Tax Reform: An Overview of Proposals in the 111th Congress

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Summary

Tax reform is of congressional interest in the 111th Congress. This report examines three main categories of tax reform: fundamental tax reform, tax reform based on the elimination of the individual alternative minimum tax (AMT), and proposals for reforming the corporate income tax in the 111th Congress.

Most proposals for fundamental tax reform involve the concept of replacing our current income tax system with some form of a consumption tax, usually with a single or "flat tax" rate. Other proposals would significantly broaden the income tax base and lower tax rates. Proponents of these tax revisions often maintain that they would simplify the tax system, make the government less intrusive, and create an environment more conducive to saving. Critics express concern about the distributional consequences and transitional costs of a dramatic change in the tax system. Most observers believe that the problems and complexities of our current tax system are not primarily related to the number of tax rates but rather stem from difficulties associated with measuring the tax base. For those fundamental tax reform proposals involving shifting to a consumption tax, one or more of the following four major types of broad-based consumption taxes are included in these congressional tax proposals: the value-added tax (VAT), the retail sales tax, the consumed-income tax, and the flat tax based on a proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution.

As of March 3, 2009, three bills for fundamental tax reform have been introduced: Representative David Dreier's proposal (H.R. 99), Representative John Linder's proposal (H.R. 25), and Senator Saxby Chambliss' proposal (S. 296). H.R. 25 and S. 296 are companion bills. H.R. 99, *The Fair and Simple Tax Act of 2009*, would amend the Internal Revenue Code of 1986 to reduce taxes by providing an alternative determination of income tax liability for individuals.... " H.R. 25 and S. 296, each titled the *Fair Tax Act of 2009*, would "promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the States."

A temporary patch for 2009 for the individual alternative minimum tax (AMT) was included in *American Recovery and Reinvestment Tax Act of 2009* (P.L. 111-5). The patch increased the individual AMT exemption amount and allowed personal credits against the AMT. But, bills may be introduced that would eliminate the individual AMT and require major changes in the tax code.

In the 111th Congress, the concept of lowering the marginal corporate income tax rate and broadening the corporate income tax base has been advocated by some Members of Congress, including Representative Charles B. Rangel, Chairman of the House Ways and Means Committee.

This report will be updated as issues develop and new legislation is introduced.

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Introduction

Tax reform has been of congressional interest in the 111th Congress. This report examines three main categories of tax reform: fundamental tax reform, tax reform based on the elimination of the individual alternative minimum tax (AMT), and proposals for reforming the corporate income tax in the 111th Congress.

Most proposals for fundamental tax reform involve the concept of replacing our current income tax system with some form of a consumption tax, usually with a single or “flat tax” rate. Other proposals would significantly broaden the income tax base and lower tax rates. Proponents of these tax revisions are concerned about the administrative and compliance costs of the current income tax system. Proponents also believe that the current income tax system discourages saving, reduces economic growth, causes economic distortions, and worsens the nation’s balance of trade. Critics question whether most of these proposals will improve macroeconomic performance, express concern about equity issues, and maintain that transitional costs will be prohibitive. Most observers believe that the problems and complexities of our current tax system are not primarily related to the number of tax rates but rather stem from difficulties associated with measuring the tax base.

A temporary patch for 2009 for the individual alternative minimum tax (AMT) was included in *American Recovery and Reinvestment Tax Act of 2009* (P.L. 111-5). The patch increased the individual AMT exemption amount and allowed personal credits against the AMT. But, bills may be introduced that would eliminate the individual alternative minimum tax and require major changes in the tax code.

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Fundamental Tax Reform

Most proposals for fundamental tax reform would change the tax base from income to consumption. Consequently, the initial sections of this report examine topics concerning broad-based consumption taxation. Later in this report, other tax reform proposals are discussed.

The Relationship Between Income and Consumption

Although our current tax structure is primarily an income tax, it actually contains elements of both an income- and a consumption-based tax. For example, the current tax system includes in its tax base wages, interest, dividends, and capital gains, all of which are consistent with an income tax. At the same time, however, the current tax system excludes some savings, such as pension and individual retirement account (IRA) contributions, which is consistent with a tax using a consumption base.

The easiest way to understand the differences between the income and consumption tax bases is to define and understand the economic concept of income. In its broadest sense, income is a measure of the command over resources that an individual acquires during a given time period. Conceptually, individuals can exercise two options with regard to their income: they can consume it or they can save it. This theoretical relationship between income, consumption, and saving allows a very useful accounting identity to be established: income, by definition, must equal consumption plus saving. It follows that a tax that has a measure of comprehensive income applies to both consumption and savings. A consumption tax, however, applies to income minus saving.

