in America, regardless of their income level. If the tax rate was 34 percent and the before-tax poverty level for an individual was $10,000, all single individuals would receive $3,400 a year from the government. The cash grant would also be adjusted for marital status and family size. For married couples with two children, the cash grant amount in 2006 would be $6,694 per year.

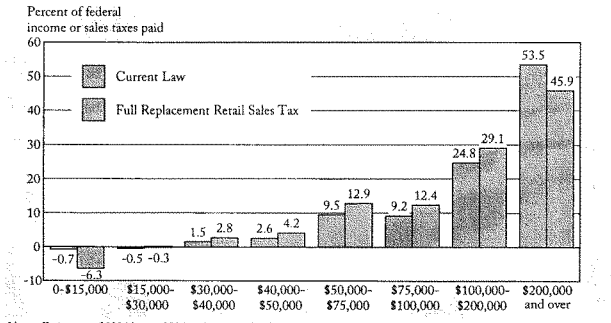
The Prebate-type program would cost approximately $600 billion in 2006 alone. This amount is equivalent to 23 percent of projected total federal government spending and 42 percent of projected total federal entitlement program spending, exceeding the size of Social Security, Medicare, and Medicaid. The Prebate program would cost more than all budgeted spending in 2006 on the Departments of Agriculture, Commerce, Defense, Education, Energy, Homeland Security, Housing and Urban Development, and Interior combined.

Figure 9.3. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461 Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.4. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.3 and 9.4 show that low-income and high-income Americans would benefit from the retail sales tax with a Prebate, while middle-income Americans would pay a larger share of the federal tax burden. Separate figures with distributional estimates for 2015 law are not provided because the distribution of the retail sales tax burden in these estimates was identical to the distribution shown in Figures 9.3 and 9.4. American families with the lowest 20 percent of cash incomes currently pay negative 0.5 percent of total federal income taxes because the tax credits they claim exceed their total positive tax liability. Under the retail sales tax with a Prebate, this group would pay negative 5.6 percent of the federal sales tax burden because the amount they would receive in monthly checks from the government would exceed what they would pay in retail sales tax at the cash register. In total, the bottom quintile would bear 5.1 percentage points less of the tax burden. Families with the top 10 percent of cash incomes would also benefit substantially from the retail sales tax. Their share of the tax burden would fall by 5.3 percentage points – from 70.8 percent to 65.5 percent.

Middle-income Americans, however, would bear more of the federal tax burden under the retail sales tax with a Prebate. The Treasury Department's analysis of hypothetical taxpayers shows that married couples at the bottom 25th percentile, 50th percentile, and 75th percentile of the income distribution for married taxpayers would see substantial tax increases under a full replacement retail sales tax. A typical married couple at the bottom 25th percentile of the income distribution earns $39,300 per year and would pay $5,625 dollars in federal taxes in 2006. Under the retail sales tax with a Prebate, the same family would pay $7,997 in net federal taxes after subtracting the Prebate of $6,694, resulting in a tax increase of $2,372, or 42 percent. A typical married couple at the 50th percentile of the income distribution making $66,200

would pay an additional $4,791, a tax increase of 36 percent, and a typical married couple in the 75th percentile, making $99,600 would pay an additional $6,789, a 29 percent tax increase. A typical single mother at the bottom 25th percentile of the income distribution for head of household taxpayers has $23,100 of income per year and, compared to current law, would pay $5,866 more under the retail sales tax with a Prebate.

Targeted Cash Grant Program

The Panel requested that the Treasury Department develop a more targeted cash subsidy program to alleviate the burden of a retail sales tax on lower- and middle-income American families. The resulting program required a cash grant of up to $7,068 to married couples, plus $2,570 per dependent per year, with a phase-in and a phase-out. Further details regarding the program are provided in the Appendix, as well as a brief discussion of an alternative targeted subsidy program.

The Treasury Department's proposed targeted cash grant program would cost $780 billion in 2006. It would represent 30 percent of total federal government spending, and would dwarf all other federal entitlement programs and exceed the combined size of Social Security and Medicaid. To implement the program, the government would need to collect 34 percent more revenue and redistribute an additional 6 percent of GDP. The Panel concluded that this substantial increase in the amount of revenue collected from taxpayers and redistributed by the federal government was undesirable. Some Panelists were also concerned that the precedent set by the large cash grant program could set the stage for further growth in the size and scope of the federal government. To pay for the targeted cash grant program and remain otherwise revenue-neutral, the tax rate would need to increase to at least 37 percent, assuming low evasion and using the Extended Base.

