547

THE VALUE-ADDED TAX

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SECOND CONGRESS

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THE VALUE-ADDED TAX

TUESDAY, MARCH 21, 1972

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met pursuant to recess, at 10:10 a.m., in room S-407, the Capitol Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire; and Representatives Conable and Blackburn.

Also present: Loughlin F. McHugh, senior economist; Courtenay M. Slater, economist; Lucy A. Falcone and Jerry J. Jasinowski, research economists; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. I am convinced the subject matter of these hearings we start today is of importance for the future of this country—how we are to meet our collective responsibility for the vast unmet needs of our society in a way which will be both equitable and conducive to economic growth.

Statements which have emanated from the administration have, in my view, been too narrow. They would not only perpetuate existing inequities, but would indeed extend them.

The administration has strongly hinted that new initiatives needed to achieve equal opportunities for all of our people will depend on development of a new source of Federal revenues, namely, the value-added tax.

This committee will explore in the next several days just what this new value-added tax is, how much revenues it might raise, how equitable it is as a source of Federal funds, vis-a-vis alternative sources or as a method of raising added funds to meet the educational, health, basic income distribution requirements of the Nation.

It has become all too clear the Federal budgetary situation is a shambles. In large part, this is due to an inadequate economic policy which has led to a $40 billion deficit. It is also a result of deficient planning for the move from war to peace, inefficient control of Federal spending programs, and policies of reducing Federal revenues in the wrong place at the wrong time.

One salient fact is clear: By the mid-1970's the Federal Government will need at least extra revenues of $50 to $100 billion, and I say at least because I can easily develop a scenario, as anybody else can, for $200 billion or more needed by the middle 1970's. These needs will be in excess of those revenues which we can hopefully expect will result from an economy working at full employment. These new revenues will (1) help States and localities meet their pressing needs—in the fields of education and other public services carried on at the local level; (2) improved health facilities; (3) eradication of poverty; and (4) elimination of discrimination.

Some of the new resources can come from improvements in, or elimination of, present Federal spending programs. But most will have to come from added Federal taxes. Such added taxes may not result in increased total taxation. But if State and local taxes are to be reduced, care must be taken to assure that such reductions are achieved on a rational basis.

We will today first hear from Congressman Charles Vanik (D–Ohio). Representative Vanik has had a long and distinguished record of public service at both the local and national level and knows intimately the financial problems faced by States and urban communities.

Following a brief statement by the Congressman we shall hear from an expert panel of private witnesses: Sheldon Cohen, former Commissioner of the Internal Revenue Service, presently practicing law in the District of Columbia and a continuing student of Federal finances; Prof. John Due, chairman of the Department of Economics at Illinois University, and a long-time student of public finance; and Prof. Charles McLure of Rice University, who is currently involved in a major study of the value-added tax.

Congressman Vanik, I understand you have a short statement. Will you proceed.

STATEMENT OF HON. CHARLES A. VANIK, A REPRESENTATIVE IN CONGRESS FROM THE 22D CONGRESSIONAL DISTRICT OF THE STATE OF OHIO

Representative VANIK. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee: The average American taxpayer has never shirked his responsibility in supporting the government. If we apply the contributions test, the average taxpayer shoulders the heaviest tax burden. He has no tax shelters; he had no depreciation gimmicks, no tax-free bonds, no capital gains. He pays on every dollar of income.

Compare this record with taxes paid by corporations. Our past record is committed to the dismemberment of the corporate tax system. The Revenue Act of 1971 has failed to provide any monumental economic recovery. As I predicted, it turned out to be a gigantic tax giveaway to a few special interests. To add insult to injury, in this same year the Federal deficit payment amounted to over $44.7 billion, largely as a result of losses to the country as a result of last year's Revenue Act; $90 billion of that figure will go to business.

One of the revealing sources of information—this is why I am here, among other reasons—as to the cause of the reduced Federal tax receipts and the skyrocketing Federal deficit, can be found in the various corporate annual reports for the year 1971.

I have before me the report of the United States Steel Corp. I was shocked to learn this corporation, the largest dollar value steel manufacturing company in the world, carried on a total business of almost $5 billion and paid absolutely not 1 penny of Federal income tax in 1971.

United States Steel is an example of a corporation engaged in operations which contribute substantially to the pollution problems of America, and in the course of its business activities, demands considerable Federal support in a variety of programs. We have got to build waterways, develop all sorts of services for this corporation; yet, it contributes not 1 penny to the Federal Treasury. If an operation of this dimension, conducting a $5 billion business in this country, has no tax liability, pray tell, Mr. Chairman, who should pay taxes?

There are no alibis; there are no justifications for us to suffer the continuance of laws and administrative policies which permit United States Steel and others to throw the Federal tax burden on the individual taxpayers of America.

I have a statement here which I would like to include in the record, which is quoting from page 26 of United States Steel's 1971 report, a year in which the corporation had net income of $154 million, in which it says:

> No provision for taxes on income is required for 1971 due principally to statutory deductions associated with mineral production and investment credits and since deferred taxes provided in prior years on foreign subsidiary earnings exceeded the taxes on such earnings repatriated in December 1971 because of credits for foreign taxes paid. Estimated United States and foreign taxes on income payable for the year 1971 of $57.9 million are offset by deferred tax credits of a like amount.
>
> The investment credits for 1971 and amortization of the pre-1968 investment credits, which are reflected in deferred taxes, reduced the provision by $23.5 million. In addition, the net effect of all timing differences served to reduce the provision for income taxes by $34.4 million. Such timing differences represent taxes applicable to items reported for tax purposes in a period different from the period in which they are included in the determination of net income for financial accounting purposes. Amounts charged for wear and exhaustion of facilities and amounts of earnings of certain foreign subsidiaries are typical examples of such reporting differences.
>
> The provision for estimated taxes on income in 1970 reflects tax deductions associated with mineral production payments completed in that year and investment credits of $31.1 million.

Now, I ask, Mr. Chairman: Certainly this great company, in the defense of its own operations in this country should at least contribute enough to pay for one foot soldier, to buy 1 day's supply of fuel for a jet, to make some contribution for its own defense and security. What we face in America today is we have equal protection of laws with an unequal contribution by the taxpayer who is least able to pay.

That report is a good report because it tells us what goes on pretty well. I want to commend the company for frankly stating this on the record. Most other corporation reports conceal it. They talk about set-asides, or provide statements in which they indicate that sums of money are set aside for income taxes, but they do not indicate the dollars of taxes actually paid or not paid by the corporation.

This information is very hard to come by. Sometimes, if you press the Securities and Exchange Commission, you may get to it, but this is one of the great secrets of our tax policy today, which keeps from the public the actual taxes paid or not paid by the various corporations of America.

Now, that is only one case. I have another one, a typical major corporation, a large utility, which does $100 million worth of business.

Chairman PROXMIRE. May I say, Congressman Vanik, any part of that you would like in the record, we can put it in in addition, whether you actually orally state it or not.

Representative VANIK. I am endeavoring to save the time of the committee.

There is another corporation, a very successful one, worth $100 million worth of business. In 1970, a rather lean year, they paid taxes of $2,243,868. In 1971 they ended up paying $156,730. Which is hardly as much as the income of some professional golfers. It just does not add up. It is for the same reasons. They are all stated in the report of the company, which I would like to put in the record.

Chairman PROXMIRE. Without objection it will be put in the record.

(The information referred to follows:)

In note 3 to the corporation's report it is stated:

Tax reductions resulting from the use of liberalized depreciation methods are reflected in Federal income tax expense currently in accordance with the rate-making policy of Utility Commissioners of the State of New Jersey. As a result of adopting Class Life (ADR) Depreciation System under the Revenue Act of 1971, Federal income tax expense was reduced in 1971 by approximately $111,000. Also, the Company has elected the percentage repair allowance rule under ADR, and Federal income tax expense under this provision, was reduced in 1971 by approximately $514,000.

As a result of investment tax credits, including $110,000 under the new investment tax credit in the Revenue Act of 1971, Federal income taxes in 1971 and 1970 have been reduced by amounts of $367,000 and $433,000 respectively. The Investment tax credit for 1971 principally represents a carryback to be applied against taxes paid in a prior year. Amounts equal to the tax reductions have been charged to income and credited to Deferred Credits for amortization by credits to income over five-year periods, or over the life of the property in the case of the investment tax credit earned under the new Revenue Act.

Representative VANIK. I have another situation here in which we have a company which I can identify. It is a lumber company. The name of it is Westvaco. It is a timber and paper corporation which had $430 million in sales last year. Its earnings last year were down, but the reduction in tax liability was even greater. As the corporation report says, that: primarily as a result of these timing differences for the year 1971, the company is entitled to a refund of $7,695,000.

So, I would very much appreciate it, if the excellent staff of this committee could do what we cannot seem to get done at the Ways and Means Committee, and that is: study the 500 Fortune list, the largest corporations of America, and find out how many of them are paying or not paying taxes for the year 1971. We were shocked last year to discover that 112 individual taxpayers paid no taxes, with an income of $200,000. My prediction, Mr. Chairman, is that you will find more than 112 of the leading corporations of America in the Fortune list of 500, who paid or are paying no income taxes for the year 1971.

I would certainly appreciate the services and the recommendations and the advice of the counsel of your committee to search out these facts so that we can be guided in determining what has happened to the tax policies of the country.

Mr. Chairman, I see in all of this, both with respect to what Congress did, to what we did in the act of 1971, to which I objected, and what was done by the addition of the asset-depreciation range, and the other varied Internal Revenue rulings that are coming out every day, a conscious effort to corporate taxation. I think the American people are entitled to know which of our partners in American enterprise are freeloaders and which are making a decent contribution to the support of the Government.

I think that we are reaching a point today where we are washing out corporation taxation as a form of Federal support. I think it is contrary to American principles, that any group of citizens—and a corporation is a citizen under our law, should be made exempt from a proper progressive system of taxation. We have to share this responsibility. And what I charge today is that we are having a dereliction of this responsibility, that we are phasing out corporation taxation. I think this is a very undesirable goal.

Now, I would like to address myself to the specific issue, the issue which you are concerned with here and which concerns me very much. I have had some opportunity to study about the way this tax works. In Europe, it has been a prime factor in contributing to inflation. But my prime argument against it, Mr. Chairman, is that it is a penalty tax, a penalty tax on family life. It multiplies for each dependent, supported by a taxpayer. It is designed for some other kind of social order, in which the dependents are supported by the State rather than the individual. For these reasons, Mr. Chairman, it is an un-American tax; it is alien to our way of life, because it multiplies the burden of that person who must support others and who wants to support others.

For that reason, I think it is completely alien to anything we have done in the past and I think it should be immediately dropped as a possibility for raising revenue.

Mr. Chairman, I contend that along with what we do to close tax loopholes—and I know you have long advocated closing these loopholes and I join with you and I do not want to go through the recitation of those propositions that we jointly agree on, that have been discussed so many times before my committee and before yours—but I would say, Mr. Chairman, that in addition to those, we must think in terms of some kind of a minimum tax on corporations. They should not be able to escape liability entirely. They should not become freeloaders in our society, whereby they enjoy the privileges of security and the right to do business and have the protection of the law, and make absolutely no contribution for this privilege.

It seems to me that we are heading in the wrong direction. In addition to those other recommendations that we have made and that we concur on, I have always advocated that we put a tax on imported oil. I think it is absolutely ridiculous for our Government to give to private people the right to import oil which they can immediately sell for an extra dollar and a half a barrel. It is an incredible system in which we allocate the import licenses to private people on which they can make a dollar and a half a barrel profit, just by turning over the paper, without doing any single one thing. It seems to me that we could very easily pick up about a billion-and-a-half dollars or more if we were to, instead of granting an import permit, make it a tariff, to the extent of what we think is an allowable import or permit entry according to market demands. But it seems to me that the present system is just handing out to private individuals a certificate worth a dollar and a half a barrel. It is utterly indefensible.

Mr. Chairman, I want to say in closing that I appreciate the service which your committee renders to my committee, to the Finance Committee and to America. In an open, direct manner, you monitor the heartbeat of the country on your economic cardiogram. Unlike the Ways and Means Committee and unlike the Senate Finance Committee, you do our work in the open for all of us to see. You are the trustees of Observatory Hill. It is my hope that as you look further into the distance, you can assure me of a stronger, more prosperous Nation. I leave my committee room every day filled with fear and filled with frustration. I see the tax system of the Nation riddled with ambiguous injustice. We tax too many too much; we tax too many too little. We miss taxing entirely too many.

Mr. Chairman, I am frightened by our insolvency, the administration's accelerated depreciation, the investment tax credit and the foreign tax credit. All of these things have made a sieve of the Treasury.

In addition, we spend in disregard of our dilemma. For example, in revenue-sharing, the Federal Government stands like a beggar dividing alms. We give away $5.3 billion to do what could be done with perhaps $2 billion in the first year. The administration says the full amount has been budgeted and should be spent, almost unaware of the tremendous contribution to the deficit.

Mr. Chairman, there is a tremendous infectious drive within the Federal Government and without to drain off the strength of the Nation and disintegrate the capacity of the Federal Government to solve social and economic problems ahead, which would make today's problems seem miniscule.

Mr. Chairman, I hope you can see something better ahead than I can. I see grave trouble.

Chairman PROXMIRE. Thank you very much, Congressman Vanik. I want to thank you for a most provocative, interesting statement.

In a way it is the best kind of statement because I can find much with which to disagree and much to agree in what you say.

First, of course, it is a very great honor to have you, as a member of the Ways and Means Committee, a man with great experience in taxes, come before this committee and pay tribute to it. We do appreciate that and are delighted to know we have been of some benefit.

I am also happy to hear you suggest that instead of the import oil quota, we have a tariff, which was recommended by a Presidential commission, but then rejected, even though the majority recommended it. The Nixon Commission recommended it but the President did not accept it.

Also, I am very happy to have the emphasis you have on the drop in corporate income tax. In 1960, of the total Federal revenue, 23 percent was from corporate taxes. In 1973 it will be only 16 percent, whereas the most regressive tax we have, social insurance taxes, have expanded from 16 percent up to 29 percent.

So, the main thrust of what you have been saying is correct. But, for the life of me, I cannot understand why you put so much emphasis on United States Steel not paying any taxes in the year in which they lost money. The income tax is based upon the ability to pay. When an individual or citizen or corporation does not make any money, they do not have any income to tax. This would be true of United States Steel; it would be true of any citizen, no matter how rich he had been in the past, in this one year it did not make any money. In 1971, I assume United States Steel did not.

There is a terrific case on oil companies. In some years they make money hand over fist and pay nothing and get a huge refund. Atlantic Richfield has had it happen to them year after year after year. But, it seems to me if a tax is based on the ability to pay, you cannot expect a corporation in a year in which they lost money, to make a payment. I think one of the values of the income tax is when the corporation is in difficulty it does not have the burden that year of getting in greater difficulty by having to pay to the Federal Government.

Over the years, United States Steel has made enormous contributions to this Government. I am sure they will in the future if they are profitable.

Representative VANIK. The point I make, Mr. Chairman, I have to support these things whether I have good years or poor years.

Chairman PROXMIRE. Not if you do not have any income.

Representative VANIK. The individual taxpayer does pay constant taxes. He does it in a variety of ways. There are certain fixed taxes. For example, the property tax and other taxes. He must pay in lean years or good years.

Chairman PROXMIRE. They pay property taxes, too.

Representative VANIK. I understand that. But, it seems to me there ought to be some contribution by a corporation.

The other point I wanted to make is that the profitability of a corporation is no longer the test we can follow from the corporation reports. We must look at cash flow and other things. There are a great many hidden deductions and credits as far as the books are concerned. They generate a tremendous cash flow. I think we have to use other tests.

Chairman PROXMIRE. In 1971, the United States Steel employees paid enormous income taxes, not only management and labor. There were great contributions to the Federal Government from the people who made the corporation operate. Their income was substantial. I am sure they must have paid millions of dollars in taxes to the Federal Government that year, based on just their salaries. Isn't that correct?

Representative VANIK. I do not think that should be credited to the corporation, Mr. Chairman.

Chairman PROXMIRE. Well, the corporation is what made the whole thing operate, made it possible.

Representative VANIK. The point I wanted to make is that I do not believe that corporation reports generally reflect the profitability of a corporation any more. I think you have to do some serious analysis over and beyond the report, to determine the cash flow and the other things that contribute to the value, to the reason they conduct business. There are a great many corporations that never show profits, as you have indicated. Some of the oil companies and others that certainly have a tremendous input of revenue and cash flow, which is a better measure of their profitability, I think, than what they say in their statement.

Chairman PROXMIRE. Would you provide in a year in which a corporation loses money, there not be any refund from past years in which they made money?

Representative VANIK. I think that principle has justification, but I do think notwithstanding all of these privileges there should be some minimum tax.

I think the cost of protecting the corporation's profits—there ought to be some kind of minimum contribution to the national security, for example. I do not think they ought to be freeloaders in any given year. I think there ought to be some kind of tax contribution made under any circumstance, because there ought to be some input in what it cost to do business.

Chairman PROXMIRE. How substantial would that minimum tax be, in your view, as a percentage of the corporate income? As I pointed out, the corporation income tax amounted to only about 16 percent in 1973 of all Federal revenues. Would you assume that could be a significant new source of revenue, of Federal revenue?

Representative VANIK. I think there could be a substantial minimum tax that would still permit all of the principles that you have suggested to carry on.

Chairman PROXMIRE. At any rate, you are very much opposed to the value-added tax?

Representative VANIK. I am opposed to that.

Chairman PROXMIRE. That would not be a tax on the corporation.

Representative VANIK. That would be a tax on the individual, a tax on the consumption. It would be a tax on what people buy for themselves, and their dependents. In Europe, it runs as high as 23 percent on some items. I think it is a horrendous system of taxation which would pass the burden on to the family, and multiply the burden for each and every dependent in the family.

Chairman PROXMIRE. Very good.

Congressman Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman. I, too, want to welcome my colleague in the House before our committee.

I must say that I have a very adverse reaction to some of the comments that gentleman has made. I share your view, Mr. Chairman, that the income tax is based on the basic principle that there has been income to tax. I am sure the gentleman is not suggesting that these corporations are acting illegally?

Representative VANIK. No, I did not suggest that.

Representative BLACKBURN. So, that being the case, if these corporations are acting within the law, the laws are the laws that Congress has enacted. Isn't that true?

Representative VANIK. What I have suggested is that the laws are ridiculous because they allow so much to be written off. We have had a difficult time trying to change, and correct these laws.

I am complaining about two things: I am complaining about laws that have over extended the writeoffs, the tax advantages, the tax preferences to both individuals, and to corporations. These laws are unjust. They must be changed in order to provide a more fair, and equitable distribution of the tax burden in accordance with the capacity to pay.

Representative BLACKBURN. Let me ask you this: If the corporation is going to pay taxes, whether it be income tax or just a minimum tax that you declare they should pay, irrespective of income (of course, they pay property taxes based on growth assets), from what source are they going to receive the funds to pay these taxes? From sales?

Representative VANIK. They take it out of their sales and profits.

Representative BLACKBURN. Out of their sales?

Representative VANIK. They take it out of their sales.

Representative BLACKBURN. That is right. And if they do not sell any goods, they go out of business; do they not?

Representative VANIK. Well, that would be normally the course. But I would say this, that actually, if there is a minimum tax, it seems to me this would provide at least some minimum contribution, even in a poor year, for the support of the Government which makes possible so much of what they do.

Representative BLACKBURN. Well, you have glossed over entirely the very substantial contributions that the employees of these corporations pay through their income tax. You are not suggesting the country would be better off if we abolished United States Steel, are you?

Representative VANIK. No. What I am saying is we have gone too far, much too far, in reducing the corporate contribution.

Representative BLACKBURN. Could I ask you a question, please, sir? If they earn no money, and we levy a tax against their assets, we are depleting the corporation's assets so they cannot stay in business if this is done too often; can they?

Representative VANIK. What I want to suggest is that your staff find out whether they are not making the profits. They hide profits in cash flow. They also own tremendous portfolios in other corporations and pick up dividends, on which they pay no taxes. We are to find out the truth. To what extent are they at a deficit condition. What is the real picture? I just do not believe all I read in the reports as they are printed.

Representative BLACKBURN. Well, then, you are being somewhat inconsistent. You said you do not accuse them of acting illegally.

Representative VANIK. I never said that.

Representative BLACKBURN. No, you did not, and you say they are not acting illegally, yet you say you would like someone to learn the truth. Are you saying they are dishonest but not illegal?

Representative VANIK. No. We are not talking about the same thing at all. I am talking about corporation reporting, corporation reporting, which will reveal the true state of the balance sheet. Under the present system we defer the investment credit. They have the options under accounting principles which they themselves tell their accountants to devise——

Representative BLACKBURN. Which are authorized by law.

Representative VANIK. Which defer the effect of the investment credit. I say these things come about through laws and regulations which are not just, laws which must be rectified. I do not think we can correct these laws until we have all of the information that we need. I ask your committee, in its tremendous powers, to gather together the information which I think is absolutely vital to make a fair judgment on this issue.

Representative BLACKBURN. Well, the point I am trying to make is this: If we levy taxes against the assets of a corporation, it must pay those taxes either out of its gross sales, or we are going to have to begin levying taxes on the capital assets of a company. The former means that the average fellow with whom you are concerned, and about whom I am concerned, would have to pay that tax in the goods that he buys from that corporation, and they are going to pass those taxes on in the form of higher sales prices. The latter means that eventually we could abolish the company. I do not think you want to see that happen either. Further, I believe it is the job of the Internal Revenue Service and the SEC to investigate your claims and not the committee staff.

Representative VANIK. I do not want to see that happen, nor in the alternative, do I want to see corporate taxes abolished. I think we are headed down that road and I think the figures of 1971 will be a shocking revelation of what has happened. I think the increase in the individual's share of the support of the Government is going to be much accelerated as a result of the asset depreciation range by the administration last year and the 1971 Revenue Act.

I think the figures are going to be shockingly different, even considerably different from those that were given by the chairman earlier in his testimony.

Representative BLACKBURN. I have no further questions.

Chairman PROXMIRE. Thank you very much, Congressman Vanik. It was most provocative. It certainly started off our hearings with a challenge.

Our next three witnesses I will ask to come forward as a panel. Sheldon Cohen, former Commissioner of the Internal Revenue; John Due, chairman of the Department of Economics, University of Illinois; and Charles McLure, Department of Economics, Rice University.

Why don't we do this alphabetically, start off with Mr. Cohen and then Mr. Due and then Mr. McLure. Go right ahead, Mr. Cohen.

STATEMENT OF SHELDON S. COHEN, COHEN & URETZ, WASHINGTON, D.C., AND FORMER COMMISSIONER OF INTERNAL REVENUE SERVICE

Mr. COHEN. My name is Sheldon S. Cohen. I am a partner in the law firm of Cohen and Uretz in Washington, D.C. During the period December 1964 through January 1969, I served as Commissioner of Internal Revenue.

I appreciate very much your invitation to appear today to present my personal views, not those of my firm or my clients, concerning proposals that a value-added tax be enacted to provide a new source of Federal revenues.

At a time when all levels of government—Federal, State, and local—are hard pressed to raise funds needed to finance vitally needed public services and programs, we must search diligently for means of raising additional revenues efficiently and equitably; I think those are the tests we must try on every new proposal, whether from existing taxes or new ones. Any serious proposal to raise revenue must be judged carefully in the light of these standards and on its merits.

It is important, therefore, that the issues presented in examining the desirability and feasibility of a value-added tax be put in proper perspective.

There are some who would have the public believe that a value-added tax is the way—indeed, the only way—to relief from the increasing burden of local property taxes. That is simply not true. Whether property tax relief is needed or desirable is a very tough, independent question. If careful analysis demonstrates that less reliance should be placed on local real estate taxes as a source of local funding, there are many alternatives, only one of which is a value-added tax, that must be examined to find the best solution—and not just the most expedient one.

Certainly the property tax as applied in some localities has been unjust and statewide or regionwide taxation may be an answer to that.

The value-added tax must, therefore, withstand scrutiny on its own to determine whether it has the potential of meeting the dual tests of efficiency and equity better than other means at our disposal.

The essence of a value-added tax system is that at each stage of production and distribution a tax is imposed at a given rate on the value added to the product or service. Although there are various ways in which the tax may be structured, it is generally accepted that in almost all cases the tax is passed along to the ultimate consumer in the form of a price increase at least equal to the aggregate tax which the product or service bears. The tax, therefore, is a tax on consumption—how much a person spends—rather than a tax on income—how much a person earns.

A consumption tax has the inherent characteristic of regressivity—lower income groups pay proportionately greater taxes than those with higher incomes, since a greater portion of their earnings are expended for living costs. Although there may be devices, and they are being discussed today and examined, which can moderate the severity of the regression, a viable system remains, nevertheless, dominantly regressive. And I might add right there that any attempt to get away from regressivity adds complexity. The very essence of the proposal seems to be: this is a simple tax. Try to add any one of these features and it becomes very complex, very hard to administer. A value-added tax studded with the requisite exemptions and exclusions merely to remove its most serious regressive impact, will, no doubt, present intensely serious administrative problems. It has abroad and in our society where we have never tried anything like this, it will create some serious problems that I think will bear a great deal of examination.

Clearly, the income tax is more equitable and fair, since it is based on ability to pay—rather than on the need to consume. If the income tax system were presently structured to yield fully its revenue potential with reasonable progressivity in fact, other alternatives for the raising of revenues might have to be considered. But, the income tax system is not operating in accord with its potential. The system is overloaded with unwise and unneeded tax preferences which narrow the base and permit many with large incomes to avoid paying their fair share.

I would like to interject and note we have seen, and I think before this committee there has been a good bit of testimony as to 112 individuals who have incomes in excess of $200,000 and who pay no tax. Several years ago it was 154 individuals who had income in excess of $200,000 and paid no tax.

That is a statistical aberration. In fact, the numbers are much larger than that. Nobody can quantify it because the Internal Revenue Service's records are kept on the basis of adjusted gross income. Adjusted gross income is determined after certain allowable statutory deductions. So that if my income, for example, was from partnerships which had large accelerated depreciation deductions on their returns, perhaps of $200,000. This is eliminated from my adjusted gross income before it ever gets onto my personal return. Then when the statistician at the Internal Revenue Service looks at that return, he classifies it as having a much lower adjusted gross income. There are thousands of people in that category in the United States.

So, the 112 are only symptomatic of a problem that bears deeper examination than I think the Congress has given it yet. As Mr. Mills has indicated, I think we can do better yet.

Large amounts of revenue can be raised now by meaningful tax reform—and at the same time we can restore public confidence in the fairness of the system.

And I would interject there, that we have a very fair income tax system compared with others. It is not fair enough. It is not as good as it ought to be. It is the best income tax system I know of in the world but if I had my way, if Sheldon Cohen could write it again, he would, hopefully, write it somewhat better than it is today. I know there are conflicting political pressures one must meet, but I think periodically the Congress should reexamine old premises and try to see whether they still hold.

Given these circumstances, I see no justification to enactment of a value-added tax which would only shift more of the tax burden to low and middle income families.

And I mean middle income because the people in this country in the $10,000 and $20,000 and $30,000 bracket are spending all of their income, and if they are spending all of their income they are bearing the full tax under the value-added system because the tax is one on consumption, as I indicated.

These considerations aside, the case for a value-added tax is still not persuasive.

Proponents of the tax point to its use in European countries as demonstrative of its success and the need for us to follow their lead in order to more fully integrate our system of taxation with theirs. But the European experience generally has been quite different from ours. The level of compliance with the income tax, indeed, any tax, in Europe has been relatively low, outside of England and Scandinavian countries, compelling those countries to find alternatives—such as value-added taxes—which, though less equitable, are more productive of revenue.

They do not trust their taxpayers. They do not trust their taxpayers with a sales tax and therefore they levy their sales tax not at one level, but at multiple levels, so if somebody makes off with a portion of the taxes, it will be only a small portion.

That has not been the case in the United States where we have an enviable record of an overall high degree of compliance with the progressive income tax system. Many a tax official from abroad has marveled at our system and expressed to me his keen desire that his own system could function as well.

Moreover, in some countries, such as Sweden, the adoption of the value-added tax was accompanied by a repeal of the retail sales tax—I gave Sweden but I think you would find it in most countries—or in some countries a cascading turnover tax. In terms of equitability, fairness to their taxpayers, the value-added tax was more equitable than that which came before it—the substitution of one form of consumption tax for another—not the substitution of a consumption tax for an efficient income tax.

I am also unconvinced that adoption of a value-added tax would have any significant beneficial effects insofar as foreign trade or balance of payments problems are concerned.

I am also concerned with the tinkering with a relatively healthy tax system to effect less than 5 percent of our commerce, if it had this effect in fact, which I doubt. The fact that a value-added tax is adopted which, as an indirect tax, may be rebated to exporters under the General Agreement on Tariffs and Trade, does not improve the existing situation. It is only where a value-added tax is substituted for a nonrefundable direct tax that a positive impact on pricing of export articles in foreign markets occurs. Even if the enactment of a value-added tax were accompanied by a concurrent reduction in some other tax, such as the property tax, the effect is likely to be so modest as to have little or no impact on our trade position. For example, the amount of property taxes borne by business as a percentage of sales is so slight, that even if property taxes were repealed completely in favor of a value-added tax, there would likely be no significant impact on the pricing of export goods. But even were we to assume that a convincing case can be made that a value-added tax would have a favorable effect on our foreign trade of meaningful proportions, the argument is still not won. The anticipated benefit still must stand the test of comparison with its cost. We have to figure out the bang for the buck, its effect on various segments of society, and indeed in this country as a matter of political reality, and the degree to which its regressive characteristics can be tolerated as a matter of tax justice. The benefits may well not be worth the burdens. Here we have new administrative costs to the government which somebody has to calculate and administrative costs to be borne by the business community in the United States.

Another serious aspect of a value-added tax is its adverse effect on inflation. Imposition of a value-added tax generally results in increasing the cost of consumer items. Thus, the cost of living rises—usually, very sharply.

European countries experienced significant inflationary pressures following adoption of value-added taxes—with prices frequently rising by more than the amount of the tax, as some businesses used the tax as a device or excuse for passing on general price increases. Since the tax also results—and I think this has been ignored—in increased cost of operation and investment, as a practical matter prices are likely to increase in amounts greater than the amount of the tax itself.

Inflation in the United States is a serious and persistent problem at the moment and for the foreseeable future. A value-added tax would only add fuel to the fire, making more difficult the job of moderating inflationary pressures in the economy.

Many businesses, as well as consumers, may also be adversely affected by a value-added tax. The tax would involve new and expanded administrative costs in order to maintain the records needed for compliance. More importantly, some business groups would be caught in a squeeze which would have significant adverse financial effects. Although it is generally assumed that the tax would be passed on in the form of higher prices to consumers, that may well not be the universal experience. The rate of tax would be very high in relation to profits in industries which have high volume and low percentage yields. And there are a number in this country.

For example, assume a business has an annual volume of $10 million and earns a 1 percent net profit of $100,000. A 3 percent value-added tax could amount to as much as $300,000. If by reason of competitive conditions, or otherwise, any portion of that tax is not passed on to consumers, the company's profit picture would be altered drastically—to a much greater degree than would result from a significant rise in corporate income tax rates.

The value-added tax has serious drawbacks—for consumers for business, and for our economy. I believe we ought to be focusing our efforts on strengthening our income tax system, which can raise revenues more fairly and efficiently.

I think, also, that we ought to be exploring ways that we can help the States increase the efficiency of their tax systems. Mr. Mills has indicated an interest in a Federal collection of State taxes, the taxes to be imposed by the States but collected by the Internal Revenue Service as a service to the State governments. I think this is a fruitful exploration which can maintain the Federal system that we have; that is, the States maintain their independence, their own rates, their own imposition of tax and yet have a more efficient, effective means of collecting the tax.

In summary, the United States in the 1970's is neither the time nor the place for a value-added tax.

Chairman PROXMIRE. Thank you very much, Mr. Cohen.

Mr. Cohen, you kept your remarks very brief. You had a brief statement. I hope the other witnesses can do likewise, because we would like to have time for the three of us to question you. Whatever you skip over will be placed in the record.

Please proceed, Mr. Due.

STATEMENT OF JOHN F. DUE, PROFESSOR OF ECONOMICS AND CHAIRMAN OF THE DEPARTMENT, UNIVERSITY OF ILLINOIS, URBANA, ILL.

Mr. DUE. Mr. Chairman and members of the committee. I would also like to express appreciation for being invited to appear before the committee.

Reform of the methods of financing education is long overdue and action to reform the system is being prompted by recent court decisions. There are a number of alternative avenues of reform: Replacement of the local property taxes by a uniform State property tax; increases in State income and sales taxes to provide the necessary funds; grants of funds out of Federal income tax revenues; and the recent suggestion by the administration, now under study by the Advisory Commission on Intergovernmental Relations, for a Federal value-added tax to raise money for this purpose.

The general objections I am going to raise to this proposal are very similar to those Mr. Cohen raised.

While the need for reform is unquestioned, there are a number of serious objections to the value-added tax proposals: Equity—a value-added tax is simply a form of sales tax, equivalent in base and yield at a given rate to a retail sales tax, differing only in that the tax is collected in increments from each firm in production and distribution channels on the value added by each firm, rather than entirely from the retailer on the final selling price at retail. The sum of the values added at each stage in production and distribution of course equals the retail selling price. The presumption is that the value-added tax will shift forward to the final consumer, with some deviations, in the same pattern as a retail sales tax. To the extent that it does not, it rests in an inequitable and capricious fashion on the owners of various businesses and their employees. As Mr. Cohen pointed out, the tax is going to be regressive relative to family income.

Under the assumption of forward shifting of the value-added tax, the tax will be distributed in a relatively regressive fashion because lower income groups spend higher percentages of their incomes on taxable goods than do persons in the higher income groups. Even more serious than the relative regressivity, which can be offset to some extent by the progressivity of the income tax, is the absolute burden on the lowest income groups, already living below a minimum subsistence budget.

The regressivity and the absolute burden on the poor can be lessened by exemption of food from the value-added tax. But this approach is highly unsatisfactory in many respects. Exemption favors those persons who spend relatively high percentages of their income on luxury foods. It unnecessarily exempts food expenditures of the higher income groups and causes a much greater reduction in tax revenue than is necessary to accomplish the objectives. The exemption does not free the lowest income groups from their entire tax burden. It materially complicates the tasks of retailers in applying the tax and of auditors in checking upon the accuracy of returns.

A much more satisfactory approach is the provision of a credit against income tax representing value-added tax paid on minimum necessary purchases, with refund for those persons having no income tax liability. This system is used with the sales taxes in Indiana, Colorado, and several other States. Compared to food exemption, this approach causes less loss in revenue and is much less discriminatory against various families while relieving the very poor of all tax liability. It causes far fewer administrative and compliance complications than food exemption. But experience in the states does show two limitations. A substantial number of the poor do not file for their refunds, and thus the intent of the program is not fully attained. Second, there is also some multiple filing, a person obtaining several refunds.

Even with food exemption or a credit against income tax, however, the value-added tax suffers from several limitations on equity grounds. The tax cannot be made progressive as can the income tax. The tax favors those families at each income level that deliberately spend relatively low percentages of their income. No adjustment for family circumstances is possible, except crudely under the credit against income tax system.

Despite popular views to the contrary, the property tax is not regressive except at the very low and very high income groups.[1] Certainly the value-added tax provides no improvement over the property tax in terms of overall distributional patterns. Much of the property tax—an estimated 40 percent—rests on land. One of the few subjects on which economists agree is that a tax on land values is one of the least objectionable of all forms of taxation and has much merit from an equity standpoint. Reduction in taxes on land will result in increases in land values and a bonus to large landowners. If the Federal Government is to increase its contribution for schools, the obvious solution, from the standpoint of equity, is to improve the structure of the income tax, close additional loopholes, and if necessary increase the rate. We have just witnessed substantial reductions in the income tax; the obvious solution to obtain more revenue is to call upon an improved income tax to supply it, not to add a new tax which on equity grounds is inevitably an inferior levy.

[1] This is shown in studies by the Advisory Commission on Intergovernmental Relations.

FISCAL POLICY EFFECTS

A Federal value-added tax would undoubtedly have greater adverse effects on employment than other forms of tax, because of its greater effect in restricting consumption, per dollar of revenue. The tax hits more heavily those families consuming all or most of their income and gives some incentive to curtail consumption. While in theory this effect could be offset by other fiscal or monetary policies, in fact such policies do not appear easy to implement or fully effective.

At the same time, the value-added tax would add to inflationary pressures by raising the cost of living. This reaction would likely more than offset the anti-inflationary effect of the tax in reducing consumption. While virtually all taxes may have some effect in leading to demands for higher wages, a levy that directly increases the cost of living index is likely to have the greatest influence, per dollar of tax revenue.

INTERGOVERNMENTAL RELATIONS

Establishment of a Federal value-added tax would infringe upon the States major revenue source, the retail sales tax, now used in 45 States and yielding 30 percent of State tax revenues. The States are restricted in the income tax field by the substantial Federal use; their one major autonomous source is the sales tax. Without question establishment of the Federal value added tax would restrict the ability of the States to gain additional revenue from this field.

OPERATIONAL COMPLICATIONS

A Federal value-added tax would create a vast new complex of tasks for business firms of types and necessitate a major new enforcement and audit staff for the Internal Revenue Service. The number of taxpaying firms would be in the neighborhood of 5 million with farmers excluded from the tax.[1] These firms would have to keep records and file returns for the new tax in addition to the ones now required of them for the State retail sales taxes. For smaller businesses, the very concept of the value-added tax would create complications, at least initially.

The value-added tax, under the usual tax credit system, as used in Europe, works most smoothly when there are no exemptions of types of taxpayers, since the tax paid by one firm constitutes a deduction for another. Each firm calculates tax by substracting the tax paid on its purchases from the figure obtained by applying the tax rate to its taxable sales. Whenever this chain is broken, special techniques are required to avoid multiple taxation by exempting sales by vendors to exempt firms or granting refunds to firms that have paid tax on purchases but are not registered vendors taxable on their sales. To make the 3 million farmers in the United States subject to the tax would add greatly to compliance and enforcement problems. But if they are exempt, either the sales to them must be specifically exempted, a refund provided to them for tax paid on purchases, or the

[1] There are 4.1 million firms now registered under the state sales taxes.

price of the products purchased from them assumed to contain a certain tax element which the purchasers, if registered firms, can deduct against their tax liability. Any of the approaches creates major complications. Commodity exemptions create more problems than under retail sales taxes since the exemption must carry through several production and distribution stages. Other exemptions are likely to be made for various social and economics reasons: Medical care, hospital service, urban transport. The concept of value added is not clearcut or easily defined with banks and insurance companies. On the whole, the value-added tax is not nearly as simple a levy as is sometimes argued.

These complications suggest that if the Federal Government were to move into the sales tax field, it should use the retail sales tax form instead. This is a simple levy familiar to most business firms in the United States, and Federal operation could be coordinated with the state sales taxes. Only firms selling at retail are vendors and the number of tax-paying firms is therefore somewhat less. The only potential advantage of the value-added tax over the retail sales tax is the possible greater ease in excluding all producers goods from the tax if desired. Firms can be permitted to deduct tax paid on all of their purchases and not just those of materials and parts, and check needs to be made only on the firm itself. With the retail sales tax the exemption applies to the sale of producers goods by the suppliers and therefore check must be made upon both supplier and purchaser. This argument has been stressed by Profs. Ann Friedlaender and Carl Shoup.[1] But the argument can easily be exaggerated. Most sales of producers goods can be excluded under retail sales taxes if desired; the States have never actually systematically sought to do so.

The other arguments for the value added form of sales tax, that it lessens evasion because much of the tax is collected at the manufacturing and wholesale levels where firms are larger, and that it provides automatic cross check since tax deducted by one firm should appear as tax paid by its suppliers, are of little merit in the United States, in view of the ability to enforce retail sales taxes with little evasion. This argument is highly significant in countries that cannot collect heavy taxes from retailers.

THE FOREIGN TRADE QUESTION

The argument is often advanced that use of a value-added tax would aid the position of American producers competing in foreign markets, since the tax would be rebated on exports. As a replacement for the property tax, there would be virtually no net advantage, except possibly for a few property intensive firms now heavily burdened by local property taxes not refunded at export. But for most manufacturers, property taxes constitute a negligible element in the costs of goods they are selling for export. As compared to a personal income tax there is no advantage whatever since the income

[1] Ann F. Friedlaender, "Indirect Taxes and Relative Prices," Quarterly Journal of Economics, vol. 81 (Feb. 1967), pp. 125–39; Carl Shoup, "Experience With the Value Added Tax in Denmark and Prospects in Sweden," Finanzarchiv, vol. 28 (March 1969), pp. 236–52.

tax does not affect export prices. The personal income tax may, it is true, result in higher wage demands, but the value-added tax also has this effect, almost certainly of greater magnitude per dollar of revenue.

Even as compared to the corporate income tax, the value-added tax offers little advantage, even though the value-added tax can be refunded on exports while the corporation income tax cannot. The inability to refund the corporate income tax is relevant for our exports only if the corporate income tax is actually reflected in higher prices of commodities exported. There is no clearcut evidence that the corporate tax is even reflected in the prices of domestic goods, despite the vehement insistence of many persons that it is; even if it is, the tax is not necessarily reflected in export prices. But more significantly, our major competitors in world markets have corporate income taxes comparable to ours in height; our producers are under no net competitive disadvantage. The European value-added taxes were introduced to replace the turnover form of sales taxes, not income, property, or other levies.

In general, no field of taxation has seen so much nonsensical discussion than the value-added tax. To some persons, the mere act of levying a value-added tax and then refunding it on exports, even without elimination of any other tax, would aid our exports; this is ridiculous nonsense. To others we must have a value-added tax because other countries are using one—there is a frantic running scared—we have to use it because they are using it—copycat bandwagon attitude on the part of many people who should know better. In reality, much of the support for the tax comes from persons who are primarily interested in reducing the overall progressivity of the tax structure; the term "value-added tax" smells sweeter, they hope, than the term "sales tax." The dogged insistence of a few persons that a value-added tax is not a sales tax plays into their hands. The property tax is notoriously unpopular; to the supporters of a Federal sales tax, the school finance crisis offers the golden opportunity to introduce the levy by tying it to elimination of a highly unpopular levy. There are far simpler and more attractive methods to meet the need to eliminate the local property tax for financing education: Statewide property taxes, higher State sales and income taxes; a more effectively progressive Federal income tax.

Chairman Proxmire. Thank you very much.

Mr. McLure, please proceed.

STATEMENT OF CHARLES E. McLURE, JR., ASSOCIATE PROFESSOR OF ECONOMICS, RICE UNIVERSITY

Mr. McLure. Mr. Chairman, I am pleased to be able to appear before you today to offer my thoughts on a subject as important to the Nation as a value-added tax.

Like most questions of tax policy, whether the United States should adopt a Federal tax on value added (TVA) has no simple answer. The verdict depends upon the alternative sources of revenue available and the context in which the decision must be made. A choice that would be acceptable under one set of circumstances might be totally unacceptable under another. In my testimony today I want to examine two widely discussed alternatives to imposition of a Federal tax on value added, with special emphasis upon the historical and institutional context in which we are facing the issue.

I. SUBSTITUTING TVA FOR THE CORPORATION INCOME TAX

Until recently, the tax on value added was discussed most commonly as a replacement for part of all of the corporation income tax. Advocates of the switch to TVA ordinarily predicated their case primarily upon hoped-for improvements in the balance of payments, with an occasional nod to the expected growth effects and neutrality of the tax on value added.

The balance of payments argument has ranged from the simplistic, but unconvincing, truism that under the General Agreement on Tariffs and Trade border tax adjustments (export rebates and compensating import duties) are allowed for the TVA but not for the corporation income tax, to more sophisticated analysis involving assumptions about the shifting and incidence of the two taxes. The growth argument relies upon the assumption that corporate saving and investment would rise substantially if the TVA replaced the corporation income tax. Finally, the neutrality of the ideal TVA contrasts sharply with the distinct nonneutrality of the corporation income tax. The latter tax discriminates between the incorporated and unincorporated sectors of the economy, against equity financing and the use of capital in the incorporated sector, and between industries.

Opponents of the substitution of the tax on value added for the corporation income tax have tended to play down the supposed advantages of such a move and have questioned whether the advantages, even if real, would be worth the cost in terms of equity. First, they have questioned both the likelihood that the balance of payments would benefit much from the shift and the desirability of predicating important decisions of internal tax policy upon their presumed balance of payments implications. I share both these doubts, the second especially strongly in the light of the recent realinement of exchange rates.

There is little doubt that substituting a TVA for the corporation income tax would increase saving and investment significantly, provided the corporation is not shifted. Of course, if it is shifted, little effect is to be expected. But one must ask whether further stimulus to corporate saving and investment is needed in the wake of the recently enacted ADR system of depreciation for tax purposes and restoration of the investment tax credit. Moreover, even if more stimulus to saving and investment is needed, there are other, and perhaps better, ways of providing it than through substitution of a TVA for the corporation tax. Finally, one could question the wisdom of creating a huge flow of corporate saving that might go uninvested if business confidence were weak, contributing to deflationary pressures.

Opponents of the tax on value added are also usually willing to admit the superiority of the TVA on neutrality grounds, with several provisos.

First, elimination of the corporation income tax would create an enormous tax haven in retained earnings. Besides having obvious implications for tax equity, this tax haven would itself distort economic decisions in important new ways. Second, it is virtually certain that any tax on value-added would contain exemptions for administratively hard-to-tax items, and it might well also contain exemptions to reduce the regressivity of the value-added tax. Thus it is an open question whether the gain in economic efficiency resulting from the tax substitution would be great. This is an issue which deserves further exploration.

The heavy artillery in the case against substituting a tax on value added for the corporation income tax is the regressivity of the TVA. Like any general sales tax, the TVA takes a decreasing share of income as income rises. Thus it imposes a proportionately heavier burden on low-income families than on high-income families. If the corporation tax is borne by recipients of profit income, as many economists think, the tax substitution under examination would represent a substantial shift toward regressivity—a shift which many see as unconscionable. Whether this equity effect should outweigh the supposed advantages of the TVA on balance of payments, growth, and neutrality grounds, as opponents of the TVA contend, involves important value judgments about which opinions can reasonably differ, though I personally think it should. Of course, if the corporation tax is shifted, as some economists and most businessmen think, there is somewhat less reason to oppose the change on equity grounds, but there is also less gain to be expected on the growth side. Unfortunately, we do not know the incidence of the corporation income tax, and are not likely to achieve early agreement on it.

On balance, I would oppose the simple substitution of the TVA for the corporation income tax, even though I am no fan of the latter tax. The balance of payments effects probably would not be large, and should not weigh heavily in the decision in any case. The growth effects, while potentially important, can be achieved in other ways, and should be viewed as less important than before the Nixon administration's measures to stimulate investment. The TVA is probably more nearly neutral than the corporation income tax, though even it is likely to be far from completely neutral. But most important, I question the advisability of the substitution because it would leave the United States with an undesirable combination of income and consumption taxation.

I do not object in principle to a dual Federal system of income and consumption taxes, as I shall make clear in a moment. But I do object strongly to the kind of dual system that the simple tax substitution would produce. The consumption tax portion would not necessarily be at fault, provided its regressivity at the lower end of the income scale were relieved. (I should hope that this relief would be provided directly through refundable tax credits or low income relief, rather than by exempting "necessities" (see below), and that administrative exemptions would be kept to a minimum, in order to preserve the neutrality of the tax.)

The fault, rather, would lie in the form of income taxation that would remain beside the TVA. The portion of income attributable to individuals taking the form of retained earnings of corporations would be reached only by the capital gains tax—a most imperfect fiscal device indeed. Massive amounts of economic income would be taxed at the preferential capital gains rates or given present tax law—would escape income taxation completely when transferred by reason of death. The preferential taxation of capital gains is, of course, most relevant for high income taxpayers. Moreover, various other well-known loopholes in the personal income tax laws would remain unfilled. Many of these are also available primarily to upper income taxpayers. So long as these blatant violations of vertical equity—not to mention horizontal equity—remain, replacement of the corporation income tax with a tax on value added seems totally unacceptable on equity grounds.

This does not, however, mean that I would not support a general sales tax at the Federal level under the right circumstances. But the circumstances are fairly special, and would involve a thorough overhaul of the Federal income tax. First, I would like to see integration of the personal and corporation income taxes, preferably utilizing the partnership method. Corporate profits would be attributed to shareholders and included in their ordinary personal income for tax purposes. A corporation tax would exist, if at all, only as a means of withholding. This would eliminate the double taxation of dividends, if it now occurs, without creating a tax haven in retained earnings. Second, substantive reform of the newly integrated income tax system along lines that have been advocated for years by economists and others interested in equitable income taxation would greatly increase both the horizontal and vertical equity of the U.S. income tax. Finally, a meaningful program of low income relief, such as a negative income tax, would provide a given minimum standard of living for those families at the bottom of the income distribution.

In this context of meaningfully progressive income taxation, a Federal sales tax would not be a particularly objectionable addition to the Federal revenue system. On balance, the Federal revenue system would have been rendered substantially more progressive in the top-income brackets by the integration and reform of the personal and corporation income taxes. And any tendency towards regressivity at the bottom end of the scale—including that involved in a TVA—would have been more than offset by the initiation of important low-income relief. In this setting it seems difficult to fault the addition of a Federal sales tax to our fiscal arsenal, especially since in principle the tax rates applied under the integrated income tax (including the negative income portion) could be adjusted as necessary in the interests of tax equity.

The tax reform just described is ambitious, or even Utopian, and perhaps it is senseless to bother to describe it. Yet I believe the description is worth the bother, if only to highlight the stringency of the circumstances under which elimination of the separate corporation income tax and imposition of a general Federal sales tax would be acceptable on equity grounds. Certainly those circumstances are a far cry from what has usually been envisaged by those advocating the simple substitution of the TVA for the corporation income tax.

It would be possible to stop short of this extreme proposal for thorough tax reform in search of acceptable conditions for imposition of a Federal sales tax. Substitution of a sales tax for the corporation income tax might be acceptable provided capital gains taxation were significantly reformed in order to prevent the tax haven in retained earnings described earlier. The necessary reform would involve both taxation of capital gains more nearly like ordinary income and constructive realization at death, with periodic valuation of assets for tax purposes being a further useful feature of such reform. Of course, loophole closing would remain a worthy goal of tax policy.

It would be desirable to combine reform of capital gains taxation and the newly imposed Federal sales tax with general low-income relief of the type mentioned in the discussion of the ideal tax package. But lacking that, relief for the burden of the sales tax should be allowed low-income families by providing refundable credits under the personal income tax. Such credits would result in refunds to those families with income tax liabilities smaller than the amount of the credit. This approach would, of course, involve a considerable administrative burden, which would be avoided by including relief for the burden of the sales tax in the general program of low income relief. Finally, relief to low-income families provided through exemption of necessities would distort choices and would rank as a distinctly third-best choice. Of course, as noted earlier, simple substitution of a TVA for the corporation income tax without either taxation of capital gains or low-income relief would be completely unacceptable on equity grounds.

II. REPLACING LOCAL PROPERTY TAXES WITH TVA REVENUES

Though details are still quite sketchy, it is said that the Nixon administration is considering proposing a Federal tax on value-added, the revenue from which would be used to relieve the burden of existing local property taxes used to finance public education. Thus in recent months the revenue from a tax on value-added has been discussed primarily as a replacement for local property taxes, rather than a substitute for the corporation income tax. In this portion of my remarks I want to comment briefly upon what I take to be the Nixon position.

In general, it seems that reduced reliance on local property taxes is a worthwhile goal of public policy. In the early days of this Nation, when economic activity was largely agricultural, the local property tax might have been a reasonable way to attempt to tax according to benefits received or ability to pay, or both. But in an industrial society, the local property tax is inferior on both counts; tax liabilities are related closely to neither benefits nor ability to pay taxes. I want to add here I agree with Professor Due in his statements about the portion on land.

The portion of the tax levied on improvements tends to distort locational decisions within metropolitan areas and to retard the economic redevelopment of our central cities. In a related vein, financing public education through local property taxes means that a child's educational opportunities depend crucially upon where he lives. Recent court cases have found this unacceptable. Finally, the local property tax is usually thought to be significantly regressive in the low-income range, due to the heavy burden on housing. Thus it seems better on virtually all grounds to finance local public services, including education, through local taxes on sales or income or through shared revenues from State or Federal taxes on sales or income than to continue to rely on the local property tax on investments. (There is no compelling case for discontinuing taxation of land values. In fact, there is a strong argument on both equity and efficiency grounds for continuing the taxation of land. The tax on land, unlike almost all other taxes, causes no economic distortions, and removing it would result in windfall capital gains to present landowners.)

Given the many faults inherent in local property taxation—not all of which would be remedied under State imposition of property taxes, another frequently discussed response to the court cases mentioned above—the Nixon proposal would not necessarily be objectionable. Certainly it would be preferable to both foregoing badly needed public services and continued reliance on the property tax. It would be a step forward on efficiency grounds. And it might not have overly adverse effects on the equity of the tax system, since the property tax is probably even more regressive than the value-added tax over the low income range. (This difference arises largely from the treatment of housing under the two taxes: The property tax imposes a heavy burden on housing, whereas the TVA would probably exempt it.) However, any endorsement of the Nixon proposal must be closely qualified.

If the ideal Federal income tax system outlined earlier were implemented, education could acceptably be financed largely through local sales or income taxes, with a minimum quality of education being assured through State or Federal grants-in-aid. This would have the advantage that local control of education would be maintained. In principle, even regressive local sales taxes would be acceptable, since they could be offset by adjusting the level of transfers under the assumed Federal program of low-income relief. Alternatively, more reliance could be placed on State or Federal taxation and revenue-sharing or grants to local governments, though perhaps at the expense of some loss of local control. In any case, substituting sales tax financing of education for property tax financing would be most acceptable in the context of thorough reform of the federal income tax system, including initiation of a system of low income relief. Seen in this light, the Nixon proposal to replace property tax revenue with revenue from a Federal TVA, without reforming Federal income taxation, represents a distinctly inferior, though perhaps acceptable, compromise with tax equity.

But other compromise solutions are available, and some are superior to the Nixon choice. The most obvious alternative and the only one I want to discuss here, would be to use revenues from reform of the existing income taxes to replace revenues from the local property tax. Base broadening would produce considerable revenue and an income tax that is more equitable, both horizontally and vertically, as well as more nearly neutral, and should be a high priority legislative item. The choice of income tax reform over imposition of a Federal tax on value-added seems especially appropriate in the present context, in that the progressivity of the Federal tax system has recently been reduced by the initiation of the ADR system and the investment tax credit. It simply seems undesirable on equity grounds to follow the granting of these incentives to business investment with imposition of a national sales tax. Thus, while the Nixon proposal may be acceptable if the alternative is to forego important public services or to continue to rely upon the property tax on improvements, imposition of a Federal TVA to replace lost property tax revenues is distinctly inferior to replacing those revenues through reform of the income tax system. It is to this matter of income tax reform, and not to the tax on value-added, that I urge the Congress to address its attention.

III. TVA OR RETAIL SALES TAX

To this point the discussion has focused upon the substitution of a Federal tax on value-added for the Federal corporation income tax or the local property tax, with or without concommitmant income tax reform. It is desirable to pause briefly at this point, however, to ask whether an American Federal sales tax—if one is to exist—should be levied as a tax on value added or in the more familiar form of a retail sales tax. The two forms of sales tax can be expected to have roughly equivalent economic and distributional effects, so the choice between them should be made primarily on administrative grounds.

The primary advantages of the value-added approach to taxing sales are the relative ease of exempting business services capital goods, and intermediate products from the tax and the self-enforcing features of the tax. The advantages of the retail sales tax include its familiarity to American businessmen, the smaller number of firms and amount of paperwork involved, and the greater ease of piggybacking State and local sales tax on a Federal retail sales tax. Which set of considerations should control any decision about a Federal sales tax is far from clear; knowledgeable authorities can be found on both sides of the issue. But one thing is certain: Any decision to levy a tax on value added, rather than a retail sales tax, should not be made by default because no one bothered to consider it explicitly. Any detailed analysis of the question will amost certainly involve considerations such as those mentioned above, and will put to rout such irrelevant or specious, but often repeated, arguments for the TVA as "the Europeans are using it" and "border tax adjustments are followed under the value-added tax."

IV. SUMMARY OF CONCLUSIONS

The most important policy conclusions offered in my remarks today can be summarized briefly. First, the simple substitution of a value-added tax for the corporation income tax would be completely unacceptable on equity grounds. Ideally imposition of a tax on value added would occur in the context of integration of the personal and corporate income taxes, reform of the newly integrated income tax, and initiation of low-income relief. A less ambitious, but acceptable, program would replace income tax integration with reform of capital gains taxation. Failing this, the TVA should not be substituted for the corporation income tax.

The Nixon proposal to replace property tax revenues with a tax on value added would be acceptable, if the alternative were to forego badly needed public services or to continue to rely upon the local property tax. But a preferable alternative would be to replace lost property tax revenues by reforming the income tax system, rather than by imposing a national sales tax. Finally, whether any future American sales tax at the national level should take the form of a value-added tax or a retail sales tax deserves far more explicit consideration than it has thus far received.

Thank you.

(The prepared statement of Mr. McLure follows:)

Prepared Statement of Charles E. McLure, Jr.*

The TVA and Fiscal Federalism

I. Introduction

Value-added taxation has been advocated by a variety of individuals and organizations, and for a wide range of reasons.[1] If a federal tax on value added (TVA) were to be adopted, or even considered seriously, there would probably be strong pressures for state and local taxes on value added as well.[2] These might take the form of piggyback taxes levied on the federal tax base and collected with the federal tax. Moreover, credits could be allowed against federal tax liability for state and local taxes on value added. It is only a short con-

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*The author is Associate Professor of economics at Rice University. He would like to thank Thomas Willett and Paul Wonnacott for serving as early sounding boards for the ideas expressed in this paper. In addition, John Due, Carl Shoup, Wonnacott, and a referee for the *National Tax Journal* made valuable comments on a preliminary draft of the paper. While many of the ideas expressed here are undoubtedly not solely his own, the author accepts full responsibility for the questionable ones. Finally, as the paper was undergoing final revision, Oliver Oldman kindly volunteered some notes he had written on the subject. While no effort was made to incorporate his observations into the paper, they seem to be generally consistent with those offered here.

[1] A comprehensive tax on value added, if substituted for the existing corporation income tax, would have a number of important advantages. It would not distort choices between products of the corporate and non-corporate sectors (and therefore between legal modes of business organization, where there is latitude for choice in the matter), it would not tax the returns to equity capital in the corporate sector at rates differentially higher than the return to borrowed capital, it would not tend to induce substitution of labor for capital in the corporate sector, it would be less uncertain in its incidence, and, according to some, it would produce favorable effects on the rate of growth and the U.S. balance of trade.

On the other hand, it is usually contended that such a substitution of taxes would be non-neutral and perhaps severely regressive, if not accompanied by the taxation of corporate retained earnings under the personal income tax, or at least substantial reform of capital gains taxation, and provision of relief to low income families, say through a negative income tax. Moreover, many economists believe that if the federal government is to adopt a general sales tax, it should use a single stage (probably retail) sales tax instead of a value-added tax. For a more complete discussion of these and other issues, see the author's paper "The Economic Effects of TVA," forthcoming. A recent exchange on the merits and demerits of TVA by Stanley S. Surrey and Dan Throop Smith is found in "Value-Added Tax: The Case For" and ". . . The Case Against," *Harvard Business Review*, November-December 1970, pp. 77–94. On the issue of whether a federal sales tax, if adopted, should be of the retail sales or value-added variety, see John F. Due, "The Case for Use of the Retail Form of Sales Tax in Preference to the Value-Added Tax," and Carl S. Shoup, "Factors Bearing on an Assumed Choice Between a Federal Retail Sales Tax and a Federal Value-Added Tax (Consumption Type), both forthcoming. Probably the most important single statement of support for value-added taxation is Committee for Economic Development, *A Better Balance in Federal Taxes on Business*, New York, 1966.

[2] Such proposals have appeared even in the absence of federal TVA; for example, see Robert D. Ebel and James A. Papke, "A Closer Look at the Value Added Tax: Propositions and Implications." *Proceedings of the Sixtieth Annual Conference of the National Tax Association*, 1967, pp. 155–70.

ceptual step to a proposal for sharing the revenue from the federal TVA with the state and local governments. Or the states and localities could simply adopt their own taxes on value added, without assistance of either piggybacking or a federal tax credit.

Thus it is worthwhile to have in advance a fairly detailed analysis of the advantages and disadvantages of such schemes, including the technical problems involved in each. This paper focuses upon this relatively neglected side of the discussion—the potential implications of a federal TVA for the financing of federalism. Section II considers the feasibility of taxes on value added levied by state governments,[3] and section III examines piggybacks, credits, and revenue sharing under a federal TVA.

II. STATE TAXATION OF VALUE ADDED

A question must be resolved for a state TVA that arises much less conspicuously for a national TVA. This is whether the tax should be levied on the origin or the destination principle, that is, by the state in which production or the earning of income occurs or by the state in which income is received and spent.[4] So far as a national TVA is concerned, the General Agreement on Tariffs and Trade (GATT) allows destination principle treatment of indirect taxes in international trade, but does not require it. Because destination-principle taxation is roughly equivalent to origin-principle taxation plus devaluation, it is not surprising that nations choose to implement the destination principle allowed under the GATT.[5]

Whether as a matter of tax policy a state TVA should be levied on the origin or destination principle depends on the nature of the benefits of public services. To the extent that production best reflects the distribution of benefits, the origin principle is preferable. But to the extent that benefits are better measured by consumption, the destination principle is indicated.[6] As usual there seems to be no uniquely correct solution; the question is essentially empirical, and a very difficult one. On the other hand, administrative considerations suggest quite strongly (a) that all state governments should employ the same principle and (b) that a TVA should not be levied by state governments on the destination principle, and (c) that states should levy an origin-principle TVA at uniform rates.

Retail sales taxes are levied on the destination principle. Except for goods sold directly to consumers in another state, tax is applied in the state where the goods are consumed, and only there.[7] Moreover, use taxes are employed to equalize the tax treatment of large consumer items sold directly in interstate trade. U.S. experience suggests that taxation of retail sales is an effective way to implement the destination principle.

By comparison, implementation of the destination principle under a TVA, using either the subtraction or credit methods, would require that tax adjustments be made at the borders of states, that is, that taxes previously paid on

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[3] Only state TVA's are considered here. Most of the difficulties noted would be compounded under a TVA levied at the local level.

[4] For a description of the origin and destination principles, the income and consumption varieties of TVA, and the credit, subtraction, and addition methods of computing liability under the TVA, see Carl S. Shoup, *Public Finance*, Aldine Publishing Co., Chicago, 1969, Chapter 9. In most of the remainder of this paper reference will be only to a TVA of the consumption type, since that is the kind employed in Europe and almost certainly the only viable candidate for adoption in the United States. Since the addition method is inferior to the subtraction and credit methods for a consumption-type TVA, it is ignored in this paper.

[5] The rules in the GATT regarding internal taxes seem to have been adopted largely as a matter of historical circumstances; they simply codified existing practices. There is no evidence that much thought went into agreeing upon the rules or justifying them; they seemed obvious and reasonable at the time. For evidence supporting this viewpoint, see Robert H. Floyd, *Domestic Tax Systems and the Provisions of the General Agreement on Tariffs and Trade: A Theoretical Analysis of Their Implications for Economic Efficiency*, doctoral dissertation submitted to Rice University, 1971.

[6] See Carl S. Shoup, "Indirect and Direct Taxes and Their Influence on International Trade," in House Ways and Means Committee, *Excise Tax Compendium*, U.S. Government Printing Office, Washington, 1964 and Richard A. Musgrave, *Fiscal Systems*, Yale University Press, New Haven, 1969, Chapter 9. See, however, footnote 27 below.

[7] Another exception occurs to the extent that investment goods and intermediate goods taxed under the ostensibly retail tax are used in the production of items entering interstate trade. The ease of exempting for a federal TVA over a federal retail sales tax; see Shoup, "Factors Bearing on an Assumed Choice Between a Federal Retail Sales and a Federal Value-Added Tax," *loc. cit.* and "Experience with the Value-Added Tax in Denmark and Prospects in Sweden," *Finanzarchiv*, March 1969, pp. 236–51.

exports from a state be rebated and that the value-added tax be collected on imports into the state or locality. There would probably need to be customs houses at every state line (and in the extreme case at every city limit and county line). While the requisite fiscal barriers might not threaten the continuance of essentially free trade within the United States, as the Neumark Committee feared they might in the European context, they would certainly encumber it.[8] Thus it seems best to focus attention in the rest of this section on the origin principle, which would require no fiscal barriers.

State governments acting individually would have little discretion in levying an origin-principle TVA. Industrial location would be distorted toward states with low tax rates, with adverse effects upon employment opportunities in the state and upon economic efficiency in the nation.[9] This suggests that tax rates under the origin principle should be nearly uniform between states. Reinforcing this conclusion are the difficulties involved (a) in implementing the credit method of computing tax liabilities under the origin principle if rates are not uniform and (b) in combining destination-principle treatment of international trade with non-uniform origin-principle taxation of internal trade under the subtraction method of computing liabilities. These two considerations are discussed in turn.

The European TVA's use the credit method, and a federal TVA would probably be implemented using the credit method. Both because of the European precedent and in order to avoid the compliance costs of calculating TVA liabilities in two (or more) different ways, it seems best as well as likely that any state or local value-added taxes would follow the same procedure. So long as rates were uniform, there would be no problem in implementing origin-principle TVA's using the credit method. But if rates are not uniform between states, difficulty arises.

The difficulty of using the credit method to implement the origin principle under conditions of unequal rates is easily seen. Suppose that state A levied a 10 percent TVA and state B a 5 percent tax. On goods valued at $100 shipped from state A to state B and sold there (after further processing) for $200, state A should collect $10 and state B $5 in taxes. State A would have no problem collecting in its $10. But in state B the $10 gross tax (5 percent of $200) would be completely offset by the credit allowed for taxes paid to state A, and under certain combinations of tax rates and interstate division of value added, credits allowed by state B on interstate trade could actually exceed gross tax liability to it.

It would not do simply to allow no credits for taxes paid to other states, for then the tax would not be levied on value added. Nor is it possible to allow credits for taxes previously paid on imports only at the rate prevailing in the

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[8] The Neumark Committee proposed that the European Economic Community adopt a uniform-rate origin-principle TVA for trade between member nations while continuing destination-principle treatment of trade with non-members. Its expressed reason for preferring the origin principle on intra-community trade was the perpetuation of fiscal barriers between members that would be necessary under the destination principle; see "Report of the Fiscal and Financial Committee," *The EEC Reports on Tax Harmonization*, International Bureau for Fiscal Documentation, Amsterdam, 1963. Neither the shift to the origin principle for inter-member trade nor the equalization of rates has been implemented, as some member nations have not yet adopted a TVA.

The Constitutional prohibition on constraints of interstate trade in the United States would probably prevent the retrogression to the more pernicious trade barriers that the Neumark Committee feared. The export rebates seem unlikely to be unconstitutional, but both they and the compensating taxes on imports might touch off internal "trade wars" if not understood and accepted. Recent experience on the border tax issue in an international context does not inpire much confidence on that score. In this regard, perhaps it should be emphasized that the preference expressed here for retail sales and use taxes over destination principle taxes on value added is based upon the belief that administratively use taxes are less disruptive of interstate trade than the border tax adjustments under the TVA would be. There is no implication, as is sometime found in literature on the subject in an international context, that the TVA is somehow uniquely neutral with regard to interstate trade. It is presumed that economically a retail sales tax and a destination-principle TVA are essentially equivalent, though this has been questioned; for example, see Due, *op. cit.*

[9] For a theoretical analysis of the locational effects of such a tax, see the author's "Taxation, Substitution, and Industrial Location," *Journal of Political Economy*, January-February 1970, pp. 112–32. The effects on industrial location mentioned in the text would not occur if the tax replaced another origin-principle tax, if it financed state expenditures that made possible lower private costs of production, or if a substantial federal credit were allowed for the state TVA. It is shown in the author's "The Interregional Incidence of General Regional Taxes," *Public Finance*, 1969, pp. 457–83 that a non-uniform destination-principle TVA has no effects on the location of industry.

importing state. The proportion of taxes actually paid allowed as a credit would depend upon the state of origin of imports and the tax rates applied there. Alternatively, the domestic rate could be applied to the value of imports. But this implies the use of the subtraction method, rather than the credit method.[10]

On trade flowing from state B to state A (with value added split between the two states as above) state B would collect its $5 on the value added within its border. But state A, by levying a gross tax of $20 and allowing credit for the $5 paid to state B, would net $15, rather than $10.

