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## Replacing the Corporate Income Tax

The tension between meeting the demands of the growing federal deficit and minimizing the potential damage to businesses through corporate taxes requires a new workhorse for federal business taxation. We recommend going further than simply adding a new tax. The current corporate income tax, with its multiple loopholes and jagged profile, should be removed and replaced by a relatively flat business tax. We consider two replacement models: a national retail sales tax (NRST) and a corporate activity tax (CAT) modeled after the VAT.

### **Option 1: National Retail Sales Tax**

For many years, the proposal of an NRST to replace the entire income tax system has circulated among a small but devoted group of members of Congress. Senator Richard Lugar (R-IN) and Representative Bill Archer (R-TX) put forth the initial proposal in 1994. In 1998, Representative Billy Tauzin (R-LA) published a book that contained the proposal introduced by himself and Representative Dan Schaefer (R-CO). The current manifestation of the NRST, backed by Americans for Fair Taxation (AFT), is the Fair Tax Act of 2005 (HR 25), sponsored by Representative John Linder (R-GA) with 37 co-sponsors. The Fair Tax Act would abolish all federal income taxes, including individual, corporate, and payroll taxes, and replace them with the NRST. House Speaker Dennis Hastert (R-IL) favors this approach.

The Fair Tax Act proposes a tax-inclusive rate of 23 percent, equivalent to a sales tax of 30 percent on the tax-exclusive price of goods sold.<sup>1</sup> However, few outside observers take this rate estimate seriously.<sup>2</sup> Jorgenson and Yun (2005) note that “it is well known that the ST [Schaefer-Tauzin] and AFT [the Fair Tax Act] proposals fail to achieve revenue neutrality and tax rates must be increased substantially above the levels proposed by the authors.”<sup>3</sup>

A more modest proposal, but still a dramatic break with US tax history, is to use the NRST to replace only the corporate income tax. This switch is the focus of our analysis. In table 5.1, we adapt Gale’s methodology (1999) to calculate the rate required of an NRST first to replace the federal corporate income tax, which collected 2.1 percent of GDP in 2000, and then to raise the additional 1.9 percent of GDP that we estimate will be needed over a period of several decades.<sup>4</sup> Then, we calculate the NRST rate that would raise sufficient revenue to address the regressivity problem for households at the lowest income level. Each estimate begins with total personal consumption expenditure as the base, and then makes several adjustments.

Gale and other scholars assume that the effect of the NRST on currently untaxed government transfers to individuals—mainly Social Security—will be neutralized by household grants or other means (Gale 1999, Gale et al. 1998, Graetz 2002a). They argue that political realities will require maintaining the real value of transfers to households. This argument might be convincing if all federal income taxes were replaced by an NRST. It has less force since we are replacing only the corporate income tax, which accounted for only 11 percent of federal income taxes, including payroll taxes, in 2000 (OECD 2003). Our calculations do not contain a markup to maintain the real value of government transfers.

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1. Sales tax rates are generally assessed exclusive of the tax. A tax that collects 23 percent of gross receipts must collect a 30 percent tax on top of the untaxed price, calculated as  $0.23/(1-0.23) = 0.30$ .

2. In analyzing this proposal William G. Gale (2004) calculates that the revenue-neutral rate required to replace all federal income taxes would be 38 percent tax-inclusive, or 60 percent on a tax-exclusive basis. Gale calculates such a high sales tax rate because in his view, the sales tax base would inevitably be eroded by evasion and the exemption of many services. Dale Jorgenson and Kun-Young Yun (2001, table 8.4) perform several simulations in which the sales tax rate is altered to achieve steady-state revenue neutrality. To completely eliminate income and payroll taxes, they calculate that a flat NRST of about 29 percent (a tax-exclusive sales tax rate of 41 percent) would be required, assuming no tax base erosion.

