

REPORT

The Republican National Retail Sales Tax Plan: THE PRICE IS TOO HIGH



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For years, the Republicans have promised to pull the tax code up by its roots. Last month, President Bush restated his four-year-old promise of a “simpler, fairer” tax system. The 2001 and 2003 tax bills added hundreds more tax provisions and the Administration has encouraged more loopholes in the tax code. As Ways and Means Ranking Democrat Charles Rangel has said, “far from pulling up the tax code by the roots, the Republicans have just added more fertilizer to it.”

Given this record, it is no surprise that the leading Republican tax reform plan is not simple, and is totally unfair to middle-income taxpayers, particularly families with children. As this report will detail, it eliminates all income tax deductions and credits. It creates a vast unfunded mandate on states and localities forcing them to raise property taxes. It would mean large tax increases on senior citizens and, in effect, make them pay twice for their Social Security and Medicare. It would increase the costs to the consumer of health care, housing, and energy. Charitable organizations would face a dramatic decline in contributions because of the repeal of the deduction for charitable contributions; also, charitable organizations, like hospitals, adoption agencies, religious publishers, and credit unions would find that the goods and services that they provide in carrying out their tax-exempt purpose are subject to the new retail sales taxes. It would create specific problems for the automobile industry, the agricultural sector, insurance industry, financial services, and tourism and encourage mail order and Internet businesses to leave the country. Investors in low-income housing or renewable energy projects would face a retroactive repeal of the credits on the basis of which they made those investments.

The retail sales tax creates a massive windfall for the wealthy. Those making more than \$315,000 would pay only about 5% of their income in Federal taxes compared to about 25% now. However, everyone else – the middle-income family, seniors, workers, the poor, small business owners, farmers – are big losers under the sales tax.

Furthermore, it’s not even simpler. It creates new paperwork for businesses and would require a huge new government enforcement agency to ensure compliance at every retail purchase.

To raise the same amount of revenue as the current system, the tax would have to be over 50%. Items and services that cost \$100 would cost \$150 or more. Since the proposed legislation calls for the equivalent of a 30% retail sales tax, the national debt will shoot up dramatically. Future generations will pay the most for the windfall for a few wealthy tax payers.

All tolled, the price of a national retail sales tax is too high.

Report on Republican Tax Restructuring Plan

I. Republican Record of Complicating the Tax Code.

Congress has enacted legislation since 1994 that has dramatically increased the complexity of our current tax system.

According to the Internal Revenue Service, today it takes an average middle-income American family 7½ hours longer to fill out their Federal income tax return than it did in 1994, an increase from 11½ hours in 1994 to 19 hours today. Since 1994, the Republican-controlled House of Representatives has successfully initiated 42 new laws with 3,533 changes to our tax code contained in more than 10,000 additional pages of complex public laws.

Millions of Americans now are required to fill out two Federal income tax returns each April 15th, the regular tax return and the alternative minimum tax (AMT) return. All of this complexity is due to the decision by the Bush Administration to use the AMT to take back much of the benefits promised in the big print of the 2001 Bush tax cut. Before the Republicans took control, only 369,000 individuals were subject to the AMT.

Today 60 percent of individuals use professional tax return preparers, up from 50 percent in 1995. The fact that 85 percent of all tax returns now are computer generated is an indication that it is now nearly impossible to file an individual tax return using pencil and paper.

President Bush has continued to complicate our tax law. Even conservative economist Bruce Bartlett concedes that “over the past three and a half years, Bush has made the tax code more complicated.” (“The Illusionary Domestic Agenda,” Albert Hunt, *The Wall Street Journal*, Sept. 2, 2004.)

II. Republican Endorsement of Radical Restructuring Plan.

The Congressional Republican Leadership and President Bush have little interest in reforming our income tax system. They intend to use the complexity of our current system, a significant portion of which they created, to justify replacing the income tax with a regressive national retail sales tax.