The problem in both these examples is that under the credit method only the tax rate at the final stage matters for determining the total tax burden. Earlier rates and the division of value added between stages combine with the final rate to determine the division of the total proceeds among states. If rates were the same in all states, no problem would arise; each state would collect the tax at the common rate on value added originating within its borders by levying a gross tax on sales and allowing credit for taxes paid at the common rate to other states. But with non-uniform rates, a state's tax receipts under the credit method need bear no close resemblance to the product of the tax rate and value added in the state.

If state governments adopted the subtraction method of computing liabilities under the origin principle, rates would not need to be uniform (ignoring the effects on the location of economic activity), except for the difficulties in making border tax adjustments on international trade. Value added would be calculated in each state and the tax rate prevailing in a given state or locality would be applied directly to the value added originating there. Thus in the example above, state A would collect $10 and state B would collect $5 on the $100 produced within their respective borders, regardless of the directions of interstate trade. Under the subtraction method the tax rate prevailing in a given state determines the amount collected in the state.

There are no particular problems under either the credit method or the subtraction method in making the border tax adjustments (BTA) necessary to render a TVA levied at uniform rates on the origin principle internally a destination principle tax with respect to international trade. For example, under the credit method, the federal BTA (refund or credit of tax on exports and imposition of tax on imports) could simply include the uniform state and local rate.[11] Alternatively, the state and local governments themselves might make the BTA necessary to put the sub-national origin-principle TVA on a destination basis for international trade.[12]

On the other hand, if the origin principle tax were levied at different rates in different states, the difficulties involved in making accurate BTA on foreign trade would seem to be insuperable under either approach. If done by the federal government, the compensating levy and rebate at the border would have to be at the average rate applied to (similar) domestic production through that stage. This would be impossible to calculate, and it would open the Pandora's box of averaging under the GATT. If each state imposed its own BTA, but at different rates, *ceteris paribus*, imports would be diverted through the states with the lowest TVA rates and exports through the states with the

[10] In *Public Finance*, Shoup notes (p. 263) that "imports . . . are bound to present a difficult problem for the origin principle if the tax credit method is used." Shoup's discussion is in terms of a non-uniform origin-principle tax.

[11] Under this scheme states from which exporting is done would levy their tax on the full value of sales, including those for export. Importing states would allow credits for the amount of "as if" state taxes included in the federally imposed BTA on imports.

[12] Under the credit method this would involve allowing credit for taxes paid on domestic production before the export stage, levying no tax on exports, and allowing no credit for taxes paid on imports. Under the subtraction method the tax base for imports would be their total value at the first resale stage. On export transactions taxable value added would be negative—the amount of purchased inputs. The choice between federal conversion of the internal origin-principle taxes into destination-principle taxes on foreign trade and conversion at the state level would involve administrative, political and Constitutional considerations. Federal BTA seems far simpler to administer, though it would favor states through which exports move relative to those through which imports move, when compared with the state-local administration of BTA. Moreover, state and local border tax adjustments on international trade, especially on the import side, might well be declared unconstitutional if the origin principle were used on interstate trade. All-in-all, federal application of BTA seems preferable, though the politically most feasible approach might be for the federal government to pay the export rebates on state and local taxes, but for the states and localities to collect the compensating import duties.

highest rates.[13] Besides being grossly inefficient and inequitable, this arrangement might fun afoul of the interstate commerce clause of the Constitution as well as the clause prohibiting use of import duties by states. Moreover, it presumably would not pass the standards of the GATT on the export side, since by assumption the rebate rate would be higher than needed to eliminate the domestic tax burden on the exported product in many cases.

The results of the analysis of this section are summarized in the following table. All things considered, it seems that any state (or local) taxes on value added should be levied on the origin principle and at uniform rates and should be calculated using the credit method.[14] Every other approach to taxing value added has a severe fault disqualifying it. Taxation at destination, if it is preferred, should probably continue to be accomplished through retail sales taxation.

TABLE 1.—FACTORS AFFECTING A CHOICE AMONG VARIOUS TYPES OF GENERAL INDIRECT TAXES TO BE COLLECTED BY STATES

	Rate structure	
	Uniform	Nonuniform
1. Destination principle	Locationally neutral.	
a. TVA	Fiscal border control needed for interstate trade.	
b. Retail sales tax	Preferred approach.	
2. Origin principle (TVA)	Locationally neutral*	Distorts location economic activity.*
a. Subtraction method	Less feasible than credit method if Federal TVA uses credit method.	Difficulty of BTA on international trade.
b. Credit method	Preferred approach	Difficulty of BTA on interstate trade.

*Conditioned upon government services not reducing private costs correspondingly.

III. FEDERAL CREDIT, PIGGYBACK TAX, AND REVENUE SHARING

As one element in efforts to relieve the fiscal pressure on state and local governments, it might be proposed that the federal government allow partial credit for state and local value-added taxes against tax liabilities under a federal TVA. Alternatively, the federal government could collect piggyback TVA's for those governments in the process of collecting a federal TVA, or it could share revenues from the federal TVA with them. This section discusses the relative merits of these approaches and the advantages of achieving similar results with piggybacking tied to a federal retail sales tax instead of a federal TVA.

As things stand now, a state government can levy a TVA on either the origin or destination principle, set any tax rate it wishes, and compute the tax liability using whatever method it prefers, barring a ruling of unconstitutionality. But any state setting out unilaterally to collect a TVA would almost certainly be forced to employ the subtraction method and to levy the tax on the origin principle.[15] The administrative infeasibility of making border tax adjustments and the desire to export its taxes to other jurisdictions would sug-

[13] See Hirofumi Shibata, "The Theory of Economic Unions," in Carl S. Shoup, editor, *Fiscal Harmonization in Common Markets*, Columbia University Press, New York, 1967, Vol. 1, pp. 189–238. These problems are the same whether non-uniform rates are levied via the credit method or the subtraction method.

[14] This is essentially the conclusion reached in the Neumark Report. If a federal TVA calculated via the subtraction method were contemplated, the choice of the credit method might, however, be reversed.

[15] For example, the tax on gross margins proposed for West Virginia would employ the subtraction method. This being the case, the income-type TVA was chosen because of the simplicity of meshing the tax with traditional business accounting for capital expenditures; see Ebel and Papke, *op. cit.* Moreover, this recent paper co-authored by one of the progenitors of the West Virginia scheme (Papke) states "The two-factor (payrolls and property), equal weight allocation formula recognized the fundamental principle of value-added taxation that factor income or output should be assessed where it originates, not where it is received or distributed." (p. 169) There is no reason to question this rationale, as West Virginia has long had a gross-receipts tax levied on the origin principle. But this "fundamental principle of value-added taxation" is far from universally accepted; note the GATT preference for the destination principle. One suspects that the difficulty of making border tax adjustments would stymie even those who would otherwise prefer the destination principle.

gest the origin principle, though producers would clearly prefer the destination principle, which would also affect industrial location less unfavorably.[16] States would act their tax rates with some regard for rates elsewhere, but there is no presumption that rates would be uniform across the country. Finally, without either uniform rates or BTA on interstate trade, the credit method would be impossible to implement.

The arguments presented earlier suggest that the states should be encouraged to levy any TVA on the origin principle, but at uniform rates. Moreover, the credit method is preferable to the subtraction method, especially if the federal government chooses the former. This suggests that it would not be optimal for use of TVA by state governments to develop without coordination.[17] One means of achieving coordination would be for the states to follow the example of the members of the EEC and agree to levy uniform-rate, origin-principle taxes on value added collected via the credit method. An agreement of this kind could conceivably take the form of an interstate compact or an amendement to the federal Constitution. U.S. history in the coordination of taxation of interstate commerce does not, however, inspire much optimism that this approach will be followed.[18]

A second alternative would be for the federal government to collect for the states piggyback taxes on value added imposed on the federal tax base. Under this approach states would have an inducement to adopt both the same tax base and uniform rates. This could result in substantial savings in both administrative and compliance costs. There are, however, several problems. First, enabling legislation could provide that if the federal collection facilities are used, the piggyback tax must be based on the credit method and set at a federally specified rate, but it could not assure that all jurisdictions would in fact levy the tax. For goods sent initially from no-tax states to states with taxes this might pose only minor problems; under the credit method the tax not previously collected would simply accrue to the first state in the chain of transactions that imposes the tax. But no-tax states could hardly be expected (and could not be coerced) to rebate taxes paid to other states because of credits against its own non-existent TVA.[19] Thus this approach would not of itself provide uniform taxation across the nation. Without uniform tax rates, it would be difficult to reconcile origin principle treatment of internal trade under the piggyback tax with destination principle taxation of international trade under the federal TVA, as noted in section II above.

Moreover, the federal government would be put in the doubly unfamiliar business of allocating taxable value added among the states as well as verifying value added. It seems unlikely that this would be conducive to harmonious fiscal federalism, though this could probably be overcome.

A third approach, which could be applied by itself or in conjunction with either of the first two, would be to allow a (partial) credit against the federal TVA for similar taxes paid to state governments. This could produce uniform rates across the country, much as the credit for unemployment insurance taxes does. The law could be written to allow credit for a given rate of tax, no more and no less; presumably all states would adopt the tax, but if they did not it would make no difference for economic efficiency.[20]

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[16] The Michigan tax on business activity repealed in 1967 was levied essentially on the origin principle, probably in large part to export tax burdens to other states in the form of higher automobile prices.

[17] The need for coordination explains the appointment of the Neumark Committee to examine the problem of tax harmonization in Europe.

[18] As noted in footnote 8 above, the agreement to harmonize taxation of value added in the EEC has not yet been implemented. For a recent summary of U.S. efforts in the field of horizontal tax coordination, see George F. Break, *Intergovernmental Fiscal Relations in the United States*, Brookings Institution, Washington, 1967, pp. 50–61. Even if such an agreement could be worked out between the states, it would be difficult to extend it to some local governments. The desirability of having the tax imposed at uniform rates across the nation means that TVA could be used only by governments that together blanket the nation. Thus the tax could be used by counties, but not by cities, etc.

[19] This is the equivalent, in the context of fiscal federalism, to the break in the chain of tax credits that occurs when exemptions are granted for some business activities; see Carl S. Shoup, "Experience with the Value-Added Tax in Denmark, and Prospects in Sweden," *loc. cit.*, especially pp. 242–3. Citizens and businesses in the non-taxing state would be taxed on goods imported from other states, but their state would receive no tax revenue. No credit would be allowed in other states for taxes paid before a product passed through a non-taxing state, breaking the chain of credits, unless a special credit were allowed for taxes "as if paid."

[20] Any government could levy a tax greater than that for which credit is allowed, so coordination would not be complete. But this is no worse than the present situation.

If this were the extent of efforts at coordination in the TVA field, each state would levy and collect its own TVA, with uniformity in the rules for allocating value added between jurisdictions being assured, at least in theory, by the statute allowing the federal tax credit.[21] But in practice states might be willing to engage in substantial litigation (probably against the interstate firms) to have the value added originating in interstate firms allocated to them. Whether this crucial problem of allocating value added between states could be worked out would probably determine the feasibility of achieving adequate coordination through this approach.[22] Combining federal credit with an interstate compact or constitutional amendment regarding state taxes on value added might be more successful, but it seems less likely to occur.

A more far-reaching solution would be to combine a federal credit with state and local piggyback taxes on the federal tax base. This would assure uniform rates and tax base, simplify border tax adjustments on international trade, and minimize compliance and administrative costs.

But this approach would be economically equivalent to sharing the proceeds of a federal TVA with the states on the basis of origin of value added, and the less extreme credit approaches would be almost equivalent. Thus it might reasonably be asked if it is not preferable for the federal government to share those revenues directly. Sharing the revenues from the federal TVA would avoid the detailed record-keeping, legislative and administrative complications, and litigation involved under the piggyback tax *cum* tax credit approach. It would be necessary only to divide some fraction of the federal revenue among the lower level governments on the basis of value added originating in them.[23] This being the case, sharing the revenue from a federal TVA seems preferable to piggybacking state and local taxes on the federal tax and then allowing credit for them against the federal tax, if origin-principle taxation is favored. The saving in administrative and compliance costs would be even greater if TVA revenue sharing were used instead of allowing federal credit for taxes levied by the state and local governments themselves.

IV. TVA, RETAIL SALES TAXES, AND FISCAL FEDERALISM

If it were decided that the federal government should impose a broad-based tax on consumption (the consumption-type TVA being mentioned favorably more frequently than the income type), it would still be open to debate whether that tax should be a tax on value added or a single-stage consumption tax, presumably at the retail level. The tax on value added is sometimes favored over the retail sales tax because of the following: (a) it allows border tax adjustments for internationally traded goods, (b) the TVA, being collected at more stages and in smaller quantities, is easier to hide from both businessmen and the public, (c) the TVA has self-enforcing features lacked by the retail sales tax, which may be important if the tax rate is high, and (d) capital goods are more easily excluded from the TVA than the retail sales tax.[24]

The first of these arguments is, of course, irrelevant, since a proper retail sales tax requires no border tax adjustments to achieve taxation on the destination principle. The second is based upon a tenet of taxation that need not be followed. The third, the relative ease of evading the two taxes, may be relevant in the United States, but probably much less so than in other countries. Finally, it should be feasible to establish a credit against subsequent tax liabilities for retail sales taxes paid by business firms on their purchases of capi-

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[21] The most important of these rules would involve intracompany pricing by interstate firms.

[22] Similar litigation would probably occur under the piggyback approach, though against whom is less clear. If the credit and piggyback tax proposals were combined, these problems presumably would be diminished.

[23] However, at present statistical information on the geographic origin of value added is quite rudimentary. The allocation of returns to capital among states stymies any efforts in this direction. One side-benefit of a tax on value added, especially if it employed an original-basis piggyback, would be an improvement in these statistics.

[24] For a sophisticated presentation of point (d) see Ann F. Friedlaender "Indirect Taxes and Relative Prices," *Quarterly Journal of Economics*, February 1967, pp. 125–39 and Shoup, "Factors Bearing on an Assumed Choice Between a Federal Retail Sales Tax and a Federal Value-Added Tax." *loc. cit.*, and "Experience with the Value-Added Tax in Denmark and Prospects in Sweden," *op. cit.* Shoup does not, of course, advance the first two points in favor of a value-added approach to taxing consumption. It should be noted that both Shoup and Due, *op. cit.*, weigh the pros and cons of a federal TVA and federal retail sales tax without any presumption that they would favor adopting *either* approach to taxing consumption over other changes in the U.S. tax system.

tal goods without going to a full-fledged TVA. Moreover, some authorities argue that exempting capital goods under a retail sales tax is not as difficult as is sometimes claimed.[25]

In favor of the retail sales tax would be its familiarity to U.S. firms and its relative simplicity. But more important in the present context, retail sales taxes seem more adaptable to the needs of financing federalism. Continued use of retail sales taxes by states and localities would in no way conflict with federal use of the tax. In fact, it would be rather easy to piggyback state or even local taxes on a federal retail sales tax. Of course, for piggybacking to be feasible, taxable sales would have to be defined uniformly by all governments using the arrangement. This would have the potential advantage that services could be included in the tax base and capital and intermediate goods excluded.[26] Moreover, it seems likely that piggybacking would largely eliminate the need for use taxes. The piggyback tax could be collected by the federal government on the basis of the state of destination of a retail sale and remitted to that state. There would seem to be less need than now to determine whether or not a given interstate firm were doing business in the destination state. Finally, unlike state and local taxes on value added, which would probably be origin-principle taxes, retail sales taxes, being levied on the destination principle would not need to be imposed at uniform rates in all jurisdictions. Even at non-uniform rates retail sales taxes would have only minimal effects on the location of economic activity.

In summary, it appears that the destination principle could be implemented most feasibly through the taxation of retail sales, via either an independent state tax or a piggyback on a federal tax. On the other hand, sharing of revenue from a federal TVA on the basis of origin of value added appears to be the most satisfactory means of accomplishing origin-principle taxation. The choice between the two principles and the corresponding methods of implementing them would probably make very little difference for either tax equity or economic efficiency.[27] Thus it appears that with regard to fiscal federalism the choice between a retail sales tax and a tax on value added at the federal level could be made largely on administrative grounds. If so, the retail sales tax seems to be vastly superior, unless we are willing to go all the way to sharing the revenue from a federal TVA on the basis of origin of output.[28]

Chairman PROXMIRE. Thank you, gentlemen. I think these have been extraordinarily helpful and competent statements. This is a relatively new subject for this Senator, for this committee, and for the Congress. It is most desirable and useful that three of the outstanding authorities in the country have come to us this morning and given us this kind of very helpful analysis.

There are a couple of differences, however, I think I would have to take. Frankly, I viewed this as a Nixon proposal and you seem to. I am not sure that is fair to the President. His spokesmen have

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[25] See Due, *op. cit.* Due also makes the argument that on the basis of coordinating federal and state and local taxation of consumption the retail sales tax is preferable to the TVA.

[26] State and local revenue authorities might complain about the loss of (potential) revenue resulting from the exemption of capital and intermediate goods. But that attitude, carried to the extreme, would suggest taxing gross sales, rather than either truly retail sales or value added.

[27] With regard to tax equity, receipts from a destination-principle tax would accrue to the state in which consumption occurs, whereas revenues from an origin-principle tax (or revenue-sharing based on origin of production) would accrue to states in proportion to production. The interstate distribution of potential receipts would probably differ little under the two alternatives. Moreover, thorough-going tax reform, including initiation of a negative tax, should be a *sine qua non* of any flat-rate federal consumption (or production) tax; see McLure "Economic Effects of TVA," *loc. cit.* for a further discussion of this point. If that were achieved, whether or not the origin or consumption base would otherwise be preferable on equity grounds would be relatively unimportant. On the efficiency side, neither a destination principle tax nor a uniform-rate origin principle tax should have much effect on the location of economic activity. Moreover, international trade theory tells us that for general taxes financing broadly diffused benefits of public services, there would be little long-run difference between the origin and destination principles. Adjustments in relative price levels between states could be expected to wash out the choice of one principle or the other.

[28] Such sharing is not dependent upon the existence of a federal TVA; income tax revenues could also be shared on the basis of value added orignating.

appeared before this committee and flatly denied they had an interest in offering this tax. There are rumors floating in the newspapers they were thinking of it, but there is no question it won't be offered this year; may or may not be offered next year. In my view, it ought to be an issue in the campaign, but that is a political matter. So, I think it may not be fair to identify it with this administration, although of course. that is a political decision.

In the second place I notice that almost all of you talked about the value-added tax as a substitute. And, as I tried to say in my opening statement, we are going to need, in my view, $50 billion to $100 billion in addition to the revenues that are now yielded by our present Federal tax system at full employment.

As you know, we are operating now with a full employment deficit and we have calculations made by Brookings and others to show if we enact no new programs, no welfare programs, no health programs, no substantial revenue-sharing programs, we still are going to have no margin for the next 5 years. But, we are going to enact some of these programs. The question is: where is the money coming from?

I have been one of those who said income tax, but I also realistically look at what we have done in the Congress. Every time we come up with a new income proposal, it is very hard to add new revenue because the forces working to prevent it are so great.

I would like to ask each of you, starting alphabetically again, Mr. Cohen, to tell us what you would do on the assumption we are going to need additional revenue, not a substitution, that we won't be able to drop the property tax or anything else; number two, that it is going to be extremely difficult to reform the property tax, as all of us would like to see it done. Under those circumstances would you still feel there is any ground for any kind of a value-added tax, Mr. Cohen?

Mr. COHEN. Well, you give me very tough alternatives, but those are the kind of alternatives you gentlemen are faced with all of the time.

I have been practicing law for 20 years this spring. I came to the Treasury in 1952 and I have seen during that time only tax reductions. I came right after the tax was raised during the Korean exercise. I participated in the first cut that occurred after the war in 1953 when President Eisenhower had a 10 percent cut in taxes. We then had another cut in 1954, because of certain liberalization—such as depreciation.

Chairman PROXMIRE. You are extraordinarily young looking in view of that background; even without hair transplants, too.

Representative BLACKBURN. He is not running for office.

Mr. COHEN. It is my grandfather's genes.

I drafted the depreciation deduction, accelerated depreciation deduction in 1954. That was my job at the Treasury. I came back to the Treasury about the time we were cutting taxes again, in the early 1960's, several times and I witnessed the 1969 act which had some reform and yet some liberalization. Not really a revenue raising measure, overall. And the 1971 act.

So, I have seen us whittle away—and I should have taken the trouble yesterday to add up the amount of revenue we have whittled away. The economists would have to say, and I suspect they would say, many of those cuts were necessary at the time for economic purposes, but the fact that they were necessary at the time for economic purposes does not mean they were necessary for all time for economic purposes.

A tax cut for stimulation does not mean it has to stay that way. We had tremendous economic growth in this country with higher taxes. I am one who happens to believe that consumption is a more important factor in our economy than has been given much play, lately at least. We have more productive facilities today than we are using. We really need more consumption.

So, I think there is a good deal of room in our system for raising our income tax structure, one way or another, by loophole closing, by raising the rates if necessary. I do not like the rate increase. I would not choose that as my desirable alternative. I would rather see a structure that is fairer.

Chairman PROXMIRE. You do not think it would be counter-productive? One of the arguments made in 1964, when I opposed the tax reduction, was the tax reduction would result in greater revenues because you stimulate the economy.

Mr. COHEN. I think that is true at a given time and given place in the economy. But, my point is that the given time and given place does not last forever. To carry that argument to its logical extreme we stop taxing. You know, where do you go? You get to some point where you have got to have revenue.

Now, I would go with Professor Due: If we are going to enact a sales tax, which is an abomination to me personally, but if the alternative were such, if it was the only way politically we could raise revenue we needed for an education program or antipollution program, or some other program, I would choose the retail sales tax, or what I call "an ultimate disposition sales tax." That is a tax on a last level of commerce, rather than a value added tax. I think in the American society, we owe a duty to our public to tell them what their tax is.

It is hard to be the Commissioner of Internal Revenue and get bricks thrown at you in a nice way or an un-nice way by a lot of people. But, our tax is an honest tax. Everybody knows what it is. We get more gripes about our tax in our country because we tell people what it is. You understand when you pay an income tax, this is the price you pay for living in our society. You do not tell people when they pay a sales tax, or at least when they pay the value added kind of a sales tax, because they do not see it. That makes it more palatable. I suspect if you took a popularity poll there would be a lot of citizens in the United States who would say they wanted a value-added tax. They want it because it is kind of esoteric and they do not understand it, for instance. For some people it is the easy way out. They do not want to know what kind of taxes they are paying.

Chairman PROXMIRE. I don't. They would refer to a value-added tax—no tax is popular. You won't get people to respond they want a tax. They say: We have to have our property tax cut. If you need a value added tax, okay; that is better than what we are doing.

Mr. COHEN. I think Professor Due indicated this. I do not pretend to be an economist, but all tax lawyers, I suppose, are amateur economists, and I had some minor economics at college. Most of the people who would be relieved of some burden of the property tax would find that their consumption tax, whatever you are going to call it, is going to be as high or higher than what they were relieved of. All you have done is relieve them of a tax that shows and impose on them a tax that does not show. I suspect that might be popular at the beginning, but as a man tries to take a salary and hand it over to his wife to take to the supermarket, and finds prices are up and they have less because of this tax, you are going to get the same complaint—it will just take a little while and you will get the same kind of unrest in our populace.

So, we just have to face up to the educational problem, that you do not get something for nothing in this country. If we want good services from our State, local, and Federal Government, and we do and we deserve them, then we have to pay for them.

Chairman PROXMIRE. I take it your response, Mr. Cohen, almost under no situation would you offer value-added tax. If necessary, you would prefer a Federal sales tax?

Mr. COHEN. Yes, sir.

Chairman PROXMIRE. Mr. Due.

Mr. DUE. I spoke in terms of substitution, but I would use exactly the same arguments in regard to the value-added tax as an alternative. That is, the question then becomes that of choice of a value-added tax in preference to increases in other levies and basically the same argument applies.

More specifically, to raise the additional money, I would also rely primarily on the income tax through more effective progression, through raising the rate, if necessary, and reducing the exemption figures somewhat, if necessary.

Chairman PROXMIRE. As an economist, do you feel the problem of economic growth, of efficiency, of encouraging incentive, that that can be killed by a higher income tax more than one of these less progressive, but also less discouraging taxes?

Mr. DUE. I feel we could raise 50 percent more revenue from the income tax than we do without having noticeable effects. I cannot prove it but this is my feeling. There are limits somewhere, but I feel we are a long ways away from the limits so far as the income tax is concerned.

One other reason in addition to equity for the Federal Government to stay in the income tax field is the State use of the sales tax. I have somewhat more faith in the States than Professor McLure has. I would not agree with him that the ideal Federal tax structure, if one could make all the changes one wanted, would include a sales tax. I would leave this tax to the States and not have the Federal Government move into what is the only autonomous state revenue source.

One more point: The value-added tax, going back to Mr. Cohen's point, does not necessarily have to be concealed in the price. European countries do so, but our tradition is to keep sales taxes separate from the price. There is no inherent difference between the value-added tax and the retail sales tax on this score. They both can be kept separate and, I suspect, in the United States, retail groups would push very hard to see that the value-added tax was kept separate at the retail level.

Chairman PROXMIRE. You, too, would come down hard on the side of being against the value-added tax, even if you felt these other taxes posed great difficulties and you recognized it is not a substitution but an additional revenue you need, Mr. McLure?

Mr. McLURE. If, in fact, income tax reform is ruled out, and yet we want to raise the level of services——

Chairman PROXMIRE. I would not say ruled out. I say it is going to be very difficult. We might have to do what Mr. Cohen says, increase rates.

Mr. McLURE. I think probably I would be more reluctant to raise the general pattern of rates than Professor Due. I think moving the top rates down to 70 percent from 91 percent was certainly a move in the right direction. Whether we should go further is a question I do not really have any opinion about. I do not think we ought to raise them back to earlier levels.

I would like to say in response to what Professor Due has said, that I do not know that I would really favor addition of a Federal sales tax to the Federal revenue system, even in conjunction with reform. I think what I would say is that that would be tolerable. It really becomes an issue only if for some reason we want to have Federal support of state and local spending, perhaps to make up revenue lost by taking off the property tax. Given that we might want to do this, I think that it might make sense. But the primary thing I would like for the Federal Government to do is to be sure that the overall distribution of taxes in this country is progressive instead of roughly proportional or even regressive over the lower income.

Chairman PROXMIRE. My question poses an especially difficult problem for you, because you based your reliance on the value-added tax, on the reform of the Federal income tax. I say, assume that reform is not possible and in addition you need the revenue, then where do you go?

Mr. McLURE. It seems to me you have three alternatives. You can either levy additions to a payroll tax and use them for this purpose, you can levy a value-added tax, or you can levy a retail sales tax.

The payroll tax I personally believe to be more unacceptable than the value-added tax. The choice between the retail sales tax and the value-added tax I find to come out fairly near a draw, although I would tend on balance to favor the retail sales form, primarily because of its familiarity, the fact it is explicit, and the fact that State and local governments can piggyback State and local taxes on retail sales tax substantially more easily than they can piggyback a value-added tax.

Chairman PROXMIRE. My time is up.

Congressman Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman.

I find the discussions most interesting. I agree that the value-added tax is another form of sales tax and what we are doing is trying to tell the citizen, in effect: while you are paying more, you won't notice it as much. I think the basic political decision is whether or not the American public is willing to finance some of these programs that we are financing very heavily right now. And that is the question we have to answer in the arena politically every 2 years, those of us in the Congress.

I just thought perhaps that was the reason Mr. Cohen looked so young; he is not trying to explain to both sides on these issues why they are not both right and we cannot vote on both sides when the vote comes in Congress. That is one of the difficult things we face.

Mr. Cohen, if my memory serves me correctly, after President Kennedy reduced taxes, there was actually an increase in gross national product and an increase in Federal revenues. Is my memory correct?

Mr. COHEN. There was a slight dip first and then there was an increase; yes, sir.

Representative BLACKBURN. So that experience indicated that there are circumstances under which taxing rates and taxing procedures can be a disincentive to produce?

Mr. Cohen. I think that is right. As I indicated, there are times in our economy, in order to get things moving, one ought to have a good stiff medicine. In this case, it has to be pleasing medicine in a tax cut. I think there are other times when the opposite might be effective.

Representative BLACKBURN. Actually, what we are dealing with is the accumulation of experiences that we have had in taxing measures. It is in trying to utilize all of these experiences that each time we make a change in our tax law we hope it is a change for the better—that is, better for the citizen, better for the revenues of the Federal Treasury.

Mr. COHEN. Senator, I should have added when I was answering your question before, we neglected to state the estate and gift tax. While it is not a very large revenue producer, it is a terrible tax. It is an abomination as it has grown up. It is just riddled with loopholes. It collects very little of its potential revenue. It is another source of increased revenues. I do not think in terms of the dollars you are talking about, that it is a source that could contribute a major amount to that, but it could contribute a substantial amount.

Representative BLACKBURN. Let me be the devil's advocate and ask all three of you gentlemen this question: There is a great move afoot in the country to either abolish or certainly restrict State and local property taxes. I am of the opinion that the property tax has a valid place in our society. I think they are very fair in that property values are enhanced by local services, that is: paving, utilities, police protection, school facilities, and so forth, all of which must be paid for through these taxes. If you live in a community that does not have these services, your property is not worth as much as if you lived in a community that does have these services.

Now, are any of you gentlemen advocating the abolition of State property taxes?

Mr. COHEN. I would not. I would favor the result of the California court; that is, that property taxes ought to be more uniform throughout the State. And the happenstance that my child happens to live in the richest county of the State of Maryland, should not benefit him in his educational experience any more than the child who happens to live in the poorest county in the State of Maryland.

Representative BLACKBURN. I do not want to get into that digression.

Mr. COHEN. That is the only problem that has occurred in the States. It has not been that the court has said the property tax is unconstitutional; they just said that the distribution of the property tax has been unfair.

Representative BLACKBURN. Distribution of the receipt of property taxes.

Mr. COHEN. That is right.

Representative BLACKBURN. None of you are arguing the property tax should be abolished. Is that right, Mr. McLure?

Mr. McLURE. I would say certainly I am not a very big fan of the local property tax as presently administered. I think at the very least, that the administration should be strengthened considerably. Perhaps the tax should even be moved to the State level, so that you do not get the results that these recent court cases have decried, that a person's educational opportunity depends on the accident of where his parents happen to live.

I certainly would not abolish the portion of the property tax on land. Perhaps if anything, I would like to see that increased, because I think your argument here is quite valid. Public expenditures do contribute a great deal to the growth in land values and there is no reason these should accrue to the private sector without making a contribution to public financing. The portion on improvements is another question.

Representative BLACKBURN. Is it safe for me to conclude then most of the objection to the property tax arises from its poor administration? I know we have a situation in many States where local taxing authorities in one area will assess a piece of property for 10 percent of its actual value, whereas if you live two counties over, the taxing authorities will assess it at 35, 40, or 50 percent of its fair tax market value. So, we should not confuse principle with administration, should we?

Mr. McLURE. May I answer this? I think this kind of phenomenon is particularly important in a State such as the one where I live, Texas, where you have many local jurisdictions which happen to be lucky enough to have oil resources located under them. I personally grew up in an area that did not, and I felt the way the Servano v. Priest case came out when I was in high school. I did not have to wait until 1971 to be told that educational opportunities depend on where you grow up. For this reason, I tend to oppose the local property tax, and this is not an administrative question.

Representative BLACKBURN. You came to oppose the property tax?

Mr. McLURE. I oppose the locally administered property tax without sufficient State equalization, because you do get tremendous differences in the resources available to a particular community, depending in part on the extent of wealth. Also, as you know, it turns out that you have suburban enclaves that exist solely to try to avoid paying taxes for the education of children of less fortunate families.

Representative BLACKBURN. Here again, we are talking about the administration problem——

Mr. McLURE. No——

Representative BLACKBURN (continuing). And not the principle of the tax itself, which is the fact the property should bear some share of the costs of providing services for that property. What about that, as an economist? If we do not have a property tax, doesn't this encourage people to withhold property from its most economic use?

Mr. McLURE. It would encourage them to withhold land. And as I have said, I would not take the tax off land. I think you are quite right about land. In fact, there are a number of States that have provisions that allow essentially urban land to be taxed as though it were rural. One can easily imagine why these provisions were enacted, and I think this is dreadful on both equity grounds and in terms of efficiency. It does encourage withholding of land from its most profitable use. It encourages speculation.

Representative BLACKBURN. Mr. Due, do you want to comment?

Mr. DUE. I would agree the property tax should not be eliminated. I also agree some administrative improvements are clearly necessary. Some States have done a good bit with this and some have not. I think that for some local functions, there needs to be more equalization throughout the state, particularly in the education and welfare field. There are some very, very poor communities and some very, very wealthy ones relative to, say, welfare needs or education needs.

So, I think that further state equalization in most states is necessary. But I would not eliminate the tax by any means.

Representative BLACKBURN. I have no further questions. I think it is fair to add this statement regarding the generalized premise that more dollars mean better education. It may mean the availability of more educational opportunities, but we are witnessing a number of areas in the country where more dollars are being spent per pupil than they are in my own county, and yet my county's educational system is second to none.

So, I don't think we should generalize in talking about property taxes. We should not also make the same error of generalizing in regard to expenditures for education and assume educational services are going to be delivered and received based on the amount of money being spent.

Thank you.

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. There is some limit to the joy a politician feels about being on television. I wonder if it is possible to turn off the lights. I cannot even see the witnesses out there, sitting where I am. If I am going to ask any dramatic questions, I will let you know. Okay?

Chairman PROXMIRE. Then they have to see whether there is going to be a dramatic answer to the dramatic question.

Representative CONABLE. If you feel a dramatic answer coming on, gentlemen, please let us know.

Thank you very much.

Chairman PROXMIRE. You can turn those back on as soon as I start questioning.

Representative CONABLE. Mr. Cohen, roughly 65 percent of the taxes that we collect in this country come from income tax. Is there any optimum?

Mr. COHEN. That is a question perhaps an economist ought to answer. The income tax is an efficient tax. It is the most efficient in the world. The cost of collecting the income tax has dropped dramatically over the last number of years, as we have had falling tax rates. So, that shows a double efficiency.

When I left the service, we were paying about 45 cents on a hundred dollars. It is a very, very low administrative cost. That includes all costs of administration—collection, processing. If you took the voluntarily paid tax, it would be, of course, infinitesimal.

There is no other tax that can match that in terms of efficiency. In terms of proportions of our tax, we have collected greater proportions of our tax in income tax in the past.

Representative CONABLE. Aren't we continuing to do that because of expansion of the economy, despite reduction in rate?

Mr. COHEN. Yes. But our taxes on employment have increased more than proportionate. So they make up a greater percentage—if you take a look at a fellow who makes six or seven thousand, he may pay more in terms of social security withholding, unemployment, that kind of tax, than he does in terms of income tax. That was not true 10 or 15 years ago. We have had a dramatic increase in that tax.

Representative CONABLE. That is because it is an earmarked tax and we have been increasing the benefits of social security.

Mr. COHEN. I do not argue that. It is a fact that has been rising more rapidly than any other segment of our tax.

Representative CONABLE. But, I suppose an economist would say there is some advantage in a balanced tax system, which provides money from other sources than simply the income taxes.

Mr. COHEN. I would defer to the economists for that.

Representative CONABLE. Mr. Due, do you want to say something about that?

Mr. DUE. I do not know any way of defining an optimal balance. I do think the balance has to be described in terms of all levels of government. You cannot look at the Federal alone, because what is optimal for the Federal depends in part on what the States and localities are doing.

Representative CONABLE. I think 92 percent of the income taxes are collected by the Federal Government.

Mr. DUE. I think that is roughly correct. But, when you are talking about an optimal, you have to consider the amounts coming in from other levies, it seems to me. I think as a practical matter, there is a limit as to how far you want to go on any one particular tax. Again, considering Federal, State, and local combined, it is impossible to make any tax perfectly equitable and the higher the rate the more serious these inequities become. But you have absolutely no way of defining precisely what an optimal system is.

Representative CONABLE. I note you gentlemen are all very cautious about the extent to which the corporate income tax is an indirect tax. You are apparently unwilling to say that. To a very substantial extent, isn't it almost as indirect as the value-added tax? Eighty percent of the business in this country is done through corporations. The chairman of my committee, Wilbur Mills, loves to quote some antecedent of his in that capacity, is the effect that you never tax a corporation; all you do is increase its costs of doing business. Apparently you have some reservation about that viewpoint. Let me ask you if you would still have that reservation if we were to do what one of you suggested, and start considering stockholders as partners, taxable on corporate profits, to the extent of their being stockholders, or even if we were to eliminate the long-term capital gains rate, which is roughly half—it is not exactly that, following the Tax Reform Act of 1969—so that people could not hold stock for the purpose of its appreciation in value, but would be forced to hold it for the amount it can earn.

Let's go over to Mr. McLure on that.

Mr. McLURE. Let me see if I understand exactly the question.

Representative CONABLE. I asked you several questions, I guess. I would like your comment on it, though, because we are taking a look at the tax structure here. We have to kind of keep the big picture in mind and try to see what we want to accomplish.

Mr. McLURE. I would say with regard to whether or not the corporation tax is shifted, which is one of the fundamental questions that must come up when we discuss substituting the value added tax for the corporation tax—in fact, most discussions degenerate into a discussion of only that. They do not wait nearly this long to get precisely to that question, which is the crucial question.

Representative CONABLE. I agree with you, the value added tax would be shifted to consumers, obviously. It is designed for that purpose. The corporation income tax, I suspect, is normally shifted, too, but perhaps not to the extent we are competing with foreign countries.

Mr. McLURE. Economists, as you know, are in complete disagreement upon this. The traditional view has been that the corporation tax cannot be shifted in the short run, while a certain number of economists feel it might be shifted in the long run. I tend to believe that, in fact, it may be shifted in manufacturing fairly quickly and that it is almost certainly shifted with the passage of a fairly small amount of time to get to the long run.

This being the case, then it does look somewhat more like an indirect tax than is usually assumed. Even here, I have to remain cautious. The econometric studies we have just do not tell us the answer. You can get perfectly respectable people on both sides and nobody to tell us which is right.

Representative CONABLE. Mr. Due.

Mr. DUE. I essentially agree. The more studies we get the less we are sure of the answer.

My own suspicion is that corporate taxes are in part shifted. On the other hand, it has always been hard for me to see how the tax can be shifted fully, because the tax burden will differ among competing firms. The value-added and sales taxes are uniform in relation to sales, but the corporation tax is nonuniform relative to sales. This would seemingly mean that more profitable firms would have trouble to shift the tax when their competitors are bearing less tax per dollar of sales. To the extent the corporate tax does shift, it looks much more like a value-added tax and does not look very good from an equity standpoint.

Representative CONABLE. I have a theory Ol' Smoky Joe Public is going to pay for everything the Government does anyway, in one way or another. The important thing is that the system makes some sense to him. I do not ask for your comment on that, but I do think we play a lot of games with this idea of loophole closing, and that we are playing an unusual number of games with respect to it right now.

Mr. Cohen, I really think we have got to face some facts in our tax system. We have fallen under the influence of the economists, so we use that system to stimulate or restrain the economy. We also use it to express our national priorities and there isn't one of us sitting up here who has not sponsored a lot of tax credit and tax reference bills even though we were creating loopholes, justifying it if it was addressed to a worthy cause. If we put a ceiling on expenditures we would have a whole new crop of tax credit bills because that is one thing that cannot be controlled. I am just not convinced.

Mr. COHEN. I must take the statement if that course were to be continued for any substantial period of time, you could have a lot of efficiency in government. Abolish all government departments and the Internal Revenue Service at that point, runs the country. You have, in effect, substituted a tax expenditure for an agricultural expenditure, for a resource expenditure. Of course, it is facetious, but there is a piling on, and a piling on makes for an inefficient tax system because Internal Revenue agents are well trained and expert in their jobs and their jobs are accounting jobs. They are not sociologists and they are not economists, and they are not dispensers of various kinds of subsidies. They are not very expert in this and it gets them into problems. It creates all kinds of administrative difficulties.

Representative CONABLE. I suspect that will happen instead, we will carry this to a ridiculous extreme and eventually have some revolutionary overhauling our income tax system whereby we tax all income from whatever source at some sort of a flat rate or graduated rate, and at that point everyone will proclaim a millenium and then discover their own tax bill is considerably higher than it was before.

Mr. COHEN. That is right. Our rates are still relatively low. As I remember the data, our tax, Federal, State, and local, as a percentage of our gross national product, is lower than any of the countries of so-called Western World. If you take all of Western Europe from Scandinavia on down through the whole pack of them, you will find the tax which is used by all of their local, municipal and Federal authorities, is two or three percentage points at the very lowest end and maybe seven, eight or nine at the highest end, higher than ours.

Representative CONABLE. One last question of Professor Due. You said at one point in your statement, there are legitimate arguments for a value added tax. Could you just summarize what they are? Broaden the tax base, whatever else?

Mr. DUE. I do not remember exactly the context in which I used it. I was using it primarily in terms of other countries rather than the United States. In a country, say France, for instance, where——

Representative CONABLE. Where they cannot collect anything else and they have learned to cheat on that lately, I understand.

Mr. COHEN. They run a good company that manufactures receipts that are used for the purpose of evading.

Mr. DUE. Yes.

To answer your question more seriously, in any of the countries of Western Europe, particularly France, Italy, Belgium, and in Latin America, it is very difficult to collect substantial amounts of money from income tax or from a retail sales tax. And under those circumstances, the value-added tax is kind of a levy that can be collected.

Representative CONABLE. Then the issue is: government survival and not equity. You cannot think of any equitable legitimate argument for it?

Mr. DUE. Well, no; essentially not, as a major element in the tax structure.

Representative CONABLE. I am somewhat inclined to agree with you on this, I must say. But, I am terribly concerned about the direction of the income tax law, and I am also concerned about the extent to which we are whipsawed about it, by demagogs who want to pretend one man's tax preference is not another man's loophole.

Chairman PROXMIRE. Gentlemen, last month the White House said that they looked favorably—at least it was reported—again I say it is unfair to call it Nixon's tax—but they were reported as saying they looked favorably on a value-added tax, if you cut as much as 50 percent of the present property tax. Now, the present property tax yields $41 billion. That value-added tax would have to raise about $20 billion.

They said ways could be found to make this value-added tax much less regressive. How big a value-added tax would you have to have if you either made exemptions to it or if you provided the kind of pay out to low income people that would make it fairly stable tax? Any of you can give me an estimate about that.

Mr. MCLURE. 5 percent.

Chairman PROXMIRE. About 5 percent. How big an inflation would that give us if we followed the White House's prescription and did what they say they would like to do? Five percent value-added tax would give us what, 3 percent increase in the cost of living; 4 percent or what?

Mr. DUE. It is very difficult to say but I would suspect your figures are reasonably good guesses.

Chairman PROXMIRE. So the administration is saying they would relieve part of the burden of the property tax, 50 percent, up to 50 percent, and that in return they would give us an additional four percent increase in the cost of living. I do not want to be arbitrary about this, but would that be a fair analysis of the result?

Mr. DUE. I think that is a fair statement so far as the initial effect is concerned. One of the dangers is that an initial 4 percent inflation would generate wage demands that would result in considerably more than 4 percent.

Chairman PROXMIRE. Furthermore, on the basis—you fellows have not has the same political exposure I have—but my own experience is: When you get a value-added tax on the books, it is much more vulnerable to an increase than an income tax is. Income tax is more susceptible to decreases. So, when you cut taxes, you cut the income tax and when you need revenue you increase the value-added tax. So there would be a constant shift in that direction with all of the lobbying pressure and power we have in this town working about to bring about this result.

Would that be your conclusion, Mr. Cohen?

Mr. COHEN. It seems like a reasonable conclusion.

Chairman PROXMIRE. So, in addition, further inflation would result because of wage demands. You would have something that would be increased as the years go on. Is that a fair conclusion?

Mr. McLure, you have been more a defender of the tax. Incidentally, it has been said in a wire copy here, that this hearing was called to mobilize opposition to the value-added tax before the President could even propose it. The fact is we have two out of three witnesses tomorrow who favor the value-added tax, we are trying our best, but it is awfully hard to find economists that favor it.

Mr. McLURE. I am not sure whether I am characterized as competent or as favoring——

Chairman PROXMIRE. You are certainly competent.

Mr. McLURE. I will take exception to only one of those.

I think the statement you made is probably true, but it may be somewhat worse than you say, in the sense that once the tax gets in, say at 5 percent, there is a very good liklihood that it would then creep on up as we needed more revenue. And the income tax would probably continue to be eroded and it would probably be easier to raise revenue by adding to the value-added tax rate than by reforming the income tax.

Chairman PROXMIRE. Not only because it is regressive, but it is invisible.

Mr. McLURE. It is invisible. I think there is another thing which you perhaps omitted, but with which I am sure you will agree. The case for the value-added tax is strongest if there are virtually no exemptions. I suspect that what we would see is that the value-added tax, in terms of its broad-based neutrality, would soon go the way of our broad-based income tax. That is, special interests would probably find ways to exclude their particular products from the tax. They will have to work a little harder, but I am convinced they can do it if given a chance. Special interests will make very much a sieve of this tax like they have the income tax.

Chairman PROXMIRE. Let me ask you: you gentlemen—tell me what are the ways, in addition to the ones you have mentioned, are there other ways of making the value-added tax more progressive? You mentioned, one: exemptions, and two: rebates. Are those the only ways that are available?

Mr. McLure. You could initiate something like a negative income tax or a really strong family assistance plan, in which you set the minimum assistance to the poor high enough to take account of some increased burden from the value-added tax, although you do not technically call it relief for the value-added tax itself.

Chairman Proxmire. Any possibility the value-added tax would help us close some of the loopholes we have? Oil depletion, for example? Can we get at the oil companies this way? I have been trying since I have been in Washington to get them to pay taxes.

Mr. Cohen. I suspect the oil companies would oppose the tax, because—you know, any business that operates on large volume with some elasticity to its demand, would feel this tax is going to cut consumption, therefore, cut its profits.

Chairman Proxmire. I have been surprised Secretary Connally is inclined to favor the tax.

Mr. Cohen. Mr. Aaron, a witness tomorrow, had some figures, as I remember. I do not have them, but he produced some figures which would show which industries might, because of their profit margins, would be likely to favor the value-added tax. He could not predict for sure, but you could guess the likely supporters of the tax or opponents of the tax, depending on which way it happened to affect their business. Wholesale business, large volume, low profit, would oppose it.

Chairman Proxmire. The examples you gave, you are very able in this area, far more than I, but I am not sure the example you gave is correct. A firm that grosses $10 million, and that therefore would have to pay relatively high value-added tax.

Mr. Cohen. It would have been an integrated firm.

Chairman Proxmire. It sure would, because if it is a usual firm, a wholesaler, for example, the value added would be very small.

Mr. Cohen. Yes.

Chairman Proxmire. And because the tax is imposed in relationship to the value added, you would avoid a situation where a big volume firm otherwise would be required to pay a large portion of their income.

Mr. Cohen. The meat business is fairly integrated. I have a brother who is in the wholesale business, very large volume, very low profit.

Chairman Proxmire. In that case, very, very small value added in relation to the volume of business.

Mr. Cohen. Yes. But the profit margin is so small in relation to the volume, also, if you cannot pass at all, or if you cannot pass some portion of it on, it can take away your profits.

Chairman Proxmire. But you have to relate the tax to the value added.

Mr. Cohen. Right.

Chairman Proxmire. Rather than the volume.

Mr. Cohen. Yes. That is illustrative. Those figures are not necessarily accurate, but it would affect different businesses in different ways. Large volume, high-profit operations would be affected relatively little, whereas if you have the very small margin it can have a dramatic effect on that kind of business.

Chairman PROXMIRE. One of the most useful contributions we have, we had a number, one is the notion I heard before that the poor cannot file for refunds. I can understand why that would be true, because it is very hard for them to understand or comply.

Do you have any statistics on what this would amount to, what proportion of refunds on the basis of Wisconsin, for example, where we tried this with our sales tax, but I have not seen any figures on what proportion did not apply.

Mr. DUE. I do not have any good figures. In Indiana, it is clear several hundred thousand people did not apply. They know how many people there are in the state; they know how many people show up on income tax returns in total, and there was a considerable gap.

I do not regard this as an absolute argument against the system. But I think it has to be recognized. We probably could get fairly good figures out of Indiana.

One estimate I heard, though very rough, was that not much more than half of the people who are eligible but who have not been filing returns do so to obtain the refund.

Chairman PROXMIRE. A great majority of the people do not file.

Mr. DUE. A substantial number of the lower income groups do not.

Chairman PROXMIRE. How could you get them to do it?

Mr. DUE. Well, it is partly a matter of the publicity the state uses. The State of Vermont, when it started the system, conducted very extensive propaganda campaigns throughout the State to try to get people to file. I have not had any recent figures on how successful they were.

Some of these systems are very new, and after another couple of years' experience we will get more information.

Mr. COHEN. Some of the writeups of the negative income tax would be, when there were a number of articles a couple of years ago, were pointing up the same problem, that in this group of people is our least educated and least capable of filing the kind of documents that would be required to get this kind of relief. This kind or any of the benefits.

Chairman PROXMIRE. Combined with a negative income tax would you overcome that?

Mr. COHEN. You would, but the problem of administering a negative income tax is very difficult. It would require very extensive campaigns and heavy expenditures, efforts on many people's part to get the right information to these people so you could motivate them to apply for the relief they are entitled to.

Chairman PROXMIRE. Mr. Cohen, earlier you said that the cost of raising, collecting income tax is about 45 cents per hundred. Do you have any estimates or know of any studies of the cost of administering the value-added tax, No. 1, without any exception; No. 2, with exceptions, per hundred dollars?

Mr. COHEN. I would assume the Treasury or Internal Revenue today is making those studies for the Intergovernmental Committee, but I do not have access to that information. Setting up a new system and training new people, because it is an add-on is expensive.

Chairman PROXMIRE. On the basis of our experience with the retail sales tax, is it 3 percent?

Mr. COHEN. It would be a bit higher than the income tax.

Mr. DUE. The State figures for collection of sales tax average around 1 percent of the revenues. On the other hand, the rates are lower. Most of them are lower than the 5 percent proposed for the Federal value-added tax. Expenditures for collection do not rise in proportion to the tax rate. But, at any rate, initially with a 5 percent Federal value-added tax, I would guess it would be somewhere in the neighborhood of 1 percent.

Chairman PROXMIRE. 1 percent of the total revenue?

Mr. DUE. Total revenue from the tax.

Mr. COHEN. In other words, it would be something better than twice as expensive.

Chairman PROXMIRE. Twice as expensive as the income tax.

So, it would be far more expensive than if you just raised the income tax?

Mr. COHEN. That is right.

Chairman PROXMIRE. Gentlemen, I want to thank you very much. It has been, as I say, an excellent kickoff. I am deeply grateful to you. You have done a fine job, all three of you. I cannot thank you enough.

Tomorrow we will convene to hear Henry Aaron, the Brookings Institution; Phillip Lifschultz, vice president of Montgomery Ward; and Norman Ture, economic consultant.

(Whereupon, at 12:15 p.m., the committee was recessed until 10 a.m., Wednesday, March 22, 1972.)

THE VALUE-ADDED TAX

WEDNESDAY, MARCH 22, 1972

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room S–407, the Capitol, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire and Representative Blackburn.

Also present: John R. Stark, staff director; Loughlin F. McHugh, senior economist; Courtenay M. Slater, economist; Lucy A. Falcone and Jerry J. Jasinowski, research economists; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today we continue our hearings on the value-added tax. Yesterday we heard from two topflight economists and from a former Commissioner of Internal Revenue. I was surprised to hear those witnesses place the VAT at the bottom of the list as a means of either raising revenues or improving the structure of our tax system.

It was criticized not only on grounds of equity but on grounds of inefficiency. I know today we will not have the same degree of unanimity.

Indeed the proponents of the VAT are in the ascendency among our panelists.

Before we hear from the panel, I have asked Congressman Joseph Vigorito, Democrat from Pennsylvania, to give us his views on this subject.

As a certified public accountant as well as an experienced public official, his views must claim careful attention.

Congressman Vigorito, would you please come forward.

STATEMENT OF HON. JOSEPH P. VIGORITO, A REPRESENTATIVE IN CONGRESS FROM THE 24TH CONGRESSIONAL DISTRICT OF THE STATE OF PENNSYLVANIA

Representative VIGORITO. Senator, you will have to excuse me. I am just going to talk off the cuff. I have some notes here.

Chairman PROXMIRE. How long a statement do you have?

Representative VIGORITO. It will only be a few minutes.

Chairman PROXMIRE. Very good.

Representative VIGORITO. Thank you, Senator.

I appreciate this opportunity to appear before you to give you my views on the value-added tax. Needless to say, I am very much opposed to the value-added tax. We are entering the decade of the 1970's, at least in my opinion, worse off economically since the decade of the 1930's. I have several good reasons on which to base my conclusion.

First, of course, our foreign trade position has never been worse than it is at the present time. Even the bill that we passed in the House yesterday devaluing the dollar approximately 8 percent is not going to change the situation very much, if at all.

I do not see any possible improvement in the foreseeable future in our foreign trade position, considering the policies that this Government is taking and pursuing.

Second, we have seemed to adopt or accept an unemployment of 5 or 6 percent as the natural thing. I can remember 25-odd years ago, when Congress passed the Full Employment Bill, that our national goal was 2 percent unemployment, and we might tolerate 3 percent.

In the last 25 years we have constantly increased our tolerable limit on what we would accept as reasonable unemployment. Now, the administration thinks if we get unemployment down to 5 percent by November, it will be a tremendous victory.

How long can we go on increasing our tolerable limit on unemployment and still have our viable economic system?

On top of that, for the second time in our economic history, we have inflation and it is continuing even though we have some type of controls at the present time. The economic textbooks that I used for several years at various universities always said when you have a recession or depression, you have decreasing prices. Lo and behold, comes the recession in 1957–58: We not only had a recession, but we had inflation. Fortunately, that was a short period of time.

Well, it could possible be excused as a quirk of economic law. But in this current recession, which is now entering its third year, we are having a persistent inflation, and inflation is continuing to rob the poor.

Another feature that adds fuel to my statement that this is the worst decade in the last five decades is the Federal deficit. I do not know exactly how many millions of dollars last year and this year and next year. We are accepting 30 or 40 billion this year, a 40 billion deficit next year, and our national debt is going to end up, within a couple of short years, approaching the $500 billion mark, which is almost half of our gross national product.

I am concerned how far we can go with all of this and still have a viable economic system.

This all leads up to my views on the value-added tax, because it will put an unjust burden on the lower-income groups. To back up my statement as to how bad the low-income groups are, we know that the top 1 percent of the population receives 6.8 percent of the national income.

The top 20 percent receives 45.1 percent of the national income.

And on the other end of the scale, we have 20 percent getting 3.4 percent of the national income, or the bottom 40 percent, which means over 80 million are people receiving 14.1 percent of the gross national product.

You can see that the burden of unemployment and inflation falls on the backs of those least able to afford it.

In the 8 years I have been in Congress, I have voted for all programs, such as the war on poverty and education, for manpower training, retraining, and so forth, to help the economic groups on the lower rung of our economic ladder.

But then we go ahead and continuously give tax benefits to those in the higher brackets of our income ladder. And the higher you go, the more benefits they have.

Frankly, I am going to make a statement, and I am very sincere: I am in the top 1 percent of the income groups and I must say that I have difficulty spending my income or investing it wisely. What can I do with it after I pay my taxes, eat and cloth my family? I have to bid up the price of real estate, or bid up the price of stock on the stock market, and we think that is an economic advance.

I am sure there are tens of thousands of individuals in this country that are in the same position as I am in, who do not know what to do with their money. I could waste it, of course, but I am not in favor of wasting my income or any other individual's income. We should invest it or spend it so that we can get the most good out of it.

If we, on top of everything else, add a value-added tax, which is strictly a sales tax, I do not see anything good coming out of it for the economy and continuing to have a viable economic system.

Sure, they have a value-added tax in France, but you go there and check the prices of refrigerators or automobiles and appliances, and compare that with the wage the average Frenchman receives, and you will find it is all out of proportion. The route we are going, and the road we are taking, we are going to end up down the very same road with even more inflation, more unemployment, and more unequal distribution of our national income.

Thank you, Senator, for this opportunity to express my views.

Chairman PROXMIRE. Thank you, Congressman Vigorito, for a most unusual statement and very well organized and comprehensive in an extremely short period of time.

I think you are one of the very few witnesses we have had who has put this on such a personal basis, and one of the very few people I know, frankly, who would say that although he is in the upper income brackets, feels that it is unjust that our tax system favors people in that position.

You rarely find people who have that view. If we did have, we would not have a problem, obviously, because the reason we maintain the kind of tax system we have, the injustice we have, is the power lies with those who have the big incomes.

The way you put together the difficulties that face us in foreign trade, unemployment, inflation, deficit, was extraoirdinarily good.

I would like to ask your source for the income statistics that you gave, because they were very compelling. The top 1 percent has 6 percent of the income and the bottom 20 percent has only 3.4.

Representative VIGORITO. Senator, in the Washington Post a few weeks ago, there was an article by Richard L. Straut, entitled "More Realistic" where he mentions the breakdown. This in turn was received from two authors from the Brookings Institution. I am trying to locate their names in this article.

Chairman PROXMIRE. That was probably Peckman and Okner.

Representative VIGORITO. Yes. Thank you.

Chairman PROXMIRE. That is fine. I think that is most helpful.

At any rate, you concluded on the basis of this analysis, that a national sales tax, or a value-added tax, would be regressive, would hit those with low incomes, and therefore would be improper under the circumstances that you describe here; is that right?

Representative VIGORITO. Yes, sir.

Chairman PROXMIRE. How much opportunity have you had to study the value-added tax?

Representative VIGORITO. I have been studying economics for going on 30 years. So I have studied all phases and all types of taxation. I have traveled to many countries around the world. I have probably visited at least 30 countries and I have seen their economic systems at work.

I see in those nations the differences in the standards of living, where the top few percent of the people have most of the wealth. We wonder why events like the revolution in Cuba happen, and similar upheavals throughout the world.

I think the unequal distribution of wealth and income is the primary cause of this.

Chairman PROXMIRE. The administration has said the value-added tax can be made progressive. Do you believe that is the case?

Representative VIGORITO. No; I do not believe it. We do not need another source of raising funds. I could have added that we are constantly eroding our income tax base, that less than half of our national income is subject to the Federal income tax, and eroding it to such a point we are looking now for another means of taxation, which is a value-added tax.

Chairman PROXMIRE. They propose two ways of doing it. One would be to exempt food and other necessities.

A second would be to rebate the people with low incomes, part of the value-added tax, so they would be spared, in effect, paying the value-added tax.

Representative VIGORITO. Why adopt another system when we have a progressive income tax that we could reform and close the loopholes and shift the tax burden from the lower half of the population and put it on the upper half of the population?

I am getting tired of all of these sociologists and psychologists and all of these students of the "war on poverty" classifying the people that do not have income, to see why they do not have income, when really all they need is a dollar in their pocket to spend, so that they can lift themselves up.

Chairman PROXMIRE. Congressman, thank you very much. We most appreciate your useful testimony.

Representative VIGORITO. Thank you, Senator.

Chairman PROXMIRE. I would like to ask the panel to come forward. Mr. Henry Aaron, Mr. Phillip Lifschultz, and Mr. Norman Ture.

The minority member of our panel today is Henry Aaron, not to be confused with the great Atlanta Braves baseball star, formerly the Milwaukee Braves.

I understand you are not making $600,000 in the next 3 years as Hammering Hank is.

Henry Aaron is an exceptionally fine economist, senior fellow at Brookings Institution and former public servant with the Council of Economic Advisers.

Following Mr. Aaron, we shall hear from a strong proponent of the value-added tax, a lawyer, tax expert, and vice president of Montgomery Ward, Mr. Lifschultz.

Finally, we shall hear from Mr. Norman Ture, an outstanding economist now in private practice. I might note that Mr. Ture, a specialist in tax matters, he is a man I followed and found to be most helpful and thoughtful. Another way of saying I often agree with him. He is an alumnus of our staff and a man of whom we are very proud.

Would you lead off, Mr. Aaron.

STATEMENT OF HENRY AARON, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. AARON. Thank you very much, Mr. Chairman. I appreciate the invitation to testify before the Joint Economic Committee on the value-added tax.

My interest in the tax goes back a number of years.

Chairman PROXMIRE. Let me interrupt to say, before you begin, I have gone through all three of these prepared statements. Some of them are quite long. We have tried to confine the opening remarks from 10 to 15 minutes, so we will have time to question.

Other members, I think, will probably appear. At any rate, if you could summarize as much of your prepared statement as possible, the entire prepared statement, in every case, will be printed in the record.

I notice Mr. Lifschultz has an additional addenda to his prepared statement. The entire prepared statement will be printed in the record, including all of the material you have here today.

Mr. AARON. I will try to be brief.

Last December Congress enacted and ratified tax reductions that reduced Federal revenues by $11 billion for calendar year 1972, and over $110 billion for the succeeding decade.

The driving force behind those reductions was concern over unemployment. Now, 4 months later, the President has raised the possibility of collecting $12 billion annually from a value-added tax to pay for property tax relief.

It seems to me that the consideration of the tax increase at this time of almost exactly the same magnitude as tax reduction enacted or ratified last December, testifies to the shortsightedness of those reductions and the incorrectness of that decision.

I think we should make every effort to keep distinct the two proposals which President Nixon has advanced. One is to provide property tax relief for State and local governments. The other is a value added tax to finance increased Federal expenditure.

The proposal to provide property tax relief for State and local governments imposes exactly the same budgetary burden on the Federal Government as would efforts to improve the welfare system, build intraurban transport, or increase any other kind of Federal outlay.

What all of this means is that there is no logical connection between property tax relief and value-added taxes. Proposals to relieve property taxes or to increase any other Federal expenditure all costs money. In the short run, they would increase the full employment deficit and would speed the economy's return to full employment, but each and every one in the long run would require increased Federal revenues.

The next question really how we should raise additional revenue if we desire to increase Federal expenditures, whether from a value-added tax, an income tax, surcharge, curtailment of exemptions or reductions, an increase in payroll taxes, or some other device. This is a decision that Congress will have to make.

Let me stress again it is quite independent from any decision Congress may make regarding the provision of property tax relief to State and local governments.

At the risk of going through what you probably have heard three times yesterday and will hear three times again today, there are different kinds of value-added taxes. My prepared statement very briefly describes those differences. One is called the "gross product" value-added tax, another the "income" value-added tax, and the third the "consumption" value-added tax.

In my prepared statement I try to argue that these taxes are equivalent to other kinds of taxes. A "consumption" value-added tax is equivalent to a retail sales tax; an "income" value-added tax is equivalent to a proportional net income tax; a "gross product" value-added tax is really not like any other tax we have in our system.

Who pays the value-added tax? Well, the simple answer, of course, is the people pay it, as they do all other taxes. Neither the value-added tax nor any other tax is borne by business. All taxes are borne by people. Sometimes in proportion to one or another kind of income, sometimes in proportion to one or another kind of expenditure, sometimes in proportion to one or another kind of assets. Taxes that allegedly burden businesses in reality burden their owners in proportion either to their income derived from business sources or from wealth invested in the business.

Now, there has been a lot of discussion as to whether a value-added tax will raise prices, whether the tax is shifted backward or shifted forward. In my prepared statement I try to argue the question of whether it is shifted backward or shifted forward is relevant to an analysis of the incidence or true burden of the tax on various economic groups. Whether or not the VAT will lead to higher prices depends purely on monetary and fiscal policies pursued by government and by the Government and monetary authorities.

Most economists, I think, would anticipate that introduction of a value-added tax would be followed by at least an equal increase in prices. A 5 percent VAT, for example, would raise the price of the taxed commodities about 5 percent. They would expect that monetary authorities would expand the money supply fast enough so that wages, interest rates, rents, and profits could be maintained with no drop in economic activity.

If only the immediate impact of a VAT is considered, it would have no impact on the balance of payments. Prices of domestically-produced goods would be higher by the amount of VAT, but so would the prices of imported goods, leaving the choice of consumers and investors among importers of domestic goods unchanged.

Under the usual procedures, importers would pay a VAT at port of entry, in addition to ordinary import duties. The competitive position of domestically-produced and imported goods would be unchanged.

The same thing would be true in the export market since the VAT would be rebated on exports and, of course, would not be imposed on U.S. goods produced abroad and sold abroad. All of this follows from a consideration of the initial price effects of VAT.

It seems likely, however, that labor will try to recover lost purchasing power in succeeding wage negotiations. A large proportion of economists hold that price increases trigger at least partly successful efforts by labor to obtain offsetting wage increases. After the wage-price cycle set in motion by VAT had worked itself out, the actual increase in price and wages might considerably exceed the initial stimulus. If that occurred, VAT would damage the U.S. balance of payments.

Those who seek a VAT to assist the U.S. balance of payments must entertain rather odd assumptions about governmental behavior.

First, they must feel the authorities will greet the efforts of businessmen to pass on taxes through higher prices with monetary and fiscal policy so tight-fisted that employers will force workers to take wage cuts or forego wage increases. And second, the Government must be so stoical that the resulting strikes will be disregarded.

We have just gone through a serious international monetary crisis rather than try to improve our balance of payments through deflation of domestic incomes. Why the Government officials would behave differently in the face of a VAT is quite unclear to me.

In my next section I argue that a VAT of the consumption variety is indeed regressive. Its burden would be distributed in proportion to consumer expenditures, not in proportion to income. A consumption VAT that takes 1 percent of income from a typical household with income of $12,000 will take 1.5 percent from a family whose income is under $3,000, (half again as much from a family with an income under $3,000); about 0.9 percent from a family whose income is between $20,000 and $25,000, less than half; and 0.44 percent from families with incomes over $50,000. That "income" type of VAT would less regressive because it would effectively reach savings and it would be the equivalent to a proportional income tax.

You asked the preceding witness whether the regressivity of a consumption type of VAT could be curbed. I would like to turn to that question now.

It is possible by combining VAT with a refundable credit to all households, presumably paid under the personal income tax, to offset the regressivity of a VAT for most of the income distribution. Although it is possible to offset the regressivity of a sales tax through a refundable credit or equal per capita tax, in fact, you are combining two taxes, one positive and regressive, the VAT, and one negative and progressive, a rebate on the income tax, so that in combination the burden could be made reasonably progressive as far into the income distribution as the credit reaches. If the credit reaches to $10,000 or $20,000, the combination could be progressive up to that range. So long as the credit does not cover the whole income distribution, it cannot make the value-added tax progressive or even proportionate over the entire distribution. A credit reaching far up into the income distribution would lose or rebate a substantial part of the revenues collected from the VAT.

Concerning exemptions. Exempting food or clothing would have minimal impact on the regressivity or progressivity of VAT. It would do virtually nothing provided the same amount of revenue was collected. I cannot document this statement at this time, but it will be documented in the forthcoming Brookings volume "Setting National Priorities" which will come out later in the spring.

Obvious question concerning the VAT——

Chairman PROXMIRE. Can I interrupt? Will that volume be primarily on the value-added tax?

Mr. AARON. It will cover the entire Federal budget, as the first two editions have done.

Chairman PROXMIRE. How much of a study is that?

Mr. AARON. One chapter will be devoted to the issue of raising additional revenues.

Chairman PROXMIRE. And part of that chapter will be on the VAT?

Mr. AARON. Yes.

An obvious question concerning the value-added tax with the credit designed to remove regressivity is why bother? If the goal is to raise revenues in a reasonably progressive manner, the personal income tax is an obvious candidate.

The next question I address is what are the administrative advantages of a value-added tax. Very briefly, I maintain there are quite real and significant administrative advantages in the European context, none of which are present here in the United States. In Europe, the value-added tax in a number of countries replaced a very bad kind of tax, a multistage turnover tax, which had undesirable allocative effects on production. The administrative apparatus for handling multistage taxes was in existence, retail sales tax was little used in Europe because governments doubted they could collect revenues from all retailers.

No mechanism for collecting multistage taxes in the United States exists at the present time. We would have to create one. It does not mean that VAT is beyond the administrative capacities of the Treasury Department. On the contrary, a new branch of the Internal Revenue Service could be created, a new crop of auditors could be trained, businessmen could hire accountants to fill in a new kind of tax form. There might well be a period of confusion, but eventually at some cost a VAT could work.