3. Dale Jorgenson is cited on the Web site of Americans for Fair Taxation ([www.fairtax.org](http://www.fairtax.org)) and in Tauzin (1998) in support of their proposals.

4. Based on our earlier analysis of the federal spending trajectory and our model of tax shares. In 2000, all federal business taxes (including excise taxes and tariffs) amounted to 3.1 percent of GDP.

**Table 5.1 Possible NRST rates for replacing the corporate income tax, 2000**

Calculation	Base (billions of dollars)	Revenue (billions of dollars)	Tax- inclusive rate (percent)	Tax- exclusive rate (percent)
<b>Personal consumption expenditure (PCE) base</b>	6,739	208	3.1	3.2
Subtract 20 percent of PCE for legislated erosion	(1,348) 5,391	208	3.9	4.0
Subtract 5 percent of PCE for avoidance/evasion erosion	(337) 5,054	208	4.1	4.3
Add revenue to rebate consumption to poverty level	5,054	79 287	5.7	6.0
Or				
Raise revenue 1.9 percent of GDP (over several decades)	5,054	187 395	7.8	8.5
And add revenue to rebate consumption to poverty level <sup>a</sup>	5,054	152 547	10.8	12.1

NRST = national retail sales tax

Note: Removes all household spending below the poverty line from the NRST tax base, effectively reducing the tax base by \$1,390 billion. As revenue rises, the cost of this provision will rise in dollar terms.

Sources: BEA (2004a, table 2.1) and authors' calculations.

Next, we consider the likely erosion of the tax base. Erosion comes from two main sources. One is the legislated exclusion of "merit goods," such as housing rents,<sup>5</sup> food, pharmaceuticals, medical care, education, and several other services, from the tax base. In its evaluation of the likely tax base for a potential NRST or VAT, the CBO (1997, table 8) chose to exclude 20 percent of personal consumption expenditure for a "broad" base calculation and 40 percent for a "narrow" one.<sup>6</sup> Optimistically, we adopt the 20 percent figure for legislated erosion.

5. This would include rent on tenant housing and imputed rent on owner-occupied housing, both of which are components of personal expenditure. Merit goods are a way of addressing regressivity, but they are also a reflection of a political consensus that certain necessities should be free of tax, regardless of income.

6. The primary exclusions in the CBO calculation of a broad base were tenant-paid rent and imputed rent on owner-occupied housing. Examples of items included in the broad base, but excluded in the narrow base, are food purchases, medical care, brokerage and banking services, and education.

Avoidance and evasion will also erode the tax base. Business firms may purchase consumption items for their senior employees, and some retailers may claim that sales actually made to households were made to other businesses. Very conservatively, we calculate that 5 percent of the base will be lost to avoidance and evasion, and add this to the “broad” CBO base to calculate total erosion of 25 percent of personal consumption expenditure. We regard this base as extremely optimistic.

A flat NRST is inherently regressive with respect to income; without progressive adjustments, it will face extreme political objections. Conceptually, it is simple to redress the NRST’s regressive impact on low-income households by first increasing the tax rate beyond the bare amount needed to replace the corporate tax, and then distributing the excess in a manner that compensates the poorest households. Some advocates favor “demogrants,” literally an NRST rebate check mailed to all individual households.<sup>7</sup> However, adjusting the individual income tax system could achieve much the same effect with far less churning of tax payments and refunds, and consequently less potential for fraud. One way is to legislate refundable tax credits for estimated NRST payments on a poverty level of consumption.<sup>8</sup>

As tax revenues will need to increase in the coming decades, we also calculate the NRST rate needed to raise business tax revenue by 1.9 percent of GDP. This is the amount projected by our model of OECD tax shares in the event that federal spending, driven by entitlements, rises by 9 percent of GDP over several decades.