House Majority Leader Tom Delay has indicated that the Republican Majority is determined to repeal the federal income tax and replace it with a national retail sales tax. He has endorsed the bill (H.R. 25) that would impose a national retail sales tax as a substitute for current Federal income and payroll taxes. Republican Speaker Hastert echoed Delay's call for a repeal of the income tax on page 272 of his new book, *Speaker*, stating "Both of these ideas [the national sales tax and the flat tax] are worthy of consideration."

Larry Lindsey, former Chief Economic Advisor for President Bush, said that the best tax simplification would be replacing our current system with "A broad based cash-flow or revenue-based tax." Only a retail sales tax or other general tax on consumption, such as a value-added tax, would meet Lindsey's description of the tax that would replace our current system. ("Simplify, Simplify, Simplify," Larry Lindsey, *The Wall Street Journal*, September 16, 2004.)

President Bush called shifting to a national retail sales tax "an interesting idea that we ought to explore." ("Thomas Says Republicans Will Examine Tax Alternatives," Ryan J. Donmoyer, *Bloomberg News*, Aug. 11, 2004.)

The House Republican Leadership has been frank in their support of a retail sales tax as a substitute for our current system. President Bush and his advisors are clearly supportive, but more circumspect in their rhetoric prior to the election.

President Bush does not wish to have this matter discussed in the campaign because, as a Treasury memo in 2002 noted, “in other countries, adoption of a consumption tax has led to election losses for the incumbent party.”

III. Description of Republican Retail Sales Tax Proposal

The Republican retail sales tax proposal, H.R. 25, would repeal the current individual and corporate income taxes; Social Security, Medicare, and unemployment payroll taxes; and estate and gift taxes. Next fiscal year, those taxes are projected to raise over \$2 trillion. H.R. 25 would attempt to replace the revenue from those taxes by imposing a new Federal “retail sales tax.”

The new tax that would be imposed by H.R. 25 bears little semblance to the retail sales taxes currently imposed by most States. H.R. 25 uses a complex “tax-inclusive” method of computing the amount of the tax, a method not used by any State. State retail sales taxes apply to retail sales of some but not all goods, and to sales of very few services. In contrast, H.R. 25 would tax sales of all services, including healthcare. It would tax many items not typically subject to State retail sales tax, such as prescription drugs, new home sales, apartment rents, and insurance.

H.R. 25 would tax all non-education purchases of goods and services by Federal, State and local governments. It may seem bizarre, but it would require the Federal government to pay a tax on national defense expenditures. Similarly, it would tax State and local governments when they pay wages to public safety officers or purchase equipment for their use. Needless to say, no State retail sales tax applies to these items.

When they say “23%” it means 30% to the consumer

Much confusion has resulted from the Republicans’ efforts to use technical language to make their sales tax rate seem lower than it really is. All State retail sales taxes, and all Federal excise taxes are calculated with a “tax-exclusive” method. A “tax-exclusive” method is simple. The amount of the tax is determined by applying the tax rate to the pre-tax price of the good. For example, if the tax rate is 30% and the retail price before tax is \$100, the amount of the retail sales tax is \$30 and the amount ultimately paid by the consumer is \$130.

In order to understate the true tax rate, H.R. 25 uses a “tax-inclusive” method to determine the amount of the tax. Under that methodology, the tax rate applies to the after-tax price of the good. A 23% tax-inclusive rate is equivalent to a 30% retail sales tax imposed under a tax exclusive method. For example, again if the pre-tax price is \$100, under H.R. 25, the retailer would have to charge \$130 for the good, because 23% of \$130 is \$30.

H.R. 25 attempts to mitigate the regressivity of the new tax by exempting consumption up to the Federal poverty line from the new tax. The monthly exemption would come in the form of a monthly check based on the poverty level for the family and the new sales tax rate. The exemption is not income-related, every family of the same size would receive the same monthly check regardless of their income. Every family would have to register with the government to receive the checks. The checks would be sent by the Social Security Administration.