That is not the real problem. If one advocates the VAT, one cannot advocate a tax drawn from the dream world of public finance economies. One has to describe a tax that would be enacted after passing through the U.S. Congress. Consider the following issues in tax policy that the Congress would have to face in enacting a VAT. Should a value-added tax apply to rents? And if so, what about owner-occupied housing? To expenditures on urban mass transit? The sales of insurance companies? (Incidentally, what is the value-added tax of insurance companies?) To tuition receipts of private schools (including parochial schools), of private universities, of public universities? To receipts of publicly owned water and gas utilities? To sales of medical supplies to the aged or the poor? To sales by farmers? To lawyers' and doctors' fees? To services of domestic employees? To sales of nonprofit enterprises?

These problems are not insoluble but they are hard. Before Congress is through legislating a VAT and before the Treasury finishes writing regulations, the VAT, hailed for its simplicity and praised for its neutrality, is likely to be riddled with exemptions, different rates and other devices intended to spare meritorious causes and worthy taxpayers. In the tax world of fantasy, it may not be so, but the VAT must sojourn in the real world and the U.S. Congress.

The VAT is now under discussion as an alternative to the property tax. I suggest that we are really talking about a method of raising additional Federal revenues. Congress has at its disposal other ways of raising revenues to permit increased Federal expenditures. The simplest method would be a simple 8.5 percent surcharge on personal and corporate income. That would raise $12 billion, the amount now being discussed for a value added tax. It would do so virtually at no additional administrative cost. A surcharge would distribute the burden more progressively than a value-added tax, even, I might add, one with a credit mechanism.

The addition of 1.8 percentage points to each income tax bracket rate would raise the same amount of revenue. That approach would provide somewhat higher burdens on low income families than the surcharge and somewhat lower burdens on high income families than the surcharge, but it would be progressive, too.

A third method of raising additional revenues would be to curtail the special deductions, credits, exemptions, and exclusions available to certain groups of taxpayers.

There is something disgraceful, I think, in the prospect of imposing a value-added tax at the same time that the United States refuses to withhold income tax on dividends and interest, thereby allowing nearly $5 billion of interest and $1 billion of dividends to escape taxation; while it excludes one-half of long-term capital gains from tax; forgives all tax on unrealized capital gains of descendants; exempts municipal bond interest from taxation; allows depletion allowances far in excess of original investment; excludes $200 in dividends from tax for married couples; allows depreciation far in excess of true depreciation; exempts life insurance interest, transfer payments, inputed rent; and allows various deductions unrelated to any plausible definition of income.

At the same time, the United States retains a toothless estate and gift tax system whose bite any reasonably competent tax lawyer can help his clients largely avoid.

I am not so naive as to expect Congress to enact so far ranging a reform in the tax system soon. I would hope that tax reform, and income tax surcharge, and an increase in bracket rates all would be kept prominently in mind whenever the value-added tax is considered as a Federal revenue source. In my opinion, the value-added tax is clearly inferior to all of these alternatives, in terms of simplicity and equity.

I have not mentioned any of the other proposed uses of value-added tax, as a substitute for corporation income tax, about which I have written, or as an earmarked tax to support health insurance, or some other Federal program. I have not discussed the practical problems and policy issues in trying to use Federal revenues to get state and local governments to reduce property taxes. But we could go into those on questions, if you would like.

Chairman PROXMIRE. Thank you, Mr. Aaron.

(The prepared statement of Mr. Aaron follows:)

PREPARED STATEMENT OF HENRY AARON*

SHOULD WE ENACT THE VAT?

Mr. Chairman. Thank you for the invitation to testify before the Joint Economic Committee on the value-added tax (VAT). Last December, Congress enacted and ratified tax reductions that reduced federal revenues by $11 billion for 1972 and $110 billion over the succeeding decade. The driving force behind those reductions was concern over unemployment. Now, barely four months later, the President raised the possibility of collecting $12 billion annually from a value added tax to pay for property tax relief.

The bleak long run fiscal prospects that have led the President to study a major new revenue source testify to the short-sightedness of the tax reduction enacted last year. The economy needed temporary fiscal stimulation last year and it still does. But the Revenue Act of 1971 consisted largely of permanent tax cuts whose effects will be felt long after the current recession has ended. Even before enactment of the Revenue Act of 1971, the best available forecasts indicated that federal expenditures would grow as fast as federal revenues for several years. (See *Setting National Priorities: The 1972 Budget*, Brookings 1971.) As a result of the Revenue Act of 1971 budget prospects are even worse this year and for several years to come.

President Nixon's statement that he is seriously considering the VAT to finance property tax relief has given this tax new political importance and economic interest. The lower courts have signaled that the methods most states now use to finance education are constitutionally prohibited. Unless the Supreme Court reverses several lower court decisions, state and local governments will be compelled to find new ways to support public schools. The federal government is bound to assume some role in this process, partly because it now bears some of the cost of elementary and secondary education and partly because a reform of educational finance will probably increase educational expenditures and create fiscal problems for state and local governments. Congress and the President probably would agree to help state and local governments through such an adjustment process with some form of financial assistance. The proposal outlined by President Nixon, now under study by the Advisory Commission on Intergovernmental Relations, is one example. The edu-

* The views presented in this statement are those of the author and not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

cational proposals of Senator Adlai Stevenson are another. Other proposals are almost certain to appear. Whichever alternative Congress might choose probably will require larger, possibly much larger, federal expenditures on education. The fiscal consequences of increased educational aid would be precisely the same as those of increased federal outlays for welfare reform, health care, pollution abatement, housing assistance, urban transportation, and any other purpose.

Each of these proposals poses the same difficult problem. Even without new programs, federal expenditures are projected to grow as fast as federal revenues, due partly to new budgetary devices (principally the replacement of loans by interest subsidies), partly to phased automatic tax reductions, and partly to the growing budget share of rapidly expanding expenditures. The happy era is past when revenue growth automatically outpaced expenditure increases, leaving bugetary room for new programs or tax cuts. Any major new programs—like federal educational assistance to relieve property taxes—must be combined with new federal revenues.

What this all means is that there is no logical connection between property tax relief and value-added taxes. Proposals to relieve property taxes, to increase educational expenditures, to reform welfare, to clean up the water or the air, to build urban mass transit systems, or to provide health care have one common characteristic—they all cost money. In the short run, some increase in the full employment deficit would speed the economy's return to full employment. But any significant and long term increase in federal outlays will require increased revenues.

The next question is whether these revenues should come from reductions in other expenditures or from higher taxes such as a value-added tax, an income tax surcharge, curtailment of income tax exemptions or deductions, an increase in payroll taxes, or some other device. Congress would have to decide which way to raise taxes is most fair and would least interfere with economic efficiency. In short, Congress should consider first the relative importance and desirability of expanding federal expenditures; next, if it decides to increase outlays, it must evaluate the relative advantages of raising additional revenues from personal or corporate income taxes, pyaroll taxes, value-added taxes, or some other tax.

Given a need for more revenues should Congress enact a value-added tax? I shall argue that a value-added tax has little advantage or disadvantage as means of promoting economic growth or improving the balance of payments, that it will add somewhat, but not prohibitively, to the complexity and administrative cost of the federal revenue system, but that it is likely to be less fair than available existing revenue sources.

THE VAT—WHAT IS IT?

Value-added taxes come in three forms. The "gross product" VAT taxes all businesses on the difference between gross receipts and inputs other than capital goods purchased from other firms. The "income" VAT taxes the difference between gross receipts and the sum of inputs purchased from other firms and depreciation. The "consumption" VAT taxes the difference between gross receipts and the sum of inputs purchased from other firms including gross investment.

Discussions about the VAT have exhibited confusion about whether a VAT is really equivalent to a sales tax, an income tax, or neither. A "consumption" VAT uniform over all goods and services is exactly equivalent to a retail sales tax uniform over all goods and services. Unlike the retail sales tax, the VAT is levied at all stages of production, not just on the final seller. An "income" VAT is equivalent to a proportional net income tax without exemptions, deductions, or credits of any kind. A "gross product" VAT is unlike any other tax.

So, it is apparent that whether a VAT is equivalent to a sales tax, a proportional income tax, or neither depends on what kind of VAT is being examined.

THE VAT—WHO PAYS IT?

The answer, of course, is that *people* pay it, as they do all other taxes. Neither the value-added tax, nor any other tax is borne by business. All taxes are borne by people, sometimes in proportion to one or another kind of income, sometimes in proportion to one or another kind of expenditure, sometimes in proportion to one or another kind of asset. Taxes that allegedly burden businesses in reality burden their owners in proportion either to income derived from business sources or to wealth invested in business. In some cases one can describe the incidence of a tax equivalently in more than one way.

For example, the incidence or real burden of a "consumption" VAT—the variety of VAT most prominent in recent discussions—can be described equivalently in either of two ways. As will become apparent, the much debated question whether the VAT is shifted backward or forward has nothing to do with the burden of the VAT. The burden of a consumption VAT is distributed in proportion to consumption expenditures and, what is the same thing, it is distributed in proportion to the sum of income from labor and capital, less saving. A rational consumer shouldn't care whether the purchasing power of his income is eroded by a ten percent rise in the price of the consumer goods he buys (forward shifting) or by a ten percent cut in income (backward shifting). In either case his real capacity to consume is reduced ten percent. As an asset holder, the person may care deeply whether prices are stable or rise, just as he may be concerned at other times how inflation will affect the value of his assets, but this concern is over the incidence of inflation, not over the incidence of taxes.

Whether or not a VAT will lead to higher prices depends on the monetary and fiscal policies pursued by the government and monetary authorities. Most economists, I think, would anticipate that introduction of a value-added tax would be followed by at least an equal increase in prices—a five percent VAT, for example, will raise the price of taxed commodities about five percent. They would expect the monetary authorities to expand the money supply enough so that wages, interest rates, and rents could be maintained with no drop in economic activity.

If only the immediate impact is considered, a VAT would have no effect on the balance of payments. Prices of domestically-produced goods would be higher by the amount of the VAT. But so would the prices of imported goods. Under the usual procedures, importers would pay a VAT at port of entry in addition to ordinary import duties. The competitive position of domestically-produced and imported goods would be unaffected in U.S. markets. In foreign markets, also, a VAT would leave the competitive position of U.S. goods unchanged. Domestic prices of U.S. goods would rise by the amount of the VAT, but the VAT would be rebated on exports, leaving the foreign price of U.S. goods unchanged. The burden of an "income" VAT differs slightly from that of a "consumption" VAT because it includes net investment in the tax base. But it too will leave the balance of payments of the United States unaffected.

All of this follows from a consideration of the initial price effects of a VAT. It seems likely, however, that labor will try to recover lost purchasing power in succeeding wage negotiations. A large proportion of economists hold that price increases trigger at least partly successful efforts by labor to obtain offsetting wage increases. After the wage-price cycle set in motion by a VAT had worked itself out, the actual increase in prices and wages might considerably exceed the initial stimulus. In that case a VAT would damage the U.S. balance of payments.

Those who seek a VAT to assist the U.S. balance of payments must entertain odd assumptions about governmental behavior. First, they must feel that the authorities will greet the efforts of businessmen to pass on taxes through higher prices with monetary and fiscal policy so tight fisted that employers will force workers to take wage cuts or forego wage increases. Second, the government must be so stoical that the resulting strikes by workers trying to maintain real incomes will be disregarded. We have just gone through a serious international monetary crisis rather than try to improve our balance of payments through deflation of domestic incomes. Why government officials would behave differently today is quite unclear.

IS A VAT REGRESSIVE?

A consumption VAT is regressive when measured against current income. In plain words, low income families will pay a larger fraction of their income in value added taxes than high income families, because the proportion of income consumed declines steadily with income. A consumption VAT that takes one percent of income from a typical household with income of $12,000 will take 1.5 percent from a family whose income is under $3,000, but only .9 percent from a family whose income is between $20,000 and $25,000, and only .44 percent from families with incomes over $50,000. This sharply regressive pattern arises because the poor consume more than they earn and the rich save a lot. Part of this pattern is spurious because the low income brackets include some families whose incomes are only temporarily depressed. Expenditures describe the long term economic circumstances of such families better than does current income. Conversely the upper brackets include some who are temporarily affluent. But the overall conclusion remains that a "consumption" VAT would be regressive. An "income" VAT would be less regressive because it would cover net investment, i.e. that part of income that households save themselves or through businesses they own. By definition an "income" VAT would be proportional to income if it applied to all goods and services.

CAN THE REGRESSIVITY OF A VAT BE CURBED?

By combining a VAT with a refundable credit payable to all households, the regressivity of the VAT can be removed *for most of the income distribution.* A credit that diminishes with income and vanishes at a family income of $10,000 can make a VAT less regressive, proportional, or even progressive over incomes up to $10,000. If the credit runs to $20,000, the regressivity can be removed through that range. The larger the income range over which a credit operates, the less regressive a VAT becomes *and* the less revenue that it yields. A full credit for four-person families with incomes below $5,000, that was reduced proportionately for families with higher incomes, and that vanished at $20,000 would cost approximately one third of the revenue from a broad-based "consumption" VAT.

Above the range of the credit the VAT will be regressive. If a credit cuts out at $10,000 or $20,000 the VAT will be regressive above $10,000 or $20,000. So long as a credit does not cover the whole income distribution, it cannot make the value-added tax progressive or even proportional over the entire distribution; but such a credit would cut deeply into the revenue generated by the tax.

Exemptions would have negligible impact on regressivity because the proportion of taxable expenditures in categories likely to be exempt varies little by income class. Exemptions would, however, narrow the base and introduce capricious variations in tax burdens according to consumer preferences for taxed or untaxed items.

An obvious question concerning a VAT with a credit designed to remove regressivity is "Why bother?" If the goal is to raise revenues in a reasonably progressive manner, the personal income tax is an obvious candidate. I shall return to this point later. If we wish a proportional tax, then why not impose a flat rate tax on adjusted gross income. That such a tax would be regarded generally as unfair suggests even graver doubts about a VAT.

WHAT ARE THE ADMINISTRATIVE ADVANTAGES OF THE VAT?

If a "consumption" VAT is but a special way of collecting a broad-base retail sales tax and an "income" VAT is but a special way of collecting a proportional income tax, why is a new administrative apparatus necessary?

Advocates of the VAT point to the European example where VATs have been introduced to simplify administration and to increase tax neutrality. A tax expert should judge these claims much like the husband who was asked to evaluate his wife, "Compared to what?" Several EEC countries formerly levied multi-stage sales (turnover) taxes, imposed (unlike the VAT) without regard for taxes paid at earlier stages in production. The resulting tax structure favored industries with few productive stages and encouraged vertical integration to avoid sales taxes. Though the efficiency losses from such a tax can be easily exaggerated, any losses were entirely unnecessary since they could be avoided with a VAT. The administrative apparatus for collecting multi-stage taxes already existed in these countries. Since the switch from turnover to VAT brought some advantages and cost virtually nothing, the switch unquestionably improved the tax system of EEC countries.

The VAT has another kind of advantage over the retail sales tax in the European setting. A retail sales tax can be collected from fewer firms than a

VAT. However, a large part of retail sales in the EEC occur through small shops whose keepers are not known for scrupulous tax compliance. A VAT falls at earlier stages of production, and compels the retailer to report sales if he is to gain credit for taxes paid at earlier stages. Since the VAT paid at earlier stages typically exceeds the retailer's incremental liability, it was hoped that the VAT would create incentives for compliance. Even so many small retailers are exempted in EEC countries.

Circumstances in the United States are quite different. We have never used turnover taxes. We do not have an administrative apparatus in existence to collect a multi-stage tax. We do rely on retail sales taxes extensively at the state level and secure rather good compliance even from small retailers. The advantages of a VAT from the standpoint of economic and administrative efficiency simply are not present in the United States. That does not mean that a VAT is beyond the administrative capacities of the Treasury Department. A new branch of the Internal Revenue Service could be created. A new corps of auditors could be trained. Businessmen could hire more accountants to fill in a new kind of tax return. There might well be a period of confusion. But eventually, at some cost, a VAT would work.

Even from a political and economic—as opposed to an administrative—standpoint, the VAT would not be simple. Consider the following issues in tax policy that Congress would have to decide. Should a value-added tax apply to rents, and if so, what about owner-occupied housing? to expenditures on urban mass transit? to the sales of insurance companies (what is value added of insurance companies)? to tuition receipts of private schools, including parochial schools, of private universities, of public universities? to receipts of publicly-owned water and gas utilities? to sales of medical supplies to the aged or the poor? on sales by farmers? on lawyers', accountants', and doctors' fees? on services of domestic employees? to sales of non-profit enterprises.

These problems are not insoluble. But they are hard. Before Congress is through legislating a VAT and before the Treasury finishes writing regulations, the VAT, hailed for its simplicity and praised for its neutrality, is likely to be riddled with exemptions, different rates, and other devices intended to spare meritorious causes and worthy tax payers. In the tax expert's world of fantasy, it need not be so. But a VAT must sojourn in the real world and the United States Congress.

ALTERNATIVES TO A VAT

The VAT is under discussion now as an alternative to the property tax. In fact, two separate and distinct proposals are under discussion. One would increase federal educational aid to states and localities. Whether such aid would be designed to encourage or compel reduction in property taxes is unclear. The second would create a major new federal revenue source, the value-added tax.

Congress has at its disposal other ways of raising revenues to permit increased federal expenditures—for educational aid or for other purposes. The most obvious candidates are the personal and corporation income taxes. The simplest method of tapping these sources would be a surcharge such as was enacted in 1968. An 8.5 percent surcharge on corporate and personal tax liabilities would raise the $12 billion that the administration's value-added tax plan would yield. It would do so at virtually no additional administrative cost. A surcharge would distribute the burden more progressively than a value-added tax, even one with a credit for low income households. The addition of 1.8 percentage points to each income tax bracket rate would raise the same amount of revenue. The percentage point would impose slightly higher burdens on low income households and lighter burdens on high income households than the surcharge. Either method is superior to a value-added tax, in simplicity and equity, as a method of financing increased federal expenditures for educational aid or other purposes.

A third method of raising additional revenues would be to curtail the special deductions, credits, exemptions, and exclusions available to certain groups of taxpayers. There is something disgraceful in the prospect of imposing a value added tax at the same time that the United States: Refuses to withhold income tax on dividends and interest, thereby allowing 18 percent ($4.8 billion) of all interest and 6 percent ($1.0 billion) of all dividends to escape taxation; excludes one half of long term capital gains from tax; forgives all tax on unrealized capital gains of decedents; exempts municipal bond interest from taxation; allows depletion allowances far in excess of original investment; excludes $200 in dividends for tax ($100 for single returns); allows depreciation far in excess of true depreciation; exempts life insurance interest, transfer payments, imputed rent; and allows various deductions unrelated to any plausible definition of income.

At the same time, the United States retains a toothless estate and gift tax system whose bite any reasonably competent tax lawyer can help his clients largely avoid.

This third method would easily provide sufficient revenues to pay for increased educational assistance to state and local governments and other federal activities. It would simultaneously improve the equity of the federal income tax, and, as my colleagues Benjamin Okner and Joseph Pechman made clear before this Committee on January 14, 1972, it would permit a drastic reduction of tax rates.

I am not so naive as to expect Congress soon to enact so far ranging a reform in the tax system. I would hope that tax reform, an income tax surcharge, and an increase in bracket rates all would be kept prominently in mind whenever the value-added tax is considered as a federal revenue source. In my opinion the value-added tax is clearly inferior to all in terms of simplicity and equity.

Chairman PROXMIRE. Please proceed, Mr. Lifschultz.

I see you have a very formidable prepared statement.

STATEMENT OF PHILLIP LIFSCHULTZ, VICE PRESIDENT, TAXES, MONTGOMERY WARD & CO., INC.

Mr. LIFSCHULTZ. The attachment, of course, is just an outline and was submitted for objective informational purposes, and will not be a part of my presentation. I have cut even the text portion of the prepared statement as much as I can, and I hope to stay within the time limit that you requested.

A great deal of information has been published about VAT during the past 2 years especially, and many opinions have been expressed pro and con, mostly the latter. I appreciate the opportunity to add my views here. I might add that these are my personal views, and do not represent either Montgomery Ward's management, directors or stockholders, or the American Retail Federation.

I am the Chairman of the Tax Committee of the American Retail Federation.

Chairman PROXMIRE. The American Retail Federation has taken no position on the value-added tax?

Mr. LIFSCHULTZ. This is correct.

Chairman PROXMIRE. And you speak only on the basis of your own position?

Mr. LIFSCHULTZ. That is correct, sir.

Although we have no experience or empirical data by which to measure the influence of this form of taxation, we can nevertheless reason beyond first level effects to conclusions as to the effect of shifting reliance from direct taxation to indirect taxation. Certain advantages and disadvantages of a national indirect tax should be viewed against alternatives.

Despite the desirability of continuing efforts toward greater equity in the income tax, it is doubtful that the national income base can beyond the short run produce the yield necessary to finance all of the forseeable requirements of our society. I believe it is necessary to find a new income source. Consumption would be the largest possible base in our economy.

I believe also that our present tax system with its heavy reliance on direct taxes has tended to impede economic growth and has impacted purchasing power and prices in a way that it is an important contributing factor to cost-push inflation and to lagging productivity. The VAT with its neutrality in respect to means of financing growth, incidents on capital or labor intensive production and distribution and on efficient or inefficient producers would tend to reduce private sector wasteful spending that becomes part of our cost and price structure.

Our heavy reliance on direct taxation has caused revenue estimates to be less predictable than would be desirable due to income fluctuations. A tax based on private sector GNP would be relatively inelastic, and subject to more accurate prediction and control.

In evaluating a particular tax in today's complex environment, I would therefore suggest the following standards in relation to alternatives:

1. Sufficiency of revenues.
2. Ability to interface with other fiscal programs and policies all as an aid to economic growth.
3. Ultimate incidence should in the broadest measure be both fair and relatively painless.
4. Collection and compliance should be both simple and inexpensive.

The VAT, like a sales tax, need not be hidden, nor should it be. Taxpayers ought to know what taxes they pay. There is not only a virtue about this sort of knowledge, but surprisingly there seems to be a popular preference as measured in a 1971 study conducted by the National League of Cities Urban Observatory Secretariat staff under a contract with the Department of Housing and Urban Development. A public preference was expressed by an approximate 2 to 1 margin in favor of the sales tax over the second choice, the income tax. Citizens in 12 major U.S. cities were given the choice, assuming the revenue need between the property tax, income tax, a tax on utilities use and an automobile tax.

Their choice was overwhelming. To the final consumer, the VAT would appear the same as a sales tax. I would bring out later some basic differences, but for the purpose of public attitude, there may very well be a preference for a separately stated tax on consumption as that study indicates.

On balance, the VAT should be given serious consideration as an answer to the several tax and fiscal objectives to be achieved. In discussing specific points about the VAT compared with other revenue sources, I shall organize my remarks by referring to the objections raised about the VAT.

One objection is that the VAT is a national sales tax. To the extent that aggregate VAT revenues would be derived from gross private sector transaction values, this is almost correct. Also, if VAT were implemented as an add-on to selling price as in the case of State sales taxes then to the consumer of the goods or services, it would appear the same as a sales tax.

There are nevertheless important differences between VAT and a sales tax that should be considered.

The sales tax is imposed almost entirely within our system on retail goods and in some cases services. On the other hand, the VAT base would conceiveably include the value of all goods and services included in GNP except for government purchases. This could produce in the case of a broad based, no exemption tax almost $7 billion per percentage point. Retail volume constitutes only about one half the potential VAT base. Thus, transactions and wealth exchanges for example in the banking and brokerage fields and professional fees could be included in the VAT base that today are undertaxed within the present system. All forms of consideration paid for the value of goods and services would provide the largest and most inelastic, and therefore responsive and predictable, base possible as a source of revenue.

Timing is different under VAT than in the case of a sales tax. From the moment of implementation, all values produced would become revenue productive, not only final stage sales. Thus not only would the base be the largest possible within our economy, but the time lag between the taxable event, and the revenue collection the shortest on the whole.

If when reference is made to a national sales tax it is not limited to a retail sales tax but rather it means a final stage consumption tax, then the base would be greater, and the timing of collection shorter. But, unless a complex, and elaborate system of exemptions, and credits were built in we would have in effect a partial turnover tax with its cascading and cost-absorption effects on prices which I believe is one of the present effects we should try to eliminate. A system of exemptions to correct that feature would reduce the base, and result in administrative burdens, and legal controversies that the VAT in its purest form would be free of. While VAT administrative problems would be mechanical, and therefore reducible to procedural solutions, a 1-stage consumption tax with exemptions for further processing or resale would involve substantive legal problems. The State retail sales tax as an example has been with us in relatively the same form for almost 40 years, and we still are engaged in issues involving purchase for resale or consumption.

To those who say on the one hand a consumption tax is regressive and therefore hurts poor people more than the rich, and on the other hand, say if we're to have a national consumption tax, let's make it a retail sales tax, and avoid the administrative complexities of VAT, I say that a national retail sales tax would be more regressive because poor people spend a larger portion of their income at the retail level. Whenever a base is compacted, the rate must be increased to yield the same revenue and the incidence of a higher rate national sales tax would fall more on the poor while a significant share of private sector activity would remain undertaxed.

While admittedly VAT would be more costly to administer than would a sales tax, that cost would likely be exceeded by the tax cost absorption feature of a final stage consumption tax if we attempted to achieve a base of nearly the same magnitude. Furthermore, from the Government's point of view, the VAT has a favorable collection bias since credit must be affirmatively accounted for and claimed by successive stage taxpayers. The sales tax involves accounting without such a prorevenue bias since there is no prepayment of tax to be subsequently credited.

Another factor to be considered in comparing VAT to a final stage consumption tax is that the latter to the extent absorbed as a result of an end use of a product or service in connection with a trade or business would produce an income tax deduction thus partially offsetting the revenue from the non-VAT consumption tax. Incidentally, the same point is applicable if VAT were enacted with product, service or industry exemptions. In such a case, the tax would have to be absorbed, not passed on by a large segment of the tax paying public. The pure VAT, as in the case of the former war time retail excise taxes, would probably have no direct effect on business incomes, and consequently no significant collateral revenue effect.

That the VAT is a form of hidden taxation is another objection. Well, it need not be, nor should it be hidden. The public is entitled to know what taxes it pays. This is not so under our present system.

The VAT separately stated as an add-on to the selling price would be better than adjusting selling prices to cover the VAT and not separately stating it. From an administrative standpoint the separately stated method would facilitate the successive stage credit accountability and auditing. It would also prevent improper price increases in amounts greater than the tax by unscrupulous vendors when the tax is implemented. This would be especially important if VAT were implemented during a period of cost-push inflationary pressures.

The essential characteristic of a VAT is that it is levied proportionately at each successive level of production or distribution of a product or service, and because credit is claimed for previous level taxes paid there is no cascading effect. The final scale bears tax at only the legal rate.

Contrast the VAT as an add-on with present taxes. Federal and State payroll taxes, and employee income taxes withheld are buried in the cost of products and services. Each factor in the production and distribution sequence who pays wages passes along the tax cost in his prices. The various ad valorem taxes on real estate, machinery, equipment, and inventories (and intangibles in some states) are likewise part of the cost structure and consequently included in prices. When one considers the number of stages of production and distribution from raw material to the final consumer, the maze of cascading taxes included in the final price is a most impressive part of the price; I would estimate tax inclusion on the average of 30 percent in the prices we pay. And they are all hidden with the exception of the State and local sales tax which accounts for about only 10 percent of total taxes.

The corporate income tax is said by many to be a direct tax, and therefore absorbed, and not passed on. I believe this is true only in part. If one examines a corporation's profit and loss statement, it is obvious that taxes on income are deducted in arriving at net income. It is net income that is used in evaluating return on investment, price-earnings ratio, and management's performance. To argue that the income tax is not included in the prices that comprise sales is to ignore reality in any case where costs can be recovered in the price of goods or services.

On the other hand, if competition is keen or demand low, and prices must be reduced, and consequently costs cannot be recovered sufficiently to produce an acceptable return on investment, then it can be argued that the price does not cover taxes on income. But I believe this is true of each element of cost, and expense as well as tax, and profit. The successful business will cover all elements of expense including tax on income, while the unsuccessful business will cover what expenses it can through its prices, and only when it has no excess of revenue over costs, and expenses will it no longer cover income taxes, but at that point it won't be liable for income taxes anyway.

One can speculate on the coverage of income tax in the price structure of a particular business, but in terms of GNP it is obvious that all government revenues are derived out of the gross values produced in the total economic process. And unless they are separately stated on a sales invoice they are hidden in prices. I believe therefore that there are no truly direct taxes in that all taxes are ultimately paid for in prices, and are for the most part hidden under our present system.

Another objection to VAT is that it is regressive. The revenues collected, and the expenditure of those revenues must be viewed together to perceive the resulting regressivity of the fiscal system. When expenditures confer proportionately greater benefit to higher income groups than their aggregate contribution to the revenues, then I believe that the fiscal system operates regressively regardless of how steeply progressive the tax rate structure may be. On the other hand, even under a flat rate tax structure, when Government expenditures directly or indirectly confer proportionately greater benefit on low income groups than their aggregate contribution, then the fiscal system operates progressively. One need not observe very critically the results under our present system to notice regressive characteristics. Even loophole closing in the income tax would not dent the regressive character of the system resulting from public expenditure priorities.

Loophole closing has been suggested as an effective method of raising needed revenue. While it might accomplish a more equitable distribution of the base, it won't raise the revenue unless present income tax rates (with the exception of eliminating the effect of income splitting) are retained. It would not eliminate the economic problems inherent under our present system, and indeed it might worsen them to the extent greater progressivity would further aggravate cost-push pressures selectively.

Moving from our present taxable income base to a comprehensive economic base won't do both jobs of raising revenue and of achieving reform.

A real impact, over 87 percent of the base increase under their comprehensive taxable income concept, would fall on adjusted gross incomes of under $50,000, and persons with adjusted gross incomes of $20,000 or less would absorb 62 percent of the taxable income base increase under the comprehensive income tax.

No case can be effectively made that significant revenues can be generated by loopholes closing without impacting low income groups more heavily than high income groups. Nor can reform be achieved without accompanying the change in base with a more progressive system of exemptions and/or rates.

While the comprehensive income concept would eliminate preferences that comprise a 43 percent erosion of the individual income tax revenues, it should be emphasized that 76 percent of that erosion applies to expanded income groups earning $50,000 or less.

The urge to do equity in an area that demands it must not be confused with revenue raising potential.

The final cost of taxes are borne by those who pay for goods and services. To the extent that prices of certain goods and services include a greater percentage of tax cost recovery, those prices tend to burden those who spend a greater portion of their incomes on those selected goods and services. I cannot suggest validly that poor people are necessarily impacted under a heavier price burden because of the kinds of goods and services that they purchase proportionately more of, but I suspect that because the tax is hidden in prices those dollars spent pay for more taxes than do those dollars saved.

In the market competition, wages and prices seek an equilibrium based on actual purchasing power, after tax dollars. In the process the pretax compensation levels may have been pushed up merely to accommodate the progressive rate structure. Notwithstanding the tax rate structure, a pretax determination in effect yields a competitive after purchasing power that is the real measure of wage.

Because inflated pretax costs become part of the total price structure they in turn worsen its regressive character and add to cost inflation. The only genuine measure of progressivity or regressivity is how the real wealth produced is apportioned ultimately within the society.

Furthermore, public spending and selective income tax reduction confer purchasing power in the private sector. Failure to balance that input with gains in available gains in consumer goods and services to absorb it, results in pressures on prices of existing goods and services. This inflationary consequence impacts lower income people more severely and is another form of regressivity. Increased productive activity in industries that would create housing, mass transportation, energy and waste recycling systems through government-sponsored programs in partnership with the private sector would create jobs and consumer purchasing power. In addition this output would result in valuable facilities and services in the private sector to absorb some of that purchasing power.

It is said that VAT is inflationary, and there is support for this assertion. If implemented during a period of cost-push inflation, there would be a resulting inflationary pressure as consumers attempted to recapture lost purchasing power through compensation increases. On the other hand, if implemented during a period of economic stability, or even during a period of demand-pull inflation, increased prices would probably produce a dampening effect.

While the Netherlands experienced price increases beyond the amount of the VAT at the time of its introduction, because certain businesses took the opportunity improperly to raise prices during an inflationary period, Germany did not. With appropriate information and education, a separately stated tax and effective control at the time of implementation, there should be no price increases other than the VAT itself. A further safeguard relates to the form of implementation. I believe the VAT to be successful as a fiscal tool should be introduced at a low rate and phased in by scheduled increases to its desired level over a period of several years. I believe also that the VAT should be introduced initially as a substitute for an existing direct tax, especially one that tends toward greater regressivity such as payroll taxes or real estate taxes. I feel that the payroll tax probably provides the best tradeoff because it will accomplish an increase in take home pay, a decrease in labor cost, and will have a favorable collateral income tax effect.

Base increases should ultimately provide a greater VAT yield than in the case of a tax substituted, especially if the VAT will provide a greater economic growth stimulant than existing taxes which I believe it will. For example, property taxes of approximately $35 billion or social security taxes of about $40 billion could be reduced initially by 15 to 20 percent and replaced with a 1 percent VAT. Furthermore, the reduction in an existing tax that is presently deductable for income tax purposes would yield a bonus in income tax revenue and this would be anti-inflationary. I believe that through this method of introduction the redistribution of tax burdens and any resulting dislocation would be minimal but would tend toward benefiting lower income wage earners and tend also to reduce product and service cost. During a period of cost-push inflation accompanied by a lagging demand this effect should be welcome.

VAT would compete with a State sales tax it has been argued. This argument is valid to the extent that price reductions occurred reflecting the tax removed along with the VAT substitution. We experienced the World War II and Korean war retail excise taxes collected as a 10 percent add-on to the selling prices of certain categories of luxury goods. Administrative handling procedures were developed and the two tax systems worked concurrently with no major stumbling blocks.

If VAT were introduced as a supplemental tax the impact would be neutral insofar as the direct effect of VAT is concerned. If VAT were substituted for other taxes, and as a result the prices reflected otherwise reduced tax costs, then the border adjustments would produce lower U.S. prices in foreign markets, and higher foreign prices in U.S. markets.

But even if the VAT were introduced as a supplemental revenue source, I believe a competitive benefit would result. If supplemental revenues were required (and presumably this would be the only reason why VAT would be introduced if at all as a supplement) then without VAT some other tax would go up producing ultimately a price increase to cover the cost. Thus, in either event, VAT can be viewed as a substitute, i.e., for an existing tax or instead of an increase in existing taxes, and since only a consumption (indirect) tax can be subject to a border adjustment under GATT, the VAT would result in a U.S. price advantage v. foreign goods compared to the present no VAT tax system.

Another important aspect of VAT is its neutrality in respect to decisions to spend or invest. Presently, spending is favored under our income tax system, since roughly one-half the expense is recoverable through a current income tax deduction. To the extent income tax rates were increased, the after tax expense would decrease. This would tend not only to favor allocation of resources on a basis other than efficient utilization but tends toward wasteful spending because of the subsidy. More waste in business spending results in less taxable income and consequently reduced tax revenues.

In comparing alternative expenditures, the businessman would measure the present value of cost effectiveness on an after tax basis. Obviously if tax benefit were removed, the real values of alternatives would lead to more efficient resource allocation. Advocates of VAT believe that if VAT were substituted for the income tax, the result would favor modernization of plants, and equipment with increased productivity, and efficiency. This should produce lower unit costs, and thus greater competitive potential in both international trade, and our own markets. All of this would increase employment, and help reverse the present economic decline.

It is argued that our present tax system is sound. So why change it? Why not correct the present inequities. In respect to any other aspect of VAT benefit there are alternatives that can accomplish the same result without tampering with the basic structure.

No tax is a panacea, but if we can find a tax that could ultimately provide:

1. The largest possible and most revenue responsive base;
2. A base that is inelastic and therefore both predictable and a tool for economic stabilization;
3. Neutrality with respect to allocation of resources and reduction in wasteful spending;
4. A capability for price adjustments to relieve U.S. products of tax cost as a competitive tool;
5. A tendency to bring pretax values of wages and prices into equilibrium and thereby eliminate the impact of hidden taxes in prices; and
6. Simplicity for popular understanding and for ease and low cost in administering;

we should consider how to utilize such a tax. Our present tax structure is not only imperfect, it is basically no longer sound in today's social and economic environment. Further patchwork will not make it sound, perhaps at best only less imperfect. Every time it is simplified the complexity worsens.

Our present tax system has been in part responsible for a number of our present problems. The local real estate tax has contributed to unequal financial resources for education. It has also contributed to the decay of the inner city and even abandonment of property. The income tax has contributed to the obsoleting of plant facilities and a consequential lag in productivity gains. As a result, costs have risen and demand slackened in many consumer product areas. This has contributed to the cost-push inflation and the concurrent unemployment increases. I believe as I said earlier that the actual regressive effect of our present tax system is to be found in prices of those goods and services that cover inflated tax costs.

On balance, I believe that the liberal reform of the tax structure lies ultimately in simplification, neutralizing its effect on prices and wages and promotion of effective use of resources. The VAT as an ultimate replacement of present direct taxes offers the most promising possibility.

Thank you.

(The prepared statement of Mr. Lifschultz follows:)

PREPARED STATEMENT OF PHILLIP LIFSCHULTZ

This distinguished Committee has undertaken a study of alternative revenue sources with a particular emphasis on the Value-Added Tax (VAT).

The VAT would operate as an indirect tax in that it would be passed along as part of the final selling price. VAT is based on consumption and levied proportionately at each stage of production and distribution of goods and services. It is measured by the so-called value added, namely sales less previously taxed costs and expenses. Theoretically the imposition should produce revenue derived from a stated percentage of all end product private sector commercial activity collected at multi stages.

A great deal of information has been published about VAT during the past two years, and many opinions have been expressed pro and con, mostly the latter. I appreciate the opportunity to add my views here.

I served in an advisory capacity in the study made by the Cambridge Research Institute the results of which are contained in a report entitled, "The Value-Added Tax In The United States—Its Implications For Retailers," prepared for the American Retail Federation. I am chairman of the Committee on Taxation and Fiscal Policy of the Federation.

Although we have no experience or empirical data by which to measure the influence of this form of taxation, we can nevertheless reason beyond first level effects to conclusions as to the effect of shifting reliance from direct taxation to indirect taxation. Certain advantages and disadvantages of a national indirect tax should be viewed against alternatives.

Despite the desirability of continuing efforts toward greater equity in the income tax, it is doubtful that the national income base can beyond the short run produce the yield necessary to finance all of the foreseeable requirements of our society. I believe it is necessary to find a new income source. Consumption would be the largest possible base in our economy.

I believe also that our present tax system with its heavy reliance on direct taxes has tended to impede economic growth and has impacted purchasing power and prices in a way that it is an important contributing factor to cost-push inflation and to lagging productivity. The VAT with its neutrality in respect to means of financing growth, incidence on capital or labor intensive production and distribution and on efficient or inefficient producers would tend to reduce private sector wasteful spending that becomes part of our cost and price structure.

Our heavy reliance on direct taxation has caused revenue estimates to be less predictable than would be desirable due to income fluctuations. A tax based on private sector GNP would be relatively inelastic and subject to more accurate prediction and control.

In evaluating a particular tax in today's complex environment I would therefore suggest the following standards in relation to alternatives.

1. Sufficiency of revenues.
2. Ability to interface with other fiscal programs and policies all as an aid to economic growth.
3. Ultimate incidence would in the broadest measure be both fair and relatively painless.

4. Collection and compliance would be both simple and inexpensive.

The VAT, like a sales tax need not be hidden, nor should it be. Taxpayers ought to know what taxes they pay. There is not only a virtue about this sort of knowledge, but surprisingly there seems to be a popular preference as measured in a 1971 study conducted by the National League of Cities Urban Observatory secretariat staff under a contract with the Department of Housing and Urban Development. A public preference was expressed by an approximate two to one margin in favor of the sales tax over the second choice, the income tax. Citizens of twelve major U.S. cities were given the choice assuming the revenue need between the property tax, income tax, a tax on utility use, a sales tax and an automobile tax. Their choice was overwhelming. (These results were reported recently at page 213 of "The National Journal" dated February 5, 1972.) To the final consumer, the VAT would appear the same as a sales tax. I will bring out later some basic differences between the final stage consumption tax, i.e. sales tax, and the multi stage consumption tax, i.e. VAT. But, for the purpose of public attitudes there may very well be a preference for a separately stated tax on consumption as that study indicates.

On balance, the VAT should be given serious consideration as an answer to the several tax and fiscal objectives to be achieved. In discussing specific points about the VAT compared with other revenue sources I shall organize my remarks by referring to the objections raised about the VAT.

VAT IS A NATIONAL SALES TAX

To the extent that aggregate final VAT revenues would be derived from gross private sector transaction values this is almost correct. Also, if VAT were implemented as an add-on to selling price as in the case of state sales taxes then to the consumer of the goods or services it would appear the same as a sales tax.

The charge that it is a sales tax carries the implication that a sales tax is inherently bad. This may or may not be so. Until we examine the sales tax characteristics more fully and make such a determination we should not allow ourselves to be intimidated by the suggestion. But there are nevertheless important differences between VAT and a sales tax that should be considered.

The sales tax is imposed almost entirely within our system on retail goods and in some cases services. On the other hand, the VAT base would conceivably include the value of all goods and services included in GNP except for government purchases. This could produce in the case of a broad based no exemption tax almost $7 billion per percentage point. Retail volume constitutes only about one-half the potential VAT base. Thus, transactions and wealth exchanges for example in the banking and brokerage fields and professional fees could be included in the VAT base that today are undertaxed within the present system. All forms of consideration paid for the value of goods and services would provide the largest and most inelastic (and therefore responsive and predictable) base possible as a source of revenue.

Timing is different under VAT than in the case of a sales tax. From the moment of implementation, all values produced would become revenue productive, not only final stage sales. Thus not only would the base be the largest possible within our economy but the time lag between the taxable event and the revenue collection the shortest on the whole.

If when reference is made to a national sales tax it is not limited to a retail sales tax but rather it means a final stage consumption tax, then the base would be greater and the timing of collection shorter. But, unless a complex and elaborate system of exemptions and credits were built in we would have in effect a partial turnover tax with its cascading and cost absorption effects on prices which I believe is one of the present effects we should try to eliminate. A system of exemptions to correct that feature would reduce the base and result in administrative burdens and legal controversies that the VAT in its purest form would be free of. While VAT administrative problems would be mechanical and therefore reducable to procedural solutions, a one-stage consumption tax with exemptions for further processing or resale would involve substantantive legal problems. The state retail sales tax as an example has been with us in relatively the same form for almost forty years, and we still are engaged in issues involving purchase for resale or consumption.

To those who say on the one hand a consumption tax is regressive and therefore hurts poor people more than the rich and on the other hand say if we're to have a national consumption tax let's make it a retail sales tax and avoid the administrative complexities of VAT, I say that a national retail sales tax would be more regressive because poor people spend a larger portion of their income at the retail level. Whenever a base is compacted, the rate must be increased to yield the same revenue and the incidence of a higher rate national sales tax would fall more on the poor while a significant share of private sector activity would remain undertaxed.

While admittedly the VAT would be more costly to administer than would a sales tax, that cost would likely be exceeded by the tax cost absorption feature of a final stage consumption tax if we attempted to achieve a base of nearly the same magnitude. Furthermore, from the Government's point of view the VAT has a favorable collection bias since credit must be affirmatively accounted for and claimed by successive stage taxpayers. The sales tax involves accounting without such a pro-revenue bias since there is no prepayment of tax to be subsequently credited.

Another factor to be considered in comparing VAT to a final stage consumption tax is that the latter to the extent absorbed as a result of an end use of a product or service in connection with a trade or business would produce an income tax deduction thus partially offsetting the revenue from the non-VAT consumption tax. Incidentally, this same point is applicable in cases of product, service or industry exemption under a VAT where the VAT paid would be absorbed and not passed on. The pure VAT, as in the case of the former wartime retail excise taxes, would probably have no direct effect on business incomes and consequently no significant collateral revenue effect.

THE VAT IS A FORM OF HIDDEN TAXATION

It need not be, nor should it be hidden. The public is entitled to know what taxes it pays. This is not so under our present system.

The VAT separately stated as an add-on to the selling price would be better than adjusting selling prices to cover the VAT and not separately stating it. From an administrative standpoint the separately stated method would facilitate the successive stage credit accountability and auditing. It would also prevent improper price increases in amounts greater than the tax by unscrupulous vendors when the tax is implemented. This would be especially important if VAT were implemented during a period of cost-push inflationary pressures.

The essential characteristic of a VAT is that it is levied proportionately at each successive level of production or distribution of a product or service, and because credit is claimed for previous level taxes paid there is no cascading effect. The final sale bears tax at only the legal rate.

Contrast the VAT as an add-on with present taxes. Federal and state payroll taxes and employee income taxes withheld are buried in the cost of products and services. Each factor in the production and distribution sequence who pays wages passes along the tax cost in his prices. The various ad valorem taxes on real estate, machinery, equipment and inventories (and intangibles in some states) are likewise part of the cost structure and consequently included in prices. When one considers the number of stages of production and distribution from raw material to the final consumer, the maze of cascading taxes included in the final price is a most impressive part of the price; I would estimate tax inclusion on the average of 30% in the prices we pay. And they are all hidden with the exception of the state and local sales tax which accounts for about only 10% of total taxes.

The corporate income tax is said by many to be a direct tax and therefore absorbed and not passed on. I believe this is true only in part. If one examines a corporation's profit and loss statement, it is obvious that taxes on income are deducted in arriving at net income. It is net income that is used in evaluating return on investment, price-earnings ratio and management's performance. To argue that the income tax is not included in the prices that comprise sales is to ignore reality in any case where costs can be recovered in the price of goods or services.

On the other hand, if competition is keen or demand low and prices must be reduced and consequently costs cannot be recovered sufficiently to produce an acceptable return on investment, then it can be argued that the price does not cover taxes on income. But I believe this is true of each element of cost and expense as well as tax and profit. The successful business will cover all elements of expense including tax on income, while the unsuccessful business will cover what expenses it can through its prices and only when it has no excess of revenue over costs and expenses will it no longer cover income taxes, but at that point it won't be liable for income taxes anyway.

One can speculate on the coverage of income tax in the price structure of a particular business, but in terms of GNP it is obvious that all government revenues are derived out of the gross values produced in the total economic process. And unless they are separately stated on a sales invoice they are hidden in prices. I believe therefore that there are no truly direct taxes in that all taxes are ultimately paid for in prices and are for the most part hidden under our present system.

VAT IS REGRESSIVE

In the narrower sense our entire tax system is regressive, and in the broader sense our entire fiscal system is regressive. Let's first look at the fiscal system.

The revenues collected and the expenditure of those revenues must be viewed together to perceive the resulting regressivity of the fiscal system. When expenditures confer proportionately greater benefit to higher income groups than their aggregate contribution to the revenues, then I believe that the fiscal system operates regressively regardless of how steeply progressive the tax rate structure maybe. On the other hand, even under a flat rate tax structure, when government expenditures directly or indirectly confer proportionately greater benefit on low income groups than their aggregate contribution, then the fiscal system operates progressively. One need not observe very critically the results under our present fiscal system to notice regressive characteristics. Even loophole closing in the income tax would not dent the regressive character of the system resulting from public expenditure priorities.

Loophole closing has been suggested as an effective method of raising needed revenue. While it might accomplish a more equitable distribution of the base, it won't raise the revenue unless present income tax rates (with the exception of eliminating the effect of income splitting) are retained. It would not eliminate the economic problems inherent under our present system, and indeed it might worsen them to the extent greater progressivity would further aggravate cost-push pressures selectively.

While the Pechman-Okner study, "Individual Income Tax Erosion by Income Classes," Brookings Institution, dated January 14, 1972, presents some interesting ideas that should be considered in connection with reform toward a fairer income tax, the fact is there really isn't a revenue potential on the massive scale suggested by that study, nor would true reform result unless significant exemptions are allowed at the low end or alternatively the rate schedules are made so progressive as to be confiscatory at the middle and high end. Moving from our present taxable income base to a comprehensive economic base won't do both jobs of raising revenue and of achieving reform.

For example, in Table 4, of the study "Increase in the Tax Base Under Comprehensive Income Tax by Income Classes . . ." under the current base, adjusted gross incomes of $100,000 or more constitute 5.2% of total taxable incomes of all classes, while under the comprehensive base, adjusted gross incomes of $100,000 or more account for 6%, a shift of only 8/10 of 1%. The real impact, over 87% of the base increase under their comprehensive taxable income concept, would fall on adjusted gross incomes of under $50,000, and persons with adjusted gross incomes of $20,000 or less would absorb 62% of the taxable income base increase under the comprehensive income tax.

It becomes apparent when one examines the magnitude within adjusted gross income groups by class that the suggested change in taxable income base would hurt the low income groups. Increases in the tax base for the under $3,000 and $3,000—$5,000 groups would be 282% and 204%, respectively, and in the $5,000—$10,000 group, 69%. No case can be effectively made that significant revenues can be generated by loophole closing without impacting low income groups more heavily than high income groups. Nor can reform be achieved without accompanying the change in base with a more progressive system of exemptions and/or rates.

It is of further interest that the distribution of the expanded income base discloses that the rich man's "loopholes" are a small part of the total "loophole" closing effort suggested. Table 3 data may be summarized as follows to show the relative composition of "loophole" items in the taxable income increase under the comprehensive income tax proposal.

	Taxable income increase	
	Billions	Percent
Transfer payments (social security and railroad retirement benefits, public assistance, workmen's compensation, unemployment insurance and veterans' disability compensation)	$55.1	33.2
Homeowners' preferences (imputed rent income and disallowance of deductions for real estate taxes and mortgage interest)	28.7	17.3
Disallowance of personal exemptions for old age and blindness and itemized deductions	42.1	25.4
One-half of capital gains	16.5	10.0
Gain on gifts and bequests	9.5	5.7
Interest on life insurance policies	9.1	5.5
Other, consisting of tax exempt bond interest, excess percentage depletion over cost, accelerated depreciation over straight line and divided exclusion	4.9	2.9
Increase in taxable income	165.9	100.0

Looking at the revenue effect of the proposed changes shown in the same table, the exemption and rate impact becomes apparent.

	Taxable income increase	
	Billions	Percent
Transfer payments	$13.1	17.0
Homeowners preferences	9.6	12.4
Personal exemptions and deductions	14.2	18.4
One-half of capital gains	9.3	12.0
Gain on gifts and bequests	4.4	5.7
Interest on life insurance policies	2.7	3.5
Other	2.4	3.1
Income splitting rate advantage	21.6	27.9
Total	77.3	100.0

Even eliminating the joint filing preference does not produce substantial revenues from high income individuals. Based on data contained in the Pechman-Okner study I computed that only 7% of the revenue increase would be derived from adjusted gross incomes of $100,000 or more while persons with adjusted gross incomes under $25,000 would account for 53% of the increased revenues, and 40% would come from the $25,000 to $100,000 class.

A further point to consider is that under an expanded income base, the Pechman-Okner study at page 26 discloses that an additional 10.3 million families who presently pay no income taxes would become taxpayers. Of this 10.3 million families, 9.6 million families even under the comprehensive income base would be those with incomes under $10,000. While the comprehensive income concept would eliminate preferences that comprise a 43% erosion of the individual income tax revenues, it should be emphasized that 76% of that erosion applies to expanded income groups earning $50,000 or less (computed from data in Table 6 of the Pechman-Okner study).

In summary with respect to loophole closing, the urge to do equity in an area that demands it must not be confused with revenue raising potential. Even the authors acknowledged their principal purpose to be that of doing equity in the incidence of income tax by suggesting revised rate structures to yield revenues at the present level.

Turning to the present tax system itself, despite the progressive income tax rate structure (and even if loopholes were closed), the final cost of taxes are borne by those who pay for goods and services. To the extent that prices of certain goods and services include a greater percentage of tax cost recovery, those prices tend to burden those who spend a greater portion of their incomes on those selected goods and services. I cannot suggest validly that poor people are necessarily impacted under a heavier price burden because of the kind of goods and services that they purchase proportionately more of, but I suspect that because of the taxes hidden in prices those dollars spent pay for more taxes than do those dollars saved.

Prices and wages relate achieving a dynamic equilibrium in the market process. We may have come to believe that a graduated rate structure produces a progressive tax because the resulting levy takes a proportionately higher amount out of the base. But what about the possibility of a corollary principle operating that in the market competition wages and prices seek an equilibrium based on actual purchasing power, after-tax dollars. In the process the pretax compensation levels may have been pushed up to merely accommodate the progressive rate structure. Notwithstanding the tax rate structure, pretax determination in effect yields a competitive after tax purchasing power that is the real measure of wage. This is more evident in respect to the income tax, but tax on consumption affects prices which are an integral factor in the process. Thus, the question of progressivity v. regressivity viewed at first level may be illusory while the reality of a particular tax in operation within the system may be the opposite of what it appears to be. Because inflated pretax costs become part of the total price structure they in turn worsen its regressive character and add to cost inflation: The point to be stressed here is that even a flat rate tax may not operate regressively, while a progressive rate tax may depending upon the impact on after tax wages in relation to prices. The only genuine measure of progressivity or regressivity is how the real wealth produced is apportioned ultimately within the society.

Furthermore, public spending and selective income tax reduction confer purchasing power in the private sector. Failure to balance that input with gains in available consumer goods and services to absorb it, results in pressures on prices of existing goods and services. This inflationary consequence impacts lower income people more severely and is another form of regressivity. Increased productive activity in industries that would create housing, mass transportation, energy and waste recycling systems through government sponsored programs in partnership with the private sector would create jobs and consumer purchasing power. In addition this output would result in valuable facilities and services in the private sector to absorb some of that purchasing power.

VAT IS INFLATIONARY

There is support for this assertion. If implemented during a period of cost-push inflation, there would be a resulting inflationary pressure as consumers attempted to recapture lost purchasing power through compensation increases, etc. On the other hand if implemented during a period of economic stability, or even during a period of demand-pull inflation, increased prices would probably produce a dampening effect. As a matter of fact, some opponents of VAT have criticized it on this point. Those who continue to press for more consumer demand stimulation say that VAT as an add-on to selling prices would serve as a drag on demand.

While the Netherlands experienced price increases beyond the amount of the VAT at the time of its introduction (because certain businesses took the opportunity improperly to raise prices during an inflationary period), Germany did not. With appropriate information and education, a separately stated tax and effective control at the time of implementation, there should be no price increases other than the VAT itself. A further safeguard relates to the form of implementation.

I believe the VAT to be successful as a fiscal tool should be introduced at a low rate and phased in by scheduled rate increases to its desired level over a period of several years. I believe also, that the VAT should be introduced initially as a substitute for an existing direct tax, especially one that tends toward greater regressivity such as payroll taxes or real estate taxes. Base increases should ultimately provide a greater VAT yield than in the case of the tax substituted, especially if the VAT will provide a greater economic growth stimulant than existing taxes which I believe it will. For example, property taxes of approximately $35 billion or social security taxes of about $40 billion could be reduced initially by 15 to 20% and replaced with a 1% VAT. Furthermore, the reduction in an existing tax that is presently deductible for income tax purposes would yield a bonus in income tax revenue and this would be anti-inflationary. I believe that through this method of introduction the redistribution of tax burden and any resulting dislocation would be minimal but would tend toward benefiting lower income wage earners and tend also to reduce product and service costs. During a period of cost-push inflation accompanied by a lagging demand this effect should be welcomed.

VAT WOULD COMPETE WITH STATE SALES TAXES

This argument is valid only to the extent that price reductions occurred reflecting reduced taxes that were removed along with the VAT substitution. We experienced the World War II and Korean War retail excise taxes collected as a 10% add-on to the selling prices of certain categories of luxury goods. Administrative handling procedures were developed and the two tax systems worked concurrently with no major stumbling blocks.

VAT WOULD REQUIRE ADDED COLLECTION COST

If all existing Federal revenues were removed and substituted with a VAT, collection costs would be reduced to 40% of the current level based upon the states' experience in consumption tax collection costs. In other words it costs 2½ times to collect equivalent Federal tax revenues than it would under a VAT. Furthermore the rate productivity of VAT as a function of collection cost makes it a considerably more attractive form of tax from an administrative cost standpoint.

If even a 1% VAT were implemented, however, there would be an additional cost to be added to existing collection cost. This would not be the case if existing tax rates were increased unless additional audit activity was made necessary by reason of an added incentive to cheat. Equivalent rate increases to existing income taxes to yield the revenue from a 1% VAT would be, as follows:

Individual—6% surcharge.

Corporation—increase from 48% to 54%.

Although the initial collection cost on a low VAT rate may run high (assuming it would cost as much to collect $7 billion under a 1% VAT as it would to collect, let's say, $21 billion under a 3% VAT), the initial cost may run around 5% based on a $360 million collection cost estimate. Looking at the VAT, however, as ultimately becoming a principal revenue source with corresponding administrative reductions in other tax areas, the collection cost factor should become a benefit rather than a detriment.

From the standpoint of the taxpayer, the VAT would be relatively simple and cheap to administer assuming a single rate and a broad base with no exemptions. The greatest burden per dollar of revenue would probably fall on the retailer due to the larger number of small transactions compared with other industries. On the other hand the retailer is already accustomed to consumption tax handling and should have few problems in adapting his procedures.

VAT WOULD HAVE LITTLE OR NO EFFECT ON INTERNATIONAL TRADE COMPETITION

This would depend on what happened to prices as a result of VAT introduction. If VAT were introduced as a supplemental tax the impact would be neutral insofar as the direct effect of VAT is concerned. If VAT were substituted for other taxes and as a result the prices reflected otherwise reduced tax costs, then the border adjustments would produce lower U.S. prices in foreign markets and higher foreign prices in U.S. markets.

But even if the VAT were introduced as a supplemental revenue source, I believe a competitive benefit would result. If supplemental revenues were required (and presumably this would be the only reason why VAT would be introduced if at all as a supplement) then without VAT some other tax would go up producing ultimately a price increase to cover the cost. Thus, in either event, VAT can be viewed as a substitute, i.e., for an existing tax or instead of an increase in existing taxes, and since only a consumption (indirect) tax can be subject to a border adjustment under GATT, the VAT would result in a U.S. price advantage v. foreign goods compared to the present no VAT tax system.

Another important aspect of VAT is its neutrality in respect to decisions to spend or invest. Presently, spending is favored under our income tax system. since roughly one-half the expense is recoverable through a current income tax deduction. To the extent income tax rates were increased, the after tax expense would decrease. This would tend not only to favor allocation of resources on a basis other than efficient utilization but tends toward wasteful spending because of the subsidy. More waste in business spending results in less taxable income and consequently reduced tax revenues.

In comparing alternative expenditures, the businessman would measure the present value of cost effectiveness on an after tax basis. Obviously if tax benefit were removed, the real values of alternatives would lead to more efficient resource allocation. Advocates of VAT believe that if VAT were substituted for the income tax, the result would favor modernization of plants and equipment with increased productivity and efficiency. This should produce lower unit costs and thus greater competitive potential in both international trade and our own markets. All of this would increase employment and help reverse the present economic decline.

OUR PRESENT TAX SYSTEM IS SOUND

So why change it? Why not correct the present inequities. In respect to any other aspect of VAT benefit there are alternatives that can accomplish the same result without tampering with the basic structure.

No tax is a panacea for all ills, but if we can find a tax that could ultimately provide:

1. The largest possible and most revenue responsive base,
2. A base that is inelastic and therefore both predictable and a tool for economic stabilization,
3. Neutrality with respect to allocation of resources and reduction in wasteful spending,
4. A capability for price adjustments to relieve U.S. products of tax cost as a competitive tool,
5. A tendency to bring pretax values of wages and prices into equilibrium and thereby eliminate the impact of hidden taxes in prices, and
6. Simplicity for popular understanding and for ease and low cost in administering;

we should consider how to utilize such a tax. Our present tax structure is not only imperfect, it is basically no longer sound in today's social and economic environment. Further patchwork will not make it sound, perhaps at best only less imperfect. Every time it is "simplified" the complexity worsens.

Our present tax system has been in part responsible for a number of our present problems. The local real estate tax has contributed to unequal financial resources for education. It has also contributed to the decay of the inner city and even abandonment of property. The income tax has contributed to the obsoleting of plant facilities and a consequential lag in productivity gains. As a result, costs have risen and demand slackened in many consumer product areas. This has contributed to the cost-push inflation and the concurrent unemployment increases. I believe as I said earlier that the actual regressive effect of our present tax system is to be found in prices of those goods and services that cover inflated tax costs.

On balance, I believe that the liberal reform of the tax structure lies ultimately in simplification, neutralizing its effect on prices and wages and promotion of effective use of resources. The VAT as an ultimate replacement of present direct taxes offers the most promising possibility.

Attachment.

Value-Added Tax Outline

I. INTRODUCTION

The Value-Added Tax (VAT) will be examined against a context of several factors:

A. Revenue and Budgetary factors.

1. Revenue estimates are less reliable with an income tax base.
2. The present tax bases, principally individual and corporate income, are smaller.
3. Tax revenue is a function of base and rate. Is it better to increase rates or promote base increases?

B. General economic and fiscal policy factors.

1. Spending and investment decisions are influenced by tax considerations.
2. Prices and wages are affected by taxes, and in the value exchange process economic relationships are determined on an after-tax basis.
3. The present tax structure penalizes our foreign trade competitive position. The degree of success in improving our competitive position will relate directly to the level of VAT substituted for existing direct taxes.

4. The present tax structure penalizes productivity resulting in higher costs and prices. This is so because the income tax falls on the efficient producer and creates a price umbrella covering waste in the less efficient producer.

a. Tax policy should promote more productive activity and lower prices rather than less activity with higher prices. Need for public revenues and private sector activities is growing.

C. Business factors.

1. Direct taxes such as the income tax tend to penalize capital formation to the detriment of the entire system. This is particularly true of double taxation of corporate income.

2. Consequently, productivity disincentives with accompanying economic drag results from high rate direct taxation.

D. Political factors.

1. Tax administration has been used to reflect political policy.

a. Progressive/regressive considerations, frequently argued in deliberating tax legislation may be illusory since these are only first level effects.

b. Payroll taxes, which constitute $40 billion or 21% of all Federal revenue is the most regressive at all levels (where assessed directly against wages and in its ultimate effect on prices).

II. VALUE-ADDED TAX CONCEPT AND MECHANICS

A. The value added tax is in general a tax on the gross profit element in the price of goods and services sold by each business entity in the production-distribution chain.

1. Any taxpayer's measure of tax consists generally of the value of labor, interest, rent, other overhead, raw materials not previously taxed, and profits that go into a product or service.

2. At any level in the economic chain, be it manufacturing, wholesaling, retailing or services, VAT would be applicable, and measured by gross revenue less previously taxed expenditures.

B. Although a tax is levied at each stage of production-distribution, the tax burden is shifted forward at every level finally reaching the consumer where it is absorbed. To the ultimate consumer, it resembles a sales tax, but it operates as a broad based excise collected in stages.

1. Each business entity in the chain is required to file a tax return periodically, remitting tax on value added at that stage in terms of selling price reduced by credits for previously taxed purchases.

2. Each business entity would bill the customer a tax based on the selling price.

a. Invoices from suppliers and servicemen would serve as the source for VAT credits taken on the taxpayers' returns.

b. Except for the retail-consumer level, a separately stated tax charge on the invoice would be essential to a properly functioning system and would serve as the IRS audit trail.

3. Subsequent taxpayers in the chain receive credits on their tax returns for tax paid to suppliers as shown on invoices, remitting the net amount with their own returns. This system avoids any part of a final selling price being taxed more than once at the stated rate.

C. An illustration of a common and elementary production-distribution-consumption process is found with the ordinary loaf of bread. In the conversion from raw wheat to bread, a number of processors and distributors are involved before a consumer finally purchases it. Each adds value, pays an appropriate tax and passes it on to the next level in the chain.

1. Assuming a VAT rate of 10%., the tax effect can be illustrated as follows:

	Value added	Selling price	VAT collected from customer	VAT paid to supplier	VAT paid on tax return	Net tax expense
Farmer (wheat)	$0.10	$0.10	$0.01	$0.01	$0.01	
Miller (flour)	.10	.20	.02	.02	.01	
Baker (bread)	.15	.35	.03½	.03½	.01½	
Grocer (market)	.15	.50	.05	.05	.01½	
Consumer						$0.05

2. Note that a tax amount is paid to the IRS by everyone in the production-distribution chain, but the tax expense is incurred only by the person who ultimately buys and uses the product or service.

3. Also note that any wasted, or self consumed materials will have produced tax revenue. The tax expense is borne by the final owner, and revenue is not lost because of a failure of productive cost to reach the final consumption stage.

4. The self-policing features of VAT are also apparent here. Auditing procedures for invoice payments will tend to correct any deviations from correct tax billing at all stages.

D. Three practical methods of determining a taxpayer's liability are possible.

1. Subtraction—Tax Credit Method. Net taxable sales are multiplied by the tax rate. The result is reduced by VAT already paid to suppliers.

a. This is the most commonly used method and would be preferable in the United States.

2. Subtraction—Sales Method. Reduce net taxable sales by all amounts paid to suppliers or servicemen and multiply the result by the tax rate.

3. Addition Method. Total all non-VAT elements, such as profit, wages, rent and taxes and multiply by the tax rate.

E. The treatment of business capital assets gives rise to three variations of VAT, each of which can be applied to the three methods described above.

1. Gross Product (Non-consumption theory). VAT paid upon purchase of the asset is absorbed by the business with no tax credits allowed.

2. Income (gradual consumption theory). VAT paid upon purchase of the asset is amortized through periodic tax credits as the asset is consumed.

3. Consumption (immediate consumption theory). VAT paid upon purchase of the asset is allowed as a total credit immediately. Durable assets are treated in the same manner as non-durables and services.

F. The consumption method is most commonly used in those countries with a VAT.

1. The consumption method tends to encourage investment, and thereby results in increased equity financing of durable assets.

a. Avoids separate tax accounting for these assets.

2. The gross product method and to a lesser degree the income method tend to discourage investment because of negative impact on cash flow and earnings.

III. HISTORY OF VAT

A. Although most interest in VAT has occurred since 1960, it actually dates back to 1918.

1. It originally evolved in Germany in 1918 as a substitute for the turnover tax.

a. A turnover tax is a sales tax imposed at every level of production and distribution resulting in a cascade of tax cost included in the final selling price.

b. The turnover tax has been a common and principal form of taxation in Europe until its recent displacement by VAT.

2. Other pre 1960 events include—

a. 1921—T. S. Adams suggests U.S. VAT.

b. 1932—VAT recommended for Alabama and Iowa.

c. 1950—Japan adopts VAT.

d. 1953—Michigan adopts VAT (called Business Activity Tax), which was repealed in 1967 when an income tax was adopted.

e. France adopts limited VAT.

B. The European Economic Community (Common Market) became interested in VAT in the early 1960's and has since adopted it as the common form of tax for member countries. This was done to avoid the cascading effect in the final price in order to provide a determinable base for export credits and to overcome the tendency to vertical integration as a tax saving device.

1. All common market countries will have VAT by 1972.

2. Other countries having VAT include Denmark, Sweden and Norway, and a limited VAT is in effect in Greece, Turkey and Finland.

3. Tax rates vary widely. Examples of standard rates are as follows:

	Percent
France	*23.0
Denmark	12.5
West Germany	*11.0
Sweden	11.1
Netherlands	*12.0
Belgium	*20.0
Luxembourg	*8.0
Italy	10.0
Norway	20.0

*Countries having reduced rates for certain staple items. France and Belgium have higher rates for some luxury items.

4. Exemptions are as follows for a sampling of countries:

	Belgium	France	Germany	Luxembourg	Netherlands
Exports	X	X	X	X	X
Services:					
Lawyers	X	X	N.A.	N.A.	N.A.
Doctors	X	X	X	X	X
Hospitals	X	X	X	X	N.A.
Old people's homes	X	X	X	X	X
Schools	X	X	X	X	X
Insurance	X	X	X	X	X
Brokerage	X	X	X	X	X
Stock transactions	X	X	N.A.	X	N.A.
Banking and lending	X	X	X	X	X
Postal service	N.A.	X	X	X	X
Broadcasting	T	X	X	T	X
Sports	T	T	T	T	X
Leasing of realty	T	N.A.	X	X	X
Telephone	T	N.A.	T	T	X
Entertainment	T	X	T	T	T
Goods:					
Artists' work	T	N.A.	T	T	T
Newspaper	T	X	T	T	T
Certain aircraft—ships	T	T	T	T	T
Fish (some)	T	X	T	T	T
Second-hand goods	T	X	T	T	T
Medicine	T	N.A.	T	T	T
Tobacco—matches	T	X	T	T	T

X=not taxable; T=taxable; N.A.=information not readily available.