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7. Drawing on the experience of US states, some will argue that the regressive character of the NRST can be entirely addressed through the use of merit goods rather than demogrants. This may be true, but we are skeptical. Because the anticipated tax rate of the NRST is much higher than any state RST rate, there will be more concern about the progressive nature of the tax system. For the purposes of exposition, we approximated a very narrow exclusion for legislated base erosion. The goods we excluded—primarily rent and imputed rent on owner-occupied housing—are political and administrative necessities for reasons that go beyond a progressive tax code. (In fact, the very popular exemption for owner-occupied housing is regressive in nature.) If merit goods alone were used to address regressivity, legislated exclusions would be much broader. As a result, the initial tax base would be smaller, so that, even without the need to pay demogrants, the required tax rate would be roughly the same. However, the market would be further distorted toward the production of the anointed merit goods.

8. Currently, the EITC already pays tax rebates greater than the amount of income tax paid. However, the system is controversial and prone to fraud. We choose not to get sidetracked by how money is disbursed to alleviate the regressive character of the NRST or CAT. However, we assume that enough money will be raised to ensure that household consumption up to the poverty line is not taxed. Once this money is raised, a key part of the political fight will be who gets it: whether it should go to every household, or specifically to low-income households identified through a means test. If the money were to go to low-income households exclusively, the system would rebate a higher level of their consumption tax payments.

We estimate that the tax base of an NRST would have been \$5 trillion in 2000, or 51 percent of GDP (alternatively 75 percent of personal consumption expenditure, PCE).<sup>9</sup> By this estimate, the rate required of the NRST to replace the corporate income tax would be 5.7 percent. To accommodate the projected increase in business taxation, the rate would have to rise to 10.8 percent. Both rates are tax inclusive, and include the cost of alleviating the regressive character of the tax for low-income households, which requires an additional \$79 billion of revenue in the pure replacement case (adding 1.6 percent to the NRST rate) and \$152 billion of revenue in the higher business tax case (adding 3.0 percent to the NRST rate).

To collect the NRST, the federal tax system would have to be expanded to cover all retail sales outlets in the United States. Currently, no federal sales tax system exists, although most states have their own systems for collecting state sales tax.<sup>10</sup> It is unclear whether NRST advocates propose an enforced harmonization of state RST tax bases with the NRST (a clear federal intrusion into a domain historically reserved to the states), or whether retailers would be forced to keep track of the separate federal and state definitions of the RST base. In any event, from data reported by California, Texas, and Illinois, we estimate there are some 6.7 million potential NRST collection points in the United States. Most states require each collection point to file RST returns on a monthly basis so retail outlets do not fall behind in remitting taxes to the state treasury. If the federal government follows the same model, NRST collection will entail a substantial administrative undertaking, for states, retail outlets, and the federal government.

To mesh the federal NRST and state RSTs, and possibly alleviate the administrative burden, the government could set a higher rate for the federal tax and allow a credit for state RST. The credit would have to be capped at, say, 6 percent to prevent state governments from cannibalizing federal revenue. Replacing the federal corporate income tax and state retail tax would require a combined federal-state rate of about 12 percent. One advantage of the credit method is that it would be likely to encourage states to harmonize their sales tax base with the federal definition, but not require them to do so.

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9. This base is probably optimistic. Edwards (2005) calculated that the average state RST base was only 36 percent of gross state product (GSP), although the RST bases vary across a wide range, 26 to 71 percent of GSP.

10. NRST advocates suggest that states should collect the NRST and forward the proceeds to the federal government. Tauzin (1998, 105), for example, suggests allowing states to charge a "commission" of 1 percentage point on the NRST; he would also permit retail sales outlets to collect a commission of 0.5 percentage point. We have not included these compliance incentives in our calculation of NRST rates. As mentioned earlier, we question whether the federal government can delegate its tax-collecting function to the states.