The Republican retail sales tax bill dramatically understates the tax rate that would be necessary for the bill to be revenue neutral. The bill, as introduced, effectively would impose a 30% retail sales tax when computed under the methodology used by all State retail sales taxes. The Joint Committee on Taxation in 2000 estimated that the budget neutral rate for the proposal would have to be in excess of 50%.

The Republican retail sales tax bill repeals all current law tax incentives for charitable giving, home ownership, and employer-provided health care. It repeals all of the family related tax credits, such as the \$1,000 per child credit, the earned income tax credit, and the dependent care credit. It repeals the low-income housing credit, and credits designed to encourage investments in renewable energy. It repeals those credits retroactively for investors who have already made investments in reliance of the credits.

IV. General Impact of Republican Sales Tax Proposal

A. Regressive Shift of Tax Burden.

The most easily understood distributional analysis of a consumption tax proposal was undertaken in 1983 by the designers of the flat tax, Robert E. Hall and Alvin Rabushka, Senior Fellows at the Hoover Institute. They describe the flat tax as a “tremendous boon to the economic elite,” conceding that “it is an obvious mathematical law that lower taxes on the successful will have to be made up by higher taxes on average people.”

H.R. 25 would reverse the existing-law pattern of effective tax rates. Currently, they start low and increase as income goes up. Under H.R. 25, they would start high and decline as income increases. (See appendix A for charts showing current law effective rates and effective rates under H.R. 25.)

Under current law, the average effective tax rate (taxes as a percent of income) faced by individuals under our current income and payroll tax system begins at 5% for the lowest 20% of individuals by income, and increases to slightly more than 25% for the top 1% of income earners.

The average effective tax rate under the Republican retail sales tax bill would begin at slightly more than 30% for the lowest income individuals, and it would gradually decline to approximately 5% for

individuals earning more than \$315,000 per year. Even with an exemption for consumption up to the poverty level, as contained in H.R. 25, the effective tax rate faced by low-income families will be greater than the sales tax rate. The reason for this is that low-income families quite often have consumption expenditures in excess of their income. The prime example is a senior citizen maintaining his or her lifestyle by consuming savings accumulated over his or her lifetime.

B. Enormous Unfunded Mandate on State and Local Governments.

The Republican retail sales tax bill probably would impose the largest unfunded mandate on State and local governments ever.

The bill would impose a tax on all non-education expenditures of State and local governments. Under H.R. 25, State and local governments would pay over \$300 billion per year to the Federal government in sales taxes.

Also, State tax administrators stated in Congressional testimony that repeal of the Federal income tax would require State and local governments to repeal their income taxes, since they rely on the Federal reporting and enforcement structure to collect their taxes.

The bill would blow a tremendous hole in all State and local budgets. It would be difficult for States to increase their local sales taxes given the new, large Federal tax. Their only option would be dramatic cuts in State and local spending or increasing real property taxes. *(See appendix B for a chart that shows the size of the unfunded mandate for each state, and the potential percentage increase in property taxes that could result.)*

C. Effect on Seniors

Today's retirees paid employment taxes during their working years in order to receive Social Security benefits in retirement. Those payroll taxes are being repealed and replaced with a retail sales tax that seniors would pay. Thus, under the Republican plan, seniors would be forced to pay twice for their Social Security benefits: once during their working years, and again during their retirement.

There is a second reason that substituting a retail sales tax for income taxes would cause "double taxation" for retirees. Many retired individuals have very little income tax liability. Much of their Social Security benefits are exempt from income tax. The portion of other pensions attributable to employee contributions also is exempt. And seniors have large expenses for medical care and long-term care that are deductible under the income tax.

Essentially, retired individuals who are spending assets already taxed under the income tax would be taxed again when they spend those assets. This would be particularly true since the Republican retail sales tax bill applies to all purchases of health care, including prescription drugs, hospital and nursing home care, and doctor visits.