5. Its introduction tended to produce inflationary pressures in some cases, because of price-wage relationships. This would depend on general economic conditions at the time of introduction and the discipline of the society in controlling prices and wages.

C. In the United States, interest at state levels has been minimal but, since 1966, there has been a growing awareness, at the Federal level, of the potential of VAT.

1. The Michigan BAT, although a form of VAT, was modified in many ways leaving little of the VAT theory intact.

a. The tax base was gross receipts less purchases, with the income form of VAT applicable to depreciable assets.

b. A flat 50% reduction of gross receipts was allowed all taxpayers. Other deductions were made for contributions and taxes and all income from intangibles was exempt and certain labor-intensive industries were allowed further deductions.

c. Loss or low-profit companies were allowed tax credits of up to 25% of tax liability.

d. The tax was administered and audited like an income tax.

e. Overall, the BAT was a combination VAT, income and gross receipts tax.

f. Michigan repealed BAT in 1967.

2. Of the other states, only West Virginia had attempted legislation which failed to pass in 1967 but passed in 1970 only to be vetoed.

3. The Committee for Economic Development recommended a national VAT in 1966 and the Nixon administration has been studying VAT seriously since 1970.

IV. INTERNATIONAL TRADE—BORDER TAXES

A. The conduct of international trade for most Western countries is regulated by treaty, GATT or General Agreement on Tariff and Trade.

1. Similar rules were also adopted in the Rome Treaty by the common market countries.

2. The agreement employs a tax neutrality theory in exempting indirect taxes on exports. Imports are taxed fully. These are known as border adjustments.

a. Only indirect taxes were allowed on the theory that they are passed forward, while direct taxes are absorbed.

b. Indirect taxes include value added, turnover and sales.

c. Direct taxes include income and payroll.

B. The border tax theory employed by GATT is intended to neutralize the tax effect in the market by eliminating export country taxes and adding import country taxes, creating tax parity in the market place.

1. At exit borders (exports) all VAT previously paid by the exporter to his sources is refunded to him by the government, making export prices tax free.

2. Conversely, at entry borders, the import country VAT is levied, thereby establishing tax parity with domestic products.

a. Concurrently, tax revenues accrue on a destination basis.

3. Price differences could be thereby relieved of tax variances between competing nations.

C. Because the United States relies primarily on direct taxes (income tax), the border tax exemption works to our disadvantage in causing relatively higher prices on U.S. produced goods in both domestic and foreign markets. Direct tax policies under GATT result in penalizing domestic producers.

1. U.S. imports, having been relieved of VAT at exit borders, enter the United States free of the indirect tax.

2. U.S. exports must bear import country indirect tax (VAT) but were not relieved of the U.S. direct tax at the exit border.

3. The result affects the international trade balance and also the balance of payments, accordingly.

D. The following example illustrates the effect of border taxes for two VAT countries (Germany and Sweden), each of which has the same VAT tax rate, and a third non-VAT country (United States). This example is an oversimplification, and is intended to illustrate only the tendency toward price differences that result from direct taxes and indirect taxes that are subject to border adjustments.

Destination market	Country of origin	Price in country of origin (tax including)	VAT rate in effect (percent)	Export tax rebate	Import border tax	Selling price—destination market
United States	United States	$100				$100
	Germany	100	11	$10		90
	Sweden	100	11	10		90
Germany	United States	100			$11	111
	Germany	100	11			100
	Sweden	100	11	10	10	100
Sweden	United States	100			11	111
	Germany	100	11	10	10	100
	Sweden	100	11			100

V. REVENUE ASPECTS OF VAT

A. In European countries, indirect taxes including VAT generally account for a much larger portion of tax revenues than in the United States.

1. European reliance on indirect taxation has been largely the result of inadequate compliance and enforcement of direct taxes.

2. Direct and indirect taxation as a percentage of gross national product in 1966.

	Percent of gross national product			Percent of total tax revenues	
	Total taxation	Direct taxes	Indirect taxes	Direct	Indirect
France	38.6	20.9	17.7	54.1	45.9
Netherlands	35.8	25.4	10.4	70.9	29.1
Germany	34.9	20.7	14.2	59.3	40.7
United Kingdom	31.3	16.4	14.9	52.4	47.6
Belgium	31.2	18.0	13.2	57.7	42.3
Italy	29.1	16.5	12.6	56.7	43.3
United States	28.2	19.3	8.9	68.4	31.6

Source: Tax Foundation, Inc., Research Publication No. 16.

B. The Gross National Product is the key to VAT revenue, but yield is dependent upon political treatment of several elements.

1. Only the private sector GNP will yield revenue.

a. U.S. Department of Commerce, Survey of Current Business (July 1970) shows total private sector GNP at $577 billion for the year 1969.

b. To the extent that VAT serves as a substitute for other taxes, a shift of resources from the private to public sector will not occur.

2. Both property and service transactions can be taxed although certain services such as banking and insurance are frequently excluded. European countries often exclude legal, medical, educational and brokerage services as well, with resultant loss of tax base.

3. Exemptions might also apply to classes of taxpayers.

a. Examples include elderly citizens, welfare recipients, students and charities.

4. Variable rates, as a form of tax relief, will also affect yield although tax based is not affected directly.

C. Ideally, the total private sector GNP would be taxed, yielding approximately $6 billion of revenue for each 1% VAT tax rate. The yield could range downward to only $4 billion with maximum exemptions and variable tax rates.

1. A 3% VAT in 1969 would yield approximately $17.3 billion at maximum base. Existing taxes would have to be raised to the following rates to yield a similar increase.

a. Corporate income tax—from 48% to 65%

b. Individual income tax—18% surtax

c. Various excise taxes—double all current rates.

VI. FISCAL TOOL

A. A VAT as contrasted with the income tax would neutralize taxes as a factor in spending/investment decisions, debt/equity financing, international trade and domestic prices and wages.

B. As a fiscal tool maximizing economic advantages, however, certain inherent qualities of VAT are apparent.

1. Revenue source. With the broad GNP base, a small tax rate will produce a significant revenue yield. Additionally, it may tend to offset certain faults of other existing taxes, thereby improving the overall tax climate.

2. Rate changes may be used to shift available resources between the private and public sectors of GNP as a means of economic control.

3. Investment could be influenced with a proper choice of the three available forms of VAT.

a. Consumption VAT would neutralize business investment decisions.

b. Income or gross product VAT will tend to discourage business investment.

4. Prices would rise and fall with the VAT rate changes, thereby influencing spending and investing as an economic tool.

a. Because rate changes have an immediate effect, market prices could be affected rapidly.

5. Because the tax is related directly to Gross National Product, tax yield expectations are more reliable and should provide a better source for planning. The income tax is not as reliable in this respect.

6. Exports—imports could be influenced through border tax adjustments, since VAT is an indirect tax and subject to favorable rules under GATT.

7. Various social, economic and political factors could be considered.
a. Exemptions for classes of taxpayers.
b. Exemptions for classes of goods or services.
c. Relief from detailed recordkeeping and reporting for certain taxpayers such as small retailers, farmers and servicemen.

VII. ARGUMENTS FOR AND AGAINST VAT

A. Neutrality.

1. For VAT. Because it is a broad based tax, it falls on all segments of the economy equally and does not influence spending/investment decisions, particularly in the business community where the tax is shifted forward.

2. Against VAT. Because of political economic and social pressure, exemptions and rate variations are inevitable. These are the very factors that influence business and personal decisions.

B. Regressiveness.

1. For VAT. Most taxes in use ultimately influence prices and accordingly produce a greater burden on persons who must spend a greater portion of their income. Therefore, even the income tax tends to be regressive, because it subsidizes waste in the price structure. A broad based VAT would tend to overcome regressiveness in its overall effect on the economy, since all segments of the economy would make a tax contribution "off the top" leaving after tax values free to achieve parity without tax influence after the first level. First level regressiveness, if politically undesirable, can be overcome through relief in other taxes such as income tax, added welfare benefits, or VAT exemptions, multiple rates or direct credits to certain taxpayers or on certain classes of products or services. Viewed in its broader aspects, VAT improved effect on the import, export markets should tend to provide a broader market for United States products, both here and abroad, thereby creating additional jobs and income.

2. Against VAT. The VAT is inherently regressive, since low income groups spend most or all of their income for taxable goods and services while upper income levels tend to save more.

C. Limitation of Present Tax Structure.

1. For VAT. Present tax rates and bases are near or at the top, and any additional increase would affect spending and other decisions disproportionately. If additional revenue is needed, a new source must be found.

2. Against VAT. Correcting problems that exist in the present tax system is much better than striking out into the unknown, with an untried substitute tax.

D. Import/Export Situation.

1. For VAT. Would tend to neutralize effect of taxes in prices in foreign trade, thereby improving the U.S. competitive position.

2. Against VAT. International trade interests and the balance of trade problems can be served best by renegotiating GATT, to provide for direct taxation relief.

a. The problem of isolating direct taxes from the value of a product or service would remain as a significant problem.

E. Inflationary Impact.

1. For VAT. VAT could be used as a flexible tool stabilizing economic cycles. VAT would tend to encourage capital formation.

2. Against VAT. VAT is inherently inflationary, and would lead to price and wage increases in an effort to recover the shift of resources from the private to public sector.

F. Income Tax Comparison.

1. For VAT. VAT is a more equitable and effective tax on corporate business because:

a. Corporate income taxes apply to earnings and dividends; it is a form of double taxation.

b. Income tax penalizes the efficient; rewards waste and inefficiency.

c. Because of the benefit conferred on waste under the income tax, the base tends to be self-limiting and in the extreme self-liquidating.

2. For Income Tax. Income tax is based primarily on the ability to pay with the more affluent bearing a larger burden proportionably.

G. Administration Costs.

1. For VAT. Compliance costs are moderate in terms of a percentage of tax collections. Based on studies of state sales taxes, retailers costs average about 4% of tax collections. Inherent control features such as self-assessment and policing offset much of the cost to government in the case of VAT.

2. Against VAT. The costs of collecting and administering a new tax would be an added burden to the government.

H. Sales Tax Comparison.

1. For VAT. Sales taxes cannot raise revenue equal to VAT because they reach only retail volume which constitutes only about ½ the potential VAT base. Collection period accelerated under VAT for revenue purposes.

2. For Sales Tax. VAT would be in effect a national sales tax. A sales tax would involve far fewer tax returns.

VIII. ADMINISTRATION—PROBLEMS AND BENEFITS

A. Cash flow in any business would be affected by VAT, but it could be either a benefit or a detriment depending upon the time relationship between tax collections from customers and tax remittances to suppliers or IRS.

1. Cash flow considerations—

a. VAT on sales becomes payable to IRS—

(1) When sale made (invoice method), or

(2) When customer collection received (cash method)

b. VAT credit on purchases become allowable against liability to IRS—

(1) When purchase invoiced (invoice method), or

(2) When vendor is paid (cash method).

2. Cash flow objectives—

a. Cash sales business—invoice method preferrable, because credit against VAT would be taken before payment to vendor.

b. Credit sales business—cash method preferrable generally because VAT would not be due until customers' collections are received. Credits on purchases would be delayed, however, until payment made to vendor.

c. Best combination for installment credit dealer would be invoice method with deferral of tax on customer receivables until collected.

3. According to a recent Cambridge Research Institute study, an all cash business might have cash flow benefits ranging from .6% to 4.6% of working capital, while a department store with 50% credit sales might range from a 2% benefit to a 2.8% detriment.

B. The cost of administration is comparable in many ways to that of a retail sales tax.

1. Government administrative costs will approximate $360,000,000 for a broad based VAT in simplest form, compared to costs of $900,000,000 for present federal taxes.

2. Studies of state sales taxes show that retailers costs as a percentage of tax collections average about 4%.

a. Many states make partial reimbursement by a discount on the tax return.

3. Costs at production-distribution stages will be substantially less than retail, because of larger volume of purchasing, sales and invoicing per transaction.

4. Favorable cash flow results would produce interest savings which in turn offset some or all of the added cost burdens.

a. Increased complexity of the tax regarding multiple rates and exemptions, could have significant effects on costs of compliance and administration.

C. Taxpayers' invoices to customers should itemize VAT.

1. Taxpayers at all stages of the production-distribution chain will rely on this information for tax credits on their tax returns.

2. Separate disclosure is not necessary at the retail level but might be desirable.

a. Disclosure of tax to customers is a form of control and relieves retailer of blame for increased prices.

b. Tax receipts are easier to control and audit.

c. Inventory control, under the retail inventory method, is not affected.

d. Price point strategies and state sales tax administration should be unaffected if stated separately.

3. Retail stage need not be included in the VAT scheme thereby avoiding invoicing problems involving exemptions or rate differentials. In Europe, however, the retail sector is included in VAT in all countries except Italy.

a. Excluding the retail level would:

(1) Encourage vertical integration by retailers so as to reduce the tax and, therefore, permit more competitive pricing for those who achieve integration.

(2) Eliminate export tax rebates for retailers who ship to other countries.

(3) Reduce the VAT base. All value added at the retail level would be eliminated; all retail services would be excluded as well. Higher VAT rates applied to a lower base would result, which may be undesirable for economic reasons.

(4) Discourage capital expenditures at the retail level, since VAT on capital expenditures would have to be absorbed.

(5) Eliminate the expense and responsibility of administering VAT for all retailers.

(6) Avoid confusion with other sales taxes already in effect.

(7) Add to retailers' costs directly and indirectly for such expenses as ad valorem taxes and interest.

Chairman PROXMIRE. Thank you very much, Mr. Lifschultz.

Please proceed, Mr. Ture.

STATEMENT OF NORMAN B. TURE, ECONOMIC CONSULTANT, WASHINGTON, D.C.

Mr. TURE. Thank you. It is always a great pleasure for me to appear before the committee. I am grateful for the opportunity to appear and discuss the value-added tax with you. This committee, I am sure, wishes to contribute to a better understanding of the VAT as the basis for informed policy decisionmaking. To date, unfortunately, most of the discussion in the press and in popular forums has had the tone of an adversary proceeding, convicting the VAT of fiscal crimes before affording it a fair trial. The VAT is labeled a consumption tax, indeed, merely a hidden retail sales tax. Bearing the label of a sales tax, it is then naturally characterized as regressive. Moreover, we are told, its imposition would be inflationary, raising the prices of consumption goods and services across the board. Finally, we are assured, it is an administrative nightmare and excessively burdensome to comply with.

A fair consideration of the VAT requires us to eschew the labels with which it has been tagged and to resist the brain washing of its articulate, vociferous opponents. The VAT may, indeed, fail to meet the major criteria of a good fiscal device, but I submit that if it is to be rejected, that decision should be made on the basis of a careful appraisal of the tax in the light of the canons of taxation rather than on the basis of hasty and superficial characterization.

To begin with, we should be sure of what the VAT is, that is, what is the base of the tax?

As the name suggests, a VAT is a tax on the value added during the course of a business' operations to the goods or services it sells. In the simplest terms, the amount of value added is measured by the difference between the dollar amount of the business's sales and its purchases from other businesses. Simple arithmetic shows that this is precisely equal to the payments the business makes for the labor and capital services it uses in its operations, that is, to the sum of its payroll and "profits."

There are varying versions of a value-added tax, but the one which has engaged our attention and is most widely used elsewehere is the so-called consumption version. In this version, a business in calculating its VAT base deducts from its net sales all of its purchases from other businesses—raw materials, semifinished goods, finished goods for resale, fuel, power, light, office supplies, and the amount of its purchases of capital facilities, for example, plant, machinery equipment, store and office furniture and machines, and so forth. Because it deducts the cost of production facilities in the year in which they are acquired, the business claims no other deduction for depreciation, depletion, or other form of a capital consumption allowance. Its tax base, to repeat, is equal to its net sales less all of its purchases from other firms. Simple arithmetic shows that this is equal to the amount it pays for the labor it hires and its profits, where profits are adjusted by adding back any capital consumption allowances and by subtracting any change in inventory and outlays for production facilities.

The national income variant of the tax differs in one major respect. Instead of subtracting the full amount of capital outlays from the base in the year in which these outlays are made, a capital consumption allowance, for example, depreciation, depletion, is permitted. In this version, the "profit" component of the tax base is very much the same as under the present corporation income tax.

The third principal version of the tax is the so-called gross national product variant, under which no deduction whatever is allowed for capital outlays, either in the year in which these outlays are made or over a period of years in the form of a depreciation or depletion allowance.

Of these three variants of the VAT, only the first, the so-called consumption type, should, in my judgment, be given serious consideration. This type of VAT most closely conforms with the criterion of neutrality as between consumption and saving and as between the use of labor and capital services in production. The "national income" version retains the bias of the present income tax against saving and capital, and the "gross national product" version increases that bias many fold.

In the remainder of this discussion, all references are to the so-called consumption version of the VAT unless a contrary specification is made.

One of the advantages claimed for the VAT by some of its proponents is that, at least in theory, the tax should apply unexceptionally to all economic entities, in the business sector, the household sector, and in the public sector as well. The theory behind this view is simplicity itself. The base of the tax is the sum of the payments made by any economic entity for the factors of production it uses. In an efficiently operating economy, these payments are at least roughly equal to the value of the products those factors of production would produce in their best alternative uses. These payments are, therefore, a pretty fair measure of the opportunity cost to the economy as a whole imposed by the economic entity's particular use of the factors of production it employs. Any and every economic entity using factors of production, and thereby depriving the rest of the economy of their use, imposes that same sort of cost no matter what its production consists of. Accordingly, there is no basis for exempting any economic unit from the tax.

Moreover, applied without exemption, the tax minimizes distortions in the allocation of resources. Any exemption erodes this neutrality and should, on these grounds be resisted.

If a VAT is to be adopted and if exemptions are to be afforded, these should be severely restricted. Households might be exempt on the grounds that total value added in the household sector, hence the VAT liabilities therein, are so small as to fall short of the administration and enforcement costs which would be attributable to this sector. I think that is a subject for research. It is unlikely that the Federal Government would impose a VAT on itself, and almost equally unlikely that the tax would be imposed on States and localities.

Granting these exceptions, no other exemptions would be warranted.

There are three basic alternative methods for computing the tax: the addition method, the substraction method, and the invoice, voucher or credit method. The addition method calls for adding up all the payments made by the VAT taxpayer for the production services it uses—its payroll and profit—and subtracting from that (1) the change in inventories and (2) capital outlays.

The subtraction method requires the taxpayer to calculate total net sales and receipts (excluding interest, dividends, and gains or losses but including gross proceeds from the sale of assets) and to subtract from this total all purchases from other economic units.

For either the addition or the subtraction method, virtually all of the information required to compute the tax is included on the present income tax forms and supporting records.

I make this statement not as an academic proposition but as a real life statement. I have recently engaged in computing value-added tax liabilities for companies in a number of different industries, and there are only two items which cannot be found on the form 1120. One is the amount of sales abroad and the other is the purchase of capital facilities. Both of these items are readily available from ordinary business records.

No new information is called for, and no record keeping other than that now required for ordinary business financial statements is needed. The tax return could be completed on a very short form, filed annually or quarterly.

The third method, the invoice, voucher or credit method, requires the taxpayer to apply the VAT rate to the amount of his sales and to show this amount as a separate item on his sales slip. Every taxpayer making purchases from other taxpayers, therefore, finds the amount of the tax on each such purchase separately stated on the invoice he receives. To compute his own VAT liability, the amount of the tax he is to pay the government, he adds up all the VAT he has charged on his sales invoices, subtracts all the VAT he has paid on his purchase invoices, and the difference is the amount he owes.

In terms of compliance, administrative and enforcement costs, the subtraction method would be most efficient. The argument for the credit method—which is the one most popularly used and generally assumed to be the method which would be used in the United States—is that it is self-enforcing. The argument is not well founded for the United States. We rely heavily on self-assessment of a frightfully complex income tax; surely we could, with far more assurance, rely on self-assessment of a far simpler VAT. U.S. taxation involves significant differences in tradition, custom, history, compliance and enforcement machinery.

Moreover, the credit method conveys and reinforces a popular but erroneous notion that every taxpayer would pass the tax forward to his customers, with the full burden coming to rest ultimately on the consumer. This is one aspect of the view that the VAT is a tax on consumption, the subject to which the discussion now turns.

The popular contention is that the VAT is a consumption tax, but it is far from clear what is intended by this contention. Does it assert that the VAT reduces private consumption but not private saving? Does it mean that the price of consumption goods and services rises by the amount of the VAT? Does it mean that people bear the tax uniquely in their role as consumers, rather than as suppliers of production services, that is, that their real incomes are reduced only to the extent that they consume?

It is clear, of course, that every tax reduces the private sector's claims over production resources and their outputs. The ultimate effects of the tax depend on how the tax changes relative prices and how people respond to these changes. Since every tax changes the price of something relative to the price of something else, the nature of the adjustment in the economy to the imposition of the tax depends on the character and the extent of the response to this relative price change, i.e., on the price elasticity of the thing on which the tax initially impacts. When the adjustments to the imposition of a tax have been completed (or substantially so), one may compare the new state of affairs with that which existed before the imposition of the tax and characterize the burden of the tax in terms of the differences between the two. Thus, if in a posttax equilibrium, a smaller proportion of private sector claims is used for consumption than in the pretax economy, one could describe the tax as a consumption tax. Or, if after the responses to the imposition of the tax were substantially completed, one found that the real income of the poor had been reduced in greater proportion than that of the rich, one might characterize the tax as regressive. Or, if one found, in comparing the pretax and posttax equilibrium situations, that there were less capital services in use relative to labor services in production generally, one could characterize the tax as burdening capital.

I apologize to the committee for imposing on them this preface concerning analytical methodology, but it strikes me this sort of approach is singularly lacking in the discussions of the tax to date and I hope you will bear with me.

With this preface in mind, let us return to the question of impact and incidence of a value-added tax.

To begin with, let us pretend that we are examining an economy without any taxes and with efficiently operating markets. Every decisionmaking individual in the economy allocates his income between current consumption and saving on the basis of his preferences between present and future exercise of claims on resources.

Clearly his and everyone's consumption—saving choice is influenced by a host of factors. Given all of these influences, the amount he consumes and saves depends on the relative cost of consumption and saving. The cost of consumption is, of course, the amount of saving foregone; similarly, the cost of saving is the amount of consumption and the satisfaction therefrom which the saver must forego. When the individual has allocated his income between consumption and saving optimumly, given his preferences, that relative cost is equal to the interest rate he finds in the market.

If the relative cost of saving and consumption is changed, the individual will change the proportion of his income which he saves. Thus, if a tax is to fall neutrally, that is, with equal impact on consumption and saving, it must not alter the relative price of saving and consumption. A tax which raises the relative price of saving, then, may be characterized as a tax on saving. Similarly, a tax which raises the relative price of consumption, hence reduces consumption by a larger proportion than it reduces saving, may be fairly characterized as a consumption tax.

Coming back to our taxless economy, let us assume that it is decided to impose a flat rate tax on everyone's income, where income, for tax purposes, is measured as including current saving. Suppose the tax rate is, say, 50 percent. Consider a person with a given income. Before the tax was imposed, he needed \$1 of current income for \$1 of current consumption or for an income of \$.10 per year in perpetuity (assuming the interest rate is 10 percent). With a 50-percent income tax, he needs \$2 of current pretax income to finance \$1 of current consumption, but he needs \$4 of pretax income to finance the purchase of perpetuity of \$.10 aftertax income. Thus, while the income tax at 50 percent has raised the cost of current consumption by 100 percent, it has increased the cost of saving, that is, of future income, by 300 percent.

Chairman PROXMIRE. You changed your prepared statement rather sharply. Why did you do that? Were you in error in the first place? In the prepared statement I have here, you talk not about \$400. Let me read it.

> With a 50 percent income tax base, he needs \$2 of current pretax income to finance \$1 of current consumption, but he needs \$2.096 of pretax income to finance \$1.10 of next year's consumption.

You say:

> Thus, while the income tax at 50 percent has raised the cost of current consumption by 100 percent, it has increased the cost of saving, i.e., of future uses of income, by 109.6 percent.

Now you give us an entirely different version.

Representative BLACKBURN. Mine does not say that.

Chairman PROXMIRE. Which Ture do we believe?

Mr. TURE. They are both perfectly comparable. In the example you had there, I had chosen to use simply a single year in the future, next year. I think the kind of case I have given you as a revised illustration is vastly more realistic, because people do not make 1-year to 1-year investment-consumption choices. People ordinarily make a decision about saving where they anticipate returns on savings over an extended period of time.

Chairman PROXMIRE. I wanted to be sure my prepared statement was not right.

Mr. Ture. To repeat, the 50-percent income tax has the effect of doubling the cost of current consumption, but it quadruples the cost of savings in this particular example.

Clearly the tax has reduced the relative cost of consumption, or, equivalently, raised the relative cost of saving. Following the suggestion above, the tax should be characterized as a tax on saving (although, to be sure, both consumption and saving will be reduced), since it has increased the cost of saving relative to consumption.

It may be argued that the response of taxpayers to this change in the relative cost of consumption and saving is negligible, that is, that the price elasticity is zero or close to, and that accordingly the tax has no significant effect on the proportion of after-tax income consumed and that saved. This is, of course, a matter for empirical determination, but it does not alter the fact that the tax is properly characterized as a tax on saving.

Now suppose that the tax which is to be imposed on the initially taxless economy allows a deduction for current saving, taxing the interest on that saving as it is earned. If the taxpayer is to spend $1 for current consumption, he needs $2 of current, pretax income. But if he wished to forego that $1 of current consumption in order to have a perpetuity of $0.10 per year, he needs only $2 in pretax current income, not the $4 required in the case of the income tax. In this case, the 50-percent tax has increased the cost of current consumption by 100 percent, and it has increased the cost of saving, that is, of future income, by the same percentage. In other words, the relative cost of saving and of consumption has not been affected by the tax. The tax which allows a deduction for saving from current income, therefore, is neutral as between consumption and saving.

To be sure, both consumption and saving are likely to be reduced by the tax. But if we assume that the taxpayer had optimumly allocated his income between consumption and saving before the tax was imposed, given the relative cost of consumption and saving, he will not presumably alter that allocation after the tax, which allows the deduction of saving, is imposed, since, as shown, the tax does not alter the relative costs.

A VAT of the so-called and misnamed consumption variety falls between the two taxes sketched above. As described, the VAT would indeed allow deductions for saving to the extent that saving was embodied in purchases of production facilities, increases in inventory, or other real assets. But other saving, particularly that embodied by private investment by households and in human capital, might well remain subject to tax (specific provisions could be made, of course, for allowing the deduction of such saving, for example, that in advanced education, if the household sector were subject to the tax). But to the extent that it were to apply to factor incomes where these incomes included returns to human capital for which no deduction had been allowed at the time the saving therein embodied was made, the VAT would not be perfectly neutral as between consumption and saving but would retain some bias against saving. Compared with the present income taxation of business, however, the VAT would represent a major step toward neutrality and away from the tax bias against saving and capital formation.

One of the fiscal crimes of which the VAT is widely accused is that is raises prices. Coming from certain critics of the VAT, this is a curious allegation, indeed, since these same critics on other occasions confidently assert that imposing or raising taxes will reduce the growth in aggregate demand and thereby reduce inflationary pressures. When they charge that the imposition of a VAT, or its substitution for other taxes, will raise prices, they are attributing to it a uniquely perverse capability.

Often the charge that the VAT raises prices is based on casual observations, rather than analysis. It is often contended, for example, that where the VAT was adopted in Europe, the price level promptly rose. I have checked this contention against the facts and find that where indeed the imposition of a VAT was followed by a rise in the price level, the explanation for the price increases is to be found in the highly expansionary monetary-fiscal policies followed by the respective governments before the VAT was imposed. The conclusion one should reach, it seems to me, is that the VAT, in these cases, probably contributed to restraining price increases which otherwise would have been more severe.

Apparently the conviction that the VAT raises prices is of a piece with the view that it is a tax on consumption and/or a tax that is passed along from production stage to production stage until it comes to rest on the consumer. I have attempted to show earlier that the tax, if universally applicable, would be neutral with respect to the relative cost of consumption and saving and is not therefore properly characterized as a consumption tax. But let us consider from another point of view the contention that the tax is passed on and hence raises prices.

The argument that the VAT would raise prices appears to be that since every business, presumably, would pay the tax, each business would pass on the tax it pays to its customers. The raw material producer would pay its tax on the amount of its value added and presumably include that tax in the price it charges the, say, manufacturer which buys those raw materials. The manufacturer, in turn, would deduct from his net sales the full cost, including tax, of its purchases from the raw material producer, and pay the value-added tax on the difference. It would, supposedly, add its value-added tax to the price of its output when it sells that output to, say, a wholesaler. And so on down to the ultimate consumer.

But could every business pass along to its customers the full amount of the VAT liability? Could the prices of all products and services sold to consumers increase by the full amount of the tax accumulated at all of the production stages? The answer has to be "no," unless enactment of the VAT were accompanied by repeal of the law of supply and demand.

Every businessman knows that when he increases the price of his products or services, other things being equal, he will sell less of those goods and services. There are exceptions, of course—cases in which the reduction in sales volume is relatively slight compared with the relative increases in prices. But all prices could be raised enough to pass the tax along fully only if there were a general inflation just because the VAT was imposed. And this could come about only if our monetary authorities were to increase the money supply sufficiently to allow all consumer prices to rise, again, just because the tax was imposed. Hopefully, the Federal Reserve Board would not follow this course. If the Federal Reserve were to hold a steady course of money expansion, prices generally could go up only if the amount of goods and services offered for sale decreased. If the physical volume of sales goes down—or rises more slowly than otherwise—so does the physical volume of production and so does, therefore, the use of factors of production, labor and capital. But if employment and the use of capital rise more slowly than otherwise, in time wage rates and profits will rise more slowly than otherwise. And in time, for that very reason, prices generally will be lower than otherwise.

So that leaves us with the following proposition: if the money supply grows no faster than it otherwise would have, the imposition of the VAT cannot generally and permanently raise prices.

This is not to say that no company or industry would be able to pass the VAT along to its customers in the form of higher prices. As we all know, some prices can be raised with little loss in sales, and these prices would be raised to pass along the VAT. But other prices would come down.

The price change by any company in response to a VAT would depend on competitive factors within the industry. No two companies, of course, are identically situated, and their VAT liabilities will depend on a large number of factors. For example, since both outlays for capital goods and for raw materials and semifurnished goods are deductible from the VAT base, a company with a vigorous expansion program may have no VAT liability, but a VAT credit to be carried over; such a company would pose an obvious competitive limit on other companies' efforts to raise their prices in order to shift the VAT forward to their customers.

As I have attempted to show, the VAT is not properly characterized as a consumption tax: it does not increase the cost of consumption relative to saving, nor does it raise the general level of prices of consumer goods and services. Then what, indeed, is the burden of the VAT?

The answer is to be found by adverting to the earlier discussion of the base to which the VAT applies. For any company, the VAT base is equal to its sales less all of its purchases from outsiders, which is the same as the sum of its payroll plus its profits, less its change in inventories and net additions to its production facilities. Clearly, the initial impact of the tax is on the payments made for factors of production employed by the firm, i.e., the payments the firm makes for the services of the labor and capital it employs. In terms of initial impact, the VAT is a proportional tax on the income of the factors of production employed by the taxpayer.

One of the popular and mistaken allegations about the VAT is that it exempts capital, since the taxpayer deducts his purchases of production facilities in arriving at the base of his VAT. As I sought to demonstrate earlier, this deduction, is equivalent to the deduction of saving, does not in fact exempt the returns of capital, that is, the payment for capital services, from the tax. Rather, it places the taxation of these services on equal footing with the taxation of other factor payments.

In more formal terms, failure to allow the deduction of capital outlays results in imposition of the tax first on the capitalized value of all the services to be generated by the capital at the time of acquisition and subsequently on the payments for these services as they are provided over time. Nondeductibility of capital outlays, thus, results in a compounding of the tax on the returns to capital and raises the cost of using capital services relative to the cost of other production inputs.

Chairman PROXMIRE. Mr. Ture, do you think you could summarize in about a minute or so?

Mr. TURE. If I may just finish this section, and I shall.

Permitting the deduction for capital outlays at the time they are made, by the same token, confines the application of the tax to the gross returns for the capital's services as these returns are generated over time. The VAT does not exempt capital from taxation but merely taxes payments for capital services at the same rate as payments for other factors of production.

It is, thus, neutral in the tax burden it imposes with respect to the use of all production inputs.

It is this neutrality, it seems to me, Mr. Chairman, that accounts for the likely desirable effects of a value-added tax substituted for the present corporate income tax. The present corporate income tax represents a very heavy selective excise on the returns to capital in the corporate sector. The value-added tax substituted for that tax in contrast would treat capital, whether acquired by equity or debt contract, on exactly the same basis as it would treat other factors of production used by all businesses. As a consequence of that, it seems to me the volume of capital information in the United States would be greater than it is under the present tax regime and as a consequence of that, the rate of advance of labor's productivity would be greater than it is under the present tax regime, and therefore, so would real earnings be greater.

It is through that route, by virtue of the long term effect on increasing productivity, that it seems to me our trade position would benefit.

It seems to me further that if indeed we are in a regrettable situation where we must increase the total tax liabilities, imposed by the Federal Government on the private sector of the economy, we would do vastly better to raise any such additional revenue through a value-added tax, rather than through any of the alternative devices that have been suggested.

I think if you look through the roster of tax reform proposals, all of which I am sure are very well intended, every one of them has the impact of increasing the effective tax cost on using capital services in the economy. The consequence of that necessarily means we must have less capital services available. And the consequence of that means we will have a less rapid advance in productivity and a less rapid advance in earnings, real earnings of labor, unless the law of diminishing returns has been repealed by tax reforms.

Thank you.

(The prepared statement of Mr. Ture follows:)

PREPARED STATEMENT OF NORMAN B. TURE

I am grateful to the Committee for this opportunity to appear and to discuss the value-added tax with you. The subject of these hearings has certainly gained in urgency with the budgetary developments of recent years and with the increasing interest in and concern over the possibilities of replacing local property taxes with shared VAT revenues as the principal means of financing public education. I respectfully submit to the Committee that the issues raised in recent court cases concerning the uneven quality and quantity of education provided children from one school district to another and the role of property taxation as a local government revenue source are quite distinct from the issues appropriately raised in considering the VAT as a Federal revenue raiser. My discussion is confined to the latter set of issues.

This Committee, I am sure, wishes to contribute to a better understanding of the VAT as the basis for informed policy decision-making. To date, unfortunately, most of the discussion in the press and in popular forums has had the tone of an adversary proceeding, convicting the VAT of fiscal crimes before affording it a fair trial. The VAT is labeled a consumption tax, indeed, merely a hidden retail sales tax. Bearing the label of a sales tax, it is then naturally characterized as regressive. Moreover, we are told, its imposition would be inflationary, raising the prices of consumption goods and services across the board. Finally, we are assured, it is an administrative nightmare and excessively burdensome to comply with.

A fair consideration of the VAT requires us to eschew the labels with which it has been tagged and to resist the brain washing of its articulate, vociferous opponents. The VAT may, indeed, fail to meet the major criteria of a good fiscal device, but I submit that if it is to be rejected, that decision should be made on the basis of a careful appraisal of the tax in the light of the canons of taxation rather than on the basis of hasty and superficial characterization.

I. WHAT IS A VALUE-ADDED TAX?

To begin with, we should be sure of what the VAT is, i.e., what is the base of the tax?

As the name suggests, a VAT is a tax on the value added during the course of a business's operations to the goods or services it sells. In the simplest terms, the amount of value so added is measured by the difference between the dollar amount of the business's sales and its purchases from other businesses. Simple arithmetic shows that this is precisely equal to the payments the business makes for the labor and capital services it uses in its operations, i.e., to the sum of its payroll and "profits."

There are varying versions of a value-added tax, but the one which has engaged our attention and is most widely used elsewhere is the so-called "consumption" version.[1] In this version, a business in calculating its VAT base deducts from its net sales all of its purchasers from other businesses— raw materials, semi-finished goods, finished goods for resale, fuel, power, light, office supplies, and the amount of its purchases of capital facilities, e.g., plant, machinery, equipment, store and office furniture and machines, etc. Because it deducts the cost of production facilities in the year in which they are acquired, the business claims no other deduction for depreciation, depletion, or other form of capital consumption allowance. Its tax base, to repeat, is equal to its net sales less all of its purchases from other firms. Simple arithmetic shows that this is equal to the amount it pays for the labor it hires and its profits, where profits are adjusted by adding back any capital consumption allowances and by subtracting any change in inventory and outlays for production facilities.

The national income variant of the tax differs in one major respect. Instead of subtracting the full amount of capital outlays from the base in the year in which these outlays are made, a capital consumption allowance, e.g., depreciation, depletion, is permitted. In this version, the "profit" component of the tax base is very much the same as under the present corporation income tax.

The third principal version of the tax is the so-called gross national product variant, under which no deduction whatever is allowed for capital outlays, ei-

[1] I use the term "consumption" merely to conform with popular usage. As I shall show later, the tax is not a consumption tax.

ther in the year in which these outlays are made or over a period of years in the form of a depreciation or depletion allowance.

Of these three variants of the VAT, only the first, the so-called "consumption" type, should, in my judgment, be given serious consideration. This type of VAT most closely conforms with the criterion of neutrality as between consumption and saving and as between the use of labor and capital services in production. The "national income" version retains the bias of the present income tax *against* saving and capital, and the "gross national product" version increases that bias many fold.

In the remainder of this discussion, all references are to the so-called consumption version of the VAT unless a contrary specification is made.

II. EXEMPTIONS FROM THE VAT

One of the advantages claimed for the VAT by some of its proponents is that, at least in theory, the tax should apply unexceptionally to all economic entities, in the business sector, the household sector, and in the public sector as well. The theory behind this view is simplicity itself. The base of the tax is the sum of the payments made by any economic entity for the factors of production it uses. In an efficiently operating economy, these payments are at least roughly equal to the value of the products those factors of production would produce in their best alternative uses. These payments are, therefore, a pretty fair measure of the opportunity cost to the economy as a whole imposed by the economic entity's particular use of the factors of production it employs. Any and every economic entity using factors of production, and thereby depriving the rest of the economy of their use, imposes that same sort of cost no matter what its production consists of. Accordingly, there is no basis for exempting any economic unit from the tax.

Moreover, applied without exemption, the tax minimizes distortions in the allocation of resources. Any exemption erodes this neutrality and should, on these grounds, be resisted.

Opponents of the VAT counter by asserting that, as a practical matter, exemptions would be provided and that, as a consequence, the tax would become an administrative nightmare and lose much of its claim to superiority on neutrality grounds in the process. Of course, one can undermine any proposal for improving fiscal measures by insisting that those responsible for its enactment and implementation will choose to cast away those features of the proposal which are its strength. But surely the Administration and the Congress are not required to emasculate a VAT by riddling it with exemptions.

If a VAT is to be adopted and if exemptions are to be afforded, these should be severely restricted. Households might be exempt on the grounds that total value added in the household sector, hence the VAT liabilities therein, are so small as to fall short of the administration and enforcement costs which would be attributable to this sector. It is unlikely that the Federal Government would impose a VAT on itself, and almost equally unlikely that the tax would be imposed on States and localities.

Granting these exceptions, no other exemptions would be warranted. It is often urged that certain categories of production, such as food, clothing, housing, medicine, should be exempt to overcome the allegedly regressive impact of a VAT. I will deal with this alleged regressivity later in the discussion. At this point, suffice it to repeat that analytically there is no basis for such exceptions. Moreover, it is odd that those who urge such exceptions do not argue for similar exemptions from existing taxes. Should food processors be exempt from payroll taxes for unemployment compensation and Social Security? Should manufacturers of ethical drugs be exempt from the corporation income tax?

III. METHODS OF COMPUTING AND COLLECTING THE VAT

There are three basic, alternative methods for computing the tax: the addition method, the subtraction method, and the invoice, voucher or credit method. The addition method calls for adding up all the payments made by the VAT taxpayer for the production services it uses—its payroll and profit [2]—and substracting from that (1) the change in inventories and (2) capital outlays.

[2] For this purpose, profit for income tax purposes is adjusted by adding back any capital recovery allowances, other special deductions, State and local income taxes, and proceeds from the sale of production facilities, and by subtracting certain other receipts included for income tax purposes, such as dividends, interest, net gains or losses.

The subtraction method requires the taxpayer to calculate total net sales and receipts (excluding interest, dividends, and gains or losses but including gross proceeds from the sale of assets) and to subtract from this total all purchases from other economic units.

For either the addition or the subtraction method, virtually all of the information required to compute the tax is included on the present income tax forms and supporting records. No new information is called for, and no record keeping other than that now required for ordinary business financial statements is needed. The tax return could be completed on a very short form, filed annually or quarterly.

The third method, the invoice, voucher or credit method, requires the taxpayer to apply the VAT rate to the amount of his sales and to show this amount as a separate item on his sales slip. Every taxpayer making purchases from other taxpayers, therefore, finds the amount of the tax on each such purchase separately stated on the invoice he receives. To compute his own VAT liability, the amount of the tax he is to pay the Government, he adds up all the VAT he has "charged" on his sales invoices, subtracts all the VAT he has "paid" on his purchase invoices, and the difference is the amount he owes.

The credit method is commonly used in the countries now imposing the VAT, and it is frequently assumed that it would be the method proposed in the United States. The alleged advantage of this method is that it is self-enforcing: each taxpayer to establish the correctness of his own VAT liability would have to show the amount of VAT on his purchase invoices, hence would require of his suppliers that they explicitly show the amount of VAT on their sales to him.

In terms of compliance, administrative, and enforcement costs, the subtraction method would be most efficient. The argument for the credit method—its alleged self-enforcing feature—is not well founded for the United States. We rely heavily on self-assessment of a frightfully complex income tax; surely we could with far more assurance rely on self-assessment of a far simpler VAT. U.S. taxation involves significant differences in tradition, custom, history, compliance and enforcement machinery.

Moreover, the credit method conveys and reinforces a popular but erroneous notion that every taxpayer would pass the tax forward to his customers, with the full burden coming to rest ultimately on the consumer. This is one aspect of the view that the VAT is a tax on consumption, the subject to which the discussion now turns.

IV. THE BURDEN OF A VAT

A. *Is the VAT a Consumption Tax?*

The popular contention is that the VAT is a consumption tax, but it is far from clear what is intended by this contention. Does it assert that the VAT reduces private consumption but not private saving? Does it mean that the price of consumption goods and services rises by the amount of the VAT? Does it mean that people bear the tax uniquely in their role as consumers, rather than as suppliers of production services, i.e., that their real incomes are reduced only to the extent that they consume?

1. *Effects of the VAT on Consumption and Saving.*

It is clear, of course, that every tax reduces the private sector's claims over production resources and their outputs. The ultimate effects of the tax depend on how the tax changes relative prices and how people repond to these changes. Since every tax changes the price of something relative to the price of something else, the nature of the adjustment in the economy to the imposition of the tax depends on the character and the extent of the response to this relative price change, i.e., on the price elasticity of the "thing" on which the tax initially impacts. When the adjustments to the imposition of a tax have been completed (or substantially so), one may compare the new state of affairs with that which existed before the imposition of the tax and characterize the burden of the tax in terms of the differences between the two. Thus, if in a post-tax equilibrium, a smaller *proportion* of private sector claims is used for consumption than in the pre-tax economy, one could describe the tax as a "consumption" tax. Or, if after the responses to the imposition of the tax were substantially completed, one found that the real income of the "poor" had been reduced in greater proportion than that of the "rich," one might characterize the tax as regressive. Or, if one found, in comparing the pre-tax and post-tax equilibrium situations, that there were less capital services in use relative to labor services in production generally, one could characterize the tax as burdening capital.

In truth, it is difficult to make these comparisons in a dynamic economy in which many things are continuously changing and in which the data required to isolate the effect of a tax are most elusive. Instead, analysts must rely primarily on identifying the change in relative prices which the imposition of the tax produces to suggest its probable incidence. Thus, if the tax analyst finds that a particular tax raises the price of current consumption relative to current saving, he may then characterize that tax as a consumption tax. Until he has traced out, at least in the abstract, the adjustments made to the tax, however, he should be very cautious about characterizing its ultimate incidence.

With this preface concerning analytical methodology, let us return to the question of the impact and incidence of a VAT.

To begin with, let us pretend that we are examining an economy without any taxes and with efficiently operating markets. Every decision-making individual in the economy allocates his income between current consumption and saving on the basis of his preferences between present and future exercise of claims on resources. If he saves today's income, his claims tomorrow will be greater by the amount of "interest" he receives on his saving (the amount of "interest" he receives is determined by his and everyone else's preferences as between present and future uses of income, i.e., the supply of saving, and his and everyone else's demands for the services provided by the capital in which savings may be embodied). Given the rate of interest he finds in the market, then each individual determines how much of his current income to consume and how much to reserve for future use.

Clearly his (and everyone's) consumption—saving choice is influenced by a host of factors. Given all of these influences, the amount he consumes and saves depends on the relative cost of consumption and saving. The cost of consumption, of course, is the amount of saving foregone; similarly, the cost of saving is the amount of consumption and the satisfaction therefrom which the saver must forego. When the individual has allocated his income between consumption and saving optimally, given his preferences, that relative cost is equal to the interest rate he finds in the market.

If the relative cost of saving and consumption is changed, the individual will change the proportion of his income which he saves. Thus, if a tax is to fall neutrally, i.e., with equal impact, on consumption and saving, it must not alter the relative price of saving and consumption. A tax which raises the relative price of saving, then, may be characterized as a tax on saving. Similarly, a tax which raises the relative price of consumption, hence reduces consumption by a larger proportion than it reduces saving, may be fairly characterized as a consumption tax.

Coming back to our taxless economy, let us assume that it is decided to impose a flat-rate tax on everyone's income, where income for tax purposes is measured as including current saving. Suppose the tax rate is, say, 50 percent. Consider a person with a given income. Before the tax was imposed, he needed $1 of current income for $1 of current consumption or for an income of $.10 per year in perpetuity (assuming the "interest" rate is 10 percent).[3] With a 50 percent income tax, he needs $2 of current pre-tax income to finance $1 of current consumption, but he needs $4.00 of pre-tax income to finance the purchase of a perpetuity of $.10 after-tax income.[4] Thus, while the income tax at 50 percent has raised the cost of current consumption by 100 percent, it has increased the cost of saving, i.e., of future income, by 200 percent. Clearly, the tax has reduced the relative cost of consumption or, equivalently, raised the relative cost of saving. Following the suggestion above, the tax should be characterized as a tax on saving (although, to be sure, both consumption and saving will be reduced), since it has increased the cost of saving relative to consumption.

Another, and equivalent, way of looking at this is to note that the amount currently saved, given efficient markets, is equal to the discounted or present

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[3] The amount he would have to pay for this $.10 per year income is given by the expression for the present value of a perpetuity $A_\infty = Y/r$, where Y = the annual income and r = the interest rate.

[4] Since the "interest" earned on his saving is also taxable at the 50 percent rate, he needs to save $2.00, on which his after-tax "interest" will be $.10. To save $2.00, he need a pre-tax income of $4.00.

value of the future returns on the saving. If, then, an income tax is imposed on income measured as including saving, the tax is applied to the capitalized value of those future returns and the interest included in future returns as well, as it materializes. The tax, thus, is compounded on saving, and raises the cost of saving relative to consumption.

It may be argued that the response of taxpayers to this change in the relative cost of consumption and saving is negligible, i.e., that the price elasticity is zero or close to, and that accordingly the tax has no significant effect on the proportion of after-tax income consumed and that saved. This is, of course, a matter for empirical determination, but it does not alter the fact that the tax is properly characterized as a tax on saving.

Now suppose that the tax which is to be imposed on the initially taxless economy allows a deduction for current saving, taxing the "interest" on that saving as it is earned. If the taxpayer spends $1 for current consumption, he needs $2 of current, pre-tax income. But if he wished to forego that $1 of current consumption in order to have a perpetuity of $.10 per year, he needs only $2 in pre-tax current income, not the $4.00 required in the case of the income tax.[5] In this case, the 50 percent tax has increased the cost of current consumption by 100 percent, and it has increased the cost of saving, i.e., of future income by the same percentage. In other words, the relative cost of saving and of consumption has not been affected by the tax. The tax which allows a deduction for saving from current income, therefore, is neutral as between consumption and saving.

To be sure, both consumption and saving are likely to be reduced by the tax. But if we assume that the taxpayer had optimally allocated his income between consumption and saving before the tax was imposed, given the relative cost of consumption and saving, he will not presumably alter that allocation after the tax, which allows the deduction of saving, is imposed, since, as shown, that tax does not alter the relative costs.

A VAT of the so-called and misnamed "consumption" variety falls between the two taxes sketched above. As described, the VAT would indeed allow deductions for saving to the extent that saving was embodied in purchases of production facilities, increases in inventory, or other real assets. But other saving, particularly that embodied by private investment by households and in human capital, might well remain subject to tax (specific provisions could be made, of course, for allowing the deduction of such saving, e.g., that in advanced education, if the household sector were subject to the tax). But to the extent that it were to apply to factor incomes where these incomes included returns to human capital for which no deduction had been allowed at the time the saving therein embodied was made, the VAT would not be perfectly neutral as between consumption and saving but would retain some bias against saving. Compared with the present income taxation of business, however, the VAT would represent a major step toward neutrality and away from the tax bias against saving and capital formation.

2. *Effects of the VAT on Prices.*

One of the fiscal crimes of which the VAT is widely accused is that it raises prices. Coming from certain critics of the VAT, this is a curious allegation, indeed, since these same critics on other occasions confidently assert that imposing or raising taxes will reduce the growth in aggregate demand and thereby reduce inflationary pressures. When they charge that the imposition of a VAT, or its substitution for other taxes, will raise prices, they are attributing to it a uniquely perverse capability.

Often the charge that the VAT raises prices is based on casual observations, rather than analysis. It is often contended, for example, that where the VAT was adopted in Europe, the price level promptly rose. I have checked this contention against the facts and find that where indeed the imposition of a VAT was followed by a rise in the price level, the explanation for the price increases is to be found in the highly expansionary monetary-fiscal policies followed by the respective governments before the VAT was imposed. The conclusion one should reach, it seems to me, is that the VAT, in these cases, probably contributed to restraining price increases which otherwise would have been more severe.

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[5] To have an income of $.10 per year, after tax, he needs $.20 per year pre-tax. Since by hypothesis, his saving would be deductible for purposes of *this* tax, he needs only $2.00 of pre-tax current income to pay for the perpetuity.

It is possible that the use of the invoice method by most of the countries which have adopted the VAT contributed to a temporary surge in prices. Since this method instructs the taxpayer to add, and separately show, the VAT to the price on his sales invoices, it is plausible that businesses quite generally did so at first until they had had the opportunity to see the effect of these increases on their sales. In time, however, pre-VAT prices must have adjusted such that the total prices were about in line with the level which basic monetary, fiscal, and market conditions dictated.

Apparently, the conviction that the VAT raises prices is of a piece with the view that it is a tax on consumption and/or a tax that is passed along from production stage to production stage until it comes to rest on the consumer. I have attempted to show earlier that the tax, if universally applicable, would be neutral with respect to the relative cost of consumption and saving and is not therefore properly characterized as a consumption tax.[6] But let us consider from another point of view the contention that the tax is passed on and hence raises prices.

The argument that the VAT would raise prices appears to be that since every business, presumably, would pay the tax, each business would pass on the tax it pays to its customers. The raw material producer would pay its tax on the amount of its value added and presumably include that tax in the price it charges the, say, manufacturer which buys those raw materials. The manufacturer, in turn, would deduct from his net sales the full cost, including tax, of its purchases from the raw material producer, and pay the value added tax on the difference. It would, supposedly, add its value added tax to the price of its output when it sells that output to, say, a wholesaler. And so on down to the ultimate consumer.

But could every business pass along to its customers the full amount of its VAT liability? Could the prices of all products and services sold to consumers increase by the full amount of the tax? The answer has to be "no," unless enactment of the VAT were accompanied by repeal of the law of supply and demand.

Every businessman knows that when he increases the price of his products or services, other things being equal, he will sell less of those goods and services. There are exceptions, of course—cases in which the reduction in sales volume is relatively slight compared with the relative increase in prices. But all prices could be raised enough to pass the tax along fully only if there were a general inflation just because the VAT was imposed. And this could come about only if our monetary authorities were to increase the money supply sufficiently to allow all consumer prices to rise. Hopefully, the Federal Reserve Board would not follow this course. If the Federal Reserve were to hold a steady course of money expansion, prices generally could go up only if the amount of goods and services offered for sale decreased. If the physical volume of sales goes down—or rises more slowly than otherwise—so does the physical volume of production and so does, therefore, the use of factors of production, labor and capital. But if employment and the use of capital rise more slowly than otherwise, in time wage rates and profits will rise more slowly than otherwise. And in time, for that very reason, prices generally will be lower than otherwise.

So that leaves us with the following proposition: if the money supply grows no faster than it otherwise would have, the imposition of a VAT cannot generally and permanently raise prices.

This is not to say that no company or industry would be able to pass the VAT along to its customers in the form of higher prices. As we all know, some prices can be raised with little loss in sales, and these prices would be raised to pass along the VAT. But other prices would come down.

The price change by any company in response to a VAT would depend on competitive factors within the industry. No two companies, of course, are identically situated, and their VAT liabilities will depend on a large number of factors. For example, since both outlays for capital goods and for raw materials and semi-finished goods are deductible from the VAT base, a company with a vigorous expansion program may have no VAT liability, but a VAT credit to be carried over; such a company would pose an obvious competitive

[6] If not universally applied, the tax would be somewhat biased against saving, not against consumption.

limit on other companies' efforts to raise their prices in order to shift the VAT forward to their customers.

B. *The VAT as a Proportional Tax on Factor Incomes.*

As I have attempted to show, the VAT is not properly characterized as a consumption tax: it does not increase the cost of consumption relative to saving, nor does it raise the general level of prices of consumer goods and services. Then what, indeed, is the burden of the VAT?

The answer is to be found by adverting to the earlier discussion of the base to which the VAT applies. For any company, the VAT base is equal to its sales less all of its purchases from outsiders, which is the same as the sum of its payroll plus its profits, less its change in inventories and net addition to its production facilities. Clearly, the initial impact of the tax is on the payments made for factors of production employed by the firm, i.e., the payments the firm makes for the services of the labor and capital it employs. In terms of initial impact, the VAT is a proportional tax on the income of the factors of production employed by the taxpayer.

One of the popular and mistaken allegations about the VAT is that it exempts capital, since the taxpayer deducts his purchases of production facilities in arriving at the base of his VAT. As I sought to demonstrate earlier, this deduction, equivalent to the deduction of saving, does not in fact exempt the returns of capital, i.e., the payment for capital services, from the tax. Rather, it places the taxation of these services on equal footing with the taxation of other factor payments.

In more formal terms, failure to allow the deduction of capital outlays results in imposition of the tax first on the capitalized value of all the services to be generated by the capital at the time of acquisition and subsequently on the payments for these services as they are provided over time. Non-deductibility of capital outlays, thus, results in a compounding of the tax on the returns to capital and raises the cost of using capital services relative to the cost of other production inputs. Permitting the deduction for capital outlays at the time they are made, by the same token, confines the application of the tax to the gross returns for the capital's services as these returns are generated over time. The VAT does not exempt capital from taxation but merely taxes payments for capital services at the same rate as payments for other factors of production.[7] It is, thus, neutral in the tax burden it imposes with respect to the use of all production inputs.

In the light of the above, it is clear that the charge that the VAT is a regressive tax is analytically unwarranted. Characterization of the VAT as regressive in popular discussions apparently is based on the assertion that the tax is passed on to consumers and that consumption represents a declining fraction of income as income increases. But, as shown earlier, VAT is not a consumption tax, either in the sense that it increases the cost of consumption relative to saving or in the sense that it is passed on from producer to consumer. In some more sophhisticated discussions, the charge that VAT is regressive appears to rest on the assertion that capital is exempt from the tax and that the distribution of capital ownership is skewed toward the rich. But as shown, capital is not exempt from the VAT, but is taxed on equal terms with other production inputs.

A third basis for the allegation that the VAT is regressive arises in connection with proposals to substitute the VAT for the income tax on corporations. In this case, it is sometimes explicitly conceded by the VAT critic that the VAT is in fact a proportional income tax, but it is maintained that the corporation income tax is progressive in the income-level distribution of its burden. Hence, it is argued, a substitution of the VAT for the corporation income tax represents a switch from a progressive tax to a proportional tax, i.e., a move toward regressivity. This contention clearly rests on the characterization of the corporation income tax as a progressive tax, a matter which lies beyond the immediate purview of my discussion. Suffice it to say that there is hardly a consensus as to the burden distribution, let alone the ultimate incidence, of the corporation income tax. Indeed, many VAT critics are persuaded that the corporation income tax is largely "passed forward" to consumers, a conviction which surely must undercut this basis for opposing a substitution of the VAT for the corporation income tax. It seems to me that until there is a sturdier

[7] See the appendix to this statement for a simple notational exposition.

empirical demonstration than is now available of the impact and incidence of the corporation income tax, one can't confidently compare it on these terms with the VAT.

V. VAT, CAPITAL FORMATION AND PRODUCTIVITY

Just as criticism of the VAT often exceeds the constraints of carefully reasoned analysis, advocacy of the tax is sometimes more enthusiastic than is warranted. This is nowhere so clear as in the case of the claims made on behalf of the VAT with respect to private capital formation.

In most instances, the favorable impact of the VAT on investment is attributed to the alleged exemption of capital from the tax. But as shown above, the VAT does not exempt capital but merely avoids the compounded taxation of capital imposed by an "income" tax.

If we go back to our example of the initially taxless economy, we find that the imposition of the VAT will increase, in equal proportion, the cost of private consumption and of private saving and investment. The amount of both should decline, at least relative to what they would have been in the absence of tha tax, and, again, in equal proportion, other things being equal. Moreover, so too would the amount of private employment of labor services fall and in the same proportion as the reduction in capital services, since as shown above, the VAT would not alter the relative costs of labor and capital inputs. In sum, the imposition of the VAT should result in a reduction of private sector output, at least relative to what it would have been in the tax-free economy. Of course, this is precisely the objective of taxation, to increase the prices of private uses of production capability relative to public uses in order to reallocate resources from the private to the public sector. To repeat, a VAT would so raise prices, of both consumption and saving, and of both capital services and labor services, in equal proportion.

It is this neutrality in the impact of the VAT which should chiefly commend it as the principal tax in our revenue system. By the same token, it is this neutral impact which is the principal basis for advocating the substitution of the VAT for the present income taxation of business.

Compared with the present corporation income tax, the VAT would indeed impose far less of a tax burden on private capital formation. The corporation income tax is an extremely high-rate, selective excise on the use of equity capital in corporate enterprises. It is, moreover, an incremental burden on saving and investment, since the individual income tax itself is based against saving and for consumption. Substituting the VAT for the corporation income tax would not eliminate the anti-capital bias in the individual income tax, but it would greatly mitigate the additional differential tax burden on capital imposed by the corporate tax. In this respect, therefore, the substitution would represent a major contribution to constructive tax reform. And by substantially reducing the excess cost in using capital services compared with labor services, the substitution would lead to a greater rate of private capital formation, hence to a larger, newer, and more productive stock of production facilities, hence to a greater capital-labor ratio throughout the private sector, and unless the law of diminishing returns has been repealed, to a higher level of labor productivity and real earnings than under the present tax system.

Following this route, the substitution of the VAT for the corporation income tax would contribute to improvement in the U.S. balance of payments. Much is made by many VAT advocates of the so-called border tax adjustments which are associated with the VAT, i.e., the imposition of the VAT on imports and the rebate of the tax on exports. These border tax adjustments are closely akin to a selective devaluation of the currency on trade account. It may well be that some VAT advocates attribute too much to these border tax adjustments, just as some observers and policy makers may have counted too heavily on the benefits for our trade balance from realignment of exchange rates. Be that as it may, to the extent that in the longer term any country's trade balance depends on the productivity of its real resources, substitution of the VAT for the corporation income tax should contribute to improving our trade account.

VI. CONCLUDING COMMENTS

The current discussions of the VAT are in a context of enormous deficits in the Federal budget, with little prospect for their substantial reduction in the near future with present expenditure trends and taxes. Regrettable as it is in the judgment of many of us, it appears that the VAT is more likely to be proposed as a means of obtaining additional revenues than as a substitute for all or part of any existing taxes.

If in fact expenditure growth cannot be curbed or if that growth is desired by a majority of the citizens, then we sould honestly face up to the desirability of increasing taxes. Given the other objectives and criteria of public financial policy, increasing any of the existing taxes in the Federal revenue system, whether by raising their rates or by so-called "reform" measures, would be a costly mistake. If we must increase the overall effective rate of taxes on the private sector's income, the VAT would be the least damaging means of doing so.

APPENDIX

VAT BURDEN ON CAPITAL

In the absence of a tax, if a firm wishes to purchase \$X of production facilities it needs to allocate thereto \$X of its own income or \$X of outsiders' incomes if the outlay is to be externally financed. To warrant the outlay, the present value of the net returns allocable to the facilities must be at least equal to its cost, \$X. Thus,

I. $X = A_r^N Y_I$, where

A_r^N = the expression for the present value of an annuity of \$1 for N years, discounted at r percent; and

Y_I = the annual income allocable to the facilities.

If an income tax at an effective marginal rate of t is imposed, without deduction for capital outlays but with an allowance for depreciation, a firm wishing to purchase \$X of production facilities will need $X/1-t$ of pre-tax income (or if the outlay is externally financed, outside sources will need to have $X/1-t$ of pre-tax income for each \$X provided the firm). Then the purchase of \$X of production facilities costs $X/1-t$ on which a $tax = t\ X/1-t$ is initially imposed. In addition, each year's return on the producton facilities, net of allowable depreciation, is also taxed. If the capital outlay is warranted, the present value of all of the after-tax returns to the capital facilities must be at least equal to the cost of the facilities, i.e.,

II $$\frac{\$X}{1-t} = A_r^N\left[\$Y_{II}(1-t) + t\,\frac{\$X}{N}\right], \text{ where}$$

\$X/N annual depreciation allowable, assuming, for the sake of expositional ease, straight-line depreciation. Equation II may be rewritten,

II′. $$\$X = A_r^N\left[\$Y_{II}(1-t) + t\,\frac{\$X}{N}\right][1-t]$$

Comparison of II′ with I clearly shows the tax burden (T_I) on capital under an "income" tax, the present value of which is:

$$T_I = A_r^N\left[t\left(\$Y - \frac{\$X}{N}\right)(1-t)\right]$$

If capital outlays were deductible, each year's returns to the capital, without allowance for depreciation, would be taxable at t. If the outlay is to be warranted, the present value of these after-tax returns must be at least equal to \$X, i.e.,

III. $$\$X = A_r^N[\$Y_{III}(1-t)]$$

Comparison of III with I clearly shows that with deductibility of capital outlays, as in the VAT, capital is not exempt from the tax but indeed bears a tax the present value of which (T_{VAT}) is:

$$T_{VAT} = A_r^N t\$Y$$

The payroll component ($W) of the VAT base may be substituted for the profit component in the preceding expression, i.e.,

$$T_{VAT}=A_r{}^N t\$W$$

Thus, VAT imposes the identical tax on each dollar of Y and of W.

Chairman PROXMIRE. Gentlemen, I thank all of you for very, very fine prepared statements. I hesitate—and I do not mean to be critical of any of you when I say this—but somehow we have to get our witnesses to observe the discipline that committee members do observe.

We have questions for 10 minutes and then come back. When we say 15 minutes, we have to mean it. This is the last meeting of the Joint Economic Committee where we won't have a light off here. The buzzer will go and we shut off your microphone.

Representative BLACKBURN. Let us get one of these old fashioned minstrel fellows with the old hoop——

Chairman PROXMIRE. Major Bowles.

I want to be sure, the three of you gentlemen talk about somewhat similar taxes. I think Mr. Ture and Mr. Lifschultz are not talking about the same thing. Maybe I am wrong. I got the impression that Mr. Lifschultz, you are talking about a gross product VAT and Mr. Ture, I take it, is talking about a consumption VAT. Is that correct?

Mr. LIFSCHULTZ. No, I would agree that the consumption form is the desired form.

Chairman PROXMIRE. Would you agree it is the desired form?

Mr. LIFSCHULTZ. Yes.

Chairman PROXMIRE. How do you calculate your $7 billion then with 1 percent VAT tax? You seem to include everything, no exceptions. And it seems to me if you except investment in plant and equipment and so forth, that you come considerably below 7 percent.

Mr. LIFSCHULTZ. I believe that the consumption form, although it would allow credits for the consumption of capital goods, does not exclude capital goods from the ultimate base, in terms of total private sector.

Chairman PROXMIRE. It allows exceptions. Why wouldn't that exclude them?

Mr. LIFSCHULTZ. It becomes ultimately a tax as the cost is absorbed in production and reflected in the cost and price of goods using the capital.

Chairman PROXMIRE. When you except it, how does it go back in?

Mr. LIFSCHULTZ. It becomes part of the price.

Chairman PROXMIRE. When does it become part of the price?

Mr. LIFSCHULTZ. As it is consumed over the period of its life.

Mr. TURE. The last time I had occasion to make an explicit calculation of the VAT base under the form we are talking about was for the year 1968, if memory serves me correctly. It came to about $6.5 billion per point. The calculation is to take the national income account measures of gross national product, subtract from that capital outlays, add bank all capital consumption allowances, and take out the Government sector, which I did. I also took out the household sector, which involves doing some fairly careful imputation for which the national income account data are a helpful guide. That produces the base of roughly $650 billion. So per point, I have $6.5 billion.

Mr. AARON. A somewhat more up-to-date estimate, made under different assumptions, that will appear in "Setting National Priorities" places the revenue yield between 4 and 5 billion dollars for the current year.

Chairman PROXMIRE. That was closer to what we got yesterday from the experts who testified yesterday.

Mr. TURE. What sort of exemptions are involved in that Henry?

Mr. AARON. I believe the exemptions include rents, home ownership, financial sector, large parts of the financial sector, and nonprofit sector. I am not sure about the treatment of farmers, but food is included as a final consumption product.

The effort was made to define the base as broadly as possible, subject to realistic judgment of what would be considered feasible to tax.

Mr. TURE. I think the point is, Mr. Chairman, if you go to the broadest possible conception of the tax base, really, what you are excluding from it is the Government sector and possibly the household sector. And using this so-called consumption definition of the tax base at current income levels, you would be somewhere near $700 billion or $750 billion.

Chairman PROXMIRE. Let us move into the realism of that. I thought that one of the most useful contributions was Mr. Aaron's statement. I say this as a politician, when one has been here a while. You have been around the Hill, Mr. Ture. You know how these things operate. Can you really imagine a value-added tax going through on the floor of the Senate or the floor of the House, or the Ways and Means Committee, or the Finance Committee, for that matter, that did not exempt things like sales of insurance companies, tuition receipts of private schools, including parochial schools, or private universities, public universities, receipts of publicly owned water and gas utilities, on sales of medical supplies to the aged, or the poor, on sales of farmers, on lawyers' and doctors' fees, and so on? We could go on and on.

What you do is take an ideal situation where you have a value-added tax as pure and pristine as no exceptions and you compare it with an income tax we have had since 1913, and you say the value-added tax is simple, there are no exceptions. But you are going to have the same political process.

If we go back to the Pechman-Okner proposal which is to simplify the income tax and eliminate all exceptions, I think many people would think you would have a much better situation. But you are not going to do that.

We are a political animal. We operate on the basis of our response to our constituents and we are just not going to impose a tax on the old, the blind, the lame, the kids, and so forth.

Mr. TURE. But you do now.

Chairman PROXMIRE. We exempt them in various ways.

Mr. TURE. No, sir.

Chairman PROXMIRE. That exemption may be more apparent than real, but it is an exemption that comes on the floor of the Senate, and we vote for it. The same thing would be true here, would it not?

Mr. TURE. May I point out to you, the payroll tax provides no such exemptions. Employees of tax-exempt foundations, of hospitals and so forth, are subject to payroll taxes.

Chairman PROXMIRE. Well, of course, that is one of the principal criticisms of the payroll tax. It is a highly regressive tax.