## Option 2: Subtraction-Method VAT or Corporate Activity Tax

Following Senator William Roth (R-DE) and Representative Richard Schulze (R-PA) in 1985, Representative Sam Gibbons (D-FL) in 1993, and Senators John Danforth (R-MO) and David Boren (D-OK) in 1994, we analyze the subtraction-method VAT as an alternative template for US business taxation.<sup>11</sup>

Although it has no current champions in Congress, the subtraction-method VAT has attracted support in the past for four reasons.<sup>12</sup> First, as an entity tax, it more closely resembles the corporate income tax than a credit-invoice VAT or the NRST, which are akin to transaction taxes. At a political and conceptual level, it would be far easier to transform the corporate income tax into a subtraction-method VAT than to start over with the complex transaction-tracing rules entailed by a credit-invoice tax.<sup>13</sup>

Second, the subtraction-method VAT avoids many of the political problems of the credit-invoice VAT and the NRST. The credit-invoice VAT visibly overlaps with the retail sales tax because it appears on every retail (and nonretail) sale. Thus, a federal business tax modeled on the credit-invoice VAT would intrude on tax space historically occupied only by states and cities.<sup>14</sup> The NRST, of course, also suffers from this political liability.

Third, the subtraction-method VAT would probably impose less of an administrative burden on tax collection agencies. A credit-invoice tax would entail approximately 8.4 million collection points, encompassing business firms of almost every description. By comparison, the current number of corporate returns is about 6 million. The larger number of credit-invoice

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11. Charls E. Walker, a deputy secretary of the Treasury during the Nixon administration, was the intellectual father of the business transfer tax (BTT, a version of the subtraction VAT) and largely responsible for sparking reform in the 1980s and early 1990s. Ernest Christian, working with Walker, drafted the proposed BTT legislation and subsequent variations, such as the unlimited savings allowance (USA) tax.

12. Ways and Means Chairman Bill Thomas (R-CA) has spoken favorably of a VAT but has not yet spelled out a VAT proposal; see box 4.1.

13. Of course, similarity also brings disadvantages. For example, it is very easy for corporations to “count the beans” to determine whether they win or lose from replacing the corporate income tax with CAT and lobby appropriately. However, most firms have the sophistication to perform this exercise on any proposed tax reform. It is the creation of winners and losers, and not the difficulty of determining who is which, that brings the greatest resistance to any tax reform program.

14. In Europe, many of the VAT systems were introduced to replace a tangle of cascading manufacturing sales taxes and turnover taxes. In that context, it was natural to select a credit-invoice VAT because it took advantage of established systems of tax reporting. For similar reasons, but in a different tax context, we endorse the subtraction-method VAT for the United States.

returns comes about because partnerships would also become tax collection points (IRS 2003c).<sup>15</sup>

Fourth, the subtraction-method VAT is more prone to a single tax rate than the credit-invoice VAT. It can be jiggered to result in multiple rates, but the burden of persuasion falls on legislators who depart from the single-rate premise.<sup>16</sup> The mechanical structure of the credit-invoice VAT shouts an invitation for multiple tax rates—exactly the opposite of tax reform.

Considering just the realm of VATs, these four considerations lead us to recommend a tax modeled after the subtraction-method VAT rather than the credit-invoice VAT. Our proposal is a CAT, broadly structured to include labor, capital, and technology income in the tax base. Leaving aside transition rules, we envisage several basic features.

CAT should be designed to apply to medium and large corporations, those with annual receipts of \$10 million or more.<sup>17</sup> There were about 131,000 such firms in 2000 (IRS 2004). This is a small fraction of total taxpaying business entities: In 2000, there were 4.9 million corporations with receipts of less than \$10 million, 2.1 million partnerships, and 17.9 million nonfarm proprietorships. To be conservative, we estimate that the number of firms subject to CAT liability—in other words, the number of tax collection points—would be around 200,000.