A consumption tax can be levied at the individual level in a form very similar to the current system. An individual would add up all income in the same way as is done now under the income tax but then would subtract out net savings (saving minus borrowing). The result of these calculations would be the consumption base on which tax is assessed. Equivalently, a consumption tax can also be collected at the retail level in the form of a sales tax or at each stage of the production process in the form of a value-added tax (VAT).

Regardless of the form or point where a consumption tax is collected, it is ultimately paid by the individual doing the consuming. It should be noted that consumption, in the economy as a whole, is smaller than income. Thus, to raise equal amounts of revenue in a given year, tax rates on a comprehensive consumption base would have to be higher than the tax rates on a comprehensive income base. But, currently in the United States, the low savings rate would result in the tax rate on consumption being only slightly higher than the tax rate on income.

Proposals to shift from an income tax to a consumption tax differ in their treatment of the estate and gift tax. Some proposals would eliminate the estate and gift tax while others would not affect it.

What Should Be Taxed?

Should the tax base be income or consumption? Is one inherently superior to the other? How do they stack up in terms of simplicity, fairness, and efficiency—the three standards by which tax systems are generally assessed? There appears to be insufficient theoretical or empirical evidence to conclude that a consumption-based tax is inherently superior to an income-based tax or vice versa.

One issue associated with the choice of a tax base is equity—how the tax burden will be distributed across income classes and different types of taxpayers. For example, a tax is "progressive" if tax paid as a percentage of income increases as income rises. Although some types of consumption taxes can be designed to achieve any desired level of progressivity with respect to consumption alone, their progressivity with respect to income could only be approximated. Also, a consumption tax would involve a redistribution of the tax burden by age group, with the young and old generally bearing more of the total tax burden than those in their prime earning years, who have a higher savings rate, since savings are not subject to a consumption tax. Whether or not this intergenerational transfer is "fair" is a subjective decision. And the transition from an income-based tax to a consumption-based tax would have the potential for creating windfall gains for some taxpayers and losses for others.

A definitive assessment cannot be made of the effects of taxing consumption on either economic efficiency or the aggregate level of savings. Although the current tax system's distortions of the relative attractiveness of present and future consumption (saving) would be eliminated, to raise the same amount of tax revenue, a consumption-based tax would require an increase in marginal tax rates (since consumption is smaller than income).[1] These higher marginal tax rates, in turn, would increase the current system's distortion between the attractiveness of market (e.g., purchased products) and nonmarket activities (e.g., leisure).[2] The net effect on overall economic efficiency cannot be ascertained theoretically. In addition, economic theory indicates a consumption tax would not necessarily produce an increase in saving. The increase in after-tax income might reduce saving, while the increase in the return to saving may increase it; the net result is uncertain.[3]

A positive aspect of a consumption-based tax is the ease with which the individual and corporate tax systems could be integrated. In addition, the problems introduced in the current system by separate provisions for capital gains, attempts to distinguish between real and nominal income, and depreciation procedures would essentially be eliminated. It is doubtful, however, that a consumption-based tax would have much effect on the complexities introduced into the system to promote specific social and economic goals. Many of the same factors that influenced the design of the current income tax system could exert the same influences on the final design of a consumption tax.

Whether one prefers income or consumption, one tax rate or multiple tax rates, a critical point to remember is that the benefits to be derived from tax revision would result from defining the tax base more comprehensively than it is under current law. A tax with a base that is comprehensively defined would prove more equitable and efficient than a tax with a less comprehensively defined base.

Types of Broad-Based Consumption Taxes

In prior Congresses, four major types of broad-based consumption taxes have been included in congressional tax proposals: the value-added tax (VAT), the retail sales tax, the consumed-income tax, and the flat tax based on a proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution.[4] In the 111th Congress, two companion bills have been introduced to levy a national retail sales tax. Bills to levy the other three types of broad-based consumption may be introduced.

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[1] Currently, in the United States, the personal savings rate is low. Consequently, the marginal tax rate on consumption would have to be only slightly higher than the marginal tax rate on income.

[2] The loss in economic efficiency due to a tax is referred to by economists as the deadweight loss or excess burden of the tax.

[3] For an analysis of effects of tax policy on saving, see CRS Report RL33482, *Saving Incentives: What May Work, What May Not*, by Thomas L. Hungerford.