Mr. TURE. Nobody I know of urges that if in fact we are going to do anything about payroll taxes, what we ought to do is exempt some payroll taxes, employees of hospitals, churches, educational institutions, pharmaceutical firms, and so forth.

Chairman PROXMIRE. You know how the payroll tax came about. It has been related to the social security system and the idea was people would make a minimum contribution as they do to an insurance system, and be paid in return. People with low incomes would get the benefits. Although their payments were regressive, the benefits would overcome that regressivity. You do not have that kind of thing. You do not have it here. Here you have value-added tax for general purposes.

One thing would be to relieve the property tax programs. There is some talk about relieving the payroll tax. But it could be used for any purpose at all, and it would be, because it is such a relatively painless tax, as you pointed out, to increase, whereas the income tax, it is always desirable politically to decrease.

Mr. TURE. I doubt the value-added tax is painless at all. I would urge my clients who were under the delusion the tax would be painless to them, they are in for a very harsh awakening.

Chairman PROXMIRE. You have Montgomery Ward sitting right next to you. He doesn't speak for Montgomery Ward, or the Retail Federation, but I suspect the business community would be delighted to move away from an income tax they say is or regard as progressive and imposing a burden on business success as you point out, and on capital, in which they have the deepest kind of interest, and shifting that burden to consumption, to those people with the lower incomes, who constitute a much larger proportion of the population.

Mr. Lifschultz, I know I am not being fair to you. Go ahead.

Mr. LIFSCHULTZ. I am not sure I speak for the parochial business interest when I serve as a proponent of the value-added tax. I feel very deeply the policies that need to be followed, and not from an appearance standpoint, but from the real standpoint, are those policies which must enhance productivity of this society. I think the business community will prosper if society prospers. It is against this context and background that I am appearing.

The value-added tax because of its neutrality, I think, would be a supporter of productivity.

Chairman PROXMIRE. Consider this, Mr. Lifschultz. Let's say that a person has an income of $25,000 to $30,000 a year, has stock in which he has additional income, enjoys some of the benefits of the income tax exemptions but, by and large, pays a higher income tax, higher increments of income, then he would if he had a $5,000 to

$6,000 income. Wouldn't he prefer a VAT tax with a 1 percent or 2 percent or 3 percent burden on his purchases?

Now, it is very, very tempting for that kind of a person to want to increase his net income after taxes by shifting from the present income tax system, as much as he can, to a value-added tax, which would reduce his ultimate tax, or would seem to.

Mr. LIFSCHULTZ. Admittedly, I think this is a first-level effect. However, the $25,000 is a fiction. I think it is a pre-tax number. A derivative of the progressive rate structure. I think it is the after-tax income that that person enjoys in terms of his purchasing power or discretionary purchasing power, or savings power vis a vis the $25,000 in pretax income that really matters.

So I think this is the story that perhaps more people need to understand before we err and continue erring in making very far-reaching public decisions based on first-level appearances.

Chairman PROXMIRE. Mr. Aaron.

Mr. AARON. I wanted to comment on that analysis. It strikes me as extremely interesting and disturbing. As I understand Mr. Lifschultz, he is arguing that businesses set their pay scales on the basis of after-tax incomes that will accrue to the person, taking into account the tax liabilities they will have to pay. This means if you raise the progressivity of taxes or increase taxes, salaries will rise automatically, so that after tax positions can be maintained.

I have not heard such a devastating criticism of the capitalist system from anyone since I listened to members of the Union of Radical Political Economists. They argue that salaries have little relation to productivity, that they are paid for the purpose of providing status. Now, I have never held this position, as it seems to me salaries roughly and on the average are related to the contribution which employees make to the firm.

In the economist's jargon, the marginal productivity.

Mr. Lifschultz seems to be saying the radical economists are right, that salaries are a status symbol, that they are set to provide sufficient before tax income so that after-tax status can be maintained, and that indeed the before-tax incomes are not related to productivity. For if income before taxes is related to productivity, then let's face it, the person who pays the tax is going to have to eat the tax.

Chairman PROXMIRE. I was confused also, Mr. Lifschultz and Mr. Ture, too. Mr. Lifschultz, especially, in the arguments that somehow the only direct tax is the sales tax, that income tax isn't direct. That it is somehow invisible. By God, the one tax you really know is your income tax, whether it is withheld or whether you pay it directly. People know what their income taxes are. The sales tax may or may not be disclosed. The value-added tax, you have to have some kind of system to disclose what it is. It could very easily be hidden. In many cases, I presume it would be hidden. But the income tax is a direct, explicit tax, that people know and complain about and react to very directly.

Mr. LIFSCHULTZ. I think sometimes appearances are contradictory. I did not suggest that the sales tax was the only direct tax. What I did say was that in effect there are no direct taxes and that prices cover all taxes.

But I must respond to Mr. Aaron.

I am not suggesting this is a deliberate and contrived action on the part of conspirators. I think it does me an injustice and he suggested that. What I am saying is in the dynamics of the price and wage movements over any period of time, this is the end effect, that it is the actual purchasing power that one has left after the tax impact and after all, the major portion of one's taxes are withheld and no one ever sees it, so spending and saving decisions cannot possibly be made on pre-tax levels. It is competitiveness in the free market place that ultimately determines relative prices and wages on an after-tax basis.

Mr. TURE. I would simply like to suggest to Mr. Aaron that Mr. Lifschultz' analysis does not have to drive him into the arms of the radical economists.

Henry, what I think you overlooked was the fact that there is also a supply function involved here. And how do you want to define that supply function in terms of pre-tax returns for labor services or net tax returns?

Mr. AARON. That is precisely the point. I am glad you raised it.

Chairman PROXMIRE. Gentlemen, there is a roll call, but I will be back.

I yield to Mr. Blackburn, who will follow up this colloquy.

Representative BLACKBURN. Go ahead.

Mr. AARON. The supply function I would posit is a highly inelastic supply function. A number of efforts have been made over the last 20 or 30 years to discover the impact of tax rates on work efforts. By and large, they have turned up negative results. There seem to be some people increase their work effort, some people decrease work efforts when their tax liability rises.

So the conventional assumption, one which I have no reason to assume away, is that the supply of work effort is relatively inelastic. It responds very little to changes in tax rates. In that kind of a world—that is my world, not Mr. Ture's world—there is no way by which a worker can shift a tax imposed on his factor income forward in the form of higher wages to his employer.

Representative BLACKBURN. Let me make this observation. I think we could get into a discussion about worker's incentives and taxes as a disincentive to work, and we could spend several months and end up with eight different opinions among the four of us.

Mr. TURE. May I offer just one quick observation?

Representative BLACKBURN. Sure.

Mr. TURE. Actually, I will make two.

Henry, I think the least likely assumption that you should make is that the elasticity of the supply of labor, like anything else, is zero. Nature abhors a zero price elasticity. Moreover, if you assume a zero elasticity, it seems to me you must confront the changes in the labor force that occur in short or long stages of time in a state of utter and bewildering confusion.

Representative BLACKBURN. I feel very strongly that reward for labor is a very vital incentive in human conduct and human behavior. Regarding the effect of taxes on the amount of rewards for labor, I think most people accept taxes as just a fact of life, as long as they feel others are sharing the same burden under similar circumstances. I certainly do not rule out reward for labor as being an incentive to increase the supply of labor, because we find people who work 40 hours a week in one job and go out and get another job moonlighting, because they want to make more money. They want to acquire some additional things.

It seems to me what our basic discussion really involves is the question of whether or not we want to simplify the whole taxing process. Since we developed the income tax, beginning roughly 59 years ago, in the course of political influences that come and go with the changing Congresses, some groups have been given more benefits than others in the tax treatment. We all give lip service to a desire to simplifying the whole taxing procedure.

Now, are we today speaking in terms of context of phasing in a new simplified tax procedure, and thus phasing out the existing income tax, or are we trying to delude the American public into thinking we are going to milk more out of their gross national product without their being aware of it, through another device?

Mr. LIFSCHULTZ. Well, if I may respond to this as a layman among eminent economists, I think this is a function of what the inputs are back to the American public. Obviously, the relationship between government spending and revenues and the general well-being of the public have to be taken into account. And if we can double revenues that more than double the increase of the Government-effective spending back into the economy, I think we have bettered our total situation.

Representative BLACKBURN. Say that again?

Mr. LIFSCHULTZ. If we were to double revenue, I do not think anyone would be terribly bothered if more than double the value of that revenue was pumped back into the economy.

Representative BLACKBURN. Through production. And then if we took the same percentage share of gross national product in the form of taxes, nobody would be really complaining, because our net income would still be double what it was before. That is ours as individuals.

Mr. LIFSCHULTZ. That's right.

Representative BLACKBURN. As I construe the statements of Mr. Lifschultz, he feels that this approach to raising revenues would be simple. And let us assume Congress did have the political courage to say there would be no exceptions in the levying of this tax, and if hardships occurred to some elements in our society, that should not occur, we would give them rebates, or subsidize them through direct Federal expenditures; because, really, if we start setting up exceptions on the collection of the tax, it is going to be as complicated as what we have now, and before long, we are back in the same bag of worms.

As I construe your statements, you feel the value-added tax would be an incentive to capital improvement and capital investment—that does not exist in the same degree today.

Mr. LIFSCHULTZ. As it presently exists.

Representative BLACKBURN. And you construe the investment tax credit, which recently was enacted, as being a recognition by the Congress that these disincentives are in existing law.

Mr. TURE. I would say the investment tax credit and asset depreciation range system represent very, very modest abatements of an enormous tax bias against saving and capital formation, which is inherent in our income tax system.

Representative BLACKBURN. I find this very thought-provoking.

Mr. AARON. May I speak to that point?

Representative BLACKBURN. Certainly.

Mr. AARON. I believe implicit in Mr. Ture's description of the present tax system is an erroneous view of the impact that the present tax system has on investment and on the distribution of income.

There is no evidence whatsoever that the quantity of savings is sensitive to the rate of return on investment. Over very wide variations in rates of return on investments, the savings rate seems to be explained in the best econometric work available by other considerations. In the case of households, for example, on the basis of income, the composition of assets and other characteristics. There is no major econometric model which accords the rate of return a substantial role in explaining the rate of saving.

If that is the case, and the supply of savings is for practical purposes fixed with respect to the rate of return, then the primary effect of the tax incentives being described is to reallocate investment among different categories. For example, the investment tax credit increased equipment investment and decreased housing investment, leaving the overall total of investment that goes on in the country relatively unchanged. It also has an effect on interest rates. If you increase an investment tax credit, you increase the overall demand for investment; with the supply of saving fixed, you tend to drive up interest rates. Historically, there is some naive similarity in the patterns we have observed since the early 1960's, a rather substantial secular increase in the interest rate in face of the investment tax credit and several increases in depreciation guidelines.

Accordingly, I would argue that aggregate investment is relatively insensitive to taxes on capital, and that what we are really talking about are impacts on interest rates and on the composition of investment.

Mr. Ture suggested that zero elasticities are unfamiliar objects in economics. They are quite familiar objects in economics. There is no theoretical basis whatsoever in assuming an increase on the rate of return on capital will increase savings.

Representative BLACKBURN. I am going to have to interrupt because my time is about to run out. I wish I lived in the simplistic world you live in, because you are assuming the United States of America is an island unto itself in the world and you are completely ignoring the flow of capital from one country to another, based on return. You are ignoring what we hope to be increasing productivity as a result of capital investments, as well as management exercising its imagination to improve productivity and quality of the goods we are producing.

I think you are looking at the country as though it were locked in ice and I just do not see it that way. I think furthermore, you are ignoring the role of the Federal Reserve Board in effect fixing a monetary supply and I do not see how we can disregard the impact of Federal fiscal policy on investment incentives or disincentives, as the case may be.

I frankly am more persuaded by the approaches of Mr. Lifschultz and Mr. Ture although I want to ask you this question, Mr. Ture.

When we subtract investment in capital for the current year, how do we allocate the depreciation of that capital during its life?

Mr. TURE. No depreciation allowance would be permitted.

Representative BLACKBURN. You do mention something about a value-added tax credit that may be carried forward.

Mr. TURE. That could occur in the case of a vigorously growing company where sales are, say, 100, and by virtue of the growth strategy aiming at increasing its sales to, say, 1,000 over a given period of time, it this year acquired a substantial amount of additional capital facilities, and, say, working capital—goods in process. So that its total purchase equalled or exceeded its total sales.

Representative BLACKBURN. Suppose you bought a piece of machinery for a thousand dollars this year and used it for a year. Of course, they subtracted it from this year's gross receipts, the thousand dollars. In fact, I think your tax almost approaches a tax on gross revenues, really. Put all of the incomes in one basket and subtract what you spent, and you are taxed on this basis. Then next year, the company determines that another piece of equipment is more desirable, so they sell this equipment to another company, say for $500, because it is used, and then buy a new piece of equipment for $1,200. How would that transaction be handled?

Mr. TURE. The initial purchase at a $1,000 would be deductible from his gross sales.

Representative BLACKBURN. For this year?

Mr. TURE. The sale of that same asset in the succeeding year at $500, the $500 would come into total receipts of the company. The $1,200 outlay would be subtracted therefore, leaving them a negative on that account of $700.

Representative BLACKBURN. One last question. Mr. Lifschultz, do you have any observation to make on Mr. Aaron's observation about the inelasticity of investment incentives?

Mr. LIFSCHULTZ. Yes.

Mr. AARON. I did not make that statement.

Representative BLACKBURN. I construed it that way. I may have misunderstood. But you seem to have things locked in a mold that I do not think is really realistic.

Mr. AARON. I said the supply of savings was relatively inelastic to the rate of return. The demand for investment by firms is very sensitive to rate of return. My argument was that introducing tax incentives changes the relative ability of different kinds of businesses to compete for a fixed supply of savings and consequently results in reallocation of investment.

I have just completed some research on this.

Representative BLACKBURN. I would like to hear Mr. Lifschultz's comment on it.

Mr. LIFSCHULTZ. My comment would come from the private sector standpoint, that in evaluating a capital budget, we take into account the present value of the future cost against benefits. The future cost is going to be reduced as a result of an effective capital recovery. This makes a dollar invested today in a capital expansion more attractive. So that perhaps instead of opening 20 stores without the investment credit, we might open 21 or 22 stores with the investment credit.

Representative BLACKBURN. My time has run out, so I am using your time, Senator.

Mr. LIFSCHULTZ. A quick response to Mr. Aaron's point.

I think, again, we come back to what I regard as a fixed pie theory. There is so much and we are constantly vying one sector against the other for the divvying up of that pie. I think that is not only counterproductive in our thinking, but I think it is untrue. I think we have seen a very substantial synergistic result through the last 35 years following economic policies and government participation in the private sector. That tells us that the pie is elastic and that it can grow through a unity of energies, the productive factors in our total society. I do not know what our limit is.

Representative BLACKBURN. I hope there is none.

Mr. LIFSCHULTZ. I hope there is not. I do not think we have topped out, and I hate to admit it to myself or anyone else that we have, but when we think in terms of a fixed pie and of a win-lose, zero sum game of divvying it up, I think we are going to limit ourselves.

Chairman PROXMIRE. Following up on the same line Congressman Blackburn has been pursuing, as I look at the situation now, all of the economists who appeared before this committee for the last several months, including all of the administration spokesmen complain we do not have a dearth of savings, we have a surfeit. We have too much. They complain about the fact the consumer is saving 8 percent of his income. If he were saving 6 percent, we would be much closer to full employment.

You gentlemen are calling for a situation where we would get more savings. We are operating now at 75 percent of capacity. We have put too much into capital, not too little. If we follow a fiscal policy by adopting a tax which is more neutral, as Mr. Ture puts it, and less of a handicap on savings, you will get, I suppose, savings at 10 percent, and maybe 15 percent, instead of having 5 million unemployed, we might get to 10 million instead of 6 percent, 12 percent unemployed. Who would answer that kind of objection?

Mr. TURE. It seems to me, Senator, there is confusion which is very widespread between the portions of any given volume of production that is allocated to current consumption and other uses—private savings, private investment, public investment—and the level of total resource utilization. These are two quite independent phenomena.

Chairman PROXMIRE. In the first place, I recognize that. You could conceivably have a dearth of capital equipment with a surfeit of private savings. In this case, however, you have both. We are operating far below our capacity at 73 percent of capacity. We need more consumption, not investment. In addition, we are operating at a savings rate of better than 8 percent.

Mr. TURE. But the statement we need more consumption, not more investment, I respectfully submit to you is a preference rather than analytical. What we need is fuller utilization of existing stock.

Chairman PROXMIRE. Do you get fuller utilization by putting more of your resources in more equipment that would not be used?

Mr. TURE. Certainly. That equipment is not given to us by the good Lord above. Somebody has to produce it.

Chairman PROXMIRE. It takes production resource to produce it. When you get it produced, what does it do?

Mr. TURE. It produces goods and services.

Chairman PROXMIRE. What do we have—25, 30 percent idle?

Mr. TURE. Let's come back to the original point. For any given rate of resource utilization, there is a wide spectrum of the proportion between consumption and investment. For any rate of resource utilization, we can have a high, relatively high rate of investment at a relatively low level of resource utilization, or a relatively low rate of investment at a relatively high rate of resource utilization.

Chairman PROXMIRE. Of course. You are always very logical and very appealing, and you make great arguments. The trouble is, though, we live in the situation now where we do not have a dearth of savings or a dearth of investments. We have this big excess right now.

Mr. TURE. I do not mean——

Chairman PROXMIRE. We have had for the last year or 2.

Mr. TURE. I do not mean to belabor you with what you may regard as academic propositions. I say in the real world context, I do not know what the assertion we have too much or too little means.

Chairman PROXMIRE. If you come along and say what we need is neutrality, neutrality sounds great, we do not want to be subjective or one-sided or unfair. But we want to know why. I think what we need is more consumption, what we need is something that will stimulate more consumption, not more investment. We do not need to enfeeble a system which is already doing poorly in the way of getting more consumption.

Mr. TURE. I surely would not gainsay your preference. You feel we need more consumption. My own view is—which may coincide with yours at some times and not others—what we really ought to do is have a tax system that allows private economic entities to make the choice as between consumption and investment as they wish in their own judgment.

Chairman PROXMIRE. I think that would be fine, except we now have the situation where the choices that are now being made are giving us 5 million out of work. The No. 1 economic problem is unemployment, not inadequate investment.

Mr. TURE. That is not a function of a fact we made some decision about how much consumption to have. That is the consequence of aggregate monetary-fiscal policy. Indeed, if you want to play this game, sir, one of the things you can say sparked the recession from which we are slowly recovering, if you believe in the impact of aggregate fiscal policy, were those measures enacted in 1969 which pulled the rug out from under the business sector by repeal of the investment tax credit, and a host of tax provisions which substantially increased taxes on the returns to capital.

Chairman PROXMIRE. We had Mr. McCracken come up, Mr. Stein, we had Mr. Burns, we have had Mr. Connally, and other experts come up, and bewail the fact that the consumer is saving an unusual 8 percent of his income and complaining about the fact we are operating so far below capacity. This is our problem. We have to do something about it. You say, what policy should we follow to do something about it. You fellows come up and say we need more investment, need more saving. It is very hard for us to construe this as improving. It is worsening the situation.

Mr. TURE. But that point goes to the short-run stabilization policy. The proper point goes to what is the basic tax structure of the economy, in terms of the course of the economy over an extended period of time.

Chairman PROXMIRE. As John Maynard Keynes said, in the long run, we are all dead. We just have to look at the short run.

Representative BLACKBURN. In the short run, I will be dead.

Mr. TURE. That really means therefore one should have a concern with balance-of-payments policy only with respect to the effects over the next 6 months, in which case none of the devices that have been recommended to you by people inside the administration or out have been pertinent.

Chairman PROXMIRE. No, I say there is a timing. If we are going to add a value-added tax, there may be a time for it. I am inclined to pose it, but there may be a time for it. But such a time would not be a time when you say would tend to be a neutral tax, and therefore more favorable than the tax system we have now.

Mr. TURE. If the economy were going full tilt 18 months hence?

Chairman PROXMIRE. I would like to do other things.

Mr. Lifschultz.

Mr. LIFCHULTZ. Just a comment on Keynes' comment. Each of us individually might be, but let us hope that we as caretakers will see to it that our society will live, and I think we need to take measures that do not sell us down the drain in the long run.

I think if productivity increases were had as a result of a step-up in total economic activity, consumption would go along with it.

I took a measure of the revenue impact of the 1969 tax reform act and the Revenue Act of 1971, on the 3 years that were treated under the various committee reports, 1971, 1972, and 1973, I think, the only 3 years that interfaced. I took the average annual impact and found as a result of the legislative activity, tax on corporations would have increased annually 6.8 percent, while the tax on individuals would have decreased 9.7 percent.

Chairman PROXMIRE. The best way right now we could get productivity up, in my view, is to stimulate the economy, is to get more people at work.

Mr. LIFSCHULTZ. Right.

Chairman PROXMIRE. To get more production.

This is the way you improve productivity now, it seems to me, rather than a system or a tax which would have the reverse effect.

Mr. LIFSCHULTZ. I do not think there is any question about that, but yet the 30-percent idle capacity of obsolescent plants is to be considered. If we can get unit costs driven down to the point where more people presently working can afford the products of our plants and as the result of productivity put more people to work, it would also help underemployment which I think is one of our great problems today, too, but it does not show up in statistics.

Chairman PROXMIRE. If the people would come in and attack the statistics on capacity operations and say the statistics are no good, that we have a situation in which we have a lot of obsolete plants, that would be one thing. We ought to change it. But nobody does that. It is like the unemployment situation. The administration does not like it, so they come and say, we have unemployment because you have many more women working now, many more teenagers. I do not accept that because the women and the teenagers are better trained, better educated, better skilled, than the married men were 15 years ago.

Mr. LIFSCHULTZ. I quite agree. If we look to full employment, I think it should be full employment for anyone who wants to work within our system.

Chairman PROXMIRE. The same way with your capacity statistics. If you can show there is something inaccurate about them and document it, I would like to see it.

Mr. AARON. I think Mr. Ture raises a point I would like to expand on because I go in the opposite direction from him. I think the country does face a long-term question as to whether it wishes to adopt a policy that will substantially increase the proportion of full employment output that goes to investment.

I would like to suggest we should not. The discussion up to this point really seems to ignore about 10 years of history of the country and of the economics profession. About 10 years ago, Edward Denison at Brookings, then also with the Committee for Economic Development, did a study which indicated that the rate of economic growth at full employment of the economy was quite insensitive to the rate of investment. The dominant forces over the long haul were technological changes.

Chairman PROXMIRE. Education.

Mr. AARON. Education and population growth.

Now, we are being told once again, as we were in the 1950's, that we have got to increase the fraction of GNP invested at full employment, that this is a major problem, that we have to jack up the rate of growth at full employment. None of this diminishes the importance of getting back to full employment. But once we are there, all of this sounds rather quaint.

The experiences of the last 10 years I should have thought would have convinced us that the major questions confronting the United States today are questions of distribution, of making sure all portions of the population are partaking of the benefits of a full employment growing economy and that the additional gains to be gotten from increase in the rate of growth from 4.2 to 4.5, great though they may be when you let compound interest work its miracles for a decade or two, are decidedly less important than the questions how we distribute the current output among private consumers and of how much of current output we allocate to satisfy private and public wants.

Chairman PROXMIRE. I would like to ask you, I thought Mr. Lifschultz was right, and I thought you may be not correct, Mr. Aaron. When Mr. Lifschultz said VAT would help in international trade because it would either substitute or take the place of a tax increase, I think that is correct. You cannot very well say the VAT would not help because the situation is no different after you put it on than before. Because, after all, it is a replacement for something that is not neutral with respect to prices. Any other tax you would put on would have some effect on increasing the price of exported goods. VAT would not. Therefore, it would have this. I think it is a small asset, but I think it is a definite, clear-cut advantage that VAT has over other taxes.

Mr. AARON. I know of no evidence an increase in personal income taxes would affect the price of exported goods. I can sketch out, as I tried to do in my statement, a plausible scenario under which a VAT would in the first instance—through institutional factors which Mr. Ture stressed, and I think entirely correctly—raise prices because of fiscal and——

Chairman PROXMIRE. You would not think the income tax surtax would increase prices?

Mr. AARON. I know of no evidence any has in the past.

Chairman PROXMIRE. How could it do anything else?

Mr. AARON. What is the mechanism by which it would occur? That is the question.

Chairman PROXMIRE. The mechanism, the people are just that much poorer?

Mr. AARON. That is correct. That is the primary effect. The issue then is whether individual workers or firms have some mechanism by which they can change their behavior and increase their receipts. I believe there have been efforts to detect the impact of the 1968 surcharge on the rate of increase in wages, and these have not succeeded. It is an empirical question. It is possible a surtax could affect the rate of increase in wages and if it did, I would be prepared to acknowledge the point fully.

Chairman PROXMIRE. I always had the impression that was the case.

Mr. Ture.

Mr. TURE. Let me first show agreement with Mr. Aaron and then show disagreement on a couple of points raised.

So far as agreement is concerned, I think his analysis as he sketched it in the paper of the impact of a value-added tax, given certain monetary fiscal behavior, on the short-term effects on balance of trade, I think that analysis is correct.

Chairman PROXMIRE. You all agreed on that. I do not disagree with it.

Mr. TURE. I think, on the other hand, if the substitution of a value-added tax for the corporate income tax were to have the effects I suggested on capital formation and productivity, in the long run there would be favorable effects on trade accounts. What is generally overlooked is that there would be one very powerful near-term impact on our balance of payments, on capital account, because if we were to substitute the value-added tax for the corporate income tax, the net effect in terms of the net returns on equity investment throughout the business sector would be so favorable as to produce a very large inflow of capital along the lines Congressman Blackburn suggested.

Let me point out a couple of places I disagree with Mr. Aaron. He attributed to me a view I was proposing by virtue of my advocacy of the value-added tax, an increase in the ratio of the investment to gross national product.

I offered no such advocacy whatever. I think the whole objective here, on the contrary, is to increase the capital labor ratio. That is quite a different thing. Indeed, if empirical tests show no strong correlation, no significant correlation between the fraction of GNP allocated to capital formation, and the rate of growth of GNP, that would not astonish me in the least. On the other hand, if any such empirical examination of the rate of change, change in the capital labor ratio, and change in productivity, were to show no such correlation, I would say, prima facie, that empirical work is no good.

Chairman PROXMIRE. Isn't the labor ratio slanted by the effect of rapidly rising wages? This is the real stimulus to shifting more to capital, the fact labor has become so enormously costly.

Mr. TURE. So has capital.

Chairman PROXMIRE. It seems to me that swamps any other consideration. If we did not have unions, we did not have minimum wage laws, we did not have other forces pushing wages up very, very rapidly, I think we might consider that kind of thing. But I would say under present circumstances, the incentive is so overwhelmingly strong to substitute capital for labor wherever you possibly can in this kind of society we have, that a value-added tax would contribute in a miniscule way.

Mr. TURE. I think we should not overlook the fact there have been strong upward factors on the cost of capital and indeed the substitution of a 5 percentage point value-added tax for the present 48 percent corporate income tax would not have an inconsequential effect on the cost of capital but a very, very substantial one.

May I come back to the question you raised with Mr. Aaron concerning the impact of a surcharge on prices? The price that was raised by the surcharge enactment in 1968 was the price of saving relative to the price of consumption. I found it fascinating that immediately upon enactment of the surcharge in 1968, the personal saving rate fell precipitously. Exactly what theory you would expect.

Mr. AARON. I have two points.

First of all, the question of whether the savings rate rose in response to the surtax has been dealt with by Arthur Okun in a recent issue of the Brookings Economics Papers. He finds no evidence that the surtax changed the savings rate. The changes in savings could be explained by established relationships quite independently of the surcharge.

Second, I agree if we substituted a value-added tax for a corporate income tax, you would see significant impact on the balance of payments through the capital account immediately and for very simple and obvious reasons. The rate of the taxation on capital in the United States in that case would be so low that the United States would look like the greatest tax haven in the world.

Look what would confront a prospective foreign investor. He can invest in the United States. As long as the funds remain within the corporation, there would be no tax imposed. He could watch his capital values appreciate on listed securities. His capital gains would not be taxed unless he realized them. If he held them until he died, they would not be taxed at all. If he realized them, only half of his gains would be taxed. That would be a great atmosphere for capital, because it was so lightly taxed.

I think you would see a massive inflow of capital. But the question is: Do you want to pay the price in emasculating the equity within the current tax system in order to improve the balance of payments. I think the answer is clearly no.

Chairman PROXMIRE. Congressman Blackburn.

Representative BLACKBURN. I frankly would not be disturbed by a large inflow of capital from abroad because to the extent we could improve this ratio of capital to labor, I think we would increase productivity. Whatever inequities exist in the present tax structure—I am sure there are some—but I do not sense any rioting in the streets as a result, although some people try to make political capital out of aberration effects that come from present tax structures. If you examine the real impact of these aberrational instances, and we hear it repeated up here at least three times a week, 100 people did pay no income taxes last year.

I have heard it so many times. If you analyze it just a minute, if you took the total income of these people, it would not amount to 0.1 of 1 percent of our Federal expenditures, so it would have a minuscule impact on our fiscal policy. I think we are seeing a lot of political hay made out of straws in the wind.

I never did get an answer to my question. Are we advocating or are you advocating this value-added tax as a substitute for some existing tax, or—I will say this, politically, it would be a lot more palatable and easier to sell, to say we instituted a similar tax, because we find it is easier to administer and we think that in the long run it will operate more to our advantage economically while we are also phasing out some other taxes, or is this just another device to squeeze a little more blood out of the turnip. What is your thought about that, Mr. Ture?

Mr. TURE. My great preference, of course, would be to be in a situation where there was no occasion whatever to talk about any further increases in Federal taxes. I would vastly prefer to have a value-added tax substituted for not merely the corporate income tax, but a number of taxes in the Federal tax system because I think by all odds it would be a vastly more neutral, more efficient and more equitable tax.

It would, moreover, be a much simpler tax.

Representative BLACKBURN. Frankly, when the whole subject of value-added tax came up, I looked at it with a considerable cynicism. I say, here we are, trying to find another way to squeeze a little more money out of the taxpayers and maybe by hiding it in corporate invoices they won't know about it, so that way we can raise it. I frankly do not regard that with much joy, and I would not want to go home in this next campaign explaining to people, "I raised these taxes insidiously."

Mr. LIFSCHULTZ. I think a balance needs to be maintained between direct and indirect taxation for purposes of ultimate economic success of our society. I do not think it is a fixed balance. I think it is one that has to be changed as requirements indicate.

I think the shrinking and shrunken income base indicates we need to look for a new source of revenue. I think the value-added replacement would do it, but I think the income tax is still necessary as a social leveler, and has to be maintained as a significant part of our tax structure.

Mr. AARON. Congressman, I am aghast at the way in which abuses through repetition become acceptable. The fact a number of people with very high incomes continue to be wholly exempt from taxes—and they are, of course, just symbols for large classes of incomes which are taxed relatively lightly—should not shock us any less today than they did 5 years ago when we first heard about the fact, but perhaps a bit more.

If we wish to increase revenues, my nominee would be tax reform.

My second choice would be a surtax. I suppose I could conceive of political packages under which a value-added tax would be a price I would be willing to pay for some service which the Nation might agree was desirable, but I have not seen that package put together yet.

Representative BLACKBURN. You feel the value-added tax is essentially inequitable as being a regressive tax, and if we tried to remove its regressive effects through exemption in collections, it would just get as complicated as what we are dealing with now.

So you really do not feel we are making much progress?

Mr. AARON. I see no gain in terms of fairness, and I see ample capacity for increasing revenues through alternative routes.

Representative BLACKBURN. Is it safe for me to conclude—and I do appreciate the answer being given—is it safe for me to conclude Mr. Lifschultz and Mr. Ture both feel the value-added tax would mean less Government influence on essentially private business decisions, whereas the present income tax does have a very direct Government influence on business decisions?

That is not a fair assumption?

Mr. LIFSCHULTZ. No, I would not agree to that. I think the Government influence in matters of distribution and spending should be wholly unrelated to the raising of revenue. This is why I would seek the neutrality of such a tax to eliminate the tax impact in prices and wages as much as possible.

Representative BLACKBURN. I think you misunderstood my statement. I think we are in agreement that the value-added tax would have the influence, if we eliminate present tax structures, of removing Government input on essentially private business decisions. If we went to the value-added tax, in other words, economic factors not influenced by Government policy, would determine private business investment decisions.

Mr. LIFSCHULTZ. In respect to taxes per se, yes.

Representative BLACKBURN. Thank you, gentlemen. I have just been called to prove I am on the job.

Chairman PROXMIRE. Mr. Ture, you say in your prepared statement you would not exempt—I presume you would not allow a tax rebate—for example, on food or rent paid for by low-income people.

You say "Analytically there is no basis for such exceptions."

Would you go on the stump for members of Congress and explain to the poor why they must pay a value-added tax on food and rent, which they even now cannot afford? They cannot eat or live on analyses.

You also say in the same context, "Moreover, it is odd that those who urge such exceptions do not argue for similar exemptions from existing taxes."

I guess you and I must be listening to different audiences.

Mr. TURE. Two responses to your question: First of all, you put me in the bag where I have to agree that indeed the value-added tax is a tax on these consumption items. It is not.

Chairman PROXMIRE. It is not?

Mr. TURE. It is not. It is a tax on factor incomes. It is a neutral, flat rate tax on labor incomes and on profit.

Chairman PROXMIRE. Well, wait a minute. I think you are pretty much alone in this one. You argue this would not be a tax on the ultimate purchaser of the goods.

Mr. TURE. Precisely.

Chairman PROXMIRE. It is not?

Mr. TURE. It is not.

Chairman PROXMIRE. It is an income tax?

Mr. TURE. It is, indeed. The whole analytical thrust of the prepared statement I presented to you——

Chairman PROXMIRE. Wait a minute. This makes the assumption which I thought Mr. Aaron knocked down pretty well, that there would be no action on the part of the Federal Reserve Board and the part of Congress to stimulate the economy. This would not work to diminish employment and to prevent growth. If you are going to maintain the same degree of growth and so forth, when you have to have economic policies that neutralize this, which results in high prices.

Mr. TURE. All Mr. Aaron's assertion amounts to is the tax is going to be taken out of real income by a general inflation, not because of the imposition of VAT, but inflationary monetary fiscal policies. The tax will be taken out by general inflation, depressing real earnings that way.

Chairman PROXMIRE. You are a magician. Where is it coming from?

Mr. TURE. Any tax has to come out of factor income. I do know of an economist who would dispute that. If indeed it does not, there is no effective transfer of claims to Governments.

Chairman PROXMIRE. This means although you impose a tax on the product at each stage of production.

Mr. TURE. You are not imposing it on the product.

Chairman PROXMIRE. As long as the consumer does not have to pay any more.

Mr. TURE. The tax is not imposed on ——

Chairman PROXMIRE. It is imposed on the value added to the tax as it goes on.

Mr. TURE. Which is literally the sum of factor payments.

Chairman PROXMIRE. All right, factor payments. I do not care how you describe them. They add up to the ultimate product. Now, every other element of cost that goes into creating that product results in increasing the price. If you increase the wage of the person who is making the product, or the wage of the person who is transporting the product, or award the capital of the firm that is distributing the product, you would agree that would add to the price. Now you say if you add a tax which the Government imposes at all stages, that does not come out of the price, it goes somewhere else.

Mr. TURE. Let me point out to you, if you follow Mr. Aaron, if in fact by virtue of the added value the Federal Reserve expands the monetary stock in order to prevent any reduction in employment and, moreover, real wages and real profits are maintained at their pretax level, then the Federal Government could not have collected a dime's worth of tax.

That is simple national income accounting arithmetic. In order for the Government to be able to collect anything out of the private sector, the real income of the private sector has to go down by the amount of tax. The question is whose income goes down.

Mr. AARON. I tried to deal with this exact point in my statement. May I read a couple of sentences. I tried to argue, lifting the burden of VAT, it does not make any difference for analyzing the burden of VAT, whether prices rose and factor income stayed the same, or prices stayed the same and factor incomes went down.

> As will become apparent, the much debated question whether the VAT is shifted backward or forward has nothing to do with the burden of the VAT. The burden of a consumption VAT is distributed in proportion to consumption expenditures and, what is the same thing, it is distributed in proportion to the sum of wages, interest, rent, and net profits, less saving.

Chairman PROXMIRE. You are very precise, Mr. Aaron, in indicating the effect would be regressive, but those with incomes of less than $5,000 would have a much bigger increase in their proportionate tax than those with middle incomes, and those with far bigger increase in their proportionate tax than those with middle incomes, and far bigger than those with high incomes.

Mr. AARON. That is correct, because of the fact the majority of goods which are purchased with savings would in effect be exempt from the tax.

Chairman PROXMIRE. That would be under the assumption the ultimate consumer would have to pay the tax? If you put it into factor incomes, that would not necessarily be the case.

Mr. AARON. If we put it in the factor incomes and the incomes would dip directly, the overall price level would be the same with the value-added tax but presumably the investment goods would get a credit for the tax. The tax would not apply to them.

So their prices on balance would be the same relative to factor incomes as they were before. That balance would not be changed. But there is a wedge, either way, driven between a dollar you receive to spend on consumption, whether the price of goods rises or the dollar income goes down.

Chairman PROXMIRE. do you know any study or analysis that would show where the incidence of the tax would be? The three economists who testified yesterday all seemed to agree the impact would be on the ultimate consumer.

Mr. Lifschultz in his analysis said that this would be close to a retail sales tax, but not exactly the same. He had some differential but in general the same. I presume the burden is on the ultimate consumer.

Mr. LIFSCHULTZ. I suggested the appearance on the tax to the consumer would be the same as the retail sales tax. To every dollar of goods he bought would be added 3 cents or 5 cents.

Chairman PROXMIRE. That is the appearance. Now you are telling me there is an appearance. It may be illusion, not a reality, and Mr. Ture says it is factor income. Tell me, how would you disclose this to the taxpayer? How does he know what he is paying with this value-added tax?

If you tell me the ultimate consumer does not pay it, how do I know if I am a worker in the steel mill, how much my value-added tax is on me? How is it visible?

Mr. TURE. I would like to suggest a way in which that would in fact occur. Start with the Fed announcing that the rate of change of the money stock is not going to be altered by the imposition of the tax and the rate of change of the money stock will follow a rule the Joint Economic Committee urged upon them some considerable time ago, and this is known.

Now, any employer, any business that generates value added, files a tax return, hopefully using the subtraction method I suggest which computes its value-added tax liability, can readily recognize that the amount of its value-added tax liability depends on how much payroll it has and how much profit it has. It knows if labor comes in and says we need to have a wage increase of such and so, that that will increase initially, increase its payroll by such and so. And that other things being equal, that would also increase its value-added tax liability.

I am suggesting that under those circumstances, employer representatives at the bargaining session would have a great deal more incentive to bargain harder and to resist those wage increases than they have had in the past several years, when they have been confident that active monetary and fiscal policy would bail them out of their errors.

Chairman PROXMIRE. Mr. Lifschultz, your argument we ought to accept a regressive value-added tax because the whole fiscal system is regressive, seems to me to be kind of a poor way to beat the criticism the value-added tax is regressive.

In the first place, I disagree our Federal system is regressive. You alluded to the notion because the distribution of the Federal taxes, expenditures, that they are not progressive. You make the assumption, therefore, our fiscal system is regressive and seemed to drop it there.

All the arguments I have seen are with all of its weaknesses, and there are many, with all of the loopholes, and there are too many by far, we still have a generally progressive income tax system. Do you dispute that?

Mr. LIFSCHULTZ. Yes. I, of course, would like to have the time to explain it.

I feel the total fiscal system is regressive as measured by the result—underemployment, unemployment, the poverty that exists—indicates very strongly the disparity between rich and poor has shown regressive characteristics.

Chairman PROXMIRE. Absent this, suppose we had not an income tax, suppose we added a value-added tax as the sole source of Federal revenue. Your argument is we would have a more progressive kind of situation. What many people regard as a sales tax. This would be a more progressive situation than we have at the present time?

Mr. LIFSCHULTZ. I cannot state my argument this way. I have to state the major assumption, it is the ultimate distribution of the wealth.

Chairman PROXMIRE. We are not discussing distribution this morning. I am on the appropriations committee and many of us are working to make the distribution more equitable. All we are discussing is the value-added tax.

Mr. LIFSCHULTZ. The tax system is the function of distribution of the total system, in my observation.

Chairman PROXMIRE. I think that is a good observation and too few people realize it. We have $40 billion of tax expenditures, there is no question about it. It is a function. But by and large we were discussing now, not the general expenditures, we were discussing the tax system we have. Do you really argue as far as the overall fiscal system is concerned, it changes two things: Eliminate the income tax and add in its place a value-added tax, you then have a more progressive fiscal system than we have at the present time?

Mr. LIFSCHULTZ. I think you will find prices will ultimately adjust to reflect elimination of the heavy impacting of direct taxes on the prices of goods and services.

Chairman PROXMIRE. Would you reject the analysis by Mr. Aaron which indicates people with incomes of $5,000 and less would pay about 40 percent more of their incomes than people with incomes of $50,000 or more?

Mr. LIFSCHULTZ. My logic tells me yes. In terms of real purchasing power, that would be ultimately the case.

Chairman PROXMIRE. He does it on the basis of savings. The person with low income does not save anything. He spends everything, subject to tax.

The person with a high income saves a substantial amount.

Mr. LIFSCHULTZ. If his income were greater in terms of purchasing power, in a sense he would be sharing a greater distribution of the wealth of our society. It is my view that present taxes are not paid only in terms of the add-on to the sales tickets or tax returns we file, but we pay taxes in terms of the inflation that has resulted from a number of our policies, and even more directly in the prices that we pay.

I would like to see the result of some empirical study as of the total impact of taxes in selected prices of goods and services paid for by different segments of the economy.

Chairman PROXMIRE. I invite your attention to page 35 of the Joint Economic Committee report being released tomorrow. I think you will find there that we are able to illustrate the Federal tax liabilities have decreased by 8 percent of the total tax, Federal tax liability, since 1960.

It has been less progressive and more regressive, it is true. It is still basically a progressive system and there are all kinds of ways we suggest, and Mr. Aaron suggested this morning, and others suggested in the past, to make it more progressive.

Mr. LIFSCHULTZ. We can say that 30 percent of our total productivity of the private sector ultimately goes to revenue, but it does not mean every dollar spent or saved is impacted with the 30 percent. In a given case the goods purchased might have, let's say 40/45-percent tax impact built in the cost that ultimately created that price.

Chairman PROXMIRE. Gentlemen, I want to thank you very much for a fine presentation. The hour is late. You have done an excellent job and made a fine record for us.

The committee will stand in recess until 10 o'clock tomorrow morning, when we will hear from other distinguished economists, Mr. Richard Musgrave of Harvard University, Mr. Allen Sinai of Data Resources, Inc., and Mr. Paul Taubman of the University of Pennsylvania, on the same subject, same place.

(Whereupon, at 12:35 p.m., the committee was recessed, to reconvene tomorrow at 10 a.m., Thursday, March 23, 1972.)

THE VALUE-ADDED TAX

THURSDAY, MARCH 23, 1972

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room S-407, the Capitol, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire and Representative Conable.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Courtenay M. Slater, economist; Jerry J. Jasinowski, research economist; Walter B. Laessig, minority counsel; and Leslie J. Bander, minority economist.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

On this third day of our hearing on the value-added tax we shall hear from three distinguished economists. On the basis of the first day's testimony I was beginning to think that at last we had found a subject on which economists were in agreement. But yesterday my illusion was shattered. Not only were the economists in disagreement but they seemed to be describing two different worlds.

While the opponents of the value-added tax found the tax regressive, inflationary and a pure source of additional revenues and proponents believe it to be equitable, noninflationary and efficient and, indeed, if given the opportunity they would substitute the tax for the Federal income tax.

Generally speaking, the pro-value-added tax witnesses would exempt investment purchases from the base, although they would include in the base such items as food purchases by the poor and medical aid to the aged, receipts of publicly owned utilities, farm sales, receipts of public and private schools.

I hope our witnesses today will help us dispel the fog which arose at yesterday morning's hearings. We have with us today three outstanding students of public finance: Professor Richard Musgrave of Harvard; Allen Sinai, senior economist from Data Resources, Inc., and Professor Paul Taubman from the University of Pennsylvania. All three of these experts have studied our Nation's tax system and are thoroughly familiar with its intricacies, failings and good points.

I have read the prepared statements of all three of you gentlemen and have been deeply impressed and informed by them.

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Mr. Sinai will summarize some work that DRI was asked to do for us, utilizing the econometric model of the economy. I hope Mr. Musgrave and Mr. Taubman will help us with interpreting the results of the study.

We have a situation, gentlemen. Yesterday we had, as I say, quite a day. One of the irrelevant aspects of this, as far as the substance is concerned, is that we seem to take longer and longer with our presentations. We tried to settle on a 10- to 15-minute time limit and we started off with the first witness taking 18 minutes, the second 23 and the next 33. So I said from now on, no reflection, obviously, on you, and no reflection on the specific people yesterday, we will have a timer. You can hear it tick now. In 10 minutes there will be a buzzer and in 12 minutes there will be a bell. At 12 minutes everything will go off. I would hope that you could bring your oral statement to a conclusion after that if you can. Your entire prepared statement will be placed in the record.

I have had the opportunity to read your prepared statements. I think that the question session and the dialogue among you gentlemen will be among the most revealing and interesting parts of the testimony.

I might point out that the members of the committee are confined to 10 minutes in their questioning. We enforce that discipline very closely.

Mr. Musgrave, would you lead off?

I might say, as I indicated, that if you don't include all of your prepared statement in your presentation, it will be included in full in the body of the record.

STATEMENT OF RICHARD A. MUSGRAVE, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY

Mr. MUSGRAVE. I will be glad to hold myself to 10 minutes.

Chairman PROXMIRE. Fine.

Mr. MUSGRAVE. I would suggest that the disagreement which you have received in your testimony arises because the position which one takes depends very much on the circumstances under which the value-added tax would be introduced and the form in which it would be introduced.

In certain circumstances, the VAT would be quite unacceptable to me, and in others I would not necessarily object. I will briefly run over my prepared statement and make the main points.

A first point to be made is that contrary to the frequent discussion in the press, there is no analogy, no similarity, between the value-added tax problem in the United States and in Europe. In Europe, the value-added taxes have been introduced as a substitute for the turnover tax. Everybody would agree that the value-added tax is better. They have been introduced in order to coordinate taxation within the Common Market, which was also a good idea but which is also not our problem. So there is no parallel.

Here, introduction of the value-added tax would involve a change in the Federal tax structure towards much heavier reliance on consumption taxes than we have had so far.

The second point which I would make is that the main problem before is whether the Federal tax system should move towards a consumption tax.

The question of whether this consumption would take the form of a value-added tax or whether it would take the form of the retail sales tax, while important from the point of view of tax administration, is of much less interest to the economist. Everything I have to say applies equally to the retail sales tax and to the value-added tax.

I might add that I am here talking about a value-added tax of the consumption type, not a value-added tax of the income type, hence, a value added tax which would be equivalent to a retail sales tax on consumer goods, whereas the other type would be equivalent to a general proportionate income tax.

It is the consumption type which is generally talked about. Undoubtedly, a value-added tax of the consumption type could provide very substantial amounts of yield. The base, if broadly defined, would be, say, $500 billion, so that a 1 percentage point tax would yield, say, $5 billion. One would not want to move to such a tax unless one would think in terms of a much larger yield, say a 5 percent rate with $25 billion. Otherwise, it would hardly be worthwhile.

With regard to burden distribution, as shown in the table of my prepared statement, I compare in columns one and two the burden distribution of raising $25 billion under a value-added tax and under the income tax, assuming an equal proportional increase in present income tax liabilities to secure it.

As shown in the table the income tax is progressive and the value-added tax is regressive. This is so because consumption does decline as a percent of income as we move up the income scale.

However, I do not think it fair, to judge the value-added tax on this basis because devices could be developed which would render the value-added tax at least moderately progressive over a substantial part of the income range, including, I would say, about 80 percent of all taxpayers, covering up to, say, an AGI of $12,000 or $15,000, something of that sort.

This could be done by granting a credit. In order to make this not too expensive in revenue terms, such a credit should be a vanishing credit. It should disappear, say, at an AGI of $10,000. If you did this, as I show in my column three, you would get at least a progressive distribution up to $10,000 or $15,000, a distribution which could be made to be not very dissimilar from that of the income tax.

However, there are two or three qualifications to that. One is it is not easy, administratively, to implement this credit at the lower end where cash refunds are needed. That is to say for people who are not subject to income tax.

Secondly, if, indeed, you can use the value-added tax to get a distribution which is quite similar to the income tax, then what is the purpose of introducing a huge new apparatus to get exactly the same results which you could get via the income tax route?

Thirdly, over the middle upper income range, the value-added tax could not be made progressive. The credit device could not be used effectively to secure progression, say, above $10,000 or $15,000. Here the tax would be distinctly regressive as compared to the income tax route.

It might be argued, however, that if use of a value-added tax was combined with income tax reform, including primarily full taxation of capital gains, you could get your upper end progressivity via the income tax route rather than via the value-added tax route.

So this defect would not be too serious. In other words, I would tell my seminar that you can fix up a value-added tax which, combined with income tax reform, would be acceptable on distributional grounds because it would not differ greatly from the lines of the income tax. A student will then raise his hand and say, "Yes, but is Congress going to do that? If you let them have the value-added tax they will use it and use it without a credit and they will not have income tax reform."

I need not point this aspect out to you. I am only saying that if it were done right it could be done, technically, in a way which would not be objectionable on distribution grounds.

I am not saying that in reality it would work out that way, but it is worth trying. My frame of reference is directed at a scenario which I think is the realistic one in which 5 years from now we will be in need of substantial additional revenue. We shall need, let's say, $50 billion over and above what the present taxes will yield in the mid-1970's if we are at all serious about meeting social priorities.

Everybody talks about the social priorities, but I think nobody, at least to my knowledge, has really faced up to the fact that if you want to do these things, you need substantial amounts of additional revenues.

I do not see Congress providing for a 30 percent increase in income tax liabilities. I can visualize that a value-added tax, properly adjusted with credits, may be a way of meeting the social priorities.

If that could be done, I would entertain going this route. But that does not mean that I would favor such a tax if it were to be used as a substitute for existing taxes.

There was a good deal of discussion 2 or 3 years ago of substituting the value-added tax for the corporation tax in connection with the balance of payments argument, which I think is largely fallacious.

But in any case, the attention has shifted towards a possible use of the value-added tax for school finance as a substitute for the property tax. Here let me say that while the California decision is fine, it simply argues for putting the property tax on a statewide basis as against a local basis. It is a non sequitur to argue that because local school finance is distorted by the local property tax, that, therefore, you cannot finance schools out of property taxes. All that is needed is that the property tax be shifted to the State basis.

My conclusion is that I would not advise use of the VAT as a substitute for present taxes; that if it were to be introduced with an understanding to finance massive additional programs, possibly the revenue to be put into a trust account for this purpose, and if it were done with adequate credits to remove regressivity up to, say

$10,000, I would not necessarily reject it, although I would even then give priority to income tax reform.

Thank you.

(The prepared statement of Mr. Musgrave follows:)

PREPARED STATEMENT OF RICHARD A. MUSGRAVE

APPRAISAL OF VALUE-ADDED TAX

The case for a federal value-added tax, prior to the currency adjustment of last year, was made mainly in terms of balance of payment considerations, viewing it as a means to corporation tax reduction. Since then the argument has shifted, with the VAT now to be used for property tax relief. Neither case is acceptable to me but I would not rule out the use of a value-added tax if it were applied to the finance of new social programs.

SHOULD WE FOLLOW EUROPE?

To begin with, let me point out that the background for the value-added tax in the U.S. is totally different from the European experience. There, the widespread move to a VAT in recent years was made as replacement for prior reliance on turnover taxes, a move which everyone agrees was an improvement. Moreover, it was undertaken to harmonize the tax structure among Common Market countries. Looking forward to a uniform rate, this would obviate the need for border adjustments on exports and imports within the Market. Again, an improvement. But here neither consideration applies. Fortunately, we do not have a turnover tax to replace and we do not contemplate joining the Common Market, having had one of our own for some time. For the U.S., introduction of a VAT would involve a massive shift of the federal tax structure towards sales taxation and this is quite a different matter.

VAT OR RETAIL SALES TAX?

The debate over VAT is somewhat misleading. The real issue is whether the federal government should adopt a broad-based consumption tax. Whether such a tax will take the form of a value-added tax on a retail sales tax is a relatively minor point, especially if the VAT appears as an explicit part of retail price. The two differ mainly in administration. Their burden impact and economic effects are essentially the same. My discussion, therefore, applies equally to both versions of consumption tax. While I lean towards the retail technique—mainly because it permits integration with the state sales taxes—this is not the major issue before your Committee.

RATES AND YIELD

At 1972 levels of GNP, the base for a truly broad-based VAT would be about $500 billion, while with a narrow base it may be as little as $250 billion. Using the broad base concept, a 1 percentage point tax would yield $5 billion. By its nature the VAT involves a large number of taxpayers and is not an easy tax to administer. It would seem inadvisable, therefore, to introduce such a tax unless a substantial amount of revenue—say, $25 billion with a 5 percent rate—was involved.

BURDEN DISTRIBUTION

The burden distribution under a general consumption type VAT would be regressive.[1] This is the case because such a tax falls on the consumer, and because consumption as a percent of income falls when moving up the income scale. Its incidence thus differs sharply from that of a progressive income tax. This is illustrated in Columns I and II of the table, where we compare tax

[1] Under the consumption type value-added tax the tax base for any one firm equals minus purchase of intermediate goods and minus purchases of capital goods. The sum of these bases equals consumption. Under the income type value-added tax the base for each firm equals sales minus purchases of intermediate goods and minus depreciation. The sum of these bases equals national income. The tax here at issue and the one which is uoed generally in Europe is of the consumption type.

burdens under a 5% VAT with income tax liabilities yielding the same amount. The striking difference between the two taxes is obvious and needs no further comment.

BURDEN IMPACT OF RAISING $25 BILLION IN ALTERNATIVE WAYS

[Tax as percent of AGI]

Adjusted gross income	I—Income tax [1]	II—Value-added tax, 5 percent [2]	III—Value-added tax, 6 percent with credit [3]
$2,000		5.0	
4,300		4.5	2.8
5,000	0.49	4.4	2.7
$10,000	2.26	4.0	4.9
$15,000	3.03	3.7	4.4
$50,000	5.96	2.5	3.0
$100,000	8.63	2.0	2.4

[1] Joint returns, 4 exemptions. Above $15,000 assumes 10 percent as deduction. All income fully taxable. Assuming the yield from present rates at $100 billion, the above equals one-quarter of present liabilities to yield $25 billion.
[2] Ratios estimated with reference to Tax Burden and Benefit of Government Expenditures by Income Classes 1961 to 1965, Tax Foundation, 1967. These estimates, especially for higher incomes, should be taken as illustrative.
[3] $2,000 of consumption is tax-free. Credit of $120 to vanish by $24 for each $1,000 of income in excess of $5,000.

DISTRIBUTION WITH CREDIT

It would not be fair to the cause of the VAT, however, to let matters rest here. Devices may be developed which will go far to take the regressive sting out of VAT or—to be more precise—to do so for all but the upper tail of the income scale. To some extent this might be accomplished by excluding certain items of consumption (e.g. food and clothing, in addition to housing) from the tax base, items which weigh heavily in low income budgets. Preferably and much more effectively, it could be done by using a broad-based tax but permitting an initial amount of tax-free consumption expenditure. As an administrative matter, the credit would take the form of a refund of tax on the exempted amount.

Thus, the taxpayer might be refunded for VAT paid on, say, the first $2,000 of consumption. With a 5% tax rate, the credit would equal $100 and to avoid excessive revenue loss, it might be made to vanish as income rises. Thus, the credit might shrink by $20 for each $1,000 of income in excess of $5,000, so as to disappear when an income of $10,000 is reached. The revenue cost of such a credit would be, say, $5 billion, thus calling for a 6% (rather than a 5%) rate if $25 billion was to be raised.

The resulting burden distributions as shown in Column III would be progressive up to an income of above $10,000, thus including as much as 80% of all taxpayers in the progressive range. However, it is also shown that liabilities up to $15,000 would be above those under the income tax and that the burden distribution over the higher income range would remain regressive. While the former difference could be narrowed down by granting a higher credit, the latter feature cannot be removed by a practicable credit device.

IMPLEMENTATION OF CREDIT

Before turning to this aspect, let me note that the credit scheme is nice in theory but would be difficult to implement in practice. For households which are subject to income tax, the refund would simply be taken as a credit against income tax and the vanishing feature could be handled readily. For others, a cash refund would be needed. Since the bulk of households for whom the credit matters most will not pay income tax, effective implementation of the cash refund would be of crucial importance. This would be a difficult task and might cancel out most of the simplication gained by raising the tax-free limit under the income tax. The difficulty would be compounded if allowance was made against family size. In its absence a credit against payroll tax might be explored for the case of taxpayers subject to payroll but not to income tax, thus reducing the scale over which cash refunds would be needed.

FURTHER COMPARISONS WITH INCOME TAX

However this may be, suppose that an adequate credit can be implemented. This would remove the regressivity of the tax for the bulk of taxpayers but leave open two further questions.

(1) If a credit could be imposed which would leave the burden distribution more or less the same for, say, the lower 70 percent of taxpayers, as it would be under the income tax, what then would be gained by adding a new tax with all its compliance and administrative cost? While it is true that the tax would favor savers as against consumers (relative to the income tax) one may question whether this difference is sufficiently important to justify a new tax over this income range.

(2) Regarding the other 30 percent of taxpayers, a substantial difference between the two approaches would remain. Here, progressive taxation of consumption could be implemented only via a personal expenditure tax which is not in the cards. Now it may be argued that this is not too important, provided that upper bracket progression is implemented effectively via the income tax. If a VAT were introduced, it should thus be accompanied by removal of income tax preferences over the upper part of the income range.

If this were done and if an adequate credit was provided, I see no great objection to the use of VAT on distributive grounds. But the question is whether the result is worth the extra effort, compared to improvement of and continued reliance on the income tax.

SUBSTITUTION FOR PROPERTY TAX

I am now turning to the Administration's proposal—or what is said to be its proposal—that a federal VAT be introduced to support grants to states, to be passed on to local governments for school finance. This is to achieve the double objective of (1) eliminating dependence of educational facilities on the local tax base with resulting service differentials, and (2) of permitting property tax relief. The first objective is in line with the California court decision and altogether praiseworthy; but it is a non sequitur to suggest that property tax reduction is a necessary consequence. The obvious point to make is that to equalize service levels, it is merely necessary to place the property tax on a state-wide basis with equalized assessments and to redistribute proceeds back to localities in line with school needs. If a case is to be made for replacing property taxation with VAT revenue, it must therefore be made quite independent of the school issue.

I do not believe that there is a valid case for such a substitution. While the property tax need be improved—including above all state-wide administration and assessment—it is not a bad tax nor do I believe that, on the whole, it is excessively high. Home-owners, after all, not only pay property tax, but also derive favorable treatment under the individual income tax. Given the agenda of unmet public needs and the inadequacy of present revenue sources to provide for them, I find it unacceptable to introduce a major new tax such as the VAT only to serve as a substitute for the property tax. The property tax should be improved but it will continue to be needed as a major source of revenue at the state and local level. Its incidence, though controversial, is undoubtedly on the progressive side of VAT. Moreover, federal assistance to state-local finance, whether drawn from the income tax or a value-added tax, should be given to help jurisdictions with low fiscal capacity and high need to enable them to meet minimum standards of public service; it should not be given as an invitation to tax reduction at the state-local level.

BALANCE OF PAYMENT ASPECTS

Since attention has moved away from the alleged balance of payment advantages of the VAT, I will note them but briefly. The argument has been that European countries have enjoyed a trade advantage because they have been able to apply an export credit under the turnover tax on VAT, whereas our exporters (not having such a tax to credit) have been at a disadvantage. This argument, at least in its crude form, is fallacious: introduction of such a tax without an export credit bestows a disadvantage on the exporters; and granting the credit merely removes this disadvantage, leaving the net situation unchanged. VAT-financed reduction in the corporation tax may invovle certain indirect balance of payment gains—especially on capital account—but I do not consider these sufficient to be a major factor in the VAT issue. Moreover, if tax adjustments are to be made to improve the balance of payment situation, there are other steps (e.g. reconsideration of tax deferral) which should come first.

CONCLUSION

In conclusion, I would oppose introduction of the value-added tax as a substitute for revenue from present taxes, be it the property, income or corporation tax. Rather, I would support income tax and property tax reform. At the same time, it is my view that revenue available from present taxes will not suffice to meet our public needs during the coming decade. It is by now recognized that the hoped-for bonanza of excess revenue, due to built-in revenue growth, will not materialize. This mirage having vanished, we should recognize that substantial amounts of additional revenue—say, $50 billion or more—will be needed by the mid-70's if we are to mean business in meeting our social needs, including income maintenance, schools, health, environment, housing and other public services. We should recognize also (and I have seen none of our plentiful presidential candidates do so) that this revenue will not be obtained primarily from budget cuts or the closing of income tax preferences. These measures are important, but new taxes or substantial rate increases under the income tax will be needed to meet the bill.

Viewed in this context, I am not prepared to rule out the use of a value-added tax. Assuming that an adequate credit is provided and that VAT is accompanied by income tax reform in the upper brackets, the resulting burden distribution need not differ greatly from that of raising income tax. If Congress is willing to finance overdue public needs in this way, while rejecting the income tax route, I for one would not object to the VAT approach. But this, I repeat, is a different matter from viewing the new tax as a replacement for present and in most cases superior, revenue sources.

ADDENDA

While I consider my conclusion (*no* for substitution, *possible yes* for finance of substantial new programs) sensible on substantive grounds, I must admit to some misgivings regarding its political viability. The revenue legislation of recent years has provided for substantial slippage in income and corporation tax revenue, and has been accompanied at the same time by a substantial increase in the weight of payroll taxes. Making a major new revenue source such as VAT available may well lead to further income tax slippage; and though VAT may not be introduced as a substitute in the first place, it may have a hidden long-run effect of this sort. Given this danger, it may be the better part of political wisdom to forego the VAT to begin with. Yet, nothing will be gained if nothing is risked and I would not adopt a purely defensive position.

Perhaps a solution might be found by linking VAT revenue to a specific social program such as expanded income maintenance (moving towards a negative income tax) or to the provision for health insurance. From my point of view this would be the better approach, although I must add that earmarking (under ideal conditions) is a bad budget practice.

Chairman PROXMIRE. Mr. Sinai, please proceed.

STATEMENT OF ALLEN SINAI, SENIOR ECONOMIST, DATA RESOURCES, INC.

Mr. SINAI. Thank you, Mr. Chairman. I appreciate the opportunity to be here today.

I come neither as a proponent nor as one of the severe critics of the value-added tax. Instead, my statement is concerned with a study of the probable effects of introducing it under prevailing economic conditions.

The study is quantitative, based on simulations of three alternative value-added tax programs in the U.S. economy. The simulations were performed with a large-scale model of the United States. The model is the current version of the one that is used by Data Resources, Inc., to generate forecasts of the U.S. economy.

Analyzing a broad base tax such as VAT by simulation offers several advantages over conventional methods of economic analysis. The quantitative details of the complete fiscal program can be specified. The tax can be analyzed in a fairly realistic setting with interactions occurring in all markets. Numerical estimates of the effects of the tax can be obtained. Finally, the model permits the analyst to trace the effects of the tax over a given time period as they work their way through the economy.

The study includes some plausible alternatives which contain most of the elements recent discussion indicates would be included in a value-added tax. The effects of VAT on prosperity, growth, inflation, employment, and unemployment, interest rates, international trade, and the Federal budget deficit are analyzed in the study.

The alternative programs considered have the following features. The first involves a 3 percent income based value-added tax which raises $23.4 billion and has no exemptions except for the government sector and exports. The tax is levied on imports. Transferred to States and localities is $14.8 billion to be used for reductions in property taxes. Any remaining revenues are applied to the Federal budget deficit. This program is an across-the-board value-added tax.

The second program analyzed has a 3 percent income based value-added tax which raises $18.3 billion and has exemptions for services, except financial, agriculture, food, clothing, shoes, and exports. The tax is levied on imports. Low income families receive $2.5 billion in rebates. These features make the tax considerably less regressive than the across-the-board VAT. Again, $14.8 billion is transferred to States and localities for property tax reductions. The remaining revenue is applied to the deficit. This is a VAT with exceptions and rebates.

Third, there is a 3-percent tax on a consumption base. This raises $21.5 billion and has exemptions for capital goods purchases and exports. The tax is levied on imports. Again, $14.8 billion is transferred to States and localities for property tax reduction. The remaining revenue is applied to the deficit. This is a consumption type value-added tax.

In all of the simulations it is assumed that VAT is passed forward into higher prices. Real values of Government expenditures and transfers are initially held constant. Monetary policy is kept accommodating.

Thus, the major rationale for VAT is to relieve the severe fiscal problems of States and localities and to provide a source of funds for new social legislation.

Let me now turn to the results and indicate that all of the following comparisons are based on the latest Data Resources forecast of February 23, 1971. All the figures I will mention are relative to that forecast.

The simulations extend over the 2-year period from 1972 to 1973. This was done in order to permit the effects of the value-added tax to evolve over time. It really would be unlikely that the tax, if adopted, would start before 1973 or 1974.

First, let me discuss the effects of the value-added tax on prosperity and growth. All of the VAT alternatives have restrictive effects on the economy. Real growth of GNP declines at least 0.6 in the first year and 0.4 in the second. Cutbacks in expenditures on durable goods, on fixed investment and on residential construction account for most of the drop.

Second, let me briefly deal with the effects of the value-added tax on inflation. VAT intensifies the existing price-wage inflation, especially in the first year of its introduction. This is because of the effect of inflation expectations on wages and the feedback effect of wages on prices. The chronic inflation of the last few years sensitizes inflation expectations to renewed increases in prices, whatever the source. Thus, the initial burst of higher prices from VAT leads to increased labor demands and subsequently, higher wage increases beyond those we are now forecasting cause higher prices. The inflationary aspect of VAT is the major reason for the detrimental effects of the tax on the economy in the work I am talking about. The consumer price index ranges from 5¼ to 7.5 percent in the first year of the value-added tax. It is about 4.5 percent in the second year. Wages are somewhat higher than in our current forecast, reflecting a modest "catching up" by labor.

Third, the employment situation grows substantially worse. The unemployment rate ranges from 5.9 to 6.2 percent in year 1 and between 5.8 and 6.3 percent in year 2. For year 2 our current forecast is 5.3 percent, one-half to 1 percent below the VAT simulations. There is anywhere from a 300,000 to 700,000 loss of employment in the 2 years of the simulations.

Fourth, the effect on interest rates is to raise long-term yields to almost eight percent, up from their current levels of seven to 7¼ percent. This is mainly due to the effect of inflation.

Fifth, the balance of trade improves substantially. The real value of the trade balance is almost double that without VAT. This is because of the exemption of exports and taxing of imports under the VAT program.

Finally, the Federal budget deficit improves initially as some of the VAT revenues are used to reduce it. However, by the second year the economy has so weakened that the Federal deficit exceeds its level without VAT, and there is a shortfall of tax revenues.

What can we conclude from all of these results? The obvious answer is that the study shows any VAT of the type discussed would be detrimental to economic growth and prosperity if introduced under similar economic conditions to those in the base forecast. The VAT packages would strongly interfere with almost all of the goals of the recent Nixon economic program. The only exception would be in international trade. Ranking the alternative VAT programs is difficult, but in terms of the effects of each on the various categories of economic conditions that I have mentioned, the order of preference would be VAT with exemptions and rebates, the consumption type VAT, and the across-the-board VAT. Thus, the more progressive method of VAT has the least deleterious effect on the economy.

Representative CONABLE. Would you say that again?

Mr. SINAI. The least deleterious effect on the economy.

Finally, let me say a few words about alternatives. We have not yet finished studying the effects of other methods of taxation for raising Federal revenues. However, preliminary work suggests that increases of personal income taxes may be less harmful. Changes in the corporate income tax would depend on the assumptions about shifting. If fully shifted and if all firms were covered, it would probably be less desirable than VAT. The results from any other set of assumptions about shifting profits taxes are uncertain.