Administration of a Cash Grant Program Would be Complex

The proposed cash grant programs would require all eligible American families to file paperwork with the IRS or another federal government agency in order to claim their benefits under this new entitlement program. A federal agency would need to manage the program, verify individuals' marital status and number of eligible children, and write checks to every family in the United States. Eligibility rules would be necessary, for example, to ensure that a child claimed as a dependent could not also file for his or her own separate cash grant.

Substantial additional complexity would be imposed by a targeted cash grant program because determining eligibility would require additional information. For example, a program based on annual income would require the IRS or another federal government agency to make many of the same determinations now made under the current income tax.

Evasion, the Tax Base, and the Required Tax Rate Revisited

The tax rate necessary to replace the revenues from the current individual and corporate income taxes is one key consideration in evaluating a retail sales tax. The two major factors that determine the tax rate are the size of the tax base and the level of evasion. The tax rates and rebate program cost estimates presented thus far have been based on relatively optimistic assumptions about the breadth of the tax base and the evasion rate. As explained above, even under these optimistic assumptions, the Panel does not recommend a full replacement sales tax at the resulting 34 percent tax rate.

The Panel also had substantial concerns that a base as broad as assumed above would not be viable and that evasion rates could be higher than under the present income tax. The Panel believed that in evaluating the retail sales tax it was important to consider the tax rate required under less favorable assumptions regarding the tax base and evasion. Accordingly, the Panel requested that the Treasury Department estimate the required retail sales tax rate using the same tax base as the Partial Replacement VAT described in Chapter Eight and using a base equal to the average state sales tax base.

The Partial Replacement VAT base described in Chapter Eight is slightly narrower than the Extended Base – primarily because it excludes the value of state and local government services. The Extended Base would require state and local governments not only to pay retail sales tax on their purchases from businesses, but also to pay tax at the retail sales tax rate to the federal government on the total value of the salaries that state and local governments pay their employees – this would be equivalent to the value of services provided by state and local governments to their citizens. The Panel concluded that it may be inappropriate for the federal government to directly assess a tax of this sort on state and local government in our federal system. For this reason, the Panel excluded state and local government services from the Partial Replacement VAT base discussed in Chapter Eight.

Existing state sales tax bases are substantially narrower than either of the broad bases studied by the Panel. Most states exempt a variety of specific products and many services from their sales taxes. For example, every state sales tax exempts prescription drugs, most states do not tax health care, approximately 30 states exempt food for home consumption or tax it at a preferential rate, and many states exempt clothing. These exemptions are often justified as a means to ease the burden of a sales tax on basic necessities, but are not well targeted because they often decrease the tax burden on higher-income taxpayers as much or more than they decrease the tax burden on lower or middle-income taxpayers. To illustrate the impact of extensive base erosion on a retail sales tax, the Panel requested that the Treasury Department estimate the tax rate using the average state sales tax base. The Panel acknowledges there are structural differences between state tax systems and a federal tax system that would rely on a retail sales tax instead of an individual and corporate income tax, and that these differences would affect the nature of any base erosion. Nevertheless, the Panel believes that estimating the tax rate using a base equal to the average state sales tax base is illustrative of the impact of base erosion on the tax rate.

Table 9.1. shows the Treasury Department's estimates of the tax-exclusive retail sales tax rates required to replace the federal income tax using the alternative assumptions regarding evasion rates and the breadth of the tax base. The Extended Base and Partial Replacement VAT Base estimates include the Prebate-type universal cash grant program (calculated to provide all families with cash sufficient to pay a 34 percent retail sales tax on a poverty level amount of spending). The average state sales tax base estimate includes no cash grant program, because exclusions from the base are assumed to fulfill the burden-easing function of the cash grant. These tax rates should be compared both to each other and to the overall burden an individual faces under both the corporate and individual income tax today. Tax-inclusive rates are provided in the Appendix.

Table 9.1. Retail Sales Tax Rate Estimates – Range of Tax-Exclusive Rates

Evasion Rate	Extended Base	Partial Replacement VAT Base	Median State Sales Tax Base
Low Evasion (15%)	34%	38%	64 %
Higher Evasion (30%)	49%	59%	89%

Source: Department of the Treasury, Office of Tax Analysis.

Box 9.2. Comparing the Treasury Department's Revenue-Neutral Rate Estimate with Estimates Made by Retail Sales Tax Proponents

In their submission to the Panel, proponents of the FairTax claimed that a 30 percent tax exclusive sales tax rate would be sufficient not only to replace the federal income tax, but also to replace all payroll taxes and estate and gift taxes and fund a universal cash grant. In contrast, the Treasury Department concluded that using the retail sales tax to replace only the income tax and provide a cash grant would require at least a 34 percent tax-exclusive rate.