D. Families with Children

Families with children will face some of the largest tax increases under the Republican retail sales tax proposal because of the multiple current law benefits for families with children, i.e., personal exemptions, \$1,000 per child credit, and the earned income tax credit. Under current law, families with two children are exempt from the income tax until their income exceeds \$40,000. The earned income tax credit and partially refundable per child credit offsets virtually all payroll tax liability for families with two children and incomes under \$25,000. Those families would

face dramatic tax increases under H.R. 25, i.e., 30% of their consumption spending over the Federal poverty level (approximately \$19,000 for a family of four).

Even families with middle- and upper middle-incomes would face large tax increases. *(See Appendix C for two examples.)*

E. Health Care

Unlike any State retail sales taxes currently in effect, H.R. 25 would tax all payments for healthcare, including payments for doctors' services, hospital or long-term care, and prescription drugs. It would also tax health insurance premiums. The tax would apply to payments for health insurance regardless of the source of those payments, i.e., private individuals, businesses, or governments.

The bill would impose taxes on the Medicare program. Informal estimates from the Medicare actuaries indicate that the insolvency of the Medicare Trust Fund could be accelerated by 10 years, from 2019 to 2009, if the bill were enacted.

The increased costs faced by the Medicare program also could result in a dramatic increase in Medicare premiums paid by seniors.

The bill would eliminate current law incentives for employer provided health care and instead would impose taxes on employers providing health care to their workers. There is little question there would be a rapid decline in insurance coverage.

F. Housing

H.R. 25 would impose a 30% retail sales tax on all purchases of newly constructed homes. Purchases of previously occupied homes would be exempt from the tax, but expenses to renovate or improve those homes would be subject to the tax. H.R. 25 also would impose a 30% retail sales tax on rental of apartments or other residences, including both new and existing structures.

Under current law, homeowners can deduct interest on home mortgages. That deduction is repealed, and instead, H.R. 25 would impose a new tax on payments under home mortgages. The new tax, payable monthly, would equal 30% of the difference between the interest paid on the mortgage and the interest rate on 10-year Treasury obligations.

G. Energy

The Republican national retail sales tax proposal would apply to all consumer purchases of energy, including gasoline, home heating oil, electricity, and natural gas.

Rural areas where individuals are required to travel long distances would be adversely affected by the increased transportation costs resulting from a 60-cent per gallon gasoline tax increase.

Individuals in areas with large home heating or cooling expenses also would be severely harmed.

H. Pensions

There are substantial incentives under current law for employer-provided pensions. Employers get deductions for amounts contributed to pension plans, and the amounts in those plans accumulate on a tax-free basis. In 1996, the American

Academy of Actuaries issued a study on the impact of fundamental tax reform on our pension system. They concluded that “pension plans would quickly diminish in number and size and gradually disappear” if a consumption tax were enacted as a substitute to the current income tax.

I. Charitable Organizations

Current law provides substantial tax incentives for charitable giving. Also, all activities of a charitable organization that are related to the organization’s exempt purpose are exempt from the income tax. Studies have indicated that the repeal of the deduction would result in substantial reductions in charitable giving.

Also, H.R. 25 imposes a retail sales tax on the furnishing of charitable services for which there is a separate charge. Charities would have a choice. If the tax is not passed on to the consumer of the charitable services, charities will experience a reduction in program service revenue. If it is passed on, the charitable services will be less affordable. In either circumstance, there could be a reduction in the level of charitable services.

V. Effect on Specific Sectors of the Economy.

Following are several examples of how the new retail sales taxes would affect specific sectors of the economy. It is not intended to be an exhaustive examination. For example, industries like steel or coal mining facing large employee health costs would face the same cost increases as the auto industry.

A. Automobile Industry

The Republican proposal for a national retail sales tax would involve a 30% retail sales tax on the sales of all goods and services. Official estimates indicate that a rate over 50% would be required to avoid greater deficits. The adverse impact of such an enormous tax