[4] For an overview of the economic issues relevant to broad-based consumption taxation, see CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*, by Jane G. Gravelle.

Value-Added Tax

A value-added tax is a tax, levied at each stage of production, on firms' value added. The value added of a firm is the difference between a firm's sales and a firm's purchases of inputs from other firms. The VAT is collected by each firm at every stage of production.

There are three alternative methods of calculating VAT: the credit method, the subtraction method, and the addition method. Under the credit method, the firm calculates the VAT to be remitted to the government by a two-step process. First, the firm multiplies its sales by the tax rate to calculate VAT collected on sales. Second, the firm credits VAT paid on inputs against VAT collected on sales and remits this difference to the government. The firm calculates its VAT liability before setting its prices to fully shift the VAT to the buyer. Under the credit-invoice method, a type of credit method, the firm is required to show VAT separately on all sales invoices and to calculate the VAT credit on inputs by adding all VAT shown on purchase invoices.

Under the subtraction method, the firm calculates its value added by subtracting its cost of taxed inputs from its sales. Next, the firm determines its VAT liability by multiplying its value added by the VAT rate.[5] Under the addition method, the firm calculates its value added by adding all payments for untaxed inputs (e.g., wages and profits). Next, the firm multiplies its value added by the VAT rate to calculate VAT to be remitted to the government.

All developed nations, except Japan, use the credit-invoice method. Japan uses the subtraction method.

Retail Sales Tax

In contrast to a VAT, a retail sales tax is a consumption tax levied only at a single stage of production, the retail stage. The retailer collects a specific percentage markup in the retail price of a good or service, which is then remitted to the tax authorities.

Consumed-Income Tax

Under this consumption tax, taxpayers would keep their assets in an account equivalent to a current IRA (individual retirement account). Net contributions to this account (contributions less withdrawals) would be deducted from income to determine the level of consumed-income. In contrast to a VAT or sales tax, policymakers would have the option of applying a progressive rate structure to the level of consumed-income. Each individual would be responsible for calculating consumed-income and paying the tax obligation.

Flat Tax (Hall/Rabushka Concept)

A flat tax could be levied based on the proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution. Their proposal would have two components: a wage tax and a cash-flow tax on businesses. (A wage tax is a tax only on salaries and wages; a cash-flow tax is

[5] For a comparison of the credit-invoice method and the subtraction method, see *Value-Added Tax: Methods of Calculation* (a general distribution memo), by James M. Bickley, available on request from the author.

generally a tax on gross receipts minus all outlays.) It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level. Under a standard VAT, a firm would not subtract its wage and pension contributions when calculating its tax base. Under this proposal, some wage income would not be included in the tax base because of exemptions. Under a standard VAT, all wage income would be included in the tax base.[6]

International Comparisons

There are two major distinctions between recent flat tax proposals for the United States that would change the tax base from income to consumption and the current tax systems of other developed nations. First, although the United States is the only developed nation without a broad-based consumption tax at the national level, other developed nations adopted broad-based consumption taxes as adjuncts to or replacements for other consumption taxes rather than as replacements for their income-based taxes. Most of the congressional proposals would replace our current income taxes with consumption taxes.

Second, all developed nations with VATs, except Japan, calculate their VATs using the credit-invoice method. In contrast, most of the current U.S. flat tax proposals, which include VAT components, use the subtraction method of calculation.

Other Types of Fundamental Tax Reform

Two other types of fundamental tax reform are (1) reforming the current income tax by broadening the tax base and lowering tax rates and (2) a tax plan that gives taxpayers a choice between the current income tax system and a simplified income tax.

Income Tax Reform: Base Broadening

Income tax base broadening would involve eliminating most tax preferences, increasing the standard deduction and personal exemption allowances, and reducing tax rates. In the 110th Congress, the proposal of Senator Wyden was in this category.

Option of the Current or an Alternative Income Tax System

Several proposals in the 110th Congress would have given taxpayers the option of either paying taxes under the current income tax or paying a flat rate income tax. Similar proposals may be introduced in the 111th Congress.

[6] For a comprehensive overview of this concept, see CRS Report 98-529, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, by James M. Bickley.

Legislative Proposals for Fundamental Tax Reform

As of March 24, 2009, in the 111th Congress, three bills for fundamental tax reform have been introduced.