CAT would not apply to Subchapter S corporations (usually small firms) or noncorporate business firms (partnerships and proprietorships).<sup>18</sup> This would retain the current distinction between taxable firms (normal Subchapter C corporations) and pass-through firms (Subchapter S corporations, partnerships, and proprietorships). Under current law, business entities that are organized as Subchapter S corporations, partnerships, or proprietorships are not taxed on their business income. Instead, their income (or loss) is attributed to their owners and taxed as individual income.<sup>19</sup>

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15. We assume that a minimum revenue threshold for VAT registration would largely exempt sole proprietorships.

16. To operate a subtraction-method VAT with multiple rates, all inputs must be allocated into separate rate baskets, making administration and enforcement much more complex. Japan, the most important country with a subtraction-method VAT, uses two VAT rates in addition to zero-rating exports (Ebrill et al. 2001, table 1.3). The United States should resist this temptation.

17. The rules defining a CAT payer should be such that large publicly traded partnerships would also be required to pay CAT. CAT should be envisioned as a conventional VAT with a very high minimum revenue threshold (\$10 million). For reference, the UK VAT registration threshold is £60,000 (\$110,000).

18. We do envision that CAT would apply to large publicly traded partnerships. However, for simplicity of exposition, we do not include them in our statistical analysis. Including these firms will broaden the tax base and lower the required CAT rates.

19. Pass-through firms would calculate their profits and losses as under current law, but reformed (if possible) so that taxable income matched financial income under generally accepted accounting principles (GAAP).

The CAT base would be domestic sales of goods and services, with exceptions for capital and technology income noted below, minus purchases from other US firms, *but* only if those vendors are themselves subject to CAT. Purchases of raw materials, utilities, components, and inventory from US firms subject to CAT would all be eligible deductions. So would purchases of equipment and software—the functional equivalent under the present corporate tax law of immediate expensing.<sup>20</sup> However—and this is important—purchases from US firms not subject to CAT could not be deducted by firms subject to CAT. In this way, CAT would be indirectly collected on business-to-business sales from pass-through firms (mainly small firms) to large firms, because large firms would include such purchases in their CAT base. By this mechanism, the distortion between corporate and noncorporate taxation would be substantially alleviated, although not entirely eliminated.<sup>21</sup>

Since CAT would be adjustable at the border, exports of goods and services would be zero-rated (the details of border adjustment are discussed in appendix C). Production abroad by US-based MNEs for local or third-country markets would not be subject to CAT.<sup>22</sup> The employer's portion of Social Security (currently 6.2 percent) and Medicare (1.45 percent) taxes—essentially business taxes on the use of labor inputs—would be credited against CAT.<sup>23</sup> However, no refund would be permitted for excess credits. This credit mechanism has three objectives: not to disturb the time-tested arrangements for financing Social Security and Medicare; not to discourage employment; and to ensure that payroll taxes are collected on US exports, even when no CAT is collected.<sup>24</sup> In appendix D,

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20. This means firms could not deduct depreciation of equipment from the CAT base. Moreover, to preserve revenue, we envisage that investment in long-lived assets (such as structures) would not be deductible from CAT. However, when these assets were sold (or retired), capital losses could be deducted, while capital gains could be taxed. Alternatively, annual depreciation on long-lived assets could be claimed as a deduction from the base, with a supplementary calculation of capital losses or gains when the asset is sold. This alternative would likely erode the revenue collected by CAT.

21. Strictly speaking, CAT would be collected on all value added up to the final stage of production that involves a CAT-registered company. Hence, the tax base would be larger than we have estimated in table 5.2, in which we exclude all value added from non-CAT payers (about 30 percent of total private industry value added). Industries in which a substantial portion of value added would *not* be subject to CAT would include: real estate leasing (which averaged 13 percent of private industry value added between 2000 and 2004), health services (8 percent), food services and drinking places (2 percent), legal services (2 percent), and educational services (1 percent).

22. If US-based MNEs produced goods and services abroad for export to the United States, they would be subject to CAT in the same manner as all other imports.

23. The Social Security tax is assessed on each employee's compensation up to \$90,000, while the Medicare tax is uncapped.