Some may wonder why the tax rate estimated by FairTax advocates for replacing almost all federal taxes (representing 93 percent of projected federal receipts for fiscal year 2006, or $2.0 trillion) is so much lower than the retail sales tax rate estimated by the Treasury Department for replacing the income tax alone (representing 54 percent of projected federal receipts for fiscal year 2006, or $1.2 trillion).

First, it appears that FairTax proponents include federal government spending in the tax base when computing revenues, and assume that the price consumers pay would rise by the full amount of the tax when calculating the amount of revenue the government would obtain from a retail sales tax. However, they neglect to take this assumption into account in computing the amount of revenue required to maintain the government's current level of spending. For example, if a retail sales tax imposed a 30 percent tax on a good required for national defense (for example, transport vehicles) either (1) the government would be required to pay that tax, thereby increasing the cost of maintaining current levels of national defense under the retail sales tax, or (2) if the government was exempt from retail sales tax, the estimate for the amount of revenue raised by the retail sales tax could not include tax on the government's purchases. Failure to properly account for this effect is the most significant factor contributing to the FairTax proponents' relatively low revenue-neutral tax rate.

Second, FairTax proponents' rate estimates also appear to assume that there would be absolutely no tax evasion in a retail sales tax. The Panel found the assumption that all taxpayers would be fully compliant with a full replacement retail sales tax to be unreasonable. The Panel instead made assumptions about evasion that it believes to be conservative and analyzed the tax rate using these evasion assumptions.

Evasion

Tax evasion occurs when taxpayers do not pay taxes that are legally due. Analysts agree that some evasion is inevitable in any tax, and that evasion rates for any tax tend to rise as the tax rate rises. At the request of the Panel, the Treasury Department estimated the revenue neutral retail sales tax rate assuming evasion rates of 15 and 30 percent of personal consumption spending. The Treasury Department assumed no evasion by state and local governments. By comparison, for 2001 the IRS estimates that the evasion rate for the individual income tax was between 18 and 20 percent and the evasion rate of the entire U.S. tax system was about 15 percent.

The retail sales tax would rely on retail businesses to collect all federal tax revenue and eliminate federal individual income tax filing. Therefore, the number of federal tax return filers would fall significantly under the retail sales tax. Further, the complexity of filing a business tax return would decline dramatically as compared to corporate income tax returns. Retail sales tax returns would indicate only total sales, exempt

sales (sales to businesses with exemption certificates plus export sales) and tax liability. From an enforcement perspective, both the reduced number of tax return filings and the simple nature of the retail sales tax return represent substantial advantages.

Nevertheless, the Panel concluded that a number of features of the retail sales tax would make it difficult to administer and enforce at the high tax rate necessary to be revenue-neutral. A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide a substantial inducement for evasion at the retail level. Retailers and shoppers could use a number of techniques to evade a retail sales tax. For example, unregistered cash sales to a consumer would allow a transaction to escape taxation. Retailers facing a high retail sales tax might also misapply exemption criteria, whether intentionally or unintentionally, and fail to tax goods that should be taxed. Or, the retailer might collect the tax from customers, but keep the money rather than remit it to the government. At high tax rates, the gain to retailers from evasion is high.

Empirical evidence suggests third-party reporting substantially improves tax compliance, particularly when tax rates are high. For the portion of income from which taxes are not withheld and there is no third-party reporting, income tax evasion rates are estimated to be around 50 percent. There is no third-party reporting in a retail sales tax. Retailers would add their retail sales tax to the pre-tax price for their goods and would remit that amount to the government, but shoppers would not separately report what they bought, and at what price, to the government. The government would rely on retailers alone to report their own taxable and exempt sales.

To obtain exemption from tax, retail purchasers might try to fabricate exemption certificates or otherwise masquerade as tax-free buyers of retail products. For example, individuals might create "paper" businesses solely to obtain business exemption certificates and avoid taxes on purchases for personal use. A related problem involves individuals with legitimate businesses using their business exemptions for personal purchases or for goods or services to give to employees in lieu of cash compensation. Using their business purchase exemption would provide a discount equal to the retail sales tax rate.

With a retail sales tax, retailers would have the responsibility to determine whether the ultimate use of a good or service would be for a business purpose, and therefore would be deserving of the business purchase exemption. Retailers are often ill-equipped to carry out this role. State experience suggests that abuse of exemptions is common, in part because distinguishing between business and individual consumer purchases of so-called "dual use" goods and services – goods and services that are commonly purchased by both businesses and final consumers, such as a plane ticket – can be difficult and costly.