There may be other alternatives besides VAT. First, we should be sure that large sums of additional revenues are really going to be necessary, given the existing expenditure plans. Tax receipts have a way of surpassing expectations when there are sharp recoveries in the economy. This has already occurred somewhat recently, primarily because of over-withholding on taxes. Congress may trim spending requests. A full employment deficit is really appropriate policy for fiscal 1973 anyway.

Do we really need more revenues? That is one question, given existing expenditure programs. The question of additional programs for social needs, beyond those proposed by the administration that Professor Musgrave mentioned are another question.

Second, if we do need the revenues, the clearest choice is to close tax loopholes although that is probably the most difficult choice on a political basis. Enough revenue might be obtained in this way to begin to relieve some of the severe problems of States and localities.

Third, if closing tax loopholes is opted against, a combination of tax changes might prove more desirable than a VAT by itself. It isn't really an either/or situation, that is, increase or have the value-added tax, or increase corporate taxes or increase personal income taxes. There may be ways of combining these taxes and putting exemptions in so that the same revenue yields may be achieved.

Finally, if VAT were to be decided upon, the work I am reporting on shows that a lower rate would be better than a higher one. Exemptions and rebates which would give the tax a more progressive tone would be appropriate.

The details of all of this I have in a prepared statement which I assume will be entered into the record.

That concludes my statement. Thank you.

(The prepared statement of Mr. Sinai follows:)

PREPARED STATEMENT OF ALLEN SINAI*

THE VALUE-ADDED TAX AND THE U.S. ECONOMY

I. INTRODUCTION AND SUMMARY

Evidence is mounting which indicates new sources of Federal revenues must soon be found. Vast amounts of funds may be required for welfare reform, revenue sharing and other expenditure programs. A budget margin for 1976 of only $5 billion is projected by the Administration, down substantially from last year's estimate of $30 billion. And this is under the assumption of no new Federal initiatives!

At the same time that new programs are being proposed, the options available for financing them are rapidly disappearing. There is no "peace dividend"

*The views expressed are the author's and not necessarily those of the officers or other staff members of Data Resources, Inc. This paper was written while the author was on leave from the University of Illinois at Chicago Circle.

from the gradual cessation of the Vietnam War. Tax reduction aimed at spurring a stagnant economy has just taken effect. Prolonged deficit financing might eventually lead to renewed inflation and higher interest rates. Even the return of full employment may not bring any fiscal bonus. Independent estimates of the full employment surplus show a substantial deficit for fiscal 1973.

Thus, the problem seems to be one of raising additional taxes, given the present expenditure programs in the Federal budget.[1] One candidate for this task is a Value-Added Tax (VAT), already adopted by most major European countries and under consideration in Latin America.

This paper analyzes the quantitative economic effects of introducing VAT in the U.S. economy. The method of analysis involves simulating the behavior of the economy under alternative VAT programs. The simulations are performed with the Data Resources, Inc. econometric model of the United States. Comparisons are made on the basis of the Data Resources Control Solution of February 23, 1972. The VAT simulations are run over the two year period from 1972 to 1973. This is done in order to permit comparisons with a base forecast. It is unlikely that the tax, if adopted, would begin before 1973 and 1974 would be a more probable starting date.

Three basic alternatives are considered in this study. The first is an income type of VAT with essentially no exemptions, except for exports. The second is also an income based VAT but with a number of exclusions and rebates to low income families. The third alternative is an across-the-board consumption type VAT. All of the examples assume a 3% tax and that $14.8 billion of the generated revenues are transferred to state and local governments through increased grants-in-aid. These revenues are used by States and localities to reduce property taxes by an equal amount. The $14.8 billion figure represents about one-third of the present estimated state and local government outlays for elementary and secondary school education. Any additional revenue is applied to the Federal budget deficit that arises from other new spending programs. Thus, the major rationale for VAT is as a means of reform for the present methods of financing education and to provide a source of funds for new social legislation.

A sketch of the principal findings follows. *Comparisons are relative to the DRI forecast of February 23, 1972.*[2]

Prosperity and growth

The economy is weaker under all three VAT alternatives. The real growth of GNP slows by an average of 0.75–1.5% per year for the two year period of the simulations, depending on the program that is assumed. An average of $9–19 billion of real GNP is lost. There are significant declines in real consumption and real capital expenditures. After tax profits fall anywhere from 2.2–4.4% by the second year of the new tax. The unemployment rate rises 0.6%, at a minimum, by the last quarter of the simulation.

The weakness in the economy is the result of inflation and subsequently lower real disposable income which causes a decrease in real consumption; the effect of higher interest rates on housing and business fixed investment; the effect of lower final demands and a reduced cash flow on investment; and the elimination of a portion of the full employment budget deficit without a compensatory easing of monetary policy.[3]

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[1] It is not certain that all of the proposed programs of the Administration will be totally enacted or effective at the times indicated in the 1973 budget. There is also the possibility that a strong recovery may generate more tax receipts than are expected. This has occurred in other recoveries, most notably during the period following the enactment of the Revenue Act of 1964. Thus, with *no additional spending initiatives* the budget margin projected by the Administration might be too low.

[2] The economic environment surrounding the introduction of a VAT is reflected in the DRI Control Solution of February 23, 1972. The effects of VAT may very well depend on the prevailing state of the economy. For example, a salient feature of the February DRI forecast is the presence of substantial slack in the economy. The unemployment rate ranges from 5.9—5.0%, capacity utilization remains low at approximately 78%, and the gap between potential and actual GNP is still $28.6 billion at the end of 1973. Introducing a VAT at full employment might produce somewhat different results. For a discussion of the conditions underlying the Control Solution, see Data Resources, Inc., *Forecast of the U.S. Economy*, January 31, 1972 and *The Data Resources Review*, February 23, 1972.

[3] In another VAT simulation nonborrowed reserves were raised in the first period to maintain a constant real value. At the end of eight quarters real GNP still had decreased by 0.9%, profits after tax were down by 4.3%, and the unemployment rate was up 0.3%.

Inflation and unemployment

Inflation intensifies as the VAT is passed forward into higher prices. In the initial year of the VAT simulations the implicit GNP deflator grows by at least 5% and in the second year by about 4.0%. This compares to the present forecasted rates of 3.4% and 3.5%. Wage claims gradually rise in response to the new burst of inflation. Further price reactions occur as wages move upward and productivity falls. The recently experienced chronic inflation makes inflation expectations especially sensitive to price changes and contributes to the price-wage interaction. The current incomes policy is assumed to continue.

Unemployment worsens, ranging from 5.8–6.3% by the second year of the three VAT simulations. The corresponding unemployment rate in the Control Solution is 5.3%. Thus, VAT is associated with a rightward shift in the Phillips curve.

Interest rates

Substantial increases occur in bond yields and initially in short-term rates. Higher long-term rates persist because of the continuing inflation, but a weak economy causes short-term rates to fall slightly by the end of the second year.

International trade and finance

The balance of trade improves substantially as the weaker economy reduces the demand for imports. This would contribute to an improvement in the balance of payments which would also be aided, in the beginning, by higher short-term interest rates. However, relatively higher domestic prices would somewhat offset these effects.

Federal budget deficit

The deficit is reduced initially except in the simulation with rebates. By the second year the deficits in all three simulations exceed their levels before VAT. The feedback effect of the weaker economy on tax receipts is responsible for this result.

II. METHOD OF ANALYSIS

The quantitative effects of broad based taxes, such as VAT, are impossible to determine with traditional methods of economic analysis. The principal analytical problem is the difficulty of applying a general equilibrium theoretical framework in an examination of the tax. The other major impediment is the absence of numerical estimates of the relations that realistically characterize economic behavior.

A large-scale econometric model is a useful device for dealing with these problems. A fully specified model will include equations which represent the interactions of all sectors of the economy, at least on the macroeconomic level. Such a model also will incorporate the appropriate time lags of economic behavior.

Established statistical methods are used to estimate the parameters of the model's equations. Once these have been obtained, the equations can be solved to provide a set of values for all of the dependent variables. The dynamic nature of the model permits solution at each period of time, as previously solved for variables are "fed" into equations in subsequent periods. Thus, a solution path for each dependent variable can be generated over a specified interval of time in a general equilibrium framework.

Of course, the solution depends upon the prespecified or exogenous variables, definitions, and the estimated parameters of the model. Some of the exogenous variables and parameters are thought to be subject to the control of policymakers. These are called policy instruments. Some large-scale econometric models are structured so a user can adjust the constants of the equations and the values of exogenous variables to correct for equation errors or to reflect judgment.[4]

A control solution is one where a "best" set of assumptions about the state of the world is incorporated into the model by the selection of specific values for variables and by constant term adjustments. A policy simulation is a solution of the model after one or more changes have been made in the set of assumptions about the world; specifically in the values of the policy instruments.

[4] See L. R. Klein, *Theory of Economic Prediction*, Chicago, 1971, for a discussion of constant term adjustments.

The difference between the solution path of a variable in the control solution from that in a policy simulation provides a quantitative estimate of the policy's effect. Thus, in principle, a large-scale econometric model could be used to evaluate many of the effects of a VAT.

The Data Resources Econometric Model that was used for the VAT simulations consists of over 100 behavioral equations in its macroeconomic sectors.[5] Definitions and exogenous variables bring the number of economy-wide variables forecast to approximately 340. Parameters are estimated by ordinary least squares and two-stage least squares. Adjustments can be made by adding to the constant term, multiplying the solution values of dependent variables by a constant, and by changing exogenous variables. The Gauss-Seidel technique is used to solve the model.

III. RESULTS OF SIMULATIONS

A. Assumptions.

The following discussion indicates the assumptions underlying each VAT simulation.

1. An Across-the-Board VAT.

a. Coverage.

The base is national income plus the change in inventories. The government sector is exempted Depreciation is excluded but expenditures on capital goods are included. These characteristics define an income type, destination principle method of VAT. The resulting base is approximately $780 billion.

b. Rates and rebates.

A 3% VAT is assumed. This yields $23.4 billion of revenue in the first year of the tax. The tax is rebated on exports but fully levied on imports.

c. Use of revenues.

$14.8 billion of the increased federal revenues are transferred to States and localities by increasing grants-in-aid. The remaining $8.6 billion is applied to the Federal budget deficit. States and localities. in turn, reduce property taxes by $14.8 billion. Thus, there is no direct extra local spending, just a change in revenue sources.

d. Monetary and fiscal policy.

No compensating ease of monetary policy is assumed. The DRI control forecast underlying this VAT simulation already embodies an accommodating monetary policy. Real government expenditures and real transfers are assumed to be constant during VAT's initiation. Economy feedbacks affect transfers later in the simulation period.

e. Prices and wages.

VAT is assumed to be almost fully shifted forward. This is because the slack economy of the underlying Control Solution does not assure a 100% shifting. Wages rise somewhat with the increase in prices as workers bargain for maintained real purchasing power. This process, however, is assumed to be a modest one. Only one-eighth of the initial rise in the GNP deflator is regained in the first period of the VAT. By the end of two years almost one-half of the first quarter's rise in prices has been recovered in wages. Phase II continues in effect. No additional incomes policy is assumed.

2. A VAT with Exemptions and Rebates.

a. Coverage.

The base is national income plus the change in inventories. The government sector is exempted. Depreciation is excluded but expenditures on capital goods are included. Services, except financial, are excluded. The value added in agriculture and in the manufacturing of food, clothing and shoes also is exempted. These features make this VAT more progressive than one that is levied across-the-board. However, it is still an income type, destination principle method of VAT. The resulting base is approximately $610 billion.

b. Rates and rebates.

A 3% VAT is assumed. This yields $18.3 billion of revenue in the first year of the tax. The tax is rebated on exports but fully levied on imports. Rebates to low income families are assumed, adding another element of progressivity to this VAT.

c. Use of revenues.

$14.8 billion of the increased Federal revenues are transferred to States and localities by increasing grants-in-aid. States and localities by increasing

[5] There are a large number of additional equations that deal with industry sales, profits, and production. See *The Data Resources Econometric Forecasting System: A Preliminary Account*, December 1971.

grants-in-aid. States and localities, in turn, decrease property taxes by $14.8 billion. Low income families receive $2.5 billion in transfer payments. The remaining $1.0 billion is applied to the Federal budget deficit.

d. Monetary and fiscal policy—same as in the Across-the-Board VAT except for an increase in transfer payments to low income families.

e. Prices and wages.

VAT is assumed to be fully shifted forward. Wages rise somewhat with the increase in prices as workers bargain for maintained real purchasing power. This process, however, is assumed to be a modest one. Only one-fifth of the initial rise in the GNP deflator is regained in the first quarter of VAT. By the end of two years almost 60% of the first period's price rise has been recovered in wages. Phase II remains in effect with no new incomes policies.

3. Consumption Type VAT.

a. Coverage.

The base is equivalent to total consumer expenditures plus imports. The full value of capital goods purchased from other firms is exempted. Depreciation and other indirect taxes are included. These characteristics define a consumption type, destination principle method of VAT. The base is approximately $717 billion.

b. Rates and rebates.

A 3% VAT is assumed. This raises $21.5 billion of revenue in the first year of the tax. The VAT is rebated on exports and fully levied on imports.

c. Use of revenues.

$14.8 billion of the increased Federal revenues are transferred to States and localities by increasing grants-in-aid. States and localities reduce property taxes by that amount. The remaining $6.7 billion is applied to the Federal budget deficit.

d. Monetary and fiscal policy—same as in the Across-the-Board VAT.

e. Prices and wages.

The consumption based VAT is assumed to be fully shifted forward into prices of consumer goods. Import prices also are increased. No other prices are changed initially; however, wage increases and feedback effects do raise the prices of investment goods and exports somewhat in subsequent years. Wages are assumed to rise slightly as labor bargains for maintained purchasing power. About 10% of the initial rise in the GNP deflator is regained in the first period of VAT. After two years only 35% of the first period's price rise has been recovered in wages. The incomes policy of Phase II is assumed for the simulation.

B. Simulation Procedures.

The assumptions are incorporated in the model through the use of constant term adjustments, multiplicative factors, and changes in exogenous variables.[6] The model then is solved and the values obtained in the policy simulations are compared with the control solution to obtain the quantitative effects of VAT.

Federal tax receipts are increased by raising indirect taxes $23.4 billion in the Across-the-Board VAT, $18.3 billion for the VAT with Exemptions, and $21.5 billion for the Consumption Type of VAT. These figures are the expected revenues from the application of a 3% VAT to the tax base in each program. State and local taxes are reduced by $14.8 billion, the assumed reduction in property taxes. Grants-in-aid are increased by $14.8 billion to reflect the transfer of Federal revenues to States and localities. Other government expenditures and transfers are held constant in real terms. This requires increasing nominal Federal government expenditures except in the Consumption Type of VAT simulation.

To achieve the initial increase in prices caused by VAT the relevant implicit price deflators are raised in the first quarter with multiplicative factors. The price of exports is never increased since each VAT assumes rebates on exports. In the Across-the-Board VAT all other prices are increased by approximately 3% except for the government expenditure deflators. The latter are increased by less since only a portion of government purchases are for goods and services from the private sector.

In the VAT with Exemptions and Rebates, no change is made in the deflators for food and beverages, clothing and shoes; and only a partial increase is imposed on the deflator for services. The other deflators, except for those related to government expenditures and exports, are increased by 3%.

[6] Multiplicative factors change the solution values of the variables by a multiplicative constant.

Finally, for the consumption type VAT simulation the implicit deflators for consumer expenditures are raised by 3%. So is the deflator on imports. In all the simultations multiplicative factors are used to increase private, non-farm wages modestly during the first year. If larger gains had been assumed, the subsequent wage-price inflation would have been greater. Also, first quarter feedback effects intensify the change in prices.

Analysis of the structure of the DRI model leads to other adjustments because the price increases are brought about by the VAT rather than by normal economic forces. Most of these apply only to the first quarter of the simulation.

C. Results.

All comparisons are relative to the DRI Control Solution of February 23, 1972.

1. Prosperity and Growth.

All of the VAT alternatives have restrictive effects on the economy. Tables 1 and 2 show some differences between the Control and VAT solutions.

TABLE 1.—EFFECT OF A 3-PERCENT VAT ON THE ECONOMY (DIFFERENCES BETWEEN VAT SIMULATIONS AND FEB. 23, 1972, DRI CONTROL SOLUTION)

	Year 1			Year 2		
	VAT across-the-board	VAT with exemptions	VAT construction type	VAT across-the-board	VAT with exemptions	VAT construction type
GNP (current dollars)	5.1	10.3	2.5	−1.4	6.0	1.4
GNP (1958 dollars)	−14.4	−5.1	−12.5	−23.9	−12.9	−16.9
Consumer (1958 dollars)	−11.9	−3.8	−12.1	11.2	−6.4	−13.6
Durables	−3.8	−2.0	−4.2	−6.3	−4.3	−5.2
Nondurables	−3.8	−.6	−5.0	−5.5	−.8	−6.4
Services	−4.3	−1.2	−2.9	−4.4	−1.3	−2.0
Investments (1958 dollars)	−3.1	−2.2	−.9	−6.5	−4.9	−2.6
Business—fixed	−1.7	−1.2	.4	−5.0	−3.3	−1.3
Residental construction	−1.4	−1.0	−1.3	−1.5	−1.6	−1.3
Savings rate (percent)	.1	.5	−.5	.4	.6	−.2
Housing starts (millions)	−.156	−.118	−.148	−.065	−.122	−.075
Profits (after tax) (billions of dollars)	−2.8	−1.2	−.6	−5.5	−3.6	−1.9

TABLE 2.—EFFECT OF A 3-PERCENT VAT ON THE ECONOMY (PERCENT CHANGES IN VAT SIMULATIONS AND FEB. 23, 1972, DRI CONTROL SOLUTION)

	Year 1				Year 2			
	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23
GNP (Current dollars)	9.7	10.2	9.5	9.2	8.9	9.0	9.3	9.5
GNP (1958 dollars)	3.7	5.0	4.0	5.6	4.6	4.8	5.3	5.7
Consumer (1958 dollars)	2.1	3.7	2.0	4.5	4.8	4.9	5.4	5.5
Durables	3.3	5.4	2.9	7.6	5.9	5.9	7.5	8.2
Nondurables	1.5	3.6	.9	3.2	3.5	3.6	3.7	4.2
Services	2.2	3.8	2.9	4.4	5.7	5.7	6.2	5.7
Investments (1958 dollars)	6.8	8.3	9.0	10.7	4.1	5.0	5.9	8.2
Business—fixed	3.7	4.4	6.3	5.9	4.1	5.5	5.9	8.0
Reserve construction	6.0	7.3	6.2	11.1	−2.7	−4.3	−2.3	−2.2
Housing starts	.3	2.2	.7	8.0	−.7	−4.0	−.3	−3.6
Profits (after tax)	11.1	14.5	15.8	17.0	7.0	7.3	9.2	11.4

The rise in nominal GNP is due to higher prices. Subsequently, a weaker economy lowers current dollar GNP. The effects of the Across-the-Board VAT are so severe that nominal GNP falls in the second year of the simulation.

Real growth declines at least 9.6% in the first year and 0.4% in the second, as compared to the Control Solution. Cutbacks in expenditures on durable goods, fixed investment, and residential construction account for most of the drop in real GNP.

Except for the effects of a Consumption Type VAT, higher prices reduce consumption, especially for durable goods where the elasticity of demand is greatest. Subsequent declines in real disposable income further diminish consumer spending. Business fixed investment falls because of decreases in final demand, higher interest rates which affect the relative price of capital goods, and declines incorporate profits. Residential construction is down because of an inflation induced rise in mortgage rates and a decreased supply of mortgage money. Deposits at mutual savings banks and savings and loan institutions, the major source of funds for conventional mortgages, are diminished as short-term money market rates of interest rise during VAT's first year. The private sector saving rate increases sharply, but this rise does not enhance the growth of capital stock. The decrease in product demand, higher interest rates, and reduced business saving more than offsets the increase in private saving.

In the case of the VAT on consumption, there is a clear shift in the allocation of resources to investment. Real consumption declines more in this simulation than in the others. Fixed investment is stronger than in the other simulations. However, there is still a total loss of $29.4 billion in real GNP over the two year period. The VAT with Exemptions and Rebates showed the smallest cumulative decline in real GNP, $18 billion, of the three VAT simulations.

Table 3 shows the effect of VAT on prices, wages, and productivity. VAT intensifies the existing price-wage inflation, especially in the first year of its introduction. The chronic inflation of the last few years "sensitizes" inflation expectations to renewed increases in prices, whatever the source. The rate of wage increase depends mainly on unemployment and current price expectations. Since these expectations are particularly sensitive, a given change in prices leads to a greater reaction of wages than in a situation where severe inflation has not been present recently. Prices subsequently react more because the movements in wages are greater than otherwise would have been the case. This sharper interaction of wages and prices occurs when the average of the annual rates of inflation has exceeded 2½% during the previous two years.[7]

TABLE 3.—EFFECT OF A 3-PERCENT VAT ON INFLATION AND PRODUCTIVITY (PERCENT INCREASES IN VAT SIMULATIONS AND FEB. 23, 1972, DRI CONTROL SOLUTIONS)

	Year 1				Year 2			
	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23
CPI	6.9	5.2	7.4	3.9	4.4	4.5	4.3	4.1
GNP deflator	5.8	5.0	5.3	3.4	4.1	4.0	3.9	3.5
Wages [1]	6.4	6.4	6.3	6.0	5.9	5.9	5.8	5.6
Productivity [2]	2.4	2.8	2.8	3.3	2.7	2.5	3.0	2.8

[1] Private nonfarm index of compensation per man-hour.
[2] Real output per man-hour, excluding agriculture.

Table 4 shows the course of employment and the unemployment rate. The labor situation grows substantially worse because of the weaker economy. The unemployment rate increases at least 0.2% in Year 1 (in VAT with Exemptions) and 0.5% in Year 2. In the other VAT simulations the unemployment rate gets even worse. The minimum declines in employment are 300,000 in the first year and 700,000 in the second. Decreases in aggregate demand lead to reductions in output and employment.

TABLE 4.—EFFECT OF A 3-PERCENT VAT ON EMPLOYMENT AND UNEMPLOYMENT

	Year 1				Year 2			
	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23
Employment (millions)	81.5	81.9	81.1	82.2	84.4	84.9	84.4	85.6
Unemployment rate (percent)	6.2	5.9	6.2	5.7	6.3	5.8	6.0	5.3

[7] O. Eckstein and R. Brinner, "The Inflation Process in the United States", A Study Prepared for the Joint Economic Committee, February 1972, p. 3.

Table 5 shows the effects of VAT on some long and short-term interest rates. Long-term interest rates rise substantially as a result of VAT. The new issue rate rises by as much as 80 basis points during the first year and 95 basis points in the second year. This increase occurs in the VAT on consumption where the deflator for consumer purchases of goods and services rises the most of any simulation. Inflation expectations are rekindled and drive long-term rates upward. The increases are net of the weaker economy and show the important effect of sustained inflation on bond yields.

Short-term rates climb in the first year of VAT but fall slightly during the second year as the weaker economy limits the demand for short-term funds. The supply of funds and demand for credit are relatively more important in determining short-term interest rates than is inflation.

TABLE 5.—EFFECT OF A 3-PERCENT VAT ON INTEREST RATES (PERCENT)

	Year 1				Year 2			
	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23
Long-term rates:								
New bonds	7.70	7.38	7.77	6.97	8.15	7.81	8.23	7.28
Mortgages	7.67	7.60	7.65	7.38	7.49	7.51	7.43	7.19
Government bonds	5.85	5.76	5.86	5.65	6.18	6.03	6.21	5.81
Short-term rates:								
3-month bills	4.09	4.09	4.07	3.80	4.46	4.68	4.44	4.59
4-6 month paper	4.69	4.67	4.66	4.35	5.14	5.38	5.12	5.29
90-day CD's	4.61	4.59	4.59	4.29	5.03	5.26	5.00	5.15

Table 6 presents the impact of VAT on international trade. The destination principle method of VAT taxation that is employed decreases imports because domestic goods prices become relatively less than foreign goods prices. The weaker U.S. economy also contributes to the improvement in the trade balance. The result is a very substantial improvement in international trade. The real value of the trade balance is about double that of the Control Solution for all of the VAT simulations. The implications of the increased balance of trade are an improved balance of payments and a strengthening of the dollar in foreign exchange markets.

TABLE 6.—EFFECT OF A 3-PERCENT VAT ON THE U.S. TRADE BALANCE

[Billions of dollars]

	Year 1				Year 2			
	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23	VAT across-the-board	VAT with exemptions	VAT construction type	Control Feb. 23
Exports-imports (current dollars)	0.9	0.5	0.5	0.3	3.9	3.1	1.3	2.0
Exports-imports (1958 dollars)	3.2	3.1	3.2	1.4	5.3	4.8	5.0	2.8

Finally, Table 7 contains the figures for the NIA budget. Most of the VAT revenues that are earmarked to reduce the deficit are lost in the first year because of the feedback effects on tax receipts of a weaker economy. In the second year, the deficit is higher than it would have been without a VAT.

TABLE 7.—EFFECT OF A 3-PERCENT VAT ON THE FEDERAL BUDGET DEFICIT (DIFFERENCE IN VAT SIMULATIONS AND FEB. 23, 1972, DRI CONTROL SOLUTION)

	Year 1			Year 2		
	VAT across-the-board	VAT with exemptions	VAT construction type	VAT across-the-board	VAT with exeptions	VAT construction type
Federal surplus (NIA)	3.0	−2.3	3.1	−2.2	−1.9	−.4

IV. CONCLUSIONS

This study analyzes the quantitative economic effects of three alternative programs for a value-added tax. The effects of VAT on prosperity and growth, inflation, employment and unemployment, interest rates, international trade, and the Federal budget deficit are examined in simulations with the Data Resources, Inc. forecasting model of the U.S. economy. Traditional economic analysis of a broad based tax, such as VAT, would be difficult since the general equilibrium effects of a complete fiscal package are of interest. Furthermore, the quantitative effects of a VAT can not be obtained without adequate estimates of the parameters of relations that realistically characterize economic behavior.

The alternative programs are:

(1) a 3% income based VAT which raises $23.4 billion and has no exemptions except for the government sector. The tax is levied on imports and rebated on exports. $14.8 billion is transferred to States and localities for property tax reform. The remaining revenue is applied to the Federal budget deficit.

(2) a 3% income based VAT which raises $18.3 billion and has exemptions for the government sector, services, except financial, agriculture, food, clothing, and shoes. The tax is levied on imports and rebated on exports. Low income families receive $2.5 billion in rebates. $14.8 billion is transferred to States and localities to be used instead of an equal amount of property taxes. $1 billion of additional revenue is applied to the Federal budget deficit.

(3) a 3% consumption based VAT which raises $21.5 billion and has exemptions for capital goods and purchases. The tax is levied on imports and rebated on exports. $14.8 billion is transferred to States and localities for property tax reform. $6.7 billion are applied to the deficit.

The effects of all three alternatives are similar over the two year simulation period. *Comparisons are based on the Data Resources, Inc. Forecast of February 23, 1972.* The real growth of the economy declines. Inflation intensifies and unemployment rises. The growth of employment slows and productivity drops. Long-term interest rates increase sharply. The Federal budget deficit improves at first but later increases to a figure greater than it would have been without the tax. The only bright spot is in international trade where the trade balance grows substantially. This is due to border tax adjustments and declining real national income.

Ranking the alternative VAT programs is difficult, but in terms of the effects of each on real economic growth, inflation, profits, unemployment and interest rates, the order of preference would be VAT with Exemptions and Rebates, the Consumption Type VAT, and the Across-the-Board VAT.[8] Thus, the more progressive method of VAT has the least deleterious effect on the economy.

The VAT is detrimental to economic growth in the U.S. economy, primarily because of its effect on the inflationary process.[9] Any of the VAT packages considered in this study would severely interfere with almost all of the goals of the recent Nixon Economic Program, i.e., greater economic growth, lower inflation and unemployment, increased productivity, and reduced interest rates. Only the position of the United States in international trade would be enhanced.

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[8] One need merely rank each simulation with respect to its performance in each category. The above ranking clearly emerges. No clear-cut evidence on the distribution of income could be obtained from the results.

[9] However, the results obtained in these simulations might not be matched in other instances where a different fiscal package was considered, e.g., the substitution of VAT for the corporate income tax or for personal taxes.

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Chairman PROXMIRE. Thank you.
Mr. Taubman, please proceed.

STATEMENT OF PAUL TAUBMAN, DEPARTMENT OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA

Mr. TAUBMAN. The tax bill of 1971 reduced revenues by $15 billion to $20 billion annually. Now faced with financing new and generally urgently needed programs, Congress has been asked to raise revenues by about $15 billion by instituting a value-added tax while earmarking some of these funds to decrease local property taxes. The extra revenues are needed but the value-added tax, even with exemptions or tax credits for the poor, is inferior to many other taxes and will create a net set of "loopholes." Thus, to raise new revenues Congress should make the income tax fairer. To this end capital gains should be taxed as ordinary income and should be constructively realized at death.

Congress should also eliminate the loopholes and subsidies in the existing tax law as detailed in the recent report of the JEC, and should also consider changing the estate tax.

Moreover, while I would agree with the spirit of the *Serrano* decision the appropriate response to it is to replace a local with a statewide property tax.

THE VALUE-ADDED TAX

Technically, the value-added tax is imposed on the difference between revenues and the costs of goods and services purchased from other businesses. In alternative versions of this system firms: write off investment costs immediately; depreciate these costs over their useful life; or have no deduction for investment costs.

The Nixon administration's proposals, to which I will address myself, allow a firm to write off investment costs immediately. With such a writeoff, the value-added tax is equivalent to a tax on the sum of domestic retail sales and imported goods. The value-added tax as any other tax should be judged in terms of its equity and efficiency.

EFFICIENCY

Some economists have supported a value-added tax in preference to a personal or corporate income tax on the grounds of efficiency. Roughly speaking, a tax is considered efficient if its imposition either does not alter resource allocation or does eliminate a preexisting misallocation. The income taxes in use in this country cause inefficiencies because of loopholes and preferential treatment.

But even if these deficiencies were corrected, it is usually argued that income taxes would discriminate against the corporate form of business and against personal savings in general because of "double taxation" of profits and of savings.

The proposed value-added tax, however, produces its own inefficiencies. First, since investment costs are, but labor costs are not, allowed as a deduction, this particular value-added tax would increase the cost of labor relative to capital and induce firms to use a more capital intensive process.

Additional capital subsidies are not needed since the recently enacted investment tax credit and asset depreciation range system, both of which are unnecessary, bestowed a $7 billion subsidy on capital.

Second, for practical reasons the value-added tax will not be applied to the total amount of consumption, that is, the value of all goods and services that yield satisfaction to a consumer. While this criticism can also be levied against the income tax, additional problems occur with a value-added tax. The basic areas of consumption which will not be subject to the value-added tax are: those for which there are no market transactions; those that are provided by government; and those both purchased and consumed abroad.

One extremely important type of nonmarket transaction is provided by savings and wealth. In the discussion of taxation it is generally emphasized that people accumulate savings to provide for the consumptions of goods and services in the future.

But while waiting to be consumed, wealth provides its owner with a feeling of security, status, and power—valuable services which would not be subject to the value-added tax.

In addition, there are some other points that may seem minor to some individual but involve large sums of money, especially in comparison with the loopholes in the existing tax law.

For example, two other important nonmarket transactions are the services of spouses and the rental value of owner-occupied houses. The latter may eventually be taxed as houses are sold (if a house is not counted as an investment, but even in this instance the tax would inhibit people from trading in).

The nontaxing of a spouse's services will not only reduce the incentive to women to join the (officially defined) labor force but will also mean housewives will be taken out to dinner less.

Consumers also buy some consumption goods collectively and pay for these goods through taxes. While the extent of government provisions of consumer type goods and services varies by locale, at least some and probably most areas provide entertainment (in the form of parks, swimming pools, and concerts), higher education, garbage collection, and medical services.

I presume the value-added tax will not apply to such services financed through general taxes; hence, these goods will become relatively cheaper. Such a relative price reduction would not be desirable for all such items.

Moreover, since the extent of public provisions of services varies both within and between locales, any benefits so conferred would not be distributed uniformly, but would be conferred upon people who itemize taxes paid to support personal consumption.

In recent years American tourists have spent about $3½ billion abroad exclusive of payments for transportation. While this total includes goods that will be imported, it excludes payments of Americans living abroad and non-U.S. connected transportation. Thus, perhaps some $5 billion of this type of consumer expenditures would not be subject to the value-added tax.

In other words, since the value-added tax would apply to hotel and other vacation expenses, the tax would encourage Caribbean vacations outside of Florida, Puerto Rico, and the Virgin Islands, ski vacations in Canada, and so forth.

The inefficiencies introduced by the value-added tax will be costly because it is relatively easy for consumers to substitute nontaxed for taxed items. On the other hand, I don't believe the inefficiency produced by "double taxation" to be costly.

First, the distortion introduced between present and future consumption by the tax on interest is counterbalanced by the zero tax imposed on the income (and consumption) in the form of security, status, and power.

At a more empirical level, let me also observe that the personal saving rate has not shown any trend in the last hundred years despite the major increases in income tax rates.

Moreover, there are available a number of devices such as pension funds and series E bonds which sharply reduce the double tax on saving.

While the nonintegration of the corporate and personal income tax involves an extra tax on the corporate form of business, it is difficult to believe that much extra resources have been misallocated out of the corporate and into the noncorporate sector.

The costly inefficiencies from the income tax laws arise from its loopholes and preferential treatments. Rather than putting in a new law with another set of inefficiencies, it would be better to close the existing loopholes.

EQUITY

Economics generally does not provide a definition of equity. However, I believe that we should have a progressive tax system to narrow the extremes in income and to reduce the undue concentration of power of the wealthy. In judging the progressivity of the value-added tax, it is necessary to consider this tax in isolation and as part of the tax system.

Through a system of income tax credits, the value-added tax system can be designed so that the poor effectively pay nothing, and the middle class very little. But while I have not seen the proposed rebate schedule, I would doubt that a $15 billion value-added tax would be progressive as between the middle class and the wealthy.

Indeed, I would suspect the tax to be regressive for income above $10,000 to $15,000, and certainly above $20,000. Thus, even judging the tax in isolation, I would consider it undesirable on equity grounds.

But this tax should not be judged in isolation. Congress is considering the value-added tax now because it reduced taxes so greatly last year. In the 1971 Tax Act, Congress, justifiably upset by a 6-percent unemployment rate, enacted a program of permanent tax reductions for business and for the wealthy without giving due thought to the short- and long-run consequences.

Part of these consequences are now apparent. To support needed expenditures, Congress is being asked to replace a tax on profits with one that is levied on wages and the total of profits less the expenditures on investment.

Since wages constitute about two-thirds of nongovernmental GNP, the value-added tax and last year's tax bill combine to produce a subsidy to wealthy owners of machinery and equipment paid for by consumers in general and the lower middle and middle class in particular.

This combination is unwise since the subsidy to machinery and equipment will be translated primarily into higher interest rates and into less resources available for housing, including low income housing. Therefore, the first step Congress should take to raise $15 billion is to eliminate the Investment Tax Credit and especially ADR.

THE USEFULNESS OF THE PROPERTY TAX

Recently following the blockbusting Serrano decision, the local property tax has been subjected to severe attack. I think, however, that a national or statewide tax on residential property with uniform assessment to market value ratios is appropriate for the following reasons:

First, the available evidence, which admittedly is far from conclusive, would suggest that the amount a person spends on housing increases in proportion to his income.

Second, the implicit rental income received by a homeowner is not subject to the income tax though his interest payments and property tax payments can be listed as itemized deductions. But in principle it would not make any difference if the same revenues were raised by taxing the income from capital or the value of capital.

In other words, the property tax tends to offset the inequities and inefficiencies arising from the income tax treatment of owner-occupied houses, and thus, the property tax should be kept.

A BETTER TAX PLAN

Rather than imposing a value-added tax which will introduce new elements of inequity and inefficiency, Congress should correct the well-known but glaring deficiencies in the income tax system. Much of the needed funds could be obtained by treating capital gains as ordinary income and by having constructive realization of gains at death.

The ADR and Investment Tax Credit provisions of the 1971 Tax Act were major steps backward in our tax system. Both of these subsidies should be eliminated as soon as possible.

Finally, Congress should give serious thought to improving and raising more revenues from the gift and estate tax. Total private wealth in this country is in excess of $5 trillion. Since about 1 percent of the people die each year, about $50 billion of wealth annually enters estates.

Since wealth is highly concentrated among few families, about $30 billion of wealth is subject to estate taxes. But gift and estate tax revenues only amount to about $4 billion at all levels of government. Substantially more revenues should be raised from this source.

I thank you.

Chairman PROXMIRE. Thank you, gentlemen. Congratulations on your speed and efficiency and completing your oral statements well within the time limit. You have given Mr. Conable and myself an opportunity to question you and to develop a dialog here.

All of you gentlemen presented extremely interesting analyses.

Mr. Sinai, your is, I think, different than any that we have gotten because you give us an analysis of what you say are likely to be the results based on certain assumptions and based on your econometric model. This is always very satisfying.

If you take a particular tax or take a particular policy and put it into effect, what will be the results, and you tell us the results.

It is, as I say, very interesting to get those. The trouble, however, is that what you tell us is what would happen to inflation, unemployment, interest rates, the balance of trade and the Federal budget with a value-added tax on the assumption that you don't have any other tax, don't you?

In other words, if instead of the value-added tax you imposed an equivalent increase in the income tax or if you imposed some equivalent change in State and local taxes to raise the same amount of money that would go there, then, obviously, you would get a similar impact on the economy, to some extent on prices and to some extent on employment, growth, and so forth, would you not?

Mr. SINAI. No, the effects on the economy of raising additional revenues with an alternative tax to VAT would not necessarily be the same.

Chairman PROXMIRE. I don't say they would tend to be the same, but they would undoubtedly change these various factors.

Mr. SINAI. That is correct.

Chairman PROXMIRE. What you are saying is if you impose a $20 billion additional tax, it would have these particular effects if it is VAT.

If you impose a $20 billion additional Federal income tax, it might also tend to slow growth, certainly. It would tend, perhaps to some extent, to be reflected in higher prices. Maybe not as much. But it would certainly tend to increase unemployment, would it not?

Mr. SINAI. That is correct. I think I did mention that on the corporate profits tax it is a little bit more difficult because the answer there depends upon assumptions about shifting. Raising additional revenues by raising the corporate profit tax to give an equivalent yield to the yields I talked about in the VAT programs could be as inflationary and could be more harmful to growth if one assumes full shifting of corporate taxes across the board.

Chairman PROXMIRE. Do you have any study or is there any possibility of getting some kind of analysis that would indicate the effects of various taxes and compare them right along the line?

I am certainly not a fan of VAT, I am very critical of it, but I don't think it is fair to take any tax and say if you impose this one and make the assumption at least implicit in my mind when you make this analysis that this is what the value-added tax would do. Obviously, if it is a substitute, to some extent it might not do as much harm as your analysis indicates. Is that right?

Mr. SINAI. The analysis was carried out this way for the following reason. The proposals that have been discussed suggest simply raising additional revenues and not changing the corporate or personal income tax simultaneously.

Chairman PROXMIRE. Let me interrupt. You say $14.8 billion in each case would be returned to the locality. Isn't it possible that there might be a substitution and there could conceivably be a diminution in the State and local taxes or at least a failure to increase those State and local taxes, which you otherwise would increase absent this action?

Mr. SINAI. There is a substitution of taxes going on in the study. The substitution is the Federal VAT against a State and local property tax. The substitutions of the other taxes——

Chairman PROXMIRE. But you don't crank that into your analysis, do you?

Mr. SINAI. Yes.

Chairman PROXMIRE. Does your model reflect the reduction in local property taxes?

Mr. SINAI. Yes. That is an assumption. There is really one tax being substituted for another. But it is not the two taxes that you have mentioned, the corporate profits tax and personal income taxes.

Chairman PROXMIRE. How much of a property tax reduction do you estimate this gives you? $14 billion?

Mr. SINAI. It is assumed in each case that the States use or have to use because of the legislation, $14.8 billion of the revenues raised by VAT to reduce property taxes. Anything that is left over goes to reducing the Federal deficit. Some of that deficit arises because of the plans for revenue sharing and welfare reform that are reflected in the budget. So $14.8 billion of $18 billion or $21 billion goes to the States and localities and they must reduce property taxes.

Thus, there is a substitutability of taxes. In one of the simulations another $2.5 billion of the revenue is given to low income people. That leaves only a couple of billion dollars for application to the deficit.

Chairman PROXMIRE. How do you explain without reference to the econometric model—I can understand how inflation can be aggravated more than it would be by an increased property tax—how do you explain this very decisive adverse effect on employment?

You said, I think, 300,000 to 500,000 fewer jobs because of VAT as compared with a comparable increase in the property taxes. How do you explain that?

Mr. Sinai. That effect is over a 2-year period. It is a result of the fact that the economy's real growth slows down substantially. Product demand is down and firms cut back on the amount of labor they need. Aggregate demand is down by $10 billion to $20 billion in real terms during the 2 years of the VAT program.

Chairman Proxmire. And you wouldn't get that if you had an equivalent increase in the property tax that would take that much more income from people?

Mr. Sinai. Not from an equivalent increase in the property tax. You would, of course, get some loss of employment from an increase in the personal income tax or the corporate profits tax.

Chairman Proxmire. Why wouldn't you get it regardless of where you assess the tax? It has to come out of the income, doesn't it?

Mr. Sinai. I don't think you would get as much or maybe even a significant amount out of raising additional taxes by raising property taxes.

Chairman Proxmire. Mr. Musgrave, would you comment on the Sinai analysis?

Mr. Musgrave. I don't feel it is very helpful to appraising the VAT. I think your questions have been very much to the point.

I can see why you did study this substitution for the property tax even though it is a framework which I don't like.

I would expect the employment effects or decrease in aggregate demand effects to be somewhat stronger with the value-added tax than with a corresponding increase in income tax. I don't think it would make all that much difference. But it is not a very relevant question. If increasing the value-added tax by $18 billion reduces demand by more than a comparable increase in income tax—by say $22 billion to get the same consumption effect—which would be appropriate in terms of an overall stabilization policy?

If we don't want a reduction in consumption and in aggregate demand, we should not build a surplus into this scheme. To say that the value-added tax reduces aggregate demand more than the income tax, to me says nothing about the quality of the two taxes. It only tells me how much I ought to increase each of these taxes if I want to have such aggregate demand effect as is reasonable in the context of stabilization policy.

It is correct to assume that the value-added tax would be reflective in higher prices, and assuming a stabilization policy which permits this to occur, we would have the higher prices which we would not have in the case of the income tax.

But this is really a once-and-for-all effect. Suppose you have a $20-billion increase in expenditures and, compare three situations, one being bank finance, the other a $20 billion increase in VAT, and the third a $20-billion increase with income tax finance. The different between two and three regarding inflation will be insignificant compared to that between either and one on the other.

With regard to the balance of payments point, which is the one on which the model makes the VAT come out favorable, I think the result is surprising. I would not expect it.

What happens as you introduce a value-added tax, is that prices rise. There is a compensating import duty so the relative prices of imports and domestic products in the retail market will not be affected. On the export side, the giving of an export credit, simply means that you undo the damage to exports which has resulted from the price rise. So there is no change in export cost relative to world market prices. It seems to me it ought to be neutral.

Chairman PROXMIRE. I follow you all the way up until you get to that point. It seems to me that once again, if you are going to make these things comparable, the VAT does have an advantage with regard to exports because if instead of raising your funds with the VAT you raise them with the corporate income tax, with the personal income tax, with almost any other kind of a tax, you tend to raise the price of the export to some extent, whereas with VAT you explicitly and specifically have an exemption for exports.

So here you have what may be small and what may or may not be significant, but you have what would seem to be a clear advantage with regard to exports and, therefore, the balance of trade. Why wouldn't that follow?

Mr. MUSGRAVE. I may not have understood the point. Perhaps you can correct me. Suppose we introduce the value-added tax, a value-added tax of 1 percent. As a result of that, the prices of products for sale in the domestic market will rise by 1 percent. The factor costs we assume to remain unchanged. The prices of domestic products rise by 1 percent.

As far as imports are concerned, we also put this 1-percent tax on the imports so their prices relative to those of domestically produced products remain unchanged.

With regard to exports, prior to the introduction of the VAT, producing a particular product cost $100. After introduction of the VAT, for domestic sales, it costs $101. But for export purposes, by giving this $1 credit we merely keep it at $100. So it remains $100 and its position, therefore, relative to the cost of producing the same article in the United Kingdom and France is not changed. With regard to export price all the credit does is simply neutralize the effect of the value-added tax on the export price and, therefore, keeps the export price unchanged.

Chairman PROXMIRE. Exactly. But any other kind of a tax is not neutralized.

Mr. MUSGRAVE. But why would the personal income tax affect prices?

Chairman PROXMIRE. Well, it does not. The only way it could affect prices is through negotiations, union negotiations and others, or perhaps through higher cost.

Mr. MUSGRAVE. If it did, you are right. But my assumption was that in comparison with the personal income tax, prices would not be affected by the personal income tax. On the corporation tax——

Chairman PROXMIRE. Corporate income tax might do that.

My time is up.

With Mr. Conable's permission, I would like to see if Mr. Sinai would like to reply. I don't think it would be fair to just leave it here.

Mr. SINAI. I should make clear what the study is and what is isn't, because the comments make me think there may be some misunderstanding on this point. The study deals with three proposals for raising taxes by a value-added tax. There is nothing about substitution of personal or corporate profit taxes for the VAT in raising additional revenue. That is a separate question. There is a substitution implicit in the study of Federal taxes raised by VAT for State and local property taxes.

A second point is about the once and for all change in prices. Once prices change in our economy (and this is reflected in our model and it is realistic) there is a price and wage interaction that is set up because of market imperfections and because of reactions of labor to price increases, so that this thing spirals and winds. The value-added tax in conditions like today would be imposed on an already highly inflationary situation. So unless there were some sort of control, it is hard to see how the price-wage interaction would not occur. Prices would be increased initially and the change might not disappear.

On the international trade results, there is one element that Professor Musgrave did not mention and that is that the weakening of the economy in the simulations, which go over 2 years. The study is not for just one quarter; the process takes time with all kinds of feedback effects with a general equilibrium framework. Over a 2-year period the weakened economy from the value-added tax reduces the demand for imports. This is another factor that affects the trade balance.

Chairman PROXMIRE. My time is up.

Congressman Conable.

Representative CONABLE. Thank you very much.

Mr. SINAI, how would the value-added tax come out in your study relative to the corporate income tax? Is that a whale of a lot of difference there?

Mr. SINAI. This has not been studied yet. I have only thrown out some suppositions or conjectures about what the comparative results would be under certain assumptions. But this has not been done in the study. That is why I want to dispel some of the apparent misunderstanding on the nature of the study.

The comments seem to go towards a corporate tax versus VAT and a personal income tax versus VAT. That is not what the study covered. The study covered raising taxes by VAT because that is what people are talking about. The current issue is not substitution. The substitution question is more of an analytical kind of question and tells a lot about the effects of VAT. It can be done.

We have done some preliminary work but I can't tell you any definite set of numbers as I did in this study that I reported on today. It would depend on the assumptions made about shifting. It would depend on how many firms are covered by the tax. It would depend on the amounts in a large number of circumstance. Such a study could be done if one specifically asked the question about rising reveunes by increasing corporate profits taxes.

Representative CONABLE. I just wondered. You don't have any conclusion about that but do you have any thoughts about it?

Mr. SINAI. I think if you assume full shifting and raise corporate profit taxes by an amount to bring in another $20 billion or so, it would likely, in our model, turn out to be more harmful than a value-added tax. If you assume different degress of shifting in different industries, the conclusions are uncertain, especially over a 2-year period with all kinds of feedback effects. One would just have to do the analysis to find out.

Representative CONABLE. Of course, I think roughly 80 percent of our business is done through corporations, total volume. So there is some give there, too. But in the long run we really are talking about pretty much the same economic effects because it is an indirect tax that is likely in very large part to be shifted into the price structure of the goods and services that the corporations furnish.

Mr. SINAI. Yes. The point about taxes is once they have been shifted their economic effects just don't disappear over a 2-year period. There are reactions by labor with respect to maintaining their real purchasing power.

There is a decrease, after the first period, in real disposable income which will affect consumption. Given the present structure of the economy, an imperfectly competitive kind of a sutuation which is reflected in our model, this interaction over time proves to be very harmful to the growth of the economy.

Representative CONABLE. Mr. Taubman, let's talk about loopholes a little as you refer to the ADR and the investment tax credit. You referred to the long-term capital gain, rates.

What other loopholes do you feel should be dealt with?

Mr. TAUBMAN. Some are not loopholes. I would describe them as subsidies. There are other items such as the tax-free interest on municipal bonds, some of the treatment of depletion allowances. There are various subsidies.

Representative CONABLE. Have you any feeling about how much we are talking about?

Mr. TAUBMAN. The total amount of subsidies that was put out in the recent publication of the Joint Economic Committee was, I believe, $65 billion a year.

Representative CONABLE. That included, of course, preferences for homeowners.

Mr. TAUBMAN. That is correct.

Representative CONABLE. $39 billion for tax expenditures and the rest were tax subsides and so forth.

Mr. TAUBMAN. That is right.

Representative CONABLE. All those, you feel, or the bulk of them, are disruptive of progressivity and, therefore, something that should be reduced or eliminated?

Mr. TAUBMAN. That is correct.

Representative CONABLE. Let me ask you, Mr. Musgrave, this question: You know we have several functions of our tax system. One is, of course, to raise the money the Government needs. Another is to express our national priorities through tax preferences or loopholes. All those were put in originally as an effort to attract private capital into an area of national need.

The third is as a discretionary fiscal tool. We are using our tax system to restrain or to stimulate the economy. How would the VAT be as a discretionary fiscal tool? Would it be better or worse than an income tax system, assuming that we were giving in the income tax system an across-the-board increase or reduction, which seems to be the sort of thing we tended to do, in the Tax Reform Act of 1969.

Is the VAT better designed for fiscal purposes than the income tax?

Mr. MUSGRAVE. I would say perhaps slightly better, but I would not say greatly so. People have argued that one of the problems about temporary income tax changes is that consumption is a function of longer run or more permanent income. People would therefore compensate for temporary changes in disposable income due to tax rate changes, so that they would not be too effective in affecting consumption. Whereas if you have consumption tax changes, there is a favorable substitution effect with regard to consumption; namely, people will not want to buy when rates are high and will wait to buy when rates are low.

So in principle one would suspect that the consumption tax approach would be somewhat more favorable. But I do not think that the variations in a general value-added tax which one would visualize would involve tax rate changes sufficiently powerful to have a substitution effect.

If this is what one wanted, one should concentrate on having variable tax rates on consumer durables, where your tax rates might be changed by 10, 20, or 50 or so percentage points. With the value-added tax you would hardly vary roles by two or three points in order to keep the overall revenue changes from being to large.

I do not think that there would be a major substitution effect. The VAT might be somewhat more effective, but it would hardly be a major factor. You might also have some difficulites with regard to inventory accumulations which you don't have in the income tax. I would not consider this a major reason for using the VAT.

Representative CONABLE. Mr. Sinai, to come back to you, your studies show that the VAT would have a depressing effect on growth and economic activity generally.

How do these conclusions compare with the European experience? The Europeans have had recently better growth rates than we have for the most part. They are pretty strongly committed to the value-added tax. Are we to assume from this that if they had a collectible income tax and used that system instead they probably would have grown farther than they have using the value-added tax as their basic financing tool?

Mr. SINAI. It is very hard to make a comparison because there are so many differences. There is a major difference in the particular situation that now exists in this country in the wage-price sector and the interactions going on there. This factor is really the primary source of difficulty and the detrimental effect of the value-added tax on economic growth.

There are two instances of fairly decent degrees of inflation. One was in the Netherlands when the value-added tax was introduced, although there were some special circumstances there. Another is recently an increase in the value-added tax in Sweden, with some subsequent significant inflation.

I don't think it is really easy to draw the comparison. The position of foreign trade with respect to the domestic economy is different in so many of the other countries that have adopted the value-added tax.

Representative CONABLE. If you say that that is a major factor, and the fact is that they have 20 percent foreign trade where we have only 4.8 percent, is that a concession that the border tax implications of this are significant?

Mr. SINAI. Much more significant for their domestic economy than for us. As I have said, it should be clear that it is the price-wage interaction resulting from the imposition of the value-added tax that, once in effect, causes economic consequences that lead to decreased real growth. This factor is petty much what hurts the economy across the board. The inflation factor is very much what causes the interest rates to go to almost 8 percent.

Representative CONABLE. Would it be your conclusion that these other countries that have used the value-added tax as a major financing device primarily because of the difference in their trade picture?

I understand England is going to it now because she has to as a condition to Common Market extension. We hear that even the Japanese are considering this. It seems as though it is foolish on the part of the rest of the human race to be using this as its major financing device if your conclusions are correct.

Mr. SINAI. I think I would hestiate to go that far. Under certain conditions, for example, a situation where wage-price difficulties are not so great; a lower value-added tax rate; exemptions, perhaps, and rebates; or perhaps a combination with some other increases in personal and corporate tax, then I don't think the results would come out as harmful.

The study considered only the value-added tax as the major means of raising the revenue and substituting it for property taxes.

Representative CONABLE. Are there any advantages that you can see from our adopting the same kind of system as the rest of the world, apart from the economic impact in our own bailiwick?

Mr. SINAI. Not in terms of anything mechanical.

Mr. MUSGRAVE. Could I add a point on the European background? Over the last 10 years when European countires introduced value-added taxes, these value-added taxes were introduced as substitute for turn-over taxes, multiple stage taxes where you tax each transaction as the product moves up the production line. Turn-over taxes are clearly very bad taxes because they are uneven between products, depending upon the number of stages involved.

In Germany, historically they have been a major factor towards encouraging vertical integration.

Representative CONABLE. The difference is that turn-over tax gives no credit for the previous tax paid?

Mr. MUSGRAVE. That is right. The turn-over tax is imposed again and again and again on total sales, whereas the value-added tax is on the slice of value added. So that European reform was clearly an improvement.

That reform had an impact on the balance of trade position of European countries only to the extent that in substituting the value-added tax, you could more readily compute the tax component of the export product.

In some cases, it was found to be larger than under the turn-over tax and, therefore, the credit was increased. But apart from these relatively minor adjustments the change involved no difference.

Another point is that one must not compare Federal financing in the United States with central financing in European countries which, in most cases, are much more fiscally integrated. We also have sales taxes in our system at the State level. In Epropean countries, in more integrated systems, the sales tax component is to be found in the central budget. So it isn't as if we have no such taxes at all. To be sure, we have them at the retail level and they have them at the value-added level. But I think that has no bearing on the trade situation.

Chairman PROXMIRE. Mr. Taubman, you say that the value-added tax hits the cost of labor, not capital. Mr. Ture yesterday said that the present tax system is biased against capital, that there is double taxation of capital. He argued in supporting the VAT that the VAT is neutral. He said that even with ADR and the investment tax credit, and so forth, there still is a strong bias against capital in our present tax system, and the VAT would, therefore, lead to a more efficient system, more neutral, less discouraging of capital, less discouraging of incentive to reduce labor costs, and more encouraging of efficiency and productivity. How do you deal with that argument?

Mr. TAUBMAN. First of all by defining terms a little more explicitly. As Professor Musgrave pointed out and as I mentioned—in fact, all the testimony points out today—there are various types of value-added tax systems. The value-added tax that would be neutral in terms of capital-labor choice is one that allowed for true depreciation as a deduction from value-added, rather than one that allows for the instant writeoff of investment costs. One has to specify what one means by the value-added tax. A consumption type value-added tax that allows for instant writeoff of all investment is not neutral.

Because one allows for the deduction of the investment cost there is a subsidy element or nonneutral treatment of capital and labor.

As to the second part of the statement as to what extent there is double taxation on capital, to what extent the system discourages the amount of capital being invested now, that is a very complicated question.

To some extent it is true that whenever there is a tax on capital of any type, even if there were only a single integrated income tax in this country as had been proposed in Canada, there would still be discouragement to invest in capital merely because you are taxing the returns on it. I just don't think that the effects of this discouragement are very great.

And they have been more than overwhelmed by the investment tax credit and the ADR. My reason for this is ultimately the effect of the tax on capital must show up by discouraging savers from investing. All the evidence that we have in this country would suggest that the discouraging effects are very minor.

The savings rate simply hasn't changed very much from 1900 when you had no estate taxes, when you had no personal income tax. Now you have put in all this tax on income. You have put in all the taxes on capital and you still get the same savings rate.

Chairman PROXMIRE. As a matter of fact, yesterday I pointed out that the savings rate has gone up and this is something that many economists who have appeared before this committee have deplored, especially the administration economists, who say that the reason we are not moving ahead is that savings have moved up to 8 percent.

At the same time, I think there is something in what Mr. Conable implied. Take the Japanese experience. Their savings are up to 20 percent of income. Their productivity increased far more rapidly than ours. Their growth is at a far greater rate than ours. They are setting a terrific pace. Mr. Reichauer, probably the outstanding expert on Japan, has argued that if they continue their present rate of growth they will have a $6 trillion economy by the year 2000. They must be doing something right.

They have a lower tax, overall tax, imposition than we have. European countries as well as Japan, as I say, have a better performance and less emphasis on income taxes and more on sales taxes of this kind.

Do you just throw out that historical experience? Are there other reasons that overwhelm it? Is there something to the notion that our income tax system is peculiarly discouraging of efficiency, productivity and growth?

Mr. TAUBMAN. I don't ignore the historical experience in other countries. I am not sure how directly applicable it is. I recently heard a story of how Reichauer and Henry Rosovsky, who is also at Harvard, were explaining why the Japanese were growing so much faster. Their answer was "because they are different."

Chairman PROXMIRE. As a matter of fact, Mr. Reichauer, as I recall, explained it on the basis of the two things we think we have but they apparently have to a greater extent. One is an enormous emphasis on education, and two is the work ethic which makes us and even the Germans fail by comparison, according to his study.

Mr. TAUBMAN. And they certainly save a great deal more than we do. But it is not clear that the income tax structure has very much to do with how much is actually being saved in the various countries. One can go to highly different structures in various countries, and yet I would think the overall savings rates in most countries are approximately the same, even though they are highly different tax structures.

The growth of the foreign countries in recent years can be related to many different things. Europe certainly should have benefited from the formation of the Common Market and from the fact that it was starting from a very low base in such countries as Italy. That is not true necessarily for Japan, but no one has really given good explanations of why Japan grows so well, other than the fact that they are very hard working and perhaps because of the education.

Chairman PROXMIRE. Mr. Musgrave. In response to Mr. Conable you indicated that VAT might have some fiscal changes as compared to the income tax. It seems to me that this is different kind of a question. It seems to me that in terms of the effect on stabilizing the economy, counteracting cyclical movement, VAT might be considerably worse inasmuch as it is less progressive, more regressive. Therefore, in a period of recession the progressive income tax is reduced more rapidly.

In a period of inflationary growth, the progressive income tax yields more revenue and, therefore, has a much better counter cyclical effect. To the extent that the value-added tax is the tax that we would rely on more for income than the Federal income tax, it would upset and aggravate our counter cyclical tax system now, would it not?

Mr. MUSGRAVE. I think both points are right. One really relates to the effectiveness of the two taxes with regard to discretionary changes in rates, to counteract cyclical swings. There the consumption tax might have a slight edge, although not as big as all that. Your point relates, I think, to the built-in flexibility. You are completely correct in saying that the income tax, because of its progressive rates, has a much higher degree of built-in flexibility. So certainly the VAT would reduce the built-in flexibility of the average tax dollar. That is of some importance.

Although I think built-in flexibility is fine as far as it goes, I don't think it goes very far. Sooner or later I hope that the chairman of the Joint Economic Committee will be a member of a tripartite committee, together with Ways and Means and the Secretary of the Treasury who would have authority to make discretionary short-run rate changes. I think we need that now, I think that is the main thing.

Chairman PROXMIRE. Of course, the trouble with relying on judgment of persons is that judgment has so often been wrong. The Federal Reserve Board as we know over the years has been wrong more times than it has been right, in the view of many people.

When you make this automatic, it would seem to me it would give you a lesser degree of fluctuation in your economy.

Let me ask you about your assumptions on the base, because this was pretty important. Yesterday two of the economists, Mr. Lifschultz and Mr. Ture, both agreed that the base of the value-added tax would be about $700 billion and the yield at 1 percent would be about $7 billion. You say it would be $500 billion and the 1 percent yield would be $5 billion.

Mr. MUSGRAVE. Which year did they choose? Did they take 1972?

Chairman PROXMIRE. I think they took 1972. They said they would include everything except the Government sector and the tax on investment in plant and equipment, and so forth.

Mr. MUSGRAVE. What about housing?

Chairman PROXMIRE. They included housing.

Mr. MUSGRAVE. I didn't include housing. It seems to me it would be rather difficult under a VAT or for that matter under a retail sales tax to include owner-occupied housing, which, of course, is a consumption expenditure on housing. The difference it probably is explained in terms of more modest assumptions as to base. It is my suspicion that by the time one would be through it would be likely to be substantially less than $500 billion.

Chairman PROXMIRE. I would agree with that. The trouble with the Ture-Lifschultz support of VAT is they say take this nice, clean tax—simple, no loopholes, nothing. You put that into effect instead of the Swiss cheese we have for an income tax and it is a better tax.

The fact is that Congress is Congress and once you get that nice, clean VAT on the Floor, you will get all kinds of exemptions. It will be riddled as is the income tax.

Mr. MUSGRAVE. Some people say that one of the disadvantages of the corporation tax is that it is on the corporate sector only but not on business in general, and that this creates distortions. But I would think chances are that the percentage of total consumption covered by a value-added tax would, if anything, be less than the percentage of total profits covered by the corporation tax. It would certainly not be as general as people present it to be.

Chairman PROXMIRE. Mr. Taubman, I was interested to hear you downgrade the efficiency introduced by double taxation. Do you believe there is double taxation of dividend income?

Mr. TAUBMAN. For some people, and for other people it provides a way of reducing taxes.

Chairman PROXMIRE. Do you agree with that, Mr. Musgrave?

Mr. MUSGRAVE. Yes.

Chairman PROXMIRE. You rightly point out, Mr. Taubman, that there is nontaxation of other benefits from savings, security, status and so forth. I agree with your conclusions that the main inefficiencies from the income tax laws arise because of loopholes and preferential treatment.

Your conclusions are diametrically opposed by Mr. Ture. He said, "If we must increase the overall effective rate of taxes, the value-added tax in contrast to raising the income taxes or closing loopholes would be the least damaging means of doing so."

How would you meet that statement by a competent and highly respected economist?

Mr. TAUBMAN. It would give me an opportunity to respond to his criticism of my paper at the last American Economics Association meeting but I will make it gentlemanly instead.

Mr. Ture believes that saving has been substantially reduced by the imposition of taxes on capital, and he believes to stimulate savings and presumably to redirect it to areas where there is national need one must have various types of preferential treatment. I simply don't think that saving has been that responsive in the total. Certainly in the way it has been allocated it has been responsive.

People have gone into farms while they live in New York City. Money has been invested substantially in areas where there has been tax preferential treatment. But overall I just don't think one can show there has been much of an effect on tax lost by saving. By eliminating the preferential treatment my conclusion would be you are going to be reallocating investment between various sectors, reallocating savings by type of saving, but having very little effect on the overall amount of saving.

It is because of this and because I think the loopholes have been detrimental to the overall working of the economy and the faith of the American people in the fairness of the income tax system that it would be much better to go ahead and restore faith, restore equity in the tax system, and not have much of an effect on the total amount of capital formation in the country. He obviously disagrees.

Chairman PROXMIRE. So you would put more emphasis on the believability and general support for the income tax system because you discount the discouraging effects on investment and savings?

Mr. TAUBMAN. That is right. In addition, we have many other subsidies to investment, these include the investment tax credit, ADR, double declining balance depreciation, and various other provisions.

Chairman PROXMIRE. Mr. Sinai, the witnesses yesterday called into question the progressivity of the corporate profits tax. They questioned in the first place that its incidence was very clear, that that would very well be a tax passed on as a consumption tax, especially over the long pull. Is there any doubt in your mind that given the equally uncertain status of knowledge of the burden of the VAT which is the more progressive? Could you argue that there is no real difference in progressivity between the corporate profits tax and a value-added tax?

Mr. SINAI. If we are talking about an across-the-board value-added tax, it is definitely more regressive. If we throw in rebates, exemptions, and a new social program or two one would have to carefully think about it.

Chairman PROXMIRE. Why do you react so instinctively? Give me a reason behind your argument that the corporate income tax is assuredly more progressive than a value-added tax would be.

Mr. SINAI. A value-added tax will be fully shifted forward where it is applied. A corporate tax will respond to economic conditions.

Chairman PROXMIRE. Mr. Lifschultz yesterday argued that that wouldn't necessarily happen, that the value-added tax would be borne to a considerable extent by the producers.

Mr. SINAI. It is possible that if the economy were very, very slack, the actual full shifting might not occur. But I would think that with the price structure of the economy, VAT would simply be tacked on to the price and just about fully passed forward. That is one of the assumptions we made, almost complete full shifting forward. The corporate income tax, on the other hand, will respond very much to economic conditions.

Representative CONABLE. In the long term won't the corporate income tax be shifted almost entirely, too?

Mr. SINAI. I think Professor Musgrave is the expert on shifting. I think he knows much more than I do about shifting.

Chairman PROXMIRE. Professor Musgrave and then Mr. Taubman.

Mr. MUSGRAVE. I like to look at the shifting question in two ways. One is the question whether in the more or less immediate price adjustment and response by the firm the tax would be reflected in increased prices and thus be passed on. As far as this adjustment is concerned, as Mr. Sinai pointed out, one would expect a very large part of the value-added tax to be thusly passed, while the odds would would not be as high for the corporation tax.

I happen to be one among the few economists who have argued that the larger part of the corporation tax may well be passed in the form of short ones in price adjustments. But I would bet more highly on the value-added tax than the corporation tax.

Chairman PROXMIRE. In the long run I take it it is virtually all passed on.

Mr. MUSGRAVE. In the long run, I would understand something like the following: A tax is imposed. The imposition of this tax affects the rate of saving. The reduction in the rate of saving reduces the growth rate. Because the rate of growth of the economy is reduced, 15 years from now GNP is smaller.

Depending on the production function, the smaller GNP will be reflected in both lower wages and lower prices, than they would have been if the growth rate had been higher. So the burden is shared. The burden is shared in the long run among wages and profits.

That is an argument that would apply to a competitive economy even if I assume that there is no passing on in the first instances. But that argument would also apply to the individual income tax, to any tax which affects savings.

Chairman PROXMIRE. If you have a utility and there is no competition, and it is regulated, the whole thing is passed on. We know that the corporation income tax imposed on the American Telephone & Telegraph Co. and every utility is borne by the consumer because they are allowed to make a certain rate of return.

Mr. MUSGRAVE. That is the kind of administered-price type of adjustment which I think exists. But even if that didn't exist there would be this long run possibility of higher effects on growth.

Chairman PROXMIRE. As far as something like that is concerned where you don't have a difference, it makes no difference if you have a corporate or value-added tax.

Mr. MUSGRAVE. If we assume that there is this administered-price passing on of the corporation tax, probably all economists would prefer a retail sales tax to the corporation tax.

Chairman PROXMIRE. Why?

Mr. MUSGRAVE. Because if you have a retail sales tax of 3 percent, all prices go up by 3 percent, and why should we only increase the prices of corporate sector products but not other sector products? If we want to exempt some consumer goods, then I would rather exempt low cost clothing, whether it is corporate or not.

Chairman PROXMIRE. Mr. Taubman.

Mr. TAUBMAN. I just wanted to add to that. I would generally agree with what has been said about passing on of the corporate income tax. But in terms of the short-run effect of a value-added tax the available evidence that you have from changes in excise taxes in 1954 and in 1964 would be that they would be passed on almost immediately. Price changes there occur within the space of 1 month. The same has been true when changes in cigarette and gasoline taxes occur, and I think even liquor taxes.

Chairman PROXMIRE. Then I take it between an increase in the corporation income tax and an increase in the value-added tax you don't have a great deal of preference, it doesn't make much difference.

Leon Henderson used to argue that we ought to abolish the corporation income tax as soon as possible, for many of the reasons that we have been bringing out in this discussion.

Mr. MUSGRAVE. Provided, of course, that we tax the retained earnings to the shareholder, which is an important proviso.