24. CAT, like any consumption tax, is intended to uniformly tax primary inputs: labor and capital. Allowing a credit for the payroll tax merely counteracts the distortion against

**Table 5.2 Illustrative calculation of CAT base, 2000**  
(billions of dollars)

<b>Total private industry value added:</b>	8,607
Minus value added by partnerships and nonfarm proprietorships	(1,253)
Minus value added by corporations with receipts under \$10 million	(1,178)
Plus repeal of depreciation allowances for large corporations <sup>a</sup>	516
Minus expenditures for equipment and software by large corporations	(659)
Plus imports of goods and services	1,445
Minus exports of goods and services	(1,070)
<b>Equals tax base for CAT: Corporations with receipts of \$10 million and over</b>	<b>6,408</b>
<i>Memorandum:</i>	
GDP in 2000	9,828
Corporate income tax revenue in 2000	208
As percent of GDP	2.1

CAT = corporate activity tax

a. A capital consumption adjustment is a negative component of private industry value added. Instead of allowing a depreciation deduction, the CAT will expense equipment and software in the year they are purchased.

*Sources:* US Census Bureau (2003), BEA (2004a), and authors' calculations.

we outline in greater detail how CAT would apply to imports and exports, financial receipts and payments, and capital expenditures.

Table 5.2 illustrates the base to which CAT would apply. To construct estimates, we assume that approximately 200,000 medium and large corporations with annual receipts of \$10 million or more are subject to CAT, and that all other business firms are exempt. By taxing only medium and large corporations, and therefore reducing the number of collection points, CAT avoids many of the evasion and enforcement problems of the NRST. Elements of the estimation process, spelled out in table 5.2, track the basic features laid out above.

In table 5.3, we use the base derived above to calculate the rates required to replace the federal corporate income tax with CAT, and to raise an additional 1.9 percent of GDP in business tax revenue. According to these calculations, the revenue-neutral rate would be 7.8 percent, and the rate required to meet our forecast of additional business tax revenue over several decades is 11.5 percent. These rates provide for the amounts required to alleviate the tax burden on all households up to the

labor imposed by this long-standing and politically invincible tax. We do not include a similar credit for the NRST owing to its conception as a transaction tax, although one could be considered.

**Table 5.3 Possible CAT revenue and rates for replacing the corporate income tax, 2000** (billions of dollars)

Revenues	Replace existing corporate income tax	Replace existing corporate tax and raise 1.9 percent of GDP
Revenue goal	208	395
Plus payroll credit <sup>a</sup>	181	181
Equals total collected revenue	389	576
CAT rate (flat, percent)	6.1	9.0
Plus revenue to finance progressivity <sup>b</sup>	108	160
Equals total revenue raised	497	736
CAT rate (progressive, percent)	7.8	11.5
<i>Memorandum:</i>		
CAT base	6,408	

CAT = corporate activity tax

a. Revenue amount required to meet revenue goal and allow \$181 billion tax credit for payroll taxes to large corporations.

b. Amount of revenue required to rebate CAT rate to all households for purchases up to the poverty line. This effectively removes \$1.4 trillion from the tax base.

Note: Since CAT is an entity tax, we report only the tax-inclusive rate.

Source: Authors' calculations.

poverty line for household income (the same rebates we used in our NRST calculation). As described above, we assume corporations would be allowed a tax credit to cover the employer share of Social Security and Medicare payroll taxes.

## Conclusion: Contrasting the NRST and CAT

The fiscal outlook is not so dire, nor is global tax competition so severe, that the corporate income tax needs to be replaced immediately by a new system. Nevertheless, the administration, working with Congress, should launch the reform process by enacting the legal structure for the NRST, CAT, or a similar broad-based tax. To ease the transition to the new tax system, CAT could be phased in by 1.5 percentage points each year for the first five years starting in 2010, while the federal corporate income tax could be phased out by cutting the statutory rate by about 7 percentage points each year.<sup>25</sup> A similar approach could be used for the NRST.