Box 9.3. Dual-Use Goods and the Problem of "Cascading"

The difficulty of identifying whether dual-use goods are used for business or individual purposes is one reason that states typically include a significant number of business-to-business transactions in their sales tax base. For example, states often do not ask retailers to determine whether a buyer will use a computer for entertainment at home (taxable) or to run a business (exempt). Instead, many states treat sales of computers as taxable unless the buyer certifies that they are purchasing the computer for resale. Thus, many businesses pay sales tax when purchasing computers. That tax then "cascades" into the cost of the goods and services the purchasing business sells to consumers. Taxing goods and services bought by businesses to produce other goods and services is economically inefficient because it haphazardly imposes double (or triple or quadruple) taxation on some consumer goods and services.

Cascading taxes create incentives for business to produce fewer goods or services, shift resources into tax-favored activities, or adopt tax-driven business structures. Cascading taxes also may have a negative impact on U.S. competitiveness because they impose some tax liability on exports and result in less tax being assessed on imports relative to competing domestically-produced goods.

Comparison with State Sales Tax Evasion and Administration

Retail sales tax advocates often note that evasion rates with sales taxes are lower than evasion rates with the income tax. However, state sales tax evasion rates are not likely to be representative of the evasion rate of a full replacement retail sales tax for several reasons.

First, state sales tax rates are a fraction of the tax rates required to replace the federal income tax. Among states that impose sales taxes, tax rates range from 3.5 percent in Virginia to 7.0 percent in Mississippi, Rhode Island, and Tennessee. When combined with local sales taxes, the highest sales taxes are found in Alabama (11.0 percent), Arkansas (10.625 percent), Oklahoma (10.5 percent) and Louisiana (10.5 percent).

Higher tax rates provide greater incentives for taxpayer evasion and avoidance. Those incentives also make administration and enforcement more expensive – and any failure to effectively administer the tax requires a higher tax rate to compensate for lost revenue. No state or country has ever levied a retail sales tax at a tax rate that even approaches the 34 percent required to replace the federal income tax system. State tax administrators told the Panel that they would expect significant compliance problems at such rates.

State sales taxes also do not broadly tax service providers, often because they are difficult to tax. For example, all U.S. state sales taxes exempt most financial services. Other dual-use services, such as utilities, transportation, and communication services are also difficult to tax properly and often are exempt from state sales taxes. It is reasonable to assume that trying to tax these services through a retail sales tax likely would result in more extensive evasion and higher compliance and administrative costs than existing state sales taxes. Although it is difficult to know with any measure of certainty what the evasion rate would be under the RST, the Panel believes that it would likely be at least as high as evasion under the current income tax and that a 30 percent rate of evasion would not be an unreasonable assumption.

Other Concerns

Response of the States to a Retail Sales Tax

Although some retail sales tax proposals claim the administration of the retail sales tax could be left to the states and the IRS could be eliminated, such a system would likely be unworkable. Existing state sales tax bases are both narrow and varied and it may be difficult to persuade the states to adopt the federal retail sales tax base.

The experience of Canada, which tried to federalize its provincial sales taxes, may be instructive. Canada considered adopting a unified federal and provincial sales tax base in 1987, but intergovernmental discussions failed to produce an agreement to standardize the existing provincial sales tax bases with the base for Canada's federal goods and services tax.

Variation in local sales tax rates within the United States could further complicate any effort to standardize U.S. sales tax bases and rates. As of 2001, Texas alone had 1,109 separate city tax rates, 119 county tax rates, and 67 other special tax jurisdictions. Texas is not atypical in having numerous local sales tax jurisdictions. While some states might bring their sales taxes into conformity with a federal retail sales tax, it is unlikely that all would do so. States have not adopted identical definitions, standards, and rules in their own income tax regimes as those that exist for the federal income tax, even though there would be many administrative and compliance advantages to such an approach.

Given the tremendous variance in the current taxation of retail sales across the United States, the IRS or another federal agency with substantial personnel and resources would almost certainly have to define, administer, and enforce a federal retail sales tax. For example, detailed rules would be necessary to ensure that exemption certificates were issued uniformly and only provided to legitimate businesses for use in purchasing actual business tools, materials, and other inputs. Further, the IRS or another federal agency would likely need to administer the retail sales tax directly in the five states that do not currently impose a sales tax. The same might be true in those states that do not bring their sales tax bases into conformity with the federal retail sales tax base. Finally, because failure to effectively enforce the sales tax would lower federal revenues, Congress might decide that the IRS should maintain a significant enforcement function as a backup mechanism to state tax administration efforts.