Representative David Dreier's Proposal

H.R. 99. The Fair and Simple Tax Act of 2009 was introduced on January 6, 2009, and referred to the House Ways and Means Committee. This bill would establish an alternative determination of tax liability for individuals. A "simplified taxable income" would be taxed at the rates of 10% on the first $40,000, 15% on the income over $40,000 but under $150,000, and 30% on the income over $150,000. Simplified taxable income would equal gross income less the sum of deductions for personal exemptions, the deduction allowed for the acquisition of indebtedness with respect to the principal residence, the deduction allowed for state and local income taxes, the deduction allowed for charitable giving, and the deduction allowed for medical expenses. The estate and gift taxes would be repealed. The alternative minimum tax exemption amounts would be indexed for inflation. The maximum corporate income tax rate would be reduced to 25%. The 15% rate on dividends and capital gains of individuals would be reduced to 10%. The basis for assets for purposes of determining capital gain or loss would be indexed for inflation. This bill would create tax-free accounts for retirement savings, lifetime savings, and lifetime skills. Examples of qualified life skills include assessments of skill levels, development of an individual employment plan, career planning, occupational skills training, on-the-job training, and entrepreneurial training. This bill would repeal the adjusted gross income threshold in the medical care deduction for individuals under age 65 who have no employer health coverage. This bill would make the research credit permanent. This bill would repeal Title IX of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) relating to sunset of provisions. This bill would repeal Section 107 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 relating to application of EGTRRA sunset to this title.

Representative John Linder's Proposal

H.R. 25. (A companion bill, S. 296, was introduced in the Senate.) **The Fair Tax Act of 2009** was introduced on January 6, 2009, and referred to the Committee on Ways and Means. This proposal would repeal the individual income tax, the corporate income tax, all payroll taxes, the self-employment tax, and the estate and gift taxes and levy a 23% (tax-inclusive) national retail sales tax as a replacement. The tax-inclusive retail sales tax would equal 23% of the sum of the sales price of an item and the amount of the retail sales tax. Every family would receive a rebate of the sales tax on spending amounts up to the federal poverty level (plus an extra amount to prevent any marriage penalty). The Social Security Administration would provide a monthly sales tax rebate to registered qualified families. The 23% national retail sales would not be levied on exports. The sales tax would be separately stated and charged. Social Security and Medicare benefits would remain the same with payroll tax revenue replaced by some of the revenue from the retail sales tax. States could elect to collect the national retail sales tax on behalf of the federal government in exchange for a fee. Taxpayer rights provisions are incorporated into the act. The sales tax would sunset at the end of a seven-year period beginning on the enactment of this act if the Sixteenth Amendment is not repealed. This amendment provided Congress with the "power to lay and collect taxes on incomes.... "

Senator Saxby Chambliss's Proposal

S. 296. (A companion bill, H.R. 25, was introduced in the House.) **The Fair Tax Act of 2009** was introduced on January 22, 2009, and referred to the Senate Finance Committee. This act would "promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the states." (See H.R. 25 in the preceding paragraph for a description.)

Tax Reform to Eliminate the AMT

In the 111th Congress, a temporary patch for 2009 for the alternative minimum tax (AMT) was included in *American Recovery and Reinvestment Tax Act of 2009* (P.L. 111-5). The patch increased the individual AMT exemption amount and allowed personal credits against the AMT. In the 111th Congress, bills may be introduced that would eliminate the individual alternative minimum tax and require major changes in the tax code.[7]

Reform of the Corporate Income Tax

In the 110th Congress, some tax reform proposals would have lowered the marginal corporate income tax rate and broadened the corporate income tax base.[8] Other tax reform proposals would have replaced the corporate income tax with some other form of taxation. In the 111th Congress, the concept of lowering the marginal corporate income tax rate and broadening the corporate income tax base has been advocated by some Members of Congress, including Representative Charles B. Rangel, Chairman of the House Ways and Means Committee. In addition, President Barack Obama suggested support for this proposal at the tax reform panel of the Fiscal Responsibility Summit when the President stated that "On the corporate side, I at least have always maintained that if we try to think in the same ways that we thought about it in 1986, and if you closed loopholes, you could actually lower rates."[9]

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[7] For an examination of the alternative minimum tax for individuals, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

[8] For an analysis of some important issues concerning corporate tax reform, see CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford.

[9] Representative Charles B. Rangel, *Fiscal Responsibility Summit*, Feb. 24, 2009, p. 1, available at http://rangel.house.gov/cblog/2009/02/fiscal-responsibility-summit.html, visited Feb. 27, 2009.