25. For manufacturing firms that benefit from the American Jobs Creation Act of 2004, the statutory rate would be cut by 6.4 percentage points per year.

If, as we expect, the fiscal gap continues to grow and requires more revenue, the CAT rate could be raised, say, 1 percent every 5 years for the next 25 years. If by some miracle the gap in the federal budget ceases to grow, the reforms are still worthwhile for the considerable benefits the United States would derive from consigning the jagged corporate income tax to history. As argued in previous chapters, collecting business taxes through CAT or the NRST would inflict far less distortion on the US economy than current corporate income taxes do.

Implementing either the NRST or CAT would require a major overhaul of the US business tax system. If the experiment with broad-based taxation proves successful, the new system might be extended over time to shoulder part of the revenue load from the individual income tax. In box 2.3, we briefly contemplate a more ambitious tax reform agenda, designed to encompass the individual income tax as well as the business tax system. Such a proposal might well have political appeal. We are concerned, however, that trying to do too much in a single step would sink the entire reform effort.

And business tax reform is needed. The corporate income tax badly serves the United States. It hobbles the country in global competition; it does little or nothing to promote equality, its original and still commonly recited justification; it is rife with distortions that erode efficiency; and it promises to get much worse in the future. The NRST and CAT, both strong candidates to replace the corporate income tax, are closely related, and it is tempting to consider them nearly equivalent. But tax details conceal many devils. If a consensus emerges in favor of a broad-based tax, the final shape will depend as much on political as economic considerations. To conclude, we offer several direct comparisons between the NRST and CAT.

## **Macroeconomic Effects**

In macroeconomic terms, the NRST and CAT are similar in efficiency and distributional impacts. Both systems would improve the efficiency of the US economy enormously compared with the corporate income tax. Both can be tailored to eliminate the regressive impact on poor households. With respect to border adjustment, which we examine more closely in appendix C, the two systems are likely to achieve similar results, albeit through different paths. Both would put the US traded goods and services sectors on the same tax footing as their global competition: business taxes would be imposed on imports and exempted on exports.

## **Simplicity, Evasion, and Avoidance**

The NRST is a simpler tax than CAT. Its tax base is gross retail sales with no deductions. Exemptions are only permitted for “merit” goods

and services, and for foreign sales. The NRST is also an extension of the familiar RST, whereas CAT, like all VAT systems, is strange and unfamiliar to most Americans.<sup>26</sup> However, elements of both CAT and the NRST are easy to evade. Like all VATs, CAT is self-enforcing on business-to-business transactions (because auditors can check the buying firm's reported purchases of inputs against the selling firm's reported sales), but there is no good way of verifying the final sale from businesses to households. Still, examples from other countries have shown that VAT rates of up to 25 percent can be enforced. For the NRST, the entire tax must be collected on business-to-household sales. State RST rates are generally in the range of 5 to 7 percent. If federal rates exceed 15 percent, the incentive to evade the NRST might pose a more severe enforcement problem. Moreover, it has proven politically difficult to extend the NRST to a wide range of services transactions—but that would be required if rates are to be kept at the levels we present in table 4.6.

## Tax Elasticity and the Budget

A premise of the NRST is to “starve the beast.” Advocates believe that the political difficulty of raising RST rates, or expanding the tax base to cover “merit” goods and services, will force the federal government to curtail spending, especially entitlement spending. This may be true, although evidence is severely lacking. It might well be more difficult for Congress to raise NRST than VAT rates. Our regression equations indicate that RST revenues roughly keep pace with GDP growth, but exhibit a very weak time trend. By comparison, VAT systems appear on average to collect more revenue year by year, which may reflect the lesser political difficulty of raising VAT rates or expanding the VAT base.