State Income Tax

At the Panel's public meetings, state and local tax officials suggested that a federal retail sales tax would encroach on a tax base that traditionally has been left exclusively to states and localities. Currently sales and gross receipts taxes account for about 37 percent of state general tax collections and about 17 percent of local revenues. However, if a federal retail sales tax were put in place at a rate of 34 percent or more, it could become unattractive for states to add their own rates on top of the federal retail sales tax.

If the federal government were to cease taxing income, states might choose to shift their revenue-raising to the income base from the sales base. State income taxes could rise, while state sales tax rates could fall. In any event, unless states found a substitute source of revenue, they likely would maintain their income taxes. For that reason, it is reasonable to expect that taxpayers would need to continue to keep track of income-related information and file income tax returns, regardless of whether the federal government eliminates the federal income tax. Furthermore, with an income-based cash grant program, tracking income at the federal level would remain a necessity.

Today, 45 states and the District of Columbia have state income taxes. Most states use federal adjusted gross income as the starting point in determining the state individual income tax base. Eliminating the federal income tax would remove the common basis upon which most state income taxes are now structured. State and local income tax returns would likely become much more complex if they could not be based on a pre-existing federal income tax return that includes a calculation of annual income. Greater disparities among state income tax systems and potential distortions would likely develop as state income tax structures diverge from each other over time in the absence of a common federal income tax base as a starting point.

State income tax compliance initiatives currently rely in large measure on information that the states receive from the third-party reporting structure created by the federal income tax – such as W-2 and 1099 forms as well as other standard tax forms that report income. In the absence of the federal third-party reporting system, states would need to impose information reporting requirements on individuals, employers, financial institutions, and others in order to maintain their income tax systems. States might bind together to coordinate enforcement of state income taxes and impose those reporting requirements. But if states chose to impose reporting requirements independently, multi-state businesses could face many different sets of reporting obligations. Simplification of the federal tax system through a retail sales tax might be achieved at the expense of greater overall complexity in the combined system of state and federal taxation.

Compliance Burden on Small Business

A retail sales tax also likely would place a disproportionate burden on small retail businesses. Few statistical studies exist on the compliance costs for retailers of different sizes. However, a well-regarded study conducted by the State of Washington Department of Revenue in 1998 suggests that, although such costs are low overall, they are disproportionately high for small retailers. In Washington, the cost of collecting sales tax for retailers with annual gross retail sales of between $150,000 and $400,000 was 6.5 percent of sales tax collected. By comparison, firms with annual gross retail sales greater than $1.5 million spent less than 1 percent of sales tax collected on compliance.

Small vendors, particularly those operating on a cash basis, account for a significant share of the noncompliance in many state sales taxes as well as our current income tax. A retail sales tax would cover all retailers, including small service providers,

such as dentists, car mechanics, or beauticians, as well as small retail stores. Small service providers would likely find retail sales tax compliance costly and would have noncompliance incentives that would be similar to those for small retail stores.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a retail sales tax. Although there may be some such disruptions, those considerations were secondary in the Panel's decision not to recommend a retail sales tax.

Full Replacement of the Income Tax with a VAT

The Panel considered replacing the income tax with a VAT at the same time it analyzed a replacement retail sales tax because of the similarities between the two taxes. The Panel concluded that fully replacing the income tax with a VAT would be substantially more administrable than fully replacing the income tax with a retail sales tax. The advantages of a VAT over a retail sales tax with respect to enforcement and compliance are described in Chapter Eight. However, the Panel's objections regarding the increased tax burden on the middle class and increased size of government resulting from the full replacement retail sales tax apply equally to a full replacement VAT. Because of these concerns, the Panel did not recommend a full replacement VAT.

Conclusion

Like other consumption taxes, the full replacement retail sales tax has pro-retail growth features. Nevertheless, the Panel does not recommend a full replacement retail sales tax. Without a large cash grant program to ease the burden of the tax, a retail sales tax would not be appropriately progressive. A cash grant program to make the tax appropriately progressive would cost at least $600 billion per year -- which would make it America's largest entitlement program. The Panel concluded that it was inappropriate to recommend a tax reform proposal that required the federal government to collect and redistribute this amount in additional revenue from taxpayers. The Panel also was concerned with administrative and compliance issues associated with a retail sales tax, as well as difficulties involving coordination with existing state sales taxes.