Mr. SINAI. On the shifting of the corporate income tax, it may not be the same as in the value-added tax. It is possible that there may be some time delays in the shifting of the corporate income tax, whereas in VAT, as Mr. Taubman indicated, the experience of excise taxes suggests it would be very, very fast. That would diminish any preference for the value-added tax on those grounds, in my mind.

Chairman PROXMIRE. Mr. Musgrave, you refer to the need to raise $50 billion or more in revenue by 1975 if we are to meet our social goals. I think $50 billion is on the low side. I have been one who has been emphasizing the waste we have in Government, arguing we can cut back military and space spending. But with the collosal size of the health program coming on, the welfare program coming on, the antipollution programs, and so forth, I think $50 billion is conservative and I think it could be easily $100 billion to do the job we have to do. In this context, I gather you would accept a value-added tax with a credit. Would this be preferable to raising income taxes?

Mr. MUSGRAVE. If I could have my choice, I would raise income taxes. But if I can have the value-added tax in such a way that up to, say $10,000 of AGI the pattern is much the same, I really wouldn't care too much. The problem would then be to supplement that by income tax reform at the upper end of the scale.

Chairman PROXMIRE. Let me tell you what concerns me about the value-added tax. I think you can make a good, solid, intellectual argument as we had yesterday that it doesn't make a great deal of difference.

On the other hand what concerns me is the way we operate here in the Congress is if we get a value-added tax on the books there will be a tendency to reduce the income tax very sharply and reduce the progressive features of the income tax, erode it by all kinds of preference and loopholes much faster than we have done in the past.

Whenever we have to raise a tax we will raise the value-added tax and when we have to lower a tax it will be the income tax. Pretty soon, the income tax will disappear or be reduced very greatly and the value-added tax will take its place. So we will have a national sales tax.

I am asking you now to step out of your role as an economist and look on this as a social scientist. Do you see this as a realistic concern or would it really make a great deal of difference?

Mr. MUSGRAVE. I think it is an entirely realistic concern. From my reading of the political scene, there is no question but that a great deal of pressure behind the value-added tax is precisely directed at reducing progressive taxation. Yet how do I get an adequate income maintenance program, a negative income tax with an acceptable marginal rate costing $40 billion at least? How do I get these things? That stands on the other side.

In a way, it is a gamble. I thought about the possible ways of perhaps bypassing this difficulty. I wonder whether, for instance, if a value-added tax with credit were used to finance a much more substantial income maintenance program or the health program, whether it could be assigned to a trust fund. In many ways that is a bad thing to do. If you have a fiscal system which is well run, you want to stay away from a earmarking of that sort.

Maybe if it was combined initially with a substantial income tax reform, if one could have these two things together, then perhaps one would start out with a substantial gain and the battle may come out on the favorable side. I would certainly feel one can't go into just introducing it in a setting in which we continue to reduce income taxes. But if it was combined with income tax base reform, which I would emphasize is important primarily for equity reasons, for social justice reasons—I think it can be overestimated as a revenue producer—if it was combined with that, and if then the value-added tax was clearly earmarked for some major additional program so it couldn't be used to dilute the income tax in financing the general budget, perhaps one could think of some safeguards of this sort to bypass this danger which I think is a very real danger.

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. It is just possible that some of the people advocating the value-added tax now are not so much concerned with the progressivity of the income tax as they are with its painfulness. It is a very visible tax. The value-added tax is an indirect tax. It goes into the price structure. People can complain about the foodstore at the corner because the prices are higher, but they are not going to complain that much about the government because its role is invisible. The VAT is a painless tax. It is a kind of governmental narcotic in that sense, as opposed to the income tax. The American people are quite upset about taxation generally and the value-added tax will provide government with a way of burying the cost and the pain of maintaining government services. Is there anything to that?

Mr. MUSGRAVE. This, of course, is what one of my better known Harvard colleagues who is not a great defender of high income has been arguing for years. Galbraith has been arguing for years that it is much more important to get the public services. If the only way the public will buy them is from a hidden tax, you will gain on balance.

For me, as someone who has spent much of his life on the beauties of a perfect tax system, this is a rather painful thought.

Chairman PROXMIRE. Even though I recognize the need for these priorities, I think these priorities ought to be justified. I think there ought to be a discipline. You don't get the kind of pressure that you ought to have for holding down excessive costs, waste, and so forth, unless you get some kind of consciousness on the part of the taxpayer in criticism.

It is true that there are many programs that we ought to have that we don't have. But at the same time I just dread to think of a situation in which our taxes are raised in a much less painful way, an easier way, and you don't get the kind of criticism that would be most wholesome and desirable in eliminating the waste we now have in so many of our programs, not just military but many others.

Representative CONABLE. Unfortunately, so many people who advocate the income tax as the best solution favor it primarily because of its redistributive features. This creates the impression constantly that the income tax can be raised without it costing Smoky Joe Public anything, because somebody else is going to pay it. That is terribly misleading. Eighty percent of the taxes we collect are going to come from the average citizen any way you slice it. He is the only tax asset numerous enough to provide the broad base that is required to finance massive spending. I get very concerned about the whipsawing of the public that goes on in all this talk about reform. I am interested in reform. I have been a strong advocate of it on the Ways and Means Committee where responsibilites and opportunities are real and where you have to live with the decisions you make.

It is fun to advocate it on the floor of the House, knowing that the "Great By-God Ways and Means Committee" will stand between you and having to do anything about it.

But I do think that we are inclined to use the progressivity of the income tax as a justification frequently for arguing against having to do anything painful to the average public.

Chairman PROXMIRE. There is a great deal you can do about the income tax at the present time that would not hit the average taxpayer as much as it would hit those who escape taxation. It is true that there is a limit to that. The total incomes above $100,000 are 8 percent, and if you confiscated the entire amount it wouldn't have a great effect but it would have some. There is a very significant morale factor, a justice factor, also, in the opportunity that people with high incomes now have to either reduce their taxes to something farcical or eliminate it.

Representative CONABLE. We are having a nice dialog here. The Ways and Means Committee has taken a lot of lumps because the Tax Reform Act of 1969 became a tax relief act, something no one intended for it to do. Do you know why? There were some substantial reforms in that act, but nobody would have believed it unless we gave relief, because everybody has been told so constantly, "You have to pay high taxes because somebody else isn't paying his share."

After we had made the various adjustments that involved the narrowing of a number of loopholes the net effect on the tax paid by the average taxpayer was next to nothing.

Chairman PROXMIRE. He got a tax cut in some cases.

Representative CONABLE. He got a tax cut because we cut taxes, not because we reformed the system. The reform was real, but the results were not apparent, without the tax cut.

Chairman PROXMIRE.The Smoky Joe Corporation did even better.

Let me see if we can summarize and complete this testimony which has been most helfpul. This has been one of the best days we have had.

I gather from this discussion that in today's American world prospects for the foreseeable future all three of you would favor in descending order, and correct me if I am wrong, the following actions to raise a large amount of Federal revenue: (1) Close loopholes in income taxes, (2) raise income tax rates, (3) the value-added tax. Is that a fair summary?

Mr. SINAI. I would say yes. Again, it is the either/or situation. It is possible that combinations of various taxes could be worked out so you don't have to go with this either/or kind of a question. I definitely agree with the ranking if you put it in those terms. I did raise one point earlier which was that one can think about combining a closing of loopholes with some income tax change. And, if you have to go to a value-added tax to keep it very, very small, and use some other means to get more revenue.

Chairman PROXMIRE. Once you get it, it is like being a little bit pregnant.

Mr. TAUBMAN. I would agree with that order but I would also put in there quite close to the top the changes in estate tax as opposed to income tax.

Representative CONABLE. How much money do you think we could raise that way?

Mr. TAUBMAN. You could easily raise another $5 billion.

Chairman PROXMIRE. $5 billion a year?

Mr. TAUBMAN. You are only collecting $4 billion now, so you could double it, I think.

Mr. MUSGRAVE. I would only add that the loophole closing part is a preliminary to whatever you do about alternative two and three. The real revenue will come out of alternative two and three, if one thinks of $30, $40, or $50 billion. I think the public should be told that.

Chairman PROXMIRE. You would rate two ahead of three definitely, is that right?

Mr. MUSGRAVE. Yes. If I had my choice I would rate it ahead. But I would entertain three. I would rather have three than nothing in view of the priorities problem.

Chairman PROXMIRE. Your Galbraithian associations would push you toward three, if necessary? That is, your desire for public services which you think have been neglected.

Mr. MUSGRAVE. Yes, plus the fact that if I adjusted the credit, it really makes no difference. It is going to be largely a difference in name for 80 percent of the taxpayers. It really makes no difference.

In other words, this is not a general retail sales tax but a retail sales tax with credits.

Representing CONABLE. I would like to just mention in connection with Professor Taubman's remarks about the estate and gift taxes that I agree we ought to do something on it.

We have done nothing on it for a long time. It has been a high priority item for 3 years and will probably be a high priority item for this year too. If we double it and raise $5 billion, that is almost as much as my committee decided to spend in revenue sharing, a new program, yesterday. So it is a very modest factor in the overall budget. We are talking about big money here, not just a mere $5 billion. It is hard to keep such unreal figures in any reasonable perspective.

Chairman PROXMIRE. Well, $5 billion here and $5 billion there, pretty soon it adds up.

Gentlemen, I want to thank you very much for a fine presentation.

We will conclude our hearings on the value-added tax with the session tomorrow morning at 10 o'clock with the appearance of three distinguished economists: Mr. Edward Budd, of Pennsylvania State University; Mr. Robert J. Lampman, of the University of Wisconsin; and Mr. Lester C. Thurow.

(Whereupon, at 11:50 a.m., the committee recessed, to reconvene at 10 a.m., Friday, March 24, 1972.)

THE VALUE-ADDED TAX

FRIDAY, MARCH 24, 1972

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room S-407, the Capitol Building, Hon. William Proxmire (chairman of the committee) presiding.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; John R. Karlik and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

For the past 3 days the committee has been addressing itself rather specifically to the merits of the value-added form of taxation as compared to alternative sources of revenue. One important criteria by which we judge various forms of taxation is their relative impacts. We have found wide agreement that a broadly based value-added tax would be regressive. That is, it would tend to aggravate rather than rectify existing disparities and distribution of after-tax income.

Some of our witnesses have suggested devices by which this regressivity could be partially offset, but only at the cost of greatly increased administrative complexity.

If the existing distribution of before-tax income were not so unequal, the question of tax progressivity or regressivity would be less important.

Since the distribution of before-tax income is very unequal, our tax system has become an important redistributive device. To some extent there is no alternative as an equalizer of income.

For many disabled or otherwise unable to work, Government transfer payments are the only means of providing the necessary minimum income. Likewise, we wish to reduce either large concentrations of income stemming from the ownership of capital, assets or inherited wealth, and the tax system would seem to be about the only way.

Over a wide spectrum, the distribution of income could be made more equal by equalizing the distribution of before-tax earned income as well as increasing the progressivity of the tax system.

The Joint Economic Committee has just published a study by Prof. Lester Thurow and Robert Lucas of MIT which analyzes the distribution of earned income in the United States and makes suggestions for new policies which would encourage more equal distribution of earned income.

This morning Professor Thurow will summarize some of the results of that study and the other two witnesses, both of whom are noted authorities, will offer their critique. I also plan to ask all three witnesses some questions leading to the impact of income distribution in the present tax system and the proposed value-added tax.

I will ask Professor Thurow to speak first. In addition to the study he just completed for the committee, he is the author of a recent book entitled "The Impact of Taxes on the American Economy" and several other studies.

Our next witness will be Edward Budd, professor of economics at Pennsylvania State University, who will be followed by Robert Lampman, professor of economics, at the University of Wisconsin. Both of these gentlemen are noted scholars.

I should explain to all of our witnesses we have recently adopted a new technique. We have had difficulty for years with our witnesses. We have had to discipline the members of the committee, limiting them to 10 minutes on each round. But while we have cautioned our witnesses to take 10 to 15 minutes they have have gone on and on.

The day before yesterday the first witness took 18 minutes, the next 23, and the next 33. As a result, we have timing devices that will go off and then you will be told when your deadline comes.

I understand that there is one witness this morning who would feel very badly if he is not given at least 15 minutes. I don't know. I hate to break a new system that we are just beginning. Let's see if we can try to confine it to that. Maybe you can use your ingenuity by replying to one of my questions by just adding on whatever you intended to say in your initial statement.

Mr. Thurow, go right ahead.

STATEMENT OF LESTER C. THUROW, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. THUROW. Since I wrote a published staff report, let me briefly state what I think is the important thrust of this report, then I will give my remaining minutes to the other two gentlemen, if that meets with your pleasure.

Chairman PROXMIRE. It certainly meets with my pleasure that you brief your own, but you cannot yield what you save. Incidentally, we are going to have roll calls at 10:45 and 11 o'clock. We will have to recess and I will come right back after the roll calls.

Mr. THUROW. The report that was written for this committee starts out with two propositions. One emphasizes the role that the political process has to play in a market economy. People oftentimes forget what is the first statement of any Economics I textbook. That would be something like the following: If a market economy starts off with what that society regards as an optimal distribution of income, it does nice things. We tend to remember the nice things and forget the fundamental if statement. If it is on the right track it does nice things.

The real function of Government is to adjust the distribution of income to put it on the right track, whatever that is. That is a fundamentally noneconomic problem and a fundamental noneconomic starting point for the economic system that I think we too often forget.

The report then goes on and summarizes a variety of income distribution statistics about the economy, by age, race, sex, et cetera.

All of that data is basically available in previous Government sources, but it is interesting to see it all put together.

What the report is basically trying to argue, however, is that current policies to affect the distribution of income focus too much on the supply side of the market.

If we see a person with low income or if we see an income distribution that we think is too unequal, we say to ourselves let me go and change somebody's characteristics. I will change him with education and training so that he is a high earning man or woman.

This report argues that existing economic analysis of the way the labor market works gives us a misleading view of what giving people education and training will do to their earning capacity.

People look at the labor market as if it were a system of competitive wage bidding. If you have a job that I like and I can do the job, I bid against you and I lower your wages in order to get that job away from you.

I would argue that there is very little of that kind of job bidding that really goes on in the economy. Not zero, but very little. As a result, the major part of the paper describes what I call a job competition model of the labor force. Individuals come into the labor force with a set of background characteristics that determines their cost of training to fit into various kinds of jobs.

We will be ranked by employers based on these background characteristics and given jobs in accordance with them. On the simplest level what I am arguing that we ought not to be so much asking the question how is income distributed across different individuals? But how are individuals distributed across jobs or income?

I am arguing that to some extent we distribute individuals across incomes rather than incomes across individuals. Let me give you an example.

Imagine you took an eighth-grade graduate and make him into a college graduate. In conventional economic analysis his wage would go up because he has more skills. The wages of the remaining eighth-grade graduates would go up because there is a smaller supply. The wages of college graduates go down because there is a bigger supply. The result is a three-pronged equalizing effect. The individual's wages go up, the wages of low-income individuals go up, the wages of high-income individuals come down. I would argue, however, that this is a misleading view.

In a job competition model when you train another person to be a college graduate you essentially enlarge the pool of college graduates. This doesn't affect the wages of existing college graduates but that man goes out and takes a job that used to be the best high school job away from the best high school man. His income may rise because his training costs have fallen, but you have a bumping process in the labor market.

I would remind you that in the 1930's, Macy's had a college only hiring rule for its clerks. That was not because they were going to pay the clerks more because they were college graduates but because they were available. If college graduates are available they are cheaper workers to train and they will be hired for a lot of jobs that have not been traditionally college jobs.

If you think about the total process there is a lot more of this bumping in the labor market than competitive wage bidding. Education and training still affect the distribution of income, they do, but that they affect it in a very different way. This report tries to look at how they affect it.

What this all comes down to, is an argument that we must look much more to demand side techniques to change distribution of income.

I think I would be willing to make the argument very strongly. To make most of the existing supply side techniques for changing people's characteristics work, you need to do something to the demand for people as well.

I suggest that there are several things you might want to think about if you were really serious about changing the distribution of income. One factor is conventional but nonetheless true. There is no program that will work in a recession economy. Full employment doesn't solve the problem, but it is an absolutely necessary condition to make any of these supply programs work.

Then I suggest various other techniques that the Federal Government might adopt them if it wished to compress the private wage structure, to encourage or force employers to narrow their wage differentials. One of these is the guaranteed job where you offer to employ anyone who will work at some wage level. This forces private employers to provide better jobs than the available Government jobs.

The Automation Commission of a few years ago worked on guaranteed jobs and provided the basic information, though there are a lot of things we don't know about Government guaranteed jobs, like how many housewives would go to work if they had a guaranteed job.

Some of the other things that you might want to think about are outlined. You might want a system of bonuses, where you could bribe employers to narrow the wage differentials that they pay. I would argue very strongly that we should look at the experience of World War II, which is the last time at which our income distribution became noticeably more equal.

It is clear from this experience that a lot of what it takes to make incomes more equal is sociology and sociological acceptance. Take the current situation in Sweden where college workers are striking to raise their income relative to blue collar workers. They say you can either raise our income or lower theirs, we don't care. If we want to have a policy where the average high school man catches up to the income of the college man, we have to have a majority of the college men agreeing that that is what should be done.

Thank you.

Chairman PROXMIRE. Thank you, Mr. Thurow.

(The prepared statement of Mr. Thurow follows:)

PREPARED STATEMENT OF LESTER C. THUROW

THE AMERICAN DISTRIBUTION OF INCOME: A STRUCTURAL PROBLEM

To set the stage for these hearings let me briefly review the high lights of the study that I prepared for this committee.

One of the main, if not the major, economic functions of government is to establish the right distribution of economic voting power. Not only must it establish such a distribution initially, it must continually reestablish such a distribution each year. Market economies will efficiently and equitably produce and distribute goods and services if they start with the optimum initial distribution of economic voting power, but market economies will not automatically regenerate such a distribution. But what is the right, optimum, or desired distribution of income? Fundamentally, the answer cannot be found in economic analysis. It is a moral problem that revolved around our collective judgments as to the proper degree of equality or inequality. In our political system, you gentlemen, and the President of the United States, have been elected to make such decisions.

Your starting point in making these decisions must obviously be the current distribution of economic resources. If the existing distributions are acceptable, nothing need be done. If the existing distributions are unacceptable, something must be done. To aid in your decisions a portion of the study reviews the current state and past trends in the distribution of income and wealth across age, sex, and racial groups. While many of the trends are well-known, I would call your attention to the distribution of wealth. Approximately 2½ percent of the American families own 44 percent of all the private assets of the United States. The wealthiest 20 percent of the population owns over 75 percent of all private assets while the poorest 25 percent of all families have no net worth (their debts equal their assets).

If you are not satisfied with the current distributions of income and wealth, you have two broad options. You can use tax and transfer policies to alter the distribution of disposable income or you can attempt to alter the distribution of market incomes by altering individuals earning capabilities. At your direction, I have focused on this latter possibility.

Historically our public efforts to alter the distribution of income have focused on efforts to alter individuals earning abilities by altering individual characteristics—education levels and manpower training levels. Underlying such programs is the acceptance of a particular view of how the labor market works. According to this theory, the supply of low income workers would be reduced in the process of such education and training programs. As a result, the wages for low income workers would rise. Conversely, the supply of high income workers would be enlarged and their wages would be reduced. Thus education and training would have a three pronged effect on the distribution of income. (1) Some individuals would be raised from low income jobs to high income jobs. (2) Wages for low income jobs would rise, and (3) wages for high income jobs would fall. The result, a more equal distribution of market earnings.

While a number of theoretical objections can be raised about this view of the effectiveness of education and training programs, it is perhaps more instructive to look at the post-war experience to see if existing education and training programs have had the impacts that have been predicted for them. Manpower training programs are of such recent vintage and so small in relationship to the size of the economy that it makes sense to concentrate in the impacts of educational expenditures.

Among adult white males (the group that does not suffer from discrimination or part-time work), the distribution of education has become noticeably more equal. In 1950 the bottom quintile of this group had 8.6 percent of the total number of years of education while the top quintile had 31.1 percent of the total number of years of education. By 1970 the share of the bottom quintile has risen to 10.7 percent and that of the top quintile had dropped to 29.3 percent. At the same time, the distribution of income among white males has become more unequal. From 1949 to 1969 the share of total income going to the lowest quintile has dropped from 3.2 percent to 2.6 percent and the share going to the highest quintile rose from 44.8 percent to 46.3 percent. Education has been becoming more equally distributed yet income has been becoming more unequally distributed.

While there are a variety of ad-hoc explanations that might explain why the massive post-war expenditures on education have not had the predicted effect on the distribution of income, I would like to argue that the failure springs from a fundamental failure to analyze how the labor market actually works as opposed to how it should work in a 'textbook' economy. While textbook economies rely on 'wage competition' to equalize incomes when the distribution of education becomes more equal, the real world has substantial elements of 'job competition' that modify the basic results. To make the differences as clear as possible let me describe the impact of education in a world with job competition and no wage competition. In reality, both types of competition exist together and both must be taken into account.

In a job competition model two sets of factors determine an individual's income. One set of factors determines an individual's *relative* position in the labor queue; another set of factors, not mutually exclusive of the first, determines the actual distribution of job opportunities in the economy. Wages are paid based on the characteristics of the job in question and workers are distributed across job opportunities based on their relative position in the labor queue. The most preferred workers get the best (highest real income) jobs.

In a job competition model labor skills do not exist in the labor market. New workers come into the labor market with a variety of background skills and characteristics. These background characteristics (education, age, sex, etc.) affect the cost of training a worker to fill any given job, but they do not in general constitute a set of skills that would allow the worker to enter directly into the production process. Most cognitive job skills, general and specific, are acquired either formally or informally through on-the-job training after a worker finds an entry job and the resultant promotional ladder.

Such a training program is evident in the American economy. A survey of how American workers acquired their cognitive job skills found that only 40 percent were using skills that they had acquired in formal training programs or in specialized education. In addition, most of these reported that some of the skills that they were currently using has been acquired in informal casual on-the-job training. The remaining 60 percent acquired *all* of their job skills through informal casual on-the-job training. Even among college graduates over 2/3 reported that they had acquired cognitive job skills through informal casual processes on the job. When asked to list the form of training that had been the most helpful in acquiring their current job skills, only 12 percent listed formal training and specialized education.

Thus the labor market is not primarily a market for matching the demands and supplies of different job skills, but a market for matching trainable individuals with training ladders. Except for background characteristics, the demand for job skills creates the supply of jobs skills since the demands for labor determine which job skills are taught. For new workers and entry level jobs, background characteristics form the basis of selection. Those workers with the background characteristics that yield the lowest training costs will be selected. For workers with job experience, existing job skills (including skills like reliability and punctuality) are relevant to the selection process to the extent that they lead to lower training costs.

Based on training costs, potential workers are ranked in a labor queue from the worker with the lowest training costs to the worker with the highest training costs. Employers work down from those at the top of the queue to those at the bottom of the queue. The best jobs will go to the best workers and the worst jobs will go the worst workers. Given a need for untrained (raw) labor, some workers at the bottom of the labor queue will receive little or no training. In periods of labor scarcity, however, training will extend farther and farther down the labor queue as employers are forced to train more costly workers to fill job vacancies. If there are an inadequate number of jobs, those at the bottom of the labor queue will be left unemployed.

Even given a labor queue, however, there is still the problem of determining the actual distribution of job or income opportunities. Since the labor queue is used to distribute individuals across job opportunities, the labor queue determines a group's relative position in the distribution of job opportunities but it does not determine the shape of the job distribution. Individuals compete for job opportunities based on their relative positions in the labor queue but the shape of the job opportunities distribution need not be similar to that of the labor queue. An equal group of laborers (with respect to training costs) might be distributed across a relatively unequal distribution of job opportunities. After receiving the resultant on-the-job training, the initially equal workers would have unequal marginal productivities since they now have unequal skills. As a result, the distribution of income is determined by the distribution of job opportunities and not by the distribution of the labor queue. The same factors that affect the shape of the labor queue may, however, affect the distribution of job opportunities (see below).

The shape of the income or job distribution across which individual laborers will be distributed is governed by three sets of factors—the character of technical progress, the sociology of wage determination, and the distribution of training costs. Each is the subject of extended discussion but let me convey the essential results. First, the existence of more college graduates will not in and of itself change technology to generate more of the jobs typically held by college graduates. Second, sociological views about what constitute just wage—differentials play an important role in determining the actual distribution of earning opportunities. Third, more education (and thus lower training costs) will not automatically lead to a more equal distribution of earnings. The exact, impacts depend upon a complicated set of factors, but let me give you a simple example.

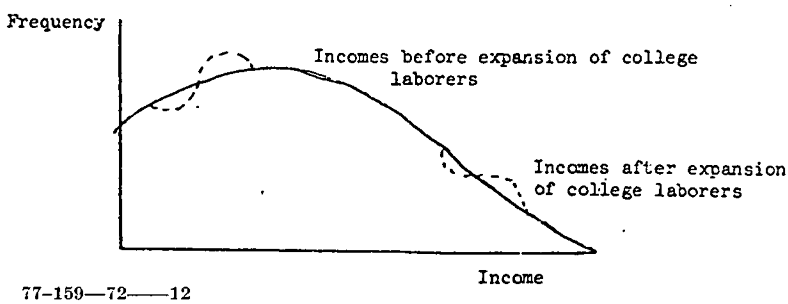
Assume that you took an 8th grade graduate and spent enough money to give him a college education. The new college laborer would replace an existing high school laborer in what had previously been the best job opportunity for high school workers. Observed wages in this job would rise since training costs would fall. High school laborers would be bumped down the job distribution and fill the job vacated by the 8th grade graduate who had been given a college education. Observed wages in this job would rise since training costs have fallen. Thus the income distribution might shift from that given by the solid lines to that given by the dotted lines. What should be noted is that the distribution of income need not become more equal simply because the distribution of education has become more equal.

Essentially I would argue to you that the post-war experience indicates a substantial amount of job competition in the economy. Predictions based on a wage competition view of the world do not accord with reality; predictions based on a job competition view of the world do accord with reality. As a result, it is necessary to be much more agnostic about the equalization benefits of education and training than is commonly the case.

CHART I

POSSIBLE CHANGES IN THE DISTRIBUTION OF INCOME BROUGHT ABOUT BY

TRANSFORMING GRADE SCHOOL LABORERS INTO COLLEGE LABORERS



As the previous analysis indicated, government programs to alter the structure of incomes cannot be focused entirely on the supply side of the labor market. No one denies the importance of programs to alter personal characteristics, but differences in personal characteristics do not explain all or even most of the observed differences in wages and salaries. Only 30 percent of the observed income differences between black and white males can be attributed to differences in personal characteristics. The remaining 70 percent is explained in terms of demand side phenomena (wage and job discrimination, full employment, etc.). Between women and men demand side elements are even more important. After standardizing for all of the personal characteristics that are demanded in the labor market, women earn only 50 percent of what men earn. The remaining 50 percentage points are explained by differences in the demand for women and men. As a consequence, no program for altering personal characteristics can hope to equalize incomes of blacks and whites or male and females. Efforts must be directly focused on relative wages and job characteristics.

If historical experience is to be used as any guide to the factors that are necessary to cause an increase in the equality of the income distribution, it is necessary to go back to the Great Depression and World War II. In both instances, the distribution of income seems to have become noticeably more equal. From 1929 to 1941 the share of total income going to the bottom 40 percent of the population rose from 12.5 percent to 13.6 percent while the share of income going to the top 5 percent fell from 30.0 percent to 24.0 percent and the share of income going to the top 20 percent fell from 54.4 percent to 48.8 percent. From 1941 to 1947 the share going to the bottom 40 percent rose to 16.0 percent while the share going to the top 5 percent fell to 20.9 percent and the share going to the top 46.0 percent. In both cases, alterations in the demand side, rather than the supply side, of the market seem to have provided the mechanism for equalizing incomes.

In the Great Depression, an economic collapse was the mechanism for changes. Individual fortunes were lost, firms collapsed, and a wage structure emerged that was noticeably more equal than that before the collapse. While interesting, the deliberate collapsing of an economy in order to equalize the distribution of income is not a policy that commends itself. World War II is more interesting from this vantage point.

As a result of an overwhelming social and political consensus that the economic burdens of the war should be relatively equally shared, the federal government undertook two major actions. First, it instituted a very progressive income tax (more progressive than the current federal income tax) that converted a regressive tax system into a mildly progressive tax system. Second, it used a combination of wage controls and labor controls to equalize market wages. This was accompanied by a conscious policy of restructuring jobs to reduce skill requirements and to make use of the existing skills of the labor force. To some extent old skill differences were simply clocked with a new set of relative wages and to some extent skill differentials were actually collapsed. When put together the two factors lead to an equalization of market incomes that was not dissipated after the war ended.

To some extent the wage policies of World War II were a deliberate attempt to change the sociology of what constitutes "fair" wage differentials. To some attempt the sociology judgments changed as a result of the war (war burdens were to be equally shared) and this was reflected in wage patterns. As a consequence of the widespread concensus that wage differentials should be reduced, it was possible to make a deliberate attempt to reduce wage differentials. While it may be difficult to alter sociological judgments concerning the definition of "fairness", such changes are an important ingredient in any attempt to alter the structure of wages. Since wage negotiators always look at relative wages as well as absolute wages, it is very difficult to change relative wages unless the participants believe that relative wages should as a matter of "fairness" be changed.

Perhaps it is impossible to generate a consensus on the desired degree of equality without a major war, but there are certainly actions that can be taken to reduce barriers to shifts in the relative distribution of income. The first is to minimize fears of job competition by insuring a full or overly full employment economy that *never* suffers from business cycles and recession. If existing employees fear that every new employee is a potential competitor for their jobs, they will simply refuse to provide the informal on-the-job learning that is necessary for an effective transfer of skills. Second, in a world of labor *shortages* every employer has an incentive to go beyond his existing labor force—to recruit and upgrade workers that he would not otherwise recruit or upgrade. Without shortages every employer will stick to his traditional labor force. Labor shortages will not automatically generate the desired distribution of income, but labor shortages are a necessary ingredient in any policy to do so. Even in wartime, labor shortages, as much as desires to equalize wartime burdens, explain the observed restructuring of the labor force.

In addition to an economy with substantial and persistent labor shortages, it is necessary to think of how the government can directly compress wage differentials without resort to the elaborate wartime structure of wage and labor controls. The answer must be found in public employment opportunities. Instead of adjusting its wage scales to the private economy, the public sets its wages at the desired level and places pressure on the private economy to adjust to the public wage structure. Thus, the government might guarantee to employ everyone who wants work at $2 per hour. This would force the private economy to pay a minimum wage of $2 per hour, but it would also eliminate the adverse unemployment effects that spring from higher minimum wages.

To encourage changes in the relative wage structure of the private economy, manpower expenditures should also shift from their present focus on personal background characteristics to a focus on the real objective—a restructuring of incomes. If the objective is to alter the distribution of wages and salaries, expenditures should be directed toward this purpose. The easiest method for doing this is to establish a system of payments that rewards employers for altering their relative distribution of wages and salaries. For some workers this might involve more training, for some workers this might involve a restructuring of jobs within a firm, and for some workers new employers might find it easiest to make use of their talents. In any case, the government would let the private economy determine the best technique for altering relative wages. It would merely stand ready to pay a bonus for any alterations that actually occurred.

Such a system has the advantage that the government only pays for the output that it wants. If relative incomes change, it pays. If relative incomes do not change, it does not pay. It is not involved with paying for different inputs, such as training, that may or may not cause the desired results. The program is either successful or it has a zero cost. If it has a zero cost or a low cost (indicating little change) the initial bonus level is too small and must be increased to bring about the desired results.

Realistically, any rapid improvement will also require some kind of quota system to place pressure on major organizations to bring their wage and salary structures into line with the desired national structure of incomes. To be effective any quota should focus on the ultimate objective—a change in the distribution of income. The goal would be expressed in terms of the firm's income distribution. Thus, if the aim were to aid minorities, the firm would be required to pay an appropriate fraction of the income in each quintile of its income distribution to minorities.

An adequate package of government programs to alter the structure of incomes would include the following: (1) Research and development expenditures directed toward finding techniques of production that used new skill mixes, (2) efforts to alter sociological judgments about "fair" wage differentials, (3) fiscal and monetary policies designed to create labor shortages, (4) public wage scales deliberately set to force the private sector of the economy to adjust to them, (5) a system of direct bribes to encourage compression of the private wage structure and to help pay for it, and (6) a set of flexible quotas. With such a package of public policies, the relative structure of earnings could undoubtedly be compressed.

Substantial efforts, however, must be directed toward altering the demand for labor as opposed to altering the personal characteristics of individuals looking for work. Without such efforts on the demand side of the market, most programs for altering personal characteristics will have little payoff. Such has been the case in the past and will be the case in the future.

It must be realized, however, that the current structure of market incomes is deeply embedded in the American economy. There are no easy solutions. Any set of programs that actually altered the structure of incomes would require enormous political pressure on its behalf. From the point of view of economics tax-transfer policies are by far the easiest to implement yet these are probably the most difficult to implement from a political viewpoint. Unfortunately, there simply are no governmental policies that will just slightly affect the economy yet cause large changes in the market distribution of earnings.

Chairman PROXMIRE. Mr. Budd, please proceed.

STATEMENT OF EDWARD C. BUDD, PROFESSOR OF ECONOMICS, THE PENNSYLVANIA STATE UNIVERSITY

Mr. BUDD. My comments will range over all of Thurow's paper and not just this one aspect, which I will touch on at the end.

In examining changes in inequality over time, economists have preferred to emphasize relative distribution and relative income differentials rather than absolute ones.

Roughly speaking, at least in the postwar period, relative distribution, as measured by the shares of income received by various fractile groups, for example, the top fifth of income recipients, has remained approximately constant.

This, in turn, implies that absolute or dollar differentials among groups in different parts of the distribution have been increasing in the same proportion as has average income. Thus, if Smith initially gets twice as much as Jones, he will still get twice as much after both receive a 10 percent increase in income, even though the dollar gap between them will necessarily have been increased by 10 percent.

This is a rather simple piece of arithmetic, and one that hardly deserves either the emphasis given it by Thurow or the headline billing that it received in The Washington Post. Of course, whether changes in inequality ought to be judged for policy purposes in relative or absolute terms cannot be determined without introducing the ethical judgments to which I have already referred.

In any case, most of the data contained in the tables to this prepared statement are in terms of relative incomes and income differentials. [To convert to dollar differentials, the following steps would be necessary: Divide the share in income of each of the two groups to be compared by the size of the group (for example, for the lowest fifth, divided by 20), multiply each by the average (mean) income for the year in question, and subtract one from the other.]

Although virtually all of the size distribution series suggest approximate constancy in the relative distribution of before-tax income among consumer units (families and unrelated individuals) in the postwar period, there is some evidence that the average income of those in the middle of the distribution (from about the 45th percentile to the 95th) rose about 6 to 8 percent more than the average incomes of either those in the lower part of the distribution (roughly the bottom 40 to 45 percent of recipients) and those at the top (the top 4 or 5 percent), at least up to 1960 or 1961.

For the period since 1960, there is some evidence, at least from the CPS, which is virtually the only source on size distribution that we have for the past decade, of a small movement toward more equality in the distribution among consumer units and among families.

There is, however, some conflicting evidence; the relative distribution among either men or women has showed little change; the distribution of all tax returns, increased inequality. Although not too much should be made of the latter, the pattern still remains mixed.

I have used rather broadly defined percentile groups for these comparisons, since the quality of our data for bottom groups is not all it might be; indeed, I would not attach any significane, as does Thurow, to estimates of the share of the bottom 5 percent.

It should also be noted that the share of the top 5 percent of families quoted by Thurow is an underestimate; the correct figure is closer to 16 percent rather than the 14 percent he uses.

Whether these changes are substantive ones that call for explanation in terms of more fundamental forces, or whether they simply reflect changes in recipient units or in coverage and definition of income, is hard to say.

There is also some uncertainty concerning the effect on income size distributions produced by differences in the income concept, as well as by the deficient reporting of income in field surveys such as the CPS and on tax returns.

At the Bureau of Economic Analysis, Social and Economic Statistics Administration, we have just completed a study of the size distribution of family personal income among consumer units for 1964, which throws some light on these questions.

What, for instances, is the effect on the relative distribution of including imputed income as it is currently estimated in the national income accounts?

The answer is provided by comparing, in table 3 of my prepared statement, the distribution of total money income (line 4) with the distribution of money plus imputed income (line 5).

There appears to be an increase in the share of the bottom two quintiles and the top 5 percent, with a consequent reduction in the share of the middle and upper groups, although the effects are relatively small.

A similar effect may be noticed when personal contributions for social insurance (mostly the social security taxes paid by employees and self-employed) are deducted from money and imputed income to arrive at BEA's concept of family personal income, although the share increase at the bottom is restricted to the bottom quintile. Again, however, the redistributive effects are small.

The BEA's concept of personal income includes only dividends of shareholders, not their proportionate share of corporate undistributed profits.

I would estimate that if corporate saving and taxes were imputed to the income of shareholders, the share of the top 5 and 1 percent of consumer units in the resulting income concept would be increased by about 1½ and 1 percentage points respectively.

If the corporate profits tax were allocated to shareholders so as to place all incomes on a before direct tax basis, these two shares would be raised by another 2½ and 2 percentage points, or a total of 4 and 3 points respectively.

The way in which the corporate income of shareholders is treated in our income concept clearly has important consequences for measuring the degree of inequality at the top of the distribution.

The biases associated with the underreporting and nonreporting of income in field surveys of income such as the CPS, on which we must still place primary reliance for time series studies, are more substantial. The details of the BEA estimation process are too involved to be described here and are referred to briefly in the notes to table 3 of my prepared statement.

The final results can be obtained by comparing the original CPS money income distribution for 1964—line 1 of table 3 of my prepared statement—with the total money income distribution shown in line 4. The effect of the correction procedures is clearly to raise the share of the bottom quintile (by 0.5 percentage points) and that of the top 5 percent (by 2.7 percentage points).

More strikingly, the mean incomes of these two groups relative to those in the third and fourth quintiles of the distribution are increased by over 20 percent, and the mean income of the top 1 percent relative to the latter two quintiles is increased by over 40 percent.

These findings can be partially explained by the fact that of all income types, wages and salaries are the most accurately reported, both in field surveys and on tax returns, and constitute the single most important source of income for the middle income groups.

Time is lacking to do more than mention some of our other findings. The effect of our methods is to raise the estimates of the income of families headed by older persons, particularly those 65 and over, by a greater proportion than families of younger heads, and for a reason similar to that just cited.

In addition, table 3 of my prepared statement is limited to relative income comparisons. Since the BEA estimation process resulted in raising the average income of consumer units by $1,400, or 22 percent, the whole distribution was shifted upward when tabulated in terms of dollar income size brackets.

Some of the corresponding size distributions for 1964 are shown in table 6 of my prepared statement, as is an extrapolation of the 1964 money income and family personal income distribution to 1970.

I want next to make some remarks on the relation of public policy to income distribution. The single most important redistributive weapon of the Federal Government is tax and transfer policy.

Thurow rightly emphasizes the importance of some variant of the negative income tax or family assistance plan in raising low incomes, not only the incomes of those unable to work, but of the working poor and near poor as well.

If integrated with the Federal personal income tax, such a plan would make that tax a more effective redistributive device than the available data indicate it now is. Unfortunately, at BEA we have not yet estimated an after Federal income tax distribution for 1964 to compare with our before tax distribution (although the family personal income concept is, of course, net of social security taxes).

The old OBE series, which our work is designed to replace, does show for 1962 an increase in the shape of the bottom two quintiles from 15.5 percent in before tax (family personal) income to 16.4 percent in after tax income, with the corresponding share of the top quintile reduced from 45.5 to 43.7 percent, and that of the top 5 percent, from 19.6 to 17.7 percent.

The average income tax rate of the bottom two quintiles in that year was 5.3; for the top quintile, 13.9; and for the top 5 percent, 19.1.

When account is taken of all taxes paid or borne by consumer units, State and local as well as Federal, the tax structure is, as Thurow notes, close to being proportional. This finding is also borne out by a recent study by the Bureau of the Census.

More precisely, the study shows that the average tax rates for the bottom and top brackets are somewhat higher than they are for the middle of the distribution, corroborating the earlier findings of Musgrave and Gillespie.

I recognize that taxes and transfers are often changed for reasons other than redistributive ones. But I would urge that policymakers take redistributive effects into account, even if they do not view them as primary. This is particularly relevant to the current debate on the value-added tax. Depending on what form the tax might take and what would be done with the revenue from it, it could have important redistributive consequences. One proposal made by Dean Richard Lindholm is to use part of the revenue from such a tax to reduce the corporate income tax rate.

As can be inferred from the data I have already cited, the share of the top groups would be raised by any reduction in the latter tax, either in dividends or in their imputed share of corporate retained earnings. Such a rise would be on top of the possible regressive effects of a VA tax itself, at least if it were restricted to consumption.

Economists have tended to emphasize redistributive fiscal policy rather than policies designed to reduce inequality in market determined incomes themselves. I would agree with Thurow that these latter policies are also of considerable importance and should not be overlooked.

The one I want to emphasize is the achievement and maintenance of full employment. In periods of slack demand unemployment generally falls more heavily on those in less skilled jobs, as employers tend to retain those workers in which they have invested more in training. In any case, the unemployed or the partially employed, whether from the upper or the lower part of the earnings distribution, are pushed toward the bottom, with a consequent increase in inequality.

What is not generally recognized, and what economists have long emphasized, is that slack labor markets result in widening of wage differentials, as the demand for less skilled and less highly trained labor declines relative to more highly paid workers with more training.

Empirical studies using prewar, war, and postwar data have served to verify the relationship between unemployment and inequality. At Penn State we are trying to quantify the effects on size distribution of changes in the unemployment rate by computer simulation, athough as yet we have no results on which I can report.

By way of underlining this point, Paul Schultz in a recent paper has gone so far as to say that:

Apparently most, if not all, of the reduction since 1939 in the inequality of annual earnings among men and women in the United States can be attributed

to the reduction in postwar unemployment and the improved management of aggregate demand.

One problem of maintaining a high level of employment is the increased risk we may run of raising the rate of inflation. Actually, that risk may well be worth running anyway, in view of the obvious benefits associated with reduced unemployment. Still, it is worth asking, what would be the effect of a higher rate of inflation considered by itself on inequality?

David Seiders and I have attempted to provide an answer to this question in a recent study. We found from our model and a resultant computer simulation that a change in the rate of inflation of, say, 5 percent, for example, from an annual rate of 2 percent to an annual rate of 7 percent, would serve to reduce the average income of the bottom two quintiles of the distribution relative to the groups above them (running from the 41st to the 96th percentile in the relative distribution) by about 1 percent, and to reduce the average income of the top 3 percent of consumer units relative to the same middle group by less than 1 percent. To us, the size distribution effects of what is a rather large change in the rate of inflation appeared to be minor.

Further, the share-reducing effect that we found on the lower quintiles could easily be offset, in my opinion, by a more prompt upward scaling of transfer payment benefits to compensate for inflation, as now appears to be congressional policy for social security benefits, since much, if not most, of transfer income goes to the bottom group.

Thus, I would agree with Thurow that antiinflationary policies, insofar as they produce increased unemployment, are harmful to the interests of lower income groups, although I do not share the view that inflation per se (apart from employment effects) helps to improve the relative position of the poor and near poor.

One of the most interesting aspects of Thurow's paper is his model of job competition, which he contrasts with the neoclassical wage competition model of the labor market, and its implications for the role of education and formal training in equalizing wage differentials.

The implications for public policy, on the other hand, are less clear, at least to me. One might agree with Thurow that "government programs to alter the structure of incomes cannot be focused entirely on the supply side of the labor market" without necessarily agreeing on the kinds of policies that might be required to alter the structure of demand.

I have already commented on the importance of full employment and a tight labor market.

Thurow suggests using public wage scales and public employment as a means of affecting private wage differentials. To be effective in altering such differentials seems to me to require a guarantee of public employment at the rates set for specific jobs, as Thurow recognizes in connection with his minimum wage guarantee of $2 per hour for public employment. With this approach there would be problems in employing such persons usefully and productively.

Thurow's bonus system, whereby "employers would be paid relative to the degree to which they raised the wages of their low income workers relative to the national average" may well have some merit.

At first glance it seems similar to certain aspects of a negative income tax plan, the major difference being that the "subsidy" would be paid directly by the Treasury to the low income workers involved, rather than having it first go through the hands of private employers.

It may well be, however, that more can be done by way of affecting relative incomes with a bonus system to employers than would be possible with a negative income tax plan. The former would have the added advantage that workers would appear to be earning their full income through the market, rather than receiving part of it in the form of transfer payments. (At least the form in which a subsidy is paid appears to be of vital importance to another occupational group—the farmers!)

On the other hand, the quota system he suggests seems to me to present difficult problems, of efficiency, equity, and enforcement.

While I would concede that we have much more to learn about this subject, I doubt that existing relative wage differentials are as functionless as this approach to the problem would imply.

Thank you.

Chairman PROXMIRE. Thank you, Mr. Budd.

(The prepared statement of Mr. Budd follows:)

PREPARED STATEMENT OF EDWARD C. BUDD

My remarks will be directed primarily to Professor Thurow's interesting study, *The American Distribution of Income: A Structural Problem*, although I want to add some comments on the measurement of inequality and its change during the postwar period.

Thurow rightly emphasizes the importance of formulating and obtaining agreement on the social value judgments required to make political decisions on the appropriate amount of income redistribution, a matter in which economists admittedly can provide only limited assistance. I would venture the guess, however, that there would be relatively broad agreement on the objective of achieving more equality than now exists if it were a "free" good, that is, if the achievement of more equality did not conflict with other important goals such as efficiency and growth. So as to get around the problem of vested interests in ascertaining such a consensus, we might ask the electorate an imaginary question: into what kind of a society, in which you could not pick your own relative income position in advance, would you prefer to be born—a society in which there was substantial inequality, or one in which income was more equally distributed?

Of course, as Thurow points out, an individual's own well-being may well depend on the well-being of others—he considers himself better off if others below him in the distribution are made better off, even if he must contribute something himself toward that result. There is a rapidly growing professional literature on the theoretical aspects of such "Pareto optimal" redistribution. Coupled with the external effects associated with substantial inequality, a limited case can be made for some redistribution that does not depend entirely on one's own ethical position on inequality. Ultimately, however, the need for ethical judgments cannot be bypassed; although economists' primary contributions come, not in providing such judgments, but in measuring inequality, analyzing its causes, and pointing up the probable economic consequences of alternative courses of action and their relative costs.

Thurow points up several alternative goals for equalization: equality of opportunity (or what he calls improving economic mobility); equality of result;

and equality among social or economic groups, each with its own degree of income dispersion. Undoubtedly there is more of a social consensus on the first than on the second: as he notes, "taxpayers may well be willing to help low income individuals earn a larger income but be unwilling to give low income individuals a higher income." The third goal is of primary relevance to the difference between black and white incomes, and between the earnings of males and females. Blacks and women have suffered and are currently suffering sufficiently from discrimination to make this a priority goal with respect to these groups, but I personally would not like to see the goal generalized indiscriminately to other groups,' particularly those defined along economic or occupational lines. Is it just, for example, to follow policies which attempt to raise the average income of farmers relative to those not living on farms, when to do so means raising further the incomes of rich farmers as well as poor ones, as some of our agricultural programs do?

In examining changes in inequality over time, economists have preferred to emphasize *relative* distribution and *relative* income differentials rather than absolute ones. Roughly speaking, at least in the postwar period, relative distribution, as measured by the shares of income received by various fractile groups, e.g., the top fifth of income recipients, has remained approximately constant. This in turn implies that absolute or dollar differentials among groups in different parts of the distribution have been increasing in the same proportion as has average income. Thus if Smith initially gets twice as much as Jones, he will still get twice as much after both receive a 10 percent increase in income, even though the dollar gap between them will necessarily have been increased by 10 percent. This is a rather simple piece of arithmetic, and one that hardly deserves either the mephasis given it by Thurow or the headline billing that it received in the *Washington Post*. Of course, whether changes in inequality ought to be judged for policy purposes in relative or absolute terms cannot be determined without introducing the ethical judgments to which I have already referred. In any case, most of the data contained in the appendix to this statement are in terms of relative incomes and income differentials. [To convert to dollar differentials, the following steps would be ncessary: divide the share in income of each of the two groups to be compared by the size of the group (e.g., for the lowest fifth, divide by 20), multiply each by the average (mean) income for the year in question, and subtract one from the other.]

Although virtually all of the size distribution series suggest approximate constancy in the relative distribution of before tax income among consumer units (families and unrelated individuals) in the postwar period, there is some evidence that the average income of those in the middle of the distribution (from about the 45th percentile to the 95th) rose about 6 to 8 percent more than the average incomes of either those in the lower part of the distribution (roughly the bottom 40 to 45 percent of recipients) and those at the top (the top 4 or 5 percent), at least up to 1960 or 1961. [See Table 1 for evidence from the CPS and from Statistics of Income (IRS); data for other sources are given in the first reference cited in Table 1 (p. 259).] This same trend in the relative distribution of income among persons, both males and females, is even more pronounced. For example, by 1960, as compared with 1947, the average income of the bottom two quintiles of all males had fallen by well over 20 percent, and the average income of the top 5 percent, by 7 percent, relative to those in the middle of the distribution. [See Table 2.] There was, therefore, no overall movement in inequality in this period: it decreased in the lower part, and increased in the upper part, of the distribution.

For the period since 1960, there is some evidence, at least from the CPS, which is virtually the only source on size distribution that we have for the past decade, of a small movement toward more equality in the distribution among consumer units and among families. The average income of the bottom 40 percent of families, relative to those in the middle and upper groups, for example, rose by 7 percent, while the average income of those in the top 5 percent fell relative to those in the middle by about 3 percent. There is, however, some conflicting evidence: the relative distribution among either men or women has showed littled change; the distribution of all tax returns, increased inequality. Although not too much should be made of the latter, the pattern still remains mixed.

I have used rather broadly defined percentile groups for these comparisons, since the quality of our data for bottom groups is not all it might be; indeed, I would not attach any significance, as does Thurow, to estimates of the share of the bottom 5 percent. It should also be noted that the share of the top 5 percent of families quoted by Thurow is an underestimate; the correct figure is closer to 16 percent rather than the 14 percent he uses.

Whether these changes are substantive ones that call for explanation in terms of more fundamental forces, or whether they simply reflect changes in recipient units or in coverage and definition of income, is hard to say. We do know that there has been a trend towards the undoubling or consumer units during the postwar period, as grown children, young couples, and particularly aged persons and couples have chosen to set up housekeeping for themselves. Such newly created units have relatively low incomes and will thus be counted as units at the bottom of the distribution. For example, subfamilies, whose members are counted as part of primary families in the statistics, have fallen as a percent of primary families from 9 percent in 1947 to 6 percent in 1950, 3½ percent in 1960, and 2¼ percent in 1969.

Even when changes in the recipient unit and the number of earners it contains are known, however, we should be careful about jumping to conclusions about the resultant effects on the size distribution. I myself would not want to predict the precise effect of undoubling on income size without first running some computer simulations with data files. Similarly, I would urge caution in accepting the conclusion that the gain by the middle of the distribution at the expense of the two tails that I previously referred to can be accounted for by the postwar increase in the proportion of working wives and in female participation in the labor force. Although he notes otherwise, Thurow's discussion of this problem seems to ignore the fact that not all wives work, hence not all couples receive the average increase in the second column of his Table 2 from the wife. The average increase in earnings for those with a working wife is considerably more than that implied by his column 2 (indeed it is equal to column 2 divided by column 1). Families in which wives work will therefore be shifted up in the distribution relative to those in which only the husband works. After families are reranked in accordance with the combined incomes of husbands and wives, it is no longer obvious that the relative distribution will show less (or indeed more) inequality than would the distribution of husbands' incomes alone. "Selective mating", by increasing the correlation between husbands' and wives' earnings, would, of course, be a disequalizing factor, although the higher the husband's earnings, at least above a certain size (about $8,000 to 10,000 in Thurow's Table 2), the less the probability the wife will work, since there is less need for her to supplement the family's earnings. Thus, I am somewhat less concerned than is Thurow about the potential disequalizing effect on the black-white family income differential of possible increases in white female labor force participation rates.

There is also some uncertainly concerning the effect on income size distributions produced by differences in the income concept, as well as by the deficient reporting of income in field surveys such as the CPS and on tax returns. At the Bureau of Economic Analysis, Social and Economic Statistics Administration, we have just completed a study of the size distribution of family personal income among customer units for 1964, which throws some light on these questions. What, for instance is the effect on the relative distribution of including imputed income as it is currently estimated in the national income accounts? The answer is provided by comparing, in Table 3, the distribution of total money income (line 4) with the distribution of money plus imputed income (line 5). There appears to be an increase in the share of the bottom two quintiles and the top 5 percent, with a consequent reduction in the share of the middle and upper groups, although the effects are relatively small. A similar effect may be noticed when personal contributions for social insurance (mostly the social security taxes paid by employees and self-employed) are deducted from money and imputed income to arrive at BEA's concept of family personal income, although the share increase at the bottom is restricted to the bottom quintile. Again, however, the redistributive effects are small. The BEA's concept of personal income includes only dividends of shareholders, not their proportionate share of corporate undistributed profits. I would estimate that if corporate saving were imputed to the income of shareholders, the share of the top 5 and 1 percent of consumer units in the resulting income concept would be increased by about 1½ and 1 percentage points respectively. If the corporate profits tax were allocated to shareholders so as to place all incomes on a before direct tax basis, these two shares would be raised by another 2½ and 2 percentage points, or a total of 4 and 3 points respectively. The way in which the corporate income of shareholders is treated in our income concept clearly has important consequences for measuring the degree of inequality at the top of the distribution.

The biases associated with the underreporting and nonreporting of income in field surveys of income such as the CPS, on which we must still place primary reliance for time series studies, are more substantial. The details of the BEA estimation process are too involved to be described here and are referred to briefly in the notes to Table 3. The final results can be obtained by comparing the original CPS money income distribution for 1964 (line 1 of Table 3) with the total money income distribution shown in line 4. The effect of the correction procedures is clearly to raise the share of the bottom quintile (by .5 percentage points) and that of the top 5 percent (by 2.7 percentage points). More strikingly, the mean incomes of these two groups relative to those in the third and fourth quintiles of the distribution are increased by over 20 percent, and the mean income of the top 1 percent relative to the latter two quintiles is increased by over 40 percent. These findings can be partially explained by the fact that of all income types, wages and salaries are the most accurately reported, both in field surveys and on tax returns, and constitute the single most important source of income for the middle income groups.

Time is lacking to do more than mention some of our other findings. The effect of our methods is to raise the estimates of the income of families headed by older persons, particularly those 65 and over, by a greater proportion than families of younger heads, and for a reason similar to that just cited. In addition, Table 3 is limited to relative income comparisons. Since the BEA estimation process resulted in raising the average income of consumer units by $1,400, or 22 percent, the whole distribution was shifted upward when tabulated in terms of dollar income size brackets. Some of the corresponding size distributions for 1964 are shown in Table 6, as is an extrapolation of the 1964 money income and family personal income distribution to 1970.

I have not had time to analyze carefully the black-white income differentials presented by Thurow. However, his conclusion that "the major source of income gains for minority groups has been geographic mobility" is more the result of a statistical calculation than of economic analysis, and should not be applied uncritically. By moving out of the South, blacks do not automatically obtain the average earnings of the blacks in the region to which they move. To be sure, the supply of black labor in the South is reduced, with an effect on the Southern black-white income differential that we can observe in the data. But the supply of black labor in the other regions to which they move is increased, with consequent pressure on the wages of emigrating blacks as well as the blacks already living in the region. At least this is one plausible interpretation of the change, shown in my Table 4, in the white-nonwhite (family) income differentials in the three other regions between 1953 and 1969, which appear to have moved, at least to a small extent, against nonwhites. As the depressing effect of black migration on labor supply in the North and West begins to wear off, I would expect the black-white differential in these regions to begin to narrow. This is not an argument, of course, for a do nothing policy with respect to employment and job discrimination against blacks, either in the North or the South.

It is true, as Thurow notes, that wealth is more unequally distributed than income and that the association between size of income and size of net worth for consumer units is relatively close. The correlation is not, however, perfect, so that ranking consumer units by income or by wealth does make a difference. While in 1962 the top 20 percent of consumer units *when ranked by size of income* received 46 percent of total money income, that same group owned just 57 percent of all wealth. On the other hand, the top 20 percent of consumer units when ranked by size of *wealth holdings* owned 77 percent of all wealth. The relevant data from the SFCC, which Thurow uses, may be found in Table 5.

I want next to make some remarks on the relation of public policy to income distribution. The single most important redistributive weapon of the Federal Government is tax and transfer policy. Thurow rightly emphasizes the importance of some variant of the negative income tax or family assistance plan in raising low incomes, not only the incomes of those unable to work, but of the working poor and near poor as well. If integrated with the Federal personal income tax, such a plan would make that tax a more effective redistributive device than the available data indicate is now is. Unfortunately, at BEA we have not yet estimated an after Federal income tax distribution for 1964 to compare with our before tax distribution (although the family personal income concept is, of course, net of social security taxes). The old OBE series, which our work is designed to replace, does show for 1962 an increase in the share of the bottom two quintiles from 15.5 percent in before tax (family personal) income to 16.4 percent in after tax income, with the corresponding share of the top quintile reduced from 45.5 to 43.7 percent, and that of the top 5 percent, from 19.6 to 17.7 percent. The average income tax rate of the bottom two quintiles in that year was 5.3; for the top quintile, 13.9; and for the top 5 percent, 19.1. When account is taken of all taxes paid or borne by consumer units, state and local as well as Federal, the tax structure is, as Thurow notes, close to being proportional. This finding is also borne out by a recent study by the Bureau of the Census. More precisely, the study shows that the average tax rates for the bottom and top brackets are somewhat higher than they are for the middle of the distribution, corroborating the earlier findings of Musgrave and Gillespie.

I recognize that taxes and transfers are often changed for reasons other than redistributive ones. But I would urge that policy makers take redistributive effects into account, even if they do not view them as primary. This is particularly relevant to the current debate on the value-added tax. Depending on what form the tax might take and what would be done with the revenue from it, it could have important redistributive consequences. One proposal made by Dean Richard Lindholm is to use part of the revenue from such a tax to reduce the corporate income tax rate. As can be inferred from the data I have already cited, the share of the top groups would be raised by any reduction in the latter tax, either in dividends or in their imputed share of corporate retained earnings. Such a rise would be on top of the possible regressive effects of a VA tax itself, at least if it were restricted to consumption.

Economists have tended to emphasize redistributive fiscal policy rather than policies designed to reduce inequality in market determined incomes themselves. I would agree with Thurow that these latter policies are also of considerable importance and should not be overlooked. The one I want to emphasize is the achievement and maintenance of full employment. In periods of slack demand unemployment generally falls more heavily on those in less skilled jobs, as employers tend to retain those workers in which they have invested more in training. In any case, the unemployed or the partially employed, whether from the upper or the lower part of the earnings distribution, are pushed toward the bottom, with a consequent increase in inequality. What is not generally recognized, and what economists have long emphasized, is that slack labor markets result in a widening of wage differentials, as the demand for less skilled and less highly trained labor declines relative to more highly paid workers with more training. Empirical studies using prewar, war, and postwar data have served to verify the relationship between unemployment and inequality. At Penn State we are trying to quantify the effects on size distribution of changes in the unemployment rate by computer simulation, although as yet we have no results on which I can report. By way of underlining this point, Paul Schultz in a recent paper has gone so far as to say that "Apparently most, if not all, of the reduction since 1939 in the inequality of annual earnings among men and women in the United States can be attributed to the reduction in postwar unemployment and the improved management of aggregate demand."

Thurow's statements on changes in distribution during the Great Depression are not necessarily inconsistent with this position. What little evidence we have on the collapse from 1929 to 1933 shows that it was associated with increased inequality, particularly of earnings. This does not deny that inequality may have fallen over the period as a whole, from 1929 to 1941, as a result of other forces although our data are none too good for such comparisons. And I would attribute a much greater role to excess demand and tight labor markets in World War II as the force leading to a compression of wage differentials than does Thurow, although there is no denying that wage and job controls during the war helped to narrow percentage differentials. I am not sure, incidently, why Thurow appeals in this connection to the wartime increase in tax rates as an additional force that helped "lead to an equalization of *market* incomes" (italics supplied). In any case, the impact of wartime increases in personal income tax rates (as contrasted with the introduction of the corporate income tax) in reducing inequality in the relative distribution was quite modest.

While there may be small differences between us in our interpretations of past trends and events, there is complete agreement on the importance of maintaining full employment by appropriate monetary and fiscal policies. Thurow on page 42 brings out some additional benefits of tight labor markets that I have not: forcing employers to reconsider their skill requirements and too upgrade workers, rather than simply relying on excessive education and skill requirements as a means of screening applicants and rationing jobs in times, such as today, when there are too many applicants for too few jobs; reducing the fear of existing employees that the newly hired are competitors for thier jobs rather than representing a necessary expansion of employment required to meet permanent increases in demand.

One problem of maintaining a high level of employment is the increased risk we may run of raising the rate of inflation. Actually, that risk may well be worth running anyway, in view of the obvious benefits associated with reduced unemployment. Still, it is worth asking, what would be the effect of a higher rate of inflation considered by itself on inequality? David Seiders and I have attempted to provide an answer to this question in a recent study. We found from our model and a resultant computer simulation that a change in the rate of inflation of, say, 5%, e.g., from an annual rate of 2% to an annual rate of 7%, would serve to reduce the average income of the bottom two quintiles of the distribution relative to the groups above them (running from the 41st to the 96th percentile in the relative distribution) by about one percent, and to reduce the average income of the top 3 percent of consumer units relative to the same middle group by less than one percent. To us the size distribution effects of what is a rather large change in the rate of inflation appeared to be minor. Further, the share reducing effect that we found on the lower quintiles could easily be offset, in my opinion, by a more prompt upward scaling of transfer payment benefits to compensate for inflation, as new appears to be congressional policy for social security benefits, since much, if not most, of transfer income goes to the bottom group. Thus, I would agree with Thurow that anti-inflationary policies, insofar as they produce increased unemployment, are harmful to the interests of lower income groups, although I do not share the view that inflation per se (apart from employment effects) helps to improve the relative position of the poor and near poor.

One of the most interesting aspects of Thurow's paper is his model of job competition, which he contrasts with the neoclassical wage competition model of the labor market, and its implications for the role of education and formal training in equalizing wage differentials. While I am not sure I fully grasp the nature and implications of his model, I would not want to quarrel with the notion that it does little good to improve the quality of the labor force through education and formal training if the structure of labor markets, for whatever reason, is not such as to permit an adjustment of relative wages to changes in labor supply. The schooling simply becomes a means of determining who is to be picked to startclimbing the limiting number of job ladders available, as determined by the fixed structure of relative wages and the level (as well as composition) of aggregate demand. Thurow's formal model emphasizes the (presumably inverse) relation between education level and the employer's cost of on-the-job training as the major selection criterion in his job queue, although it could equally well be rationalized by the use of education as a proxie for other characteristics the employer is looking for, such as "ability". The implications of this view of the labor market for the human capital model developed by a number of professional economists may well be as serious as Thurow claims.

The implications for public policy, on the other hand, are less clear, at least to me. One might agree that "government programs to alter the structure of incomes cannot be focused entirely on the supply side of the labor market" without necessarily agreeing on the kinds of policies that might be required to alter the structure of demand. I have already commented on the importance of full employment and a tight labor market. Thurow suggests using public wage scales and public employment as a means of affecting private wage differentials. To be effective in altering such differentials seems to me to require a guarantee of public employment at the rates set for specific jobs, as Thurow recognizes in connection with his minimum wage guarantee of $2.00 per hour for public employment. With this approach there would be problems in employing such persons usefully and productively.

Thurow's bonus system, whereby "employers would be paid relative to the degree to which they raised the wages of their low income workers relative to the national average" may well have some merit. At first glance it seems similar to certain aspects of a negative income tax plan, the major difference being that the "subsidy" would be paid directly by the Treasury to the low income workers involved, rather than having it first go through the hands of private employers. It may well be, however, that more can be done by way of affecting relative incomes with a bonus system to employers than would be possible with a negative income tax plan. The former would have the added advantage that workers would appear to be earning their full income through the market, rather than receiving part of it in the form of transfer payments. (At least the form in which a subsidy is paid appears to be of vital importance to another occupational group—the farmers!) On the other hand, the quota system he suggests seems to me to present difficult problems, of efficiency, equity, and enforcement. While I would concede that we have much more to learn about this subject, I doubt that existing relative wage differentials are as functionless as this approach to the problem would imply.

TABLE 1.—SHARES OF INCOME RECIPIENTS IN TOTAL INCOME, SELECTED YEARS, 1947-1969 (PERCENT)

Data source, recipient unit, and year	Bottom 2 quintiles (1-40)	Next 2 quintiles (41-80)	Top quintile (81-100)	Groups within top quintile: Next 15 percent (81-95)	Top 5 percent (96-100)	Top 1 percent (100)
CPS: Consumer units (total money income):						
1947	13.9	40.6	45.5	26.6	18.9	6.8
1950	13.5	41.3	45.2	27.7	18.5	6.6
1955	13.7	42.3	44.0	26.6	17.4	6.6
1960	13.6	42.1	44.2	26.6	17.7	6.1
1967	14.2	41.9	43.9	26.4	17.5	6.0
1968	14.7	42.4	43.1	26.0	17.1	5.5
IRS: All returns (adjusted gross income):						
1950	15.5	38.1	46.4	24.3	22.1	9.3
1955	14.1	39.6	46.4	25.7	20.7	8.9
1960	13.2	40.4	46.4	26.3	20.1	7.6
1967	11.5	40.4	48.1	27.2	20.9	8.0
CPS: Famlies (total money income):						
1947	16.9	40.1	43.0	25.5	17.5	6.2
1950	16.4	40.7	42.9	25.4	17.5	6.2
1955	17.0	41.7	41.3	25.2	16.2	5.5
1960	16.9	41.5	41.6	25.2	16.4	5.6
1967	17.7	41.2	41.1	24.7	16.4	5.7
1968	18.0	41.5	40.5	24.5	16.0	5.5
1969	18.0	41.6	40.4	24.6	15.8	NA
IRS: Joint returns (adjusted gross income):						
1955	18.4	38.7	42.9	23.6	19.3	7.6
1960	17.9	39.6	42.5	23.9	18.6	7.1
1967	18.3	39.3	42.4	23.2	19.2	7.8

NA=not available.

Source: Edward C. Budd, "Postwar Changes in the Size Distribution of Income in the U.S.," American Economic Review, May 1970, table 4. Data for CPS families for 1969 were computed from Current Population Reports, series P-60, No. 80, table 2.

TABLE 2.—SHARES OF PERSONS 14 YEARS OLD AND OVER IN TOTAL MONEY INCOME, SELECTED YEARS, 1947–64 (PERCENT)

	Bottom 2 quintiles (1–40)	Next 2 quintiles (41–80)	Top quintile (81–100)	Next 15 percent (81–95)	Top 5 percent (96–100)
Males:					
1947	14.4	39.5	46.1	24.8	21.3
1950	13.7	40.4	46.0	24.6	21.4
1955	13.1	42.5	44.5	25.3	19.2
1960	12.1	42.0	45.9	26.2	19.7
1964	12.0	41.8	46.2	27.7	18.5
1969	11.9	42.0	46.1	27.4	18.7
Females:					
1947	11.5	40.4	48.1	27.4	20.7
1950	10.6	41.8	47.5	29.5	17.9
1955	9.8	39.9	50.2	30.7	19.5
1960	9.1	39.8	51.1	32.1	19.0
1964	8.6	39.6	51.8	32.1	19.7
1969	9.2	40.5	50.3	31.3	19.0

Source: Bureau of the Census, Technical Paper No. 17, Table 35. 1964 and 1969 calculated from Current Population Reports, series P-60, No. 47, p. 36, and No. 75, table 43, pp. 91-93.