None of this says anything about government spending. In recent years, tax cuts have led not to lower spending, but rather to larger public deficits. Earlier, we argued that the enormous public support for Social Security and Medicare will require higher taxes in future decades, even as future entitlement expenditures are capped. Given this situation, after fiscal stability, our primary goal is to minimize the potential distortion of higher business taxes. If the NRST can accomplish this goal more readily than CAT, fine. But we question whether “starve the beast” logic would succeed in achieving fiscal balance; instead, it might lead to the retention or reinvention of the corporate income tax.<sup>27</sup>

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26. Tax history in other industrial countries differs sharply from the United States. While the VAT has become the system of choice in OECD countries, no OECD country maintains an NRST. Between 1967 and 1995, 19 OECD countries moved from a retail, wholesale, or turnover taxes to the VAT (Gale 1999).

27. The “starve the beast” strategy essentially entails a game of chicken within US fiscal policy. Low-tax advocates and high public spending advocates deliberately steer the budget

## Transparency

Related to these debates is the question of transparency. Conservative proponents of the NRST generally characterize the VAT as a “hidden” tax (Tauzin 1998, 67). They argue that if citizens knew the cost of taxation, political sentiment would hold federal spending at a lower level. This appeals to common sense, but Norman Gemmill, Oliver Morrissey, and Abuzer Pinar (2003) use survey data from the United Kingdom to suggest it may not hold up empirically. They find that taxpayers tend to overestimate their VAT burden rather than underestimate it, both absolutely and in relation to the individual income tax. In any case, if there are strong public demands for government transfers or services, the “solution” may be found in less visible forms of taxation (back to the corporate income tax) or new regulations, such as mandated corporate pension and health care plans for employees and retirees.

In Canada, as opposed to many other countries, the goods and services tax (GST), a cousin of the VAT, lists the tax paid on each invoice. This is all that is required to remove the “hidden” nature of the VAT, and while it is more natural to the credit-invoice method, it can be implemented with the subtraction-method VAT, such as CAT, as well.<sup>28</sup>

## Reporting Burden

From the taxpayer’s standpoint, CAT liability far more closely resembles the corporate income tax than does the NRST. CAT is paid by businesses throughout the production chain, while the NRST is assessed on goods and services only when purchased by households. It would also be comparatively simple to convert the current corporate reporting system into a CAT system. We estimate that CAT would require less than 200,000 entities to file tax returns, a substantial decline from the 6 million corporate tax returns filed in 2004 (IRS 2003c). By contrast, the NRST would require a new federal system of taxing retail sales, requiring perhaps 6.7 million returns filed monthly.

## Federal-State Tax Relations

Past federal gestures at enacting a broad-based tax aroused a very hostile response from state governors and big-city mayors, and were dropped

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toward unsustainable debt levels in hopes that the other side will blink first. Steuerle (2004, 251) offers this comment on the “spend it first” dynamic of modern fiscal policy (referring to both tax cuts and spending increases): “this practice is equivalent to dictating to our children a list of what they can and cannot consume for decades to come.”

28. Chris Edwards (2005, 24), a conservative commentator, argues that presenting the final consumer with a figure for total VAT paid should be a necessary condition for conservative support of any VAT-variant proposal.

(box 4.1). Put simply, state and city officials regard the federal retail sales tax, and anything that looks like a federal sales tax, such as the VAT, as an encroachment into “their” tax dominion.

On this score, we think CAT has a marginal advantage over the NRST, because the reporting and paying burdens under CAT closely resemble the corporate income tax. However, in the final analysis, acceptance or rejection by subfederal officials may depend more on federal inducements than the particular form of broad-based business taxation.

### **Complementary Expenditure Caps**

If business taxes are going to be raised, whether through an NRST, CAT, or something else, complementary political bargains will be needed not only to cap the growth of entitlement benefits, but also to raise payroll and individual income taxes. None of this can be done quickly or easily. But better for the next administration to start the difficult task of reforming tax and spending than bequeath the entire burden to its successors and continue the march toward an inevitable crisis.