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TABLE 3.—SHARES OF CONSUMER UNITS IN TOTAL INCOME, 1964 (PERCENT)

Steps in estimation process* and income concept	Bottom quintile (1-20)	2d quintile (21-40)	Middle quintile (41-60)	4th quintile (61-80)	Top quintile (81-100)	Bottom 2 quintiles (1-40)	Next 2 quintiles (41-80)	Next 15 percent (81-95)	Top 5 percent (96-100)	Top 1 percent (100)
(1) CPS: money income	3.41	10.40	17.37	24.85	43.97	13.81	42.22	27.01	16.96	5.79
(2) CPS and tax returns before audit	3.29	10.33	17.06	24.24	45.08	13.72	41.30	26.41	18.67	7.10
(3) CPS and tax returns after audit	3.47	10.37	16.99	24.12	45.05	13.84	41.11	26.19	18.77	7.18
(4) BEA: total money income	3.93	10.67	16.70	23.48	45.22	14.60	40.18	25.67	19.55	7.79
(5) BEA: money plus imputed income	4.15	10.71	16.56	23.32	45.26	14.86	39.88	25.58	19.68	7.84
(6) BEA: family personal income	4.20	10.63	16.44	23.22	45.51	14.83	39.66	25.55	19.96	8.01

*Steps in the estimation process refer to the relative size distribution obtained after carrying out the steps in estimating the size distribution of family personal income for 1964 by the Bureau of Economic Analysis, U.S. Department of Commerce.

(1) The CPS distribution of money income (as defined by Census), based on BEA's assignment of income to nonrespondents rather than the published CPS distribution.

(2) Distribution based on tax return amounts for wages and salaries, non-farm proprietors' income, and property income, and CPS amounts for other income types (farm income and transfer payments). Tax return amounts were obtained by statistically matching a file of individual tax returns with individual CPS units.

(3) Same as (2), except that tax return amounts were corrected for the effects of audit.

(4) Distribution obtained after adding certain money income types not contained in the file at step (3) and inflating each money income type to BEA's "control total" for that amount. The latter step was necessary to correct for income under-reporting not already accounted for in the previous steps.

(5) Distribution obtained by adding BEA's imputed income types (inputed wages, food and fuel consumed on farms, net imputed rent on owner-occupied dwellings, and imputed interest) to the money income distribution in step (4).

(6) Distribution of family personal income: distribution of money and imputed income [step (5)] less personal contributions for social insurance.

Source: Bureau of Economic Analysis.

TABLE 4.—NONWHITE MONEY INCOME OF FAMILIES AS A PERCENT OF WHITE, BY REGIONS, 1953 AND 1969

Region	1953	1969
South	49.0	57.2
Northeast	71.8	68.6
North-central	76.1	75.9
West	81.7	81.3
United States	56.1	63.2

Source: U.S. Bureau of the Census; Technical Paper No. 17 and Current Population Reports, P-60, No. 75, Table 59.

TABLE 5.—PERCENT OF WEALTH HELD OR INCOME RECEIVED BY CONSUMER UNITS WHEN RANKED BY SIZE OF INCOME OR WEALTH, 1962

Consumer units ranked by—	Lowest quintile	2d through 4th quintiles	Highest quintile	Top 5 percent	Top 1 percent
Size of wealth-holding:					
Total wealth	(*)	23	77	53	33
Corporate stock	(*)	3	97	86	62
Size of income: [1]					
Total wealth	7	36	57	38	25
Total income	4	50	46	20	8
Wages and salaries	2	53	45	15	4
Self-employment [2]	1	36	63	42	23
Property income [3]	5	29	66	47	49
Dividends [4]	2	15	83	65	36

*Less than ½ of 1 percent.

[1] The income concept used in the survey differs somewhat from the concept of family personal income underlying tables 1 through 4; in particular, it excludes imputed income and includes social security contributions of employees and private transfer payments (private pensions, for example).

[2] Income of farm and nonfarm self-employed proprietors.

[3] The sum of interest, dividends, rent, and income from estates and trusts.

[4] Includes dividends from small, closely held corporations as well as those whose stock is publicly traded, and income from estates and trusts. Source: Survey of Financial Characteristics of Consumers. The shares of the top 5 percent, ranked by the size of wealth, and of the top 1 percent have been interpolated by the editor from the underlying distributions and may therefore differ from "true" values by 1 or possibly 2 percentage points; the Federal Reserve Board staff has kindly made available the remaining percentages. The reader should recognize that data in this and in other tables are subject to some undetermined margin of error. To illustrate, respondents in field surveys usually underreport the amount of their income and wealth to interviewers. Since there is evidence that this behavior is more characteristic of the bottom and the top income groups, the shares of the lowest and highest groups in this table may be understated relative to those in the second through the fourth quintiles, that is, the middle 60 percent.

Source: Edward C. Budd, "Inequality and Poverty," W. W. Norton, 1967, Table 7, p. xxii.

TABLE 6.—SIZE DISTRIBUTIONS OF TOTAL INCOME

[Thousands of consumer units]

Size of total income	Census money income, 1964		BEA money income, 1964		BEA family personal income, 1964		BEA money income, 1964		BEA family personal income, 1970	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Loss	202	0.3	161	0.3	159	0.3	129	0.2	121	0.2
Zero	816	1.4	645	1.0	252	0.4	855	1.3	326	0.5
1-1,249	5,562	9.3	3,540	6.0	3,302	5.5	1,659	2.5	1,810	2.7
1,250-3,249	10,893	18.2	9,363	15.7	9,320	15.6	7,553	11.2	7,207	10.7
3,250-5,749	13,235	22.1	12,719	21.2	13,121	21.9	9,576	14.2	9,955	14.8
5,750-8,249	12,581	21.1	12,499	20.9	12,229	20.4	10,109	15.0	10,447	15.5
8,350-10,249	6,822	11.4	7,653	12.8	7,775	13.0	8,142	12.1	8,204	12.2
10,250-15,749	7,229	12.0	9,140	15.3	9,311	15.6	16,606	24.7	16,144	24.0
15,750-24,749	1,898	3.2	2,824	4.7	3,013	5.0	9,229	13.7	9,365	13.9
24,750-49,749	513	0.9	1,017	1.7	1,076	1.8	3,092	4.6	3,087	4.6
49,750-98,749	56	0.09	206	0.3	233	0.4	258	0.4	520	0.8
98,750+	24	0.04	39	0.07	45	0.08	97	0.14	119	0.2
Total	59,836	100.0	59,836	100.0	59,836	100.0	67,305	100.0	67,305	100.0
Mean	$6,443		$7,673		$7,865		$10,924		$11,132	

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Chairman PROXMIRE. Mr. Lampman, please proceed.

STATEMENT OF ROBERT J. LAMPMAN, DEPARTMENT OF ECONOMICS, UNIVERSITY OF WISCONSIN

Mr. LAMPMAN. Thank you, Mr. Chairman. The paper by Thurow and Lucas is addressed to three main topics, as I interpret it. One is what is the pattern of income distribution and how is it changing in this country?

What goals might we have for changing that pattern?

Second, how are labor income differences in the market determined?

This second one is the most extensively treated of the topics and discussion of it takes up more than half the paper.

The third topic is what policies could be adopted to make labor incomes less unequal?

I would like to talk about each of these very briefly.

At the present time, the U.S. Government does not have stated goals concerning income distribution in the same way that we have stated goals concerning growth, employment, and price levels. Neither do we have an official measure of income inequality, as we do for the other goals.

There are reasons, I am sure, why we have stayed away from going very far in enunciating official policies or broad government policies in this matter.

Income distribution is a more complex matter to describe and it is a more complex matter in which to prescribe goals than some of the other economic variables.

Let me suggest, for example, that total money income is only one measure of income, only one definition or concept of income.

In a broader view of the matter, certainly one should include nonmoney income which is a growing component of family incomes. We should have refernce to not only goods purchased in the private market but many of those purchased publicly, and provided free or at subsidized prices to many families.

I would suggest that there are three broad concepts of income that reflect different meanings and different significance of income distribution. One has to do with the producer contribution of an individual or of a group of individuals in a family.

A second has to do with the consumer power of families. Here we would certainly have reference to nonmoney items often as well as to money items.

Finally, we are concerned with what we might call general economic power, the influence one group of people has over the life chances of another.

Further, besides trying to define income we have to take a careful view of what the income receiving unit is. Are we interested in the individual earner more or less than we are interested in the combined family picture?

What method of ranking do we enter in appraising an income distribution? Do we rank people with regard to their total family incomes or do we rank them with regard to per capita income?

Finally, what income period is important? Is it 1 year? One year after all this very arbitrary designation? Are we more interested in average income over a lifetime?

We also should be very much aware, I am sure, of the fact that measuring differences in income distribution over a long time period, say 20 years, is often a very difficult thing to do and one is at least suspicious that the arbitrariness of definitions chosen and measurements followed may just cover over what actually has happened in underlying variables.

As the paper indicates, for example, there seems to have been relatively little change in the overall distribution of income and the inequality in it. However, within the various parts of the distribution dramatic changes have taken place. The distribution of income between young and old has altered, the distribution of income between male and female earners has altered significantly, and so on.

So one could get different conclusions, certainly, if you had a different measure of overall changes in income inequality.

With regard to goals, I will just indicate very briefly that I think the paper simplifies the problem of stating our goals. It is suggested in the paper that there are only three possible goals the country could have having to do with the reduction of inequality of income over a 1 year period, a reduction of inequality on an intergenerational basis and a reduction of inequality on a racial basis.

Clearly, there are many other goals that we could state with regard to the distribution of income.

Congress and State legislatures have often been concerned with other aspects of income distribution, not very well reflected in the statement of the three goals. For example, we are concerned with the adequacy of income at the minimum. The poverty program, of course, is a statement along this line.

We are concerned with security or regularity of income. The social insurances give great attention to this.

And we are concerned with inequality across regions of the country, I believe, as well as among occupations and industries.

I will comment briefly on the section that explains earnings differences.

I submit that Mr. Thurow and Mr. Lucas have raised a strawman on which they spend a great deal of time. I am not terribly impressed by what seems to me to be a slight difference in the inequality of distribution of educational attainment. It is observable in the tables shown, but one has to get out his magnifying glasses to see it. It is, of course, interesting that the distribution of earnings has not changed in the same direction as the distribution of educational attainment, but I don't regard it as so significant a point as the authors of the paper do.

Again, just a quick comment on the various remedies. I have despaired in reading the paper for lack of explanation as to why the authors selected five items, I believe it was, as what they called an adequate package of government programs to alter the structure of income. They assert this would undoubtedly compress the relative structure of earnings.

I suppose they would, but I wonder if these remedies are not only sufficient but also necessary. Would one need all of them? Are the costs of these programs high or low? The costs might be thought of not only in terms of inflation, but also losses of real national product and a considerable amount of transfer cost; and finally very little attention, it seems to me, was given in the paper to another important cost that might be associated with some of these, namely, the loss of freedom, freedom for individual employees or loss of freedom for employers, and for voluntary organizations in the economy.

Let me just suggest that this list of five items is a rather limited one. One should ask, any reader should ask, why they didn't discuss some other ones. For example, what would be the view here to abolishing unions and limiting business monopolies and other barriers to entry into the labor market?

Would it be possible to consider some adoption of the method the Japanese appear to have developed of lifelong tenure with individual companies, a general practice of not shifting from one company to another through a whole career?

What about regulation of immigration to assure that it will reduce inequality over time rather than perhaps compound it?

What about adapting our population policies which we at least talk about these days to reduce inequality of income?

What about the possibility of an allowance for housewives' work? Suppose we had some flat amount that we paid housewives who did not work in private monetarily rewarding work? Would that be a reasonable thing to do? What would that do to the distribution of income? Would it be any less radical than some of the other proposals suggested?

What about the notion that we might deny the wives of rich men the right to work? What about the idea that employers might be required to have 10 percent, let's say, a quota of 10 percent, of their executives with less than eight grades of education? The authors are not very expansive in talking about how they would apply their quotas other than to make a brief reference to blacks. I will stop there, Mr. Chairman.

Chairman PROXMIRE. Gentlemen, thank you very much. These are most provocative observations and this is a new departure for this committee, at least new since the late 1950's when we had our last discussion of the redistribution or maldistribution of income before this committee.

It is certainly an excellent and provocative study that Mr. Thurow has made. At a time when we are considering a new tax, the value-added tax, and have had 3 days of excellent testimony on it, it seems to me the kind of contribution that this Economic Committee can make is to try to put it in the perspective as far as the economy is concerned with this kind of question: What effect could the value-added tax have and would it be desirable to have a more proportional tax system, a less progressive tax system than we have at the present time?

How serious would it be if we make our tax system less progressive?

I would like to ask each of you gentlemen to tell us what has been happening to the distribution of income in the last few years. Has it gotten better or at least has the distribution been emphasized more than before, less income for those with less income and high incomes for those with higher incomes?

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Mr. THUROW. If you are talking about recent years, one would have to guess. The Current Population Reports provide the only hard information on the distribution of income and they are a year, or two years behind times.

Chairman PROXMIRE. Give us what you can.

Mr. THUROW. From past historical relations it is clear that in recessionary periods unemployment falls more heavily on the relatively poor. I would be very surprised if when the income numbers are published for 1972 and 1971 we don't really see some adverse effects on the poor.

Chairman PROXMIRE. What has happened over the last 10 years or 15 years?

Mr. THUROW. After you get rid of business cycles everybody's income in the American economy, on a family basis, has been going up at about the same rate. Our relative income gaps have not changed very much, black-white, male-female, however you want to look at it.

On the other hand, constant relative gaps imply widening absolute gaps. I think it is important to emphasize that whether relative gaps or absolute gaps are important depends on what you think makes people happy or unhappy about their incomes.

Is it relative incomes that makes them happy, that they are half as much as somebody else, or is it the fact that their real standard of living is $10,000 lower than ssomebody else?

I don't think economists know which of those two make people happy or unhappy and there is no theoretical way to figure it out.

Chairman PROXMIRE. Before I go the other two panelists, let me ask you, if you think that such a change as we have had in the last 10 years and the impact of the corporation income tax on the one hand and payroll taxes on the other have had a significant impact.

The corporation income tax has fallen from 23 percent of Federal revenue to 16, and payroll taxes have gone from 16 to 29 percent. Has this been significant?

Mr. THUROW. If I can put my other hat on as a tax man, it is clear that in the last 10 years we have been abandoning the progressive taxes and pushing the regressive ones. The whole tax structure has become more regressive in the last 10 years. We have had two giant income tax cuts and liberalization of depreciation which effectively reduces corporate taxes and upped the payroll taxes significantly. It has to be the case that over the last 10 years we have been dismantling the progressive tax structure.

Chairman PROXMIRE. Would you believe that the VAT is a farther step in the same direction?

Mr. THUROW. If it is adopted without large and vanishing credits, it is a step in that direction. We can sit here and construct a VAT that would be more progressive than the current system of total taxes, but that is not the one people are usually talking about when they talk about the VAT.

Chairman PROXMIRE. Mr. Budd, comment on the whole thing, first the redistribution of income over the last few years.

Mr. BUDD. Although we don't have very much evidence for before-tax income from about 1960 on, there has probably been a very small movement towards more equality or approximate constancy. The CPS shows very little change. We don't have much evidence on the after-tax distribution of income, although for the reasons Thurow cites I think it would have become more unequal, given the kinds of fiscal policies we have had. Of course, in terms of the relative distribution these things are not always too apparent. You can see the effect of deducting social security taxes, in effect, in our study for 1964, which is given in table 2 of my prepared statement. There we have a series for total money and imputed income and then come down to family personal income by taking out social security contributions. I must confess that the change in shares is not too obvious.

Certainly, as I point out in my prepared statement, the value-added tax would essentially be a trend toward more regressivity. I am certainly distressed by one proponent of the VAT who wanted to use part of the revenue from the VAT to reduce the corporate tax. I think the corporate income tax, if you compare prewar and postwar, has been one of the most significant redistributive tax devices we have had.

Chairman PROXMIRE. Let me interrupt to say that the witnesses we had 2 days ago, especially Mr. Ture and Mr. Lifschultz, both argued that the corporation income tax is not very different than the value-added tax, that the economists differ in its incidence, but they conclude it is by and large a tax that is shifted to the consumer and, therefore, a consumption tax.

Absent the corporation income tax you probably would have simply lower prices in the corporate sector. I don't say that is a general view. I say that is a view of two of the many witnesses who have appeared.

Mr. BUDD. I know there is a difference of view in the profession. I would say the weight of findings in recent years that I have seen, although I am not a full expert in this field, is that the corporate income tax has not shifted, at least in the conventional way. I know Mr. Thurow points out that it may reduce the degree of capital accumulation, and affect the rate of return on capital before tax. One could argue in a certain sense that that is shifted. But I think the degree of professional opinion would be that it is not. My observations in this paper are based on the assumption that it is not shifted.

Chairman PROXMIRE. It is also argued that the value-added tax would be a tax on factor income and would not be shifted. Mr. Ture was pretty emphatic in that. I just reviewed his remarks this morning. I must say he and Mr. Lipschultz are alone. There are not other witnesses I know of who have that view. Somehow they feel that this is a tax that would not increase prices.

There was some view that this would be the case if you didn't have any change in fiscal or monetary policy, that the value-added tax would not be inflationary.

But the general assumption is that you would have, to keep things pretty much the same.

Mr. BUDD. If you are looking at it from a relative point of view, I think that point is almost beside the point. It has to reduce somebody's income relative to the prices he is paying.

Chairman PROXMIRE. He says it reduces the income of the people who work for the corporation.

Mr. BUDD. Factor income is at a bottom of the distribution as well as the top of the distribution and presumably it will bear on lower income groups as well as top corporate executives. Whether they pay it in the form of not getting wage increases that they would have otherwise gotten or whether they pay for it in the form of higher prices makes little difference.

I wouldn't want to place a lot of emphasis on his particular distinction. Perhaps it is true that if it is reflected more in prices, those who get the larger share of their income from transfer payments would be more affected. But if you look at it in terms of earnings, whether it is reflected in lower factor prices or higher prices for the goods and services we buy seems to me not an important matter for its effect on relative distribution. The tax is going to fall on the bottom as well as the top.

Chairman PROXMIRE. Mr. Lampman, I have to run to the roll call. I will be back in a few minutes.

(A brief recess was taken.)

Chairman PROXMIRE. The committee will be in order.

Mr. Lampman, it is your turn. You didn't have a chance to reply to what happened to income distributed in the last several years and the effect of the tax changes on that, plus the propsective effect of the value-added tax.

Mr. LAMPMAN. Mr. Chairman, I would like to take the opportunity with that question to refer to the poverty idea.

Poverty measures are related to this overall income equality or inequality picture. I would note that when we begin to talk about poverty presently we talk about not just the size distribution of income, and the overall inequality in that, but the size distribution of income as adjusted for family size. I think that is a very important point to make. The numbers of people in poverty, and the percentage of the total population in poverty fell very considerably over the last decade.

As far as we know, it fell in each year, virtually each year, of the decade, except for the last one or two. So it appears something has happened to slow the reduction in poverty. I assume the recession, primarily.

If we think about tax incidence, it is useful to think about it with reference to family size as well. One of the things that a sales tax does is affect people of different family sizes in the same income bracket in a very different way. So it is sometimes said that a sales tax is not only regressive across the income classes, but it is capricious with regard to family size.

Keeping in mind the poverty notion as related to family size, I submit that the value-added tax, unless again it has very special adjustments for low income families of different sizes, would hit particularly hard at poverty level families of larger sizes.

I believe it is right to say that our overall tax system has become somewhat less progressive in recent years, especially because of changes in payroll taxes. But it would certainly be incomplete to leave out mention at the same time that income maintenance payments, Federal and State together, have gone up very pronouncedly over the last decade, as you well know, Mr. Chairman.

Mr. THUROW. Could I make one more comment on this? Often the value-added tax is suggested as a substitute for the property tax. If that is what is going to happen, I suggest that you think seriously. While everybody would admit that the property tax is capricious in the sense that it is a very different tax on people with the same incomes. It is, however, still a wealth tax and a lot of it is paid by the wealthy.

If you were to imagine abolishing the property tax tomorrow there would be enormous capital gains by the wealthy who now own big apartment buildings and property of other sorts.

Abolishing the property tax, while it may help the little widow who can't pay the property tax, will primarily help the wealthy.

Chairman PROXMIRE. A property tax on land is about as neutral a tax as you can get. The land is held by extraordinarily wealthy people. There is a maldistribution of the land holdings, undoubtedly.

Mr. THUROW. Commercial and rental property is held extensively by the wealthy. We tend to think of the relatively modest income, single family home owner, and they are important. But there is a lot of tax applied to people who are not modest, single family owners.

Chairman PROXMIRE. An overnight windfall.

Mr. THUROW. That is right. You might find the values go up by 50 or 100 percent per night. It is something to think about.

Chairman PROXMIRE. I would like to ask Mr. Lampman and Mr. Budd, in connection with the Thurow paper, to give their reaction to the basic thesis that the U.S. economy is largely a job competition economy in which much training is done on the job. Training costs are an important factor. Policies to improve earned income distribution must concentrate on making job opportunities as well as improving the personal characteristics of job applicants.

Mr. BUDD. I think Thurow's paper has brought out to us the importance of looking at the demand side and the employer requirement side of the picture, where we may have been concentrating too much on the labor supply side, including formal training and education.

I still remain skeptical of the extent to which he believes that the classical mechanism no longer works with respect to the changes in relative wage differentials. I am sure he has suggested some research for me. I am not convinced at this stage, but I am sure that these issues will turn on empirical considerations.

Lampman has expressed his dissatisfaction with some of Thurow's empirical work in this paper, and I am also somewhat dissatisfied with it. But I would really like to reserve judgment until I know what the evidence is. It certainly is disastrous for the labor supply model if relative wages aren't going to move with changes in the supplies of different kinds of labor. Then we really have to do some hard thinking about what our public policies ought to be.

I might also add that if that thesis is true, it almost implies that we can use any kind of policy, say an income tax policy with respect to labor income much more progressive than it now is, which would certainly serve to narrow wage differentials after tax. On the basis of this argument, that is not apparently going to have any effect on the allocation of labor among different kinds of occupations and within the firm.

Chairman PROXMIRE. Do you think it could have that progressive effect but you question whether or not there is sufficient basis to validate his conclusion?

Mr. BUDD. I really believe it does turn on the empirical evidence. I must confess that my own training and predispositions are such as to believe that relative wage differentials and their movements are considerably more important than the Thurow approach would imply.

I also pointed out in my prepared statement that if you are going to use some of his policies, such as subsidization of employers to hire low wage people, this in part could be accomplished by a negative income tax plan, where you give the subsidy directly from the Treasury to the individual employee rather than having the funds first go through the employer.

Certainly, if Thurow is right there is considerably more role for equalizing personal income taxation than we now have, and certainly the income equalizing effects of the personal income tax are pretty small right now.

Chairman PROXMIRE. What can we do to determine whether the Thurow thesis is correct, in your view?

Mr. BUDD. I would like to determine myself how much relative wage differentials have changed across occupations.

Chairman PROXMIRE. That shouldn't be very difficult, should it?

Mr. BUDD. No, it shouldn't.

Chairman PROXMIRE. Do you think that would give you an opinion?

Mr. BUDD. I haven't really had time to think about all the different kinds of tests that I would like to perform as a basis of testing his particular hypothesis. I believe it is dangerous to simply judge these matters in terms of our casual observations of the real world. We certainly do know that in a slack labor market, where the demand for labor is not very strong, jobs are getting rationed out among people by principles other than wages on the basis of the job opportunities that are now open.

What employers will do in this particular set of circumstances is to use screening, irrelevant screening, devices. Some of the latter may simply be formal schooling requirements. In a much stronger labor market some of these differences may well disappear.

Chairman PROXMIRE. Mr. Lampman.

Mr. LAMPMAN. Mr. Chairman, I don't find the thesis advanced in the paper very persuasive. Mainly what the authors undertake to do is to declare that one prediction that is consonant with the classical wage theory is not borne out by our observation of what happened in 20 years. Namely, they predict on classical grounds that with increasing equality of educational attainment the wage pattern should narrow in its inequality. They do not find that that happened.

I submit that many other things happened in this same period. There has been a great change in retirement patterns, a great change in participation by women in the labor force. Certainly they have had an indirect effect on the earnings of men.

It is well noted that, particularly, middle aged women have entered the market in very large numbers and have been competing for many of the jobs that were formerly held by lower wage men. I think that bears on this matter. Income maintenance payments have risen very substantially during this period. I would assume that would have something also to do with relative earnings. Sizes of families have changed. There has been a great change in the occupational-industrial composition of the labor force, and also much residential shifting.

I should think the authors could have selected any one of these other changes and said how that would affect the distribution of income and test it. They would generally indicate then, that none of these other changes by themselves have affected the distribution of earnings.

I think many of them have affected the distribution of earnings and they may have affected them in offsetting ways.

With regard to your other question about whether this indicates that we need especially to concentrate on demand-increasing policies, I think I agree that we should give very careful consideration to such policies. But I would urge along with Professor Budd, that it would be very desirable to have some kind of comparative study or some notions of trying to articulate in one broad package both Government employment at low wage levels on a kind of Government as employer of last resort idea, and earnings subsidies in private employment and/or a negative income tax type of supplement for the working poor.

The authors at one point imply that the negative income tax should be used mainly for people who are not in the labor force at all. I think they misinterpret the chief thrust of the writers in the field of negative income taxation, which is that it should be available to people who are in the working force as well as to people who are out of it, that we should try to eliminate or reduce the categorization of our income maintenance systems.

The negative income tax was thought of as one way to do that. I think it would be possible to achieve some of the same purposes by a new pattern of income maintenance programs that would complement some of these demand for work programs that are advocated by the authors.

Chairman PROXMIRE. Mr. Lampson, how optimistic are you that we can do anything about this, that we can improve the earned income? Is the only really effective thing we can do, and is that effectiveness very limited, with respect to the tax structure? What else can we do to make progress? All the arguments in the Congress, by Democrats, Republicans, liberals, and so on, is that it ought to be better, but it is getting worse. Every President who runs for election, every Senator and Congressman, favor this position, some more strongly than others, but nothing happens. How optimistic are you that we can do something about it?

Mr. LAMPMAN. You are talking about the tax system as such, or the pretax distribution of earnings?

Chairman PROXMIRE. Both.

Mr. LAMPMAN. I guess I am not quite as pessimistic as you make it sound. It seems to me we can and on occasion have made important improvements in the overall nature of our tax system, including Federal, State, and local taxes in a broad package. One of the chief changes in recent years has been the expansion of payroll taxation. I don't regard that as a total disaster from a regressive-progressive set of considerations because it is accompanied by a very substantial increase in outpayments which tend to have a progressive or pro-poor pattern of their distribution.

I would also urge that this committee, when it thinks about income distribution should think about it in a broad sense to include such things as medicare and medicaid, various types of housing allowances and public housing provisions that have been made, to a certain extent education and training themselves being a part of income that people receive in any one year.

Looking at this social welfare expenditure, including cash and inkind benefits, we see a most dramatic shifting of priorities that has occurred in the last 20 years.

Chairman PROXMIRE. That was my reaction. We had all of these things in the last few years. We had the Kennedy program and the Johnson program. We seemed to go very, very far in some respects. Not as far as some would like, but it seemed that we made some real advances. Yet you say after 10 years of this we are probably worse off than we were before.

Mr. LAMPMAN. I don't say that.

Chairman PROXMIRE. Maybe not. I am talking about the total result.

Mr. LAMPMAN. One of the criticisms I offered of the paper, Mr. Chairman, was that it did not refer to certain types of nonmoney income. For example, there is no reflection in what is shown in the improvements in people's levels of living by the introduction of Medicare. That is not a money payment that people get. There is no reference to Medicaid and to many of the other social services and public services that have increased more rapidly than almost any other segment of our economy.

The biggest growth sector of our economy, even through the Vietnam war, has been the social welfare expenditures part of our society.

Chairman PROXMIRE. Mr. Thurow, why did you omit that, or don't you think that omission is important?

Mr. THUROW. I think that omission is important. I think it is not possible to do everything in one paper. Could I respond for a minute?

Chairman PROXMIRE. Yes.

Mr. THUROW. If I had known they were going to be my critics a little earlier, I would have sent them a paper that I wrote for the Carnegie Commission on Higher Education, outlining 15 or 20 things which I think point towads the job competition model of the labor force. I didn't think they were the right thing to go into this kind of staff report. I will be glad to carry on a private dialogue with them.

According to the wage competition view of the world, unemployment can't exist, yet, unemployment does exist. That indicates at least in certain situations we have to be having job competition as opposed to wage competition. You don't see wages being bid down at the moment as the unemployment fight to get employed by undercutting in terms of wages.

I think one of the things we have to realize is that human ingenuity plus the modern computer can rescue any theory. If Newton had had the computer he never would have had to abandon epicycles, because he could always have added another epicycle. I expect wage competition is like that. Human ingenuity plus the computer will be able to find this offsetting thing that explains this or that fact that isn't in accordance with the wage competition model.

The committee should be aware, however, that at the moment I am in the process of trying to convert the economics profession to a job competition view of the way the world works. I would not claim it is the majority position. I think they still believe in wage competition epicycles. They know this job will not be taken away from them by an unemployed economics professor undercutting their wages but they still believe that is the way the economy works.

Mr. BUDD. The computer only works for us in that way and not also for you.

Mr. LAMPMAN. Could I ask Mr. Thurow a question?

Chairman PROXMIRE. Yes.

Mr. LAMPMAN. One classical interpretation of some of the points you make about wage inflexibility downward and so on would be that that is due to such things as minimum wage laws or what Clarence Long called the social minimum that no employer likes to go below even though he is not forced to stay above it. There are great pressures in that direction. They would also urge that labor unions are to some extent responsible for this inflexibility and by their barriers to entry into unions and into jobs they support this. This sounds similar to what you are saying about how wages are not bid down and they are not easily flexible and employers don't respond quickly to them.

Many employers have told me one of the reasons they don't hire low-income workers is that the wage does not reflect at all the cost to them. They have to pay many fringe benefits. They incur many liabilities as regards health insurance, unemployment compensation, and retirement benefits.

The difference between hiring a low-wage worker and a high-wage worker is much less in terms of total cost to the employer. They say if you could somehow get those payroll taxes off for the low-income workers and if you could modify the commitments we have to make to people in making an initial hire, we would do much more in the way of hiring low wage workers.

I wonder if you would comment on those classical propositions that seem to lean in the same direction as your job competition.

Mr. THUROW. I think they do lean in the same direction, but I would argue what is going on in jobs and in the labor market is a lot of on-the-job training. If a lot of on-the-job training is going on from one worker to another you have to ask what is going to make the skilled worker who is currently employed willing to train somebody else in those skills. Clearly, if he believes that the guy he trains is going to undercut his wages or force him out of a job he is not going to be willing to give that kind of informal training.

To use an analogy, if every morning MIT lined up all the potential people in the world who could be economic professors and asked them to bid on the job for that day, what would that do to education at MIT? It is clear I would go into my class and I would teach misinformation, because I wouldn't want to increase the supply of people who would be bidding against me in that daily morning shape up. That is exactly what the labor unions do in the construction trade. That is human nature whether there is or isn't a union. We are not going to be willing to give this informal training if we think that person will become a direct competitor for our livelihood.

A lot of wage competition is suppressed not because of monopolistic elements, but simply because if you had that kind of competition going on you wouldn't get this informal training.

I would argue as a further example that perhaps the Japanese economy is a clear example of job competition. You have a guaranteed job (terribly inefficient) where wages are basically set on seniority rather than on your own particular performance (which is also terrible from the point of view of competition) efficiency and all that.

What does that do? The first thing it means is that you are not worried about technical innovations throwing you out of a job and you don't resist change.

Second, it means you are willing to move from job to job, and train other workers because they cannot throw you out of a job. The Japanese formal wage structure may be terrible at getting you to the economy's current efficiency frontier is but it makes the frontier move more rapidly.

I am arguing that wage competition might be efficient in a stationary economy, but in a dynamic economy that is changing, where you want to train people, it is inefficient. It makes the efficiency frontier move more slowly, though it may be great to get you there.

I don't think it is the old classical argument that there are monopolies in the economy that keep wages from falling where they should.

Chairman PROXMIRE. I think your reference to Japan helps us understand better what you are talking about. Can you tell us how this would fit into some of the other economies, the European economies, Germany?

Mr. THUROW. The American economy is peculiar in the sense that your job insecurity is greater. You are much more likely to be fired in a recession in this country than you are in Europe. Of course, they haven't had recessions to the extent we have had.

I think in some sense it is clear that probably job security is a greater worry in the United States than in most of the European economies. Japan certainly goes the farthest towards giving people the feeling, "Now I have a job and that is it. I don't really have to worry about the insecurity of some technical innovation throwing me out of work or another worker throwing me out of work."

Chairman PROXMIRE. Much of this could be overcome by a Federal program of guaranteed jobs, then. This committee has proposed in its report that we have a big public service program. I have recommended that we have a system of the Federal Government being the employer of last resort whenever unemployment got above 5 percent; that until unemployment gets below 5 percent the Federal Government provide for the hiring in primarily State and local work 100,000 people a month every month.

I think the psychological impact would be favorable. Would that tend to meet part of the problem?

Mr. THUROW. That is a move in the right direction. Imagine the import case. It is certainly to the rational self-interest of the employees in the shoe industry to fight to establish import quotas. Even though we know in some bigger sense it is not to the self-interest of the United States to put quotas on shoes from European countries.

If you had a guaranteed job that wouldn't eliminate the intense political pressure to put inefficiencies into the system but moves in the direction of reducing that pressure. It is clear that people will fight to maintain their livelihoods. It is not obvious that you want to maximize the fear that you will be without a job.

Chairman PROXMIRE. Mr. Lampman mentioned payroll taxes.

Are payroll tax rate increases a necessary companion to improve social security benefits as Mr. Lampman advised?

Mr. THUROW. I think you could imagine changing the system and using other tax revenues as well as payroll taxes.

Chairman PROXMIRE. It is a very real issue right now in the Congress.

Mr. THUROW. I think it is clear that the books of the social security system are kept in a misleading way with the idea that some day you will fund the system. It should be on a pay-as-you-go, cash basis, and not worry about whether the fund will be in deficit 30 years from now.

The question that should be asked is what is the deficit this year and set the rate which will keep the fund in balance.

Chairman PROXMIRE. Which of Mr. Thurow's recommendations would you say would lead to loss of freedom as you put it, Mr. Lampman?

Mr. LAMPMAN. Mr. Chairman, I would say that the one that has to do with quotas perhaps would impinge on freedom of individual employers. They would be directed in some manner not clear to me concerning a whole pattern of employment that they might be expected to have.

The authors do single out as one example, but I believe they intended it to be only one example, that employers would be expected to hire a certain percentage of, say, blacks in each quintile of the wage structure in their organization.

That clearly is an additional requirement that would be imposed on the managers of businesses. I suppose it would interfere with unions' policies and others. In that sense we would have a case of restriction of freedom. Perhaps partly in jest I raise the possibility in my comments that you might extend that to requiring that the top one-fifth in each company should include a certain percentage of people who have no more than eight grades of education.

Chairman PROXMIRE. At the top management level?

Mr. LAMPMAN. Yes. I am just trying to explore, and I was hoping to get Mr. Thurow to talk more about how many quotas for what purposes. Would they be with reference to sex, age, education, or what other things? Would it be possible that he is thinking that this should lead in the direction of requiring every employer to have a given coefficient of inequality in his wage structure overall?

This seems to me to be at least something I would like to hear more about if there is time.

Mr. THUROW. I can fall back on an article which was published in the New York Times written by Professor Galbraith and myself which advocated a set of quotas.

Mr. LAMPMAN. That was for minorities, essentially.

Mr. THUROW. Yes. I think you have to put a little common sense into most things you talk about. One of the arguments always used against quotas, and I know Professor Lampman is doing it in jest, is that if there are quotas for blacks, why not quotas for hottentots. There is a certain amount of truth to that and a certain amount of nonsense.

What you have to think of is what are the important groups that are aggrieved, that they are not being justly treated. Maybe people who don't have any education are not being unjustly treated if they have low incomes because they haven't the education.

I would argue that in the United States clearly we would not want quotas on religious lines because it is not obvious that there are significant differences by religious groups.

On the other hand, if you were in Northern Ireland, if you were thinking about integrating Northern Ireland, religious lines are the relevant lines.

The relevant lines upon which you would want to think about quotas depends on the individual society. Religion is not the relevant line here but in Northern Ireland it is. Color is not the relevant line in Northern Ireland; color is a relevant line in this society.

We must determine what social problems we face that are income distribution problems. Clearly minority incomes and women's incomes are social problems that we face. We do not face a social problem where Catholics are rioting because their incomes are too low relative to Protestants. Therefore, we don't have to be worried about that.

What the report pointed out was that if you are interested in making progress quickly on earned incomes, I think you are then forced to something that you may not call a quota system but something that looks like a quota system or close to it.

That is what the Equal Employment Opportunity laws are about, what the Enforcement Branch of HEW is about. The Philadelphia plan is a quota system. It is clear that rapid progress almost demands something that is very close to a quota. That is the point that the report was making.

If you want progress in the next 2 or 3 years you must think about something like a quota, no matter what you call it.

Mr. BUDD. But the quota was not just for minority groups; it imposed relative size distributions of a wage income on individual firms, who were supposed to come down to those distributions in some limited period of time. I am sympathetic with this quota system for minorities when applied to blacks and women. But I see real problems in some of the other implications.

Mr. Thurow. There was no pressure put on firms to equalize their distribution of earnings.

Mr. Budd. In your paper there is.

Mr. Thurow. It is certainly a logical possibility. Whether you want to do it or not is something else. In terms of responding to arguments that there were a lot of policies we didn't mention, that is clearly true. That just has to do with some self-selection and talking about some policies that seemed to fall out of the discussion of job competition models.

I would agree that nonmonetary income is terribly important. The more you provide free public services, the less important monetary income becomes. What you would like is a distribution of total income, money income plus the other benefits. It is difficult to calculate.

Chairman Proxmire. Mr. Budd, would you give us your reactions to the recommendations in the Thurow-Lucas report, number one, that we should always keep the economy at high levels of employment?

Mr. Budd. I am in complete agreement on the necessity of having a high level of employment and tight labor market. In fact, I think the whole problem of job insecurity that Thurow properly emphasizes could be taken care of to a large extent if we had a commitment that we weren't going to permit unemployment and that we were going to use strong monetary and fiscal policies that would create the tight labor market that would not make people worry about whether they were going to lose their jobs from this or that thing.

Chairman Proxmire. Then you agree that the Government should guarantee employment at a certain minimum wage?

Mr. Budd. I will agree with the Government minimum guarantee on the floor, although the Government guarantee cannot effectively be extended to other parts of the wage structure as I thought Thurow was suggesting. He has a minimum in there of $2 an hour, which may be a very effective substitute for the minimum wage.

But I thought the implication was that we were going to go beyond that and set wages for different kinds of labor higher up the scale and offer Government employment for them. I have real skepticism over that.

Mr. Thurow. That was an implication that shouldn't have been drawn if it was there. It wasn't intended. What was intended was not that you would give a guaranteed job at professional wage scales but that the Government can use its own wage structure to pressure the private economy to make some adjustments.

Recent rises in Federal wages have credited such pressures, especially in small and medium-size towns. They have put some pressure on the private economy to adjust to Government pay scales and there has been some kickback from the private economy that didn't want to adjust to Government pay scales.

You don't have to offer to employ an unlimited number of people at $15,000 a year to effect private incomes at that level.

You can to some extent affect the distribution of private salaries by setting public pay scales, even though you don't guarantee to employ everybody who wants a job at $12,000 at $12,000.

Mr. Budd. Only in the wage competition model. Why would the private employers have to pay any attention to wages that are paid by the Government?

Mr. Thurow. Because the Government then takes their preferred employees away from them.

Chairman Proxmire. Is that the experience in the construction industry?

Mr. Budd. Thurow's policy would work if he believes in wage competiton.

Mr. Thurow. You are trying to paint me at the extremes. I said I think some of both goes on. The kind of policies that people talk about in this sphere, and especially in the economics profession, acts like we are at the polar extreme of wage competition.

I do not want to be put in the box of denying wage competition. I clearly believe there are elements of wage competiton. We can fight about what the exact distribution is. I will admit at this point in time that I don't know.

Mr. Budd. Then there is less disagreement if you are willing to swallow part of the wage competition model. I am willing to swallow part of the job competition, certainly in periods of less than full employment.

Chairman Proxmire. You have said that the Government should in some way reward private employers for equalizing wages among their employees has been stated. What is your view on that?

Mr. Budd. I pointed out that the negative income tax plan has very similar implications in it. If, say, for a person earning $3,000 a year in the marketplace, the negative income tax might add another 25 percent to his income which would raise him to $3,750, you might conceivably instead of that give the equivalent amount of money to the employer as a subsidy, who would then raise the person's wage rate by 25 percent and get that extra 25 from the Government. Thus, a modification of the personal income tax in the form of a negative income tax would have much the same effect as Thurow's proposal.

I haven't thought enough about this to consider whether there might be other advantages of a direct subsidization of employers that could not be achieved through the negative income tax plan. One I referred to in my prepared statement is that the employees might want to feel that all of their income comes from the marketplace, that is, from that check they get from their employer, rather than partly from the Government. Certainly the farmers appear to feel this way in connection with subsidization plans. They feel they want to get it all in terms of the market price for their product rather than having part of it come from a Government check.

Mr. Thurow. I think it is quite right that the negative income tax at low income levels has some of the same impact. I thought we were talking about the distribution of income in the sense of being interetested in high income jobs. If you look at the compensation of executives who run large corporations it is clear from country to country the kind of salary we pay the very high earnings people differs a lot.

The kind of man who heads the equivalent of General Motors in Japan will not make a salary anywhere near $1 million that the president of General Motors makes here. If you are talking about people below the poverty line, I am willing to say the negative income tax is the preferred way to do it. But presumably we have interests above that line.

Mr. BUDD. Why not impose an earned income tax of 50 or 75 percent on those corporate executives? You could do that just as well through the personal income tax as through imposing direct taxes and subsidies on firms. It is really an argument to make the personal income tax more progressive.

Mr. THUROW. I carefully point out that the tax system is a substitute. You can do a lot of things with a tax system if you want to. We could put a maximum salary on corporate executives and say the tax above $100,000 was 100 percent. In economics there is no reason you can't do that. I doubt whether the Congress will do it.

Mr. BUDD. They are more likely to do that than to buy this employers' subsidization or employers' tax plan.

Chairman PROXMIRE. Mr. Thurow, let me ask you about the effects of your proposal on inflation. A basic condition for improving the distribution of income in your view is to keep the economy consistently at very high levels of employment. Of course, that is appealing. We are all familiar with the tradeoff, the Phillips Curve. Most economists believe this would create a very inflationary situation. Do you agree that it would be inflationary?

Mr. THUROW. I believe it would be inflationary. I think the real problem is that we have no solution for the unemployment-inflation problem. What we really have to think about is there some constructive way we can learn to live with the 5-percent rate of inflation, meaning things like social security, parity bonds, ways to escalate private pensions.

If I knew how you could rearrange this economy so we could have full unemployment and end inflation I would be beating my chest in telling you. But I don't know. I haven't read anything that anybody else has written that knows.

It is clear that a lot of countries have tried things. Nobody has found a way that works. I would love to find a way out of the box but I don't know it.

Chairman PROXMIRE. Your answer is to relax and enjoy it?

Mr. THUROW. Relax and enjoy it and recognize that there are people who get hurt.

Chairman PROXMIRE. And try to compensate them?

Mr. THUROW. Yes.

Chairman PROXMIRE. We have had some witnesses who have testified, including one who had a great deal of experience in South America, who have said that policy was followed down there and inflation has ameliorated since they adopted the policy. That was in Brazil. They follow a policy of providing protection for almost every kind of income against inflation.

The argument here is if you do that you will aggravate inflation.

Mr. THUROW. From the point of view of economic theory, if everybody had a cost of living escalator you wouldn't be affecting relative prices.

Chairman PROXMIRE. They put it into savings. Everything is tied to the cost of living so that your income would increase with the inflation.

Mr. THUROW. I think that is clearly second best. It would be nice to have full employment and an end to inflation. Unless these two gentlmen have a new idea, I don't think anyone knows how to do that.

Chairman PROXMIRE. Do you gentlemen have a new idea?

Mr. LAMPMAN. I don't have a new idea. I am frank to say that I am like most other people in our profession in being baffled by this problem, and most particularly by very recent developments in this area. I would like to ask a question.

You made a comment earlier, Mr. Chairman, about loss of freedom. I noticed at least some casual reference in the paper to the use of wage controls, a la World War II, as important in a structural change. I was a little uncertain as to how to interpret that.

Is this part of a general strategy that you would see as necessary in this effort to really equalize the distribution of earnings?

Mr. THUROW. I wasn't using it as an argument that that is the way you would want to do it in peacetime. All I said was it was used in World War II where earned incomes did become more equal.

In World War II, the majority of population, because of the war, thought burdens should be equally shared and wanted to do something about wages.

I don't know how far you can go along this line, but if Americans as a group were persuaded that incomes should be more equal, as in World War II, I suspect you could have a lot of the World War II effect without wage-price controls in the sense that people would voluntarily then be willing to see other people catch up with them.

I don't know how far you could push that. But that is what the reference was to. The Swedes have had a very conscious policy of moving towards equality of earned incomes. They have recently run into a bottleneck where the college graduates are saying no, they are no longer willing to see people catch up with them.

When you get into that situation it is very hard to move farther. There is no company or institution that can't be brought to its knees by working to rule. People have to be willing to go to work voluntarily.

When groups get so aggrieved about their incomes that they feel they are really willing to quit, then your policies essentially come to an end. I think the Swedes have reached the point where because of the grievances that their college graduates seem to feel, that their conscious government policies towards equality will essentially come to a halt until they can persuade those people that they are the right policies.

Chairman PROXMIRE. Let me get your views right in a row on the value-added tax. First, Mr. Thurow, would you agree that a value-added tax, the most commonly discussed consumption type, will be passed forward almost entirely in the form of higher prices that would be essentially equivalent to a retail sales tax and would be regressive?

Mr. THUROW. The answer to both of those is yes. As you look at European experience, it has been passed forward 100 percent.

Mr. BUDD. I believe the tax would be regressive, and while I believe a substantial portion would be passed on in the form of higher prices, I still make the point that for the relative distribution it is going to have that regressive effect whether or not it is passed on in the form of higher prices.

Mr. LAMPMAN. I think I agree. I would note that the shiftability of the tax is partly perhaps influenced by the scope of it. That is, how many things are exempt from it.

Chairman PROXMIRE. I want to come to that in a minute. First, suppose you had no exemptions.

Mr. LAMPMAN. Maybe I shouldn't say exemptions.

Chairman PROXMIRE. Or no exceptions. Both Thurow and Ture and Lifschultz were opposed to exemptions.

Mr. LAMPMAN. Were they going to tax food and rental services?

Chairman PROXMIRE. Food, rental, no rebate.

Mr. LAMPMAN. In most European countries, as I understand it, it is a tax essentially on commodities and excludes food.

Chairman PROXMIRE. The only exception I recall they would make is investment in plant and equipment.

Mr. BUDD. That I would object to.

Mr. LAMPMAN. That is a logical kind of exception in a way for that sort of tax. To the extent that it covers the whole range of all the things consumers buy, it becomes relatively easy to shift.

Chairman PROXMIRE. Now let me ask each of you would it be possible to devise a value-added tax that would be progressive? If so, would the value-added tax then offer advantages that would make it preferable as a simple expedient of raising income taxes to obtain additional revenue?

Mr. LAMPMAN. One could, by a series of credits to individual families, offset some of the regressivity in the assumed shifting.

Chairman PROXMIRE. Would you go all the way up?

Mr. LAMPMAN. With credits?

Chairman PROXMIRE. That is one of the problems.

Mr. LAMPMAN. I suppose it would be a tapered credit.

Chairman PROXMIRE. Some say you couldn't make the rebate very well above $10,000, that after that it would be ridiculous.

Mr. LAMPMAN. It would moderate the regressivity. It would be the same kind of thing we have in Wisconsin with our residential property tax credit. Some States have introduced and used a retail sales tax credit. It does take the regressive stinger out of such a tax, I think. It can make some adjustment for family size.

Chairman PROXMIRE. Would you prefer that to the increasing of income taxes?

Mr. LAMPMAN. Not from an income distribution point of view. Part of the argument that business has is that this would integrate in some way better with their interest in capturing export markets and resisting imports, that it would affect our balance of payments if carefully tailored.

Chairman PROXMIRE. What is your own judgment? Some of the opponents of the value-added tax have flatly denied that it would help the import situation.

Mr. LAMPMAN. I personally am not persuaded by the arguments that I have seen for the value-added tax and for its proposed use to reduce property tax.

Chairman PROXMIRE. So you would still come down to the income tax?

Mr. LAMPMAN. If we are talking about raising another $20 billion or so a year. I think we can do that with the personal income tax and the corporation income tax, in a much more reasonable and just way.

Chairman PROXMIRE. Mr. Budd.

Mr. BUDD. I am not familiar with the possibilites of a credit system to families under a value-added tax. I would think the tax would be definitely regressive and there wouldn't be much you could do about it. If you are going to give a lot of fancy tax credits to families, you would be far better off sticking with the Federal personal income tax and increases in that. You can directly control the progressivity of the Federal income tax, whereas I think it would be extremely difficult to control the degree of progressivity that might be involved in the value-added tax.

Mr. LAMPMAN. How do you go below the level where the income tax becomes zero?

Mr. BUDD. Negative income tax. I think you have to adopt some kind of negative income tax plan.

Mr. THUROW. I would agree with these two gentlemen. If the name of the game is raise $20 billion, the value-added tax is not the way to raise $20 billion progressively.

Chairman PROXMIRE. I think you have discussed briefly how you feel about the property tax. Earlier, witnesses have agreed that while the property tax needs reform, a properly administered property tax is not necessarily regressive but is an important balance in our structure and should not be replaced with a value-added tax.

Mr. THUROW. I think you want to make two distinctions when you talk about the impact of taxes. Taxes have vertical and horizontal equalizing effects. Horizontal equity is when two people with the same income pay exactly the same tax. Property taxes are progressive taxes. They are vertically equalizing. They are a good, progressive tax.

The objection to property taxes is that they create horizontal inequities. Two people with exactly the same income will have a total tax bill which differs.

The question on property taxes is whether there is some way we can remove the horizontal inequities without scrapping the system? If you take the property tax out of our tax system then the whole system will be more regressive than it now is.

Mr. BUDD. I certainly agree with that. Insofar as the property tax is a tax on land, it is simply going to give a benefit to current landholders. In the short run, that is also going to be true for the value of the structures on the land.

I would agree with Thurow that when you have a whole variety of different tax rates across different political jurisdictions, you are going to have a substantial amount of what he calls horizontal inequity.

But I don't think that justifies getting rid of the property tax.

Mr. LAMPMAN. I would emphasize the marriage of the property tax with local government. Certainly, what we have seen up to now is no very good substitute for local autonomy and tax policy other than to follow the property tax. It seems to me that this is a very important principle and a characteristic in America, that we do have a lot of decisions being made at the local level and they are genuinely made in a responsible way by reference to taxpayers being willing to pay for their own local improvements, their own local services.

One of the necessities in continuing to use the property tax and to use it more intensively, is that we take care of this regressivity and capriciousness particularly of property taxation on homes at the low income level. I think that can be done by methods that have been pioneered in Wisconsin, and it can be extended from the aged down to the nonaged.

This is one form of negative income taxation that is possible to use which will preserve, nonetheless, the ability of local governments to raise revenue.

So I think that there are many special improvements that could be made in the property tax.

Another thing that I believe is necessary in achieving the notion that we are getting horizontal equity is to think about statewide administration of certain aspects of the property tax; a certain part of what we think of as the evils of the property tax are really maladministration of the assessment process, which arises out of the use of amateurs, in a sense, who are only part-time and poorly trained for the very important responsibility they have.

So we could perhaps have a stronger influence by the State governments in this area and more technical assistance from the Federal Government.

I don't despair of the property tax being a reasonable tax to use in conjunction with the idea of perpetuating responsible local government.

Chairman PROXMIRE. I take it you gentlemen are all generally opposed to the value-added tax. We have had some who have been opposed to the value-added tax but said there were circumstances under which they might support it. I think those circumstances are they put such a high premium on improving and increasing our public services for health, for combating pollution, for welfare and so on, that they felt that they would, under some circumstances, come down on the side of the value-added tax for additional income, not to replace any present tax.

They felt from a realistic standpoint you are not going to be able to raise the income taxes. Under those circumstances, they say they might. Would you gentlemen agree with that view or would you oppose the value-added tax, period?

Mr. THUROW. I think if you were to so constrain me by telling me that the only tax that could go up is the value-added tax and you could guarantee to me that that money was going to be put in a trust fund for these civilian uses, I could swallow the value-added tax.

Mr. Budd. Under those very severe constraints I would agree with Mr. Thurow, although I would certainly fight awfully hard before I would let you put me in that kind of box.

Mr. Lampman. I am not trying to evade the question, but Charles Shoup at Columbia University has argued from history on this that the value-added tax in most countries has come about as a substitute for another tax.

In substituting it for the corporate income tax or substituting it for a gross turnover set of taxes, certainly one could see some case to be made, especially when you tried to integrate all of the countries into the Common Market trading patterns. There is no such historical reason to be argued for it here.

I am intrigued, Mr. Chairman, by how often what starts out as a government departure in recent years, in either the revenue or expenditure area, has turned out to be really revenue sharing for the State and local governments.

The value-added tax is tied in with the idea it will relieve property taxes, and give new responsibility to the State and local governments.

I am also impressed by the number of times that the idea of the Federal Government providing for emergency employment or providing for something like the Government as the employer of last resort in recession times, the number of times that that idea really is converted into saving taxes for the State and local taxpayer, not necessarily providing more jobs on net balance.

Chairman Proxmire. There is a political reason for that. I think the generality of people are more sensitive on taxes than jobs. There is a small percentage of people, many of whom don't vote, many of whom have a lack of education, who are really interested, seriously interested, in employment, except from an ideal standpoint. A very much larger proportion of people pay taxes. As political animals we react to what the majority of our constituents are concerned with.

Let me ask you gentlemen finally, and it has been a long morning, to tell me what changes in the income tax and the payroll tax, social security tax, you would prefer.

Mr. Thurow. I want to interpret the income tax broadly. I think if I had my "druthers" to change the tax law I would go out and adopt some July 4 rhetoric and put it into law. It seems to me one of the pieces of July 4 rhetoric is Americans ought to keep what they earned but shouldn't be allowed to inherit a lot.

I would put my push on having a lifetime gift and inheritance tax law, that no American can inherit over the course of his lifetime or be given in the course of his lifetime more than some amount. I don't care what the number is. $200,000 or $300,000, but some maximum that has real import.

I think from the point of view of economic power and political power there is a long-run interest not in having great concentrations of wealth. I get disturbed by statistics which show that 2½ percent of the population own 44 percent of the country.

Chairman Proxmire. How about the payroll tax?

Mr. Thurow. I think in general it is clear that if you could put some of the burden onto the income tax of the Social Security System it would be a step in the right direction.

Mr. BUDD. I personally would prefer to incorporate the payroll tax into the Federal personal income tax and change the rate in the Federal personal income tax accordingly.

I would prefer to do something by way of reform of the Federal personal income tax with respect to current loopholes, although I recognize that is an exceedingly difficult process.

I would also agree with Mr. Thurow on the more important role for inheritance and estate taxation.

Mr. LAMPMAN. I have thought for a number of years that the most important tax reform in this country would give special attention to those people who are below the zero tax point on the Federal income tax.

Mr. BUDD. I would like to add that.

Mr. LAMPMAN. As you know, we have had several important changes in the minimum standard deduction and now we have a low income method of figuring tax that changes the starting point at which people pay the Federal personal income tax.

There is a lack of symmetry running back from that for many persons, especially those excluded from the categorical public assistance programs.

I think the adoption of some kind of income supplement especially for working families, headed by either a man or a woman, should have high priority in thinking about overall income tax reform.

I would commend to your attention, as something worth studying, the new British Family Income Supplement which is directed to tapering the negative tax or the positive transfer in a more or less reasonable way to the starting point of the British income tax.

Going beyond that, there are a good number of reforms that were offered recently by a group including Senator Nelson of our State of Wisconsin that struck me as altogether productive and useful.

One that strikes me particularly as worth careful attention is his proposal that we convert the individual or personal exemption to a credit. This credit would be a flat amount for each person regardless of income level of the family. This system is presently being practiced in Wisconsin's income tax.

Chairman PROXMIRE. We did that in Wisconsin. I am the other Senator from Wisconsin.

Mr. LAMPMAN. It makes a difference in the distribution of the overall tax burden, of course.

Chairman PROXMIRE. Why is it a difference? I have always felt it is the same thing. Am I wrong?

Mr. LAMPMAN. I think you are wrong in terms of actual dollars that are involved. As I mentioned, the credit would be a certain amount. Say $150 per person which you deduct from your tax bill after you have figured out the liability using exclusions and deductions.

Chairman PROXMIRE. Instead of a $700 deduction from income you would have a $150 credit?

Mr. LAMPMAN. Right. The $750 you can deduct per person in the family varies in tax-saving value at each rate. A very low income person gets a zero tax saving by having an additional child, whereas a person in the 50 percent bracket makes a tax savings of half of $750 if he has an additional child.

So the overall distribution of tax liabilities will be substantially different across the income bracket and across the family size groups with a credit as opposed to an exemption. That is just one of several reforms that I have seen advocated recently that I would favor very much in looking at the individual income tax.

As regards the payroll tax, I do realize this is getting to be very high and it is a highly regressive tax. There are two ways to modify its regressivity. One is to extend the range of earnings to which it is subjected. At present it is about $9,000, I guess, of income, earnings. You do not tax non-earned income in this tax. We could extend that up.

I believe if it was extended to $25,000 of earnings we would be back to something like the same ratio the social security tax had to the distribution of earnings in the late 1930's.

So that would be consistent with the original thinking about the way to finance the social security package. Over and above that, one could think about very low income people as getting some relief from this payroll tax in the form of a negative income tax or a family income supplement. This would be one of the arguments for an income supplement as I see it, that there is so much regressivivity in our overall package of taxes now. We could offset that to some extent.

Further, I think especially as we move toward the consideration of a national health insurance plan, where the premium cost or the contribution cost on a payroll basis would be added on, I suppose, to the payroll tax we have for OASDHI, we do have to think about alternative ways of adding in a general Treasury contribution to payroll contributions.

Chairman PROXMIRE. Gentlemen, I want to thank you very much. As I say, this has been a different format than we have had in the past, with one advocate and two opponents. I think it has worked out extraordinarily well. I think you have made an outstanding record. I think it fits so well into our study of the value-added tax.

The other witnesses all testified directly on it. You testified on the sociological implications of it before you tesified directly on it.

The committee will stand adjourned. We have completed the 4 days of hearings on the value-added tax. Thank you very much.

(Whereupon, at 12:15 p.m., the committee adjourned, to reconvene subject to the call of the Chair.)

APPENDIX

[From the Morgan Guaranty Survey, January 1972, published monthly by the Morgan Guaranty Trust Co. of New York]

TOWARD A NEW PHILOSOPHY OF TAXATION

The following article was written by Dr. Richard W. Lindholm, Professor of Finance at the University of Oregon's College of Business Administration. Dr. Lindholm has written extensively on tax matters and is known as a forceful advocate of the value-added tax.

By traditional standards of equity and efficiency, the system of taxation that exists in the United States—involving many different kinds of taxes levied in uncoordinated fashion by many different taxing jurisdictions—falls far short of the ideal. Few taxpayers have any sense of being treated fairly; few administrators are really satisfied that the system is nearly as economical or nondistorting as it ought to be.

Bad as the situation is now, it could get a lot worse the way things are going. Public revenue needs almost certainly will continue to mount rapidly in the years ahead, and as that occurs the distortions presently built into the system are bound to seem progressively more onerous to those they affect. And it is predictable that new distortions will be created, particularly since there is no end in sight to the helter-skelter quest by state and local governments for new revenue sources.

That some drastic reform of the tax system that exists in this country would be desirable is widely agreed on. The trouble in the past has been the difficulty of devising a remedial approach that was at once both sound and politically salable. For reasons that I shall set forth in this article, I believe that in the not-too-distant future the so-called value-added tax (VAT), which has begun to attract a great deal of attention, will be able to meet these twin tests. In my judgment, it has far more dramatic potential for bringing about radical improvement in the nation's tax system than is as yet commonly realized, and, as its strengths come to be better understood, broad-based backing for it ought to develop.

Advocated by some people merely as a new revenue source and by others who want it just for the special help it could give to exporters, the value-added tax—properly understood—would actually be a first step toward altering the basic fundamentals of American taxation. VAT's adoption—under serious consideration for some time by Nixon Administration officials but apparently not to be recommended in this month's budget message—would signal nothing less than a new tax philosophy on this side of the Atlantic. VAT is already widely in use in Europe and is spreading there rapidly.

VAT is simply a flat percentage levy paid on the value added to a product or a service at each stage of production and distribution. A manufacturer adding $100 to the value of something he processed would thus have a tax base of $100 against which the tax rate would be applied. Actually, as the tax is typically administered in Europe—and presumably would be administered here—a seller does not make a calculation as such of the value added to goods or services in his particular operations. Rather, he figures his tax at the legally specified rate on the full amount of all sales to his customers and is allowed to credit against that liability all amounts of VAT which he himself has paid to suppliers. With VAT payable at each successive stage of the production of a good or service, its theoretical base is as large as a country's gross national product.

In order to put foreign-produced goods on the same tax footing as domestically produced goods, VAT systems provide that a border tax must be paid on imports at the VAT rate. And on the theory that exported goods may be subject to other countries' border taxes and that taxes should be paid where the benefits of consumption are enjoyed, exporters receive rebates from their own government of VAT taxes they have paid to suppliers and, of course, pay no VAT on the value they themselves add to a product. This refunding to exporters is permitted under the rules of the General Agreement on Tariffs and Trade (GATT), as it is for all kinds of so-called indirect taxes. The refunding gives a competitive advantage internationally to countries that rely heavily on VAT systems in relation to those such as the U.S. that have tax systems oriented more to levies on income, which under GATT rules cannot be refunded.

Important as the benefits of a VAT system can be in aiding a nation's trade balance, I view the domestic advantages as of even greater significance. Most basic of all is the fact that VAT does not have nearly as many distorting impacts on economic decision-making as do a number of taxes now relied on heavily in the United States. VAT, therefore, could be of great potential help in preserving the vitality and productivity of the private sector of the economy.

Certainly there is good reason to think that the eventual substitution of VAT for some considerable portion of income taxes—particularly corporate income taxes—might very well yield substantial benefits. For one thing, the corporate income tax, at least at present high rates, creates a very strong inducement to minimize the legally definable tax base—that is, reported corporate profits. This encourages laxity in cost control (including tolerance in some instances of loose expense-account practices since the government picks up a substantial part of the tab). It also tends to discourage an emphasis on internal efficiency because all internal cost reductions are reflected directly in the profits tally and hence become subject to the high corporate tax rates. Prevailing "double taxation" of corporate income, moreover—once at the firm level and once after stockholders receive dividends—encourages high profits retention by businesses. This, of course, tends to funnel savings automatically into established, conventional use patterns rather than having the allocation determined by capital-market competition. Additionally, high profits taxation—combined with the deductibility of interest paid and the nondeductibility of dividends—arbitrarily favors debt financing over equity financing, thus fostering a high fixed-debt structure for corporations.

The value-added tax, by contrast, is a much more neutral levy and consequently a much less distorting one. It does not, for instance, either encourage cost padding or discourage cost reductions because a firm's value-added tax is determined entirely by what can be thought of as external factors—namely, by tax liability arising at the point of sale and by the value-added taxes a business pays its suppliers. Under a VAT system (assuming there were no corporate income tax at all), every dollar gained from internal cost reduction would get fully reflected in a firm's after-tax profits instead of being only partially reflected as is the case at present. This, of course, could generate a much greater drive for efficiency improvement in industry than now prevails.

HOW VAT WOULD WORK

A manufacturer with total sales of $1,000 and the other indicated transactions would be affected by a 10 percent VAT as follows:

	Transactions amounts	VAT liability, credit, or rebate
Total sales	$1,000	$100 liability.
Exports	200	$20 rebate.
Imports	100	$10 border tax liability.
Domestic purchases from VAT-paying suppliers	200	$20 credit.
Domestic purchases from non-VAT-paying suppliers	50	None.
Net liability of VAT and border taxes		$70 liability.

And not only does VAT have advantages over income taxes, its evenhandedness makes it superior as well to many other types of taxes, including payroll taxes. Payroll taxes are especially burdensome for labor-intensive industries. They directly increase the cost of employing a worker and thus either discourage employment or exert downward pressure on wages. VAT would have no such impact. Indeed, under a VAT system an industry's tax liability would be totally unaffected by the way in which any of the principal factors of production (land, labor, capital, and entrepreneurial effort) are combined with other factors to produce outputs. Wholly nondiscriminatory, VAT neither penalizes nor rewards a firm for using more of one factor and less of another.

It is VAT's neutrality, and hence its potential for lessening tax-related distortions in our economy, that I believe to be its strongest selling point—weightier even than the help it would give to the country's foreign-trade position. Not to be overlooked, of course, is the fact that anything making for a healthier domestic economy in terms of such things as reduced inefficiencies and better capital allocation also contributes on its own to the strengthening of international competitiveness.

VAT also possesses two administrative qualities that add powerfully to its attractiveness. The first of these is a built-in pressure for compliance. This stems from the requirement set forth in all VAT legislation that is in effect in Western Europe that only VAT amounts written down on sales invoices are deductible or refundable. This information is needed by all business purchasers in order to reduce VAT liability arising from sales. Thus, at almost every point in the production and distribution process, purchasers have a powerful vested interest in seeing that sellers record VAT amounts fully. Fraud is still distinctly possible under a VAT system (as the experience with false invoices in France shows), but evasion is at least less likely with VAT than with many other major taxes.

VAT also enjoys (at least as legislation typically is written in Europe) an inherent defense against pressures from those who plead for exemption or special treatment, action which whenever successful reduces the tax base. This deterrent arises (1) because firms in a non-VAT-taxed industry do not receive refunds of VAT amounts included in their purchases and (2) because firms that are subject to VAT receive no credits to use as an offset to their VAT liability if purchases are made from non-VAT-paying suppliers. In European countries, these deterrents to exemption and special treatment have acted to give VAT's base a predisposition to expand rather than contract, and a broad base is always a highly desirable feature of any tax, since the larger the base the lower the rate need be to raise a specified amount of revenue. And the lower the rate the smaller the danger that a given tax will seriously burden any given taxpaying unit.

In view of VAT's various strengths, both substantive and administrative, it certainly is not hard to understand why so many countries in Europe have turned to it. Initially introduced by France in 1954, it now is a vital part of the tax systems of seven other countries as well: West Germany, The Netherlands, Belgium, Luxembourg, Denmark, Norway, and Sweden. And within the next 18 months, proposed VAT legislation is likely to become effective in Great Britain, Italy, Ireland, Austria, and Switzerland. Quite a record! The really extraordinary thing, however, is that the United States has been so slow to move and that it is still hesitating.

IDEAL FOR REVENUE SHARING

One point in particular that should be appreciated about a national value-added tax for the United States—but which as yet is not—is that it would have considerable potential as an approach to revenue sharing. Specifically, it could in my judgment be a very useful device for getting rid of the infuriating complications and administrative costs associated with our great variety of state and local retail sales and use taxes—now in force in 47 states and in an additional large number of cities and counties. Once only bothersome—when rates were 1% or 2% and when coverage was limited—such taxes have now evolved to a point at which real burdens, often capriciously distributed among different classes of taxpayers, are involved.

A national, uniform VAT collected by the federal government and returned to state and local governmental bodies agreeing to abolish sales and use taxes would do several very good things. The waste, the inefficiency, and the flagrant evasion associated with the levying of sales and use taxes would end. In addition, very significant revenues would be available for revenue sharing—with VAT collections returnable (in instances where state officials so opted) to the very villages and counties from which they came. Precise feedback is readily possible administratively under the value-added tax, something that is not true with the personal income tax or the corporate profits tax. This is a very significant plus which could help the revenue sharing idea—now bogged down in controversy—become reality. The difficulties revenue sharing has encountered are related in no small measure to the fact that virtually all of the specific proposals so far advanced identify federally collected income taxes as the revenue to be shared. The inability to allocate accurately taxable income back to its source has proved a major stumbling block.

VAT, of course, is not without detractors. Perhaps the charge most frequently hurled is that it is nothing but a national retail sales tax parading just another name. Labeling VAT an "unjust, regressive levy on consumption" has indeed become standard with those who do not like it.

Actually, VAT in essence is really a procedure for including the cost of maintaining government in the total cost of producing GNP. It is thus more accurately called a production tax than anything else. If VAT were the exclusive source of government revenue and if it were applied at a single rate against a very broad base, it would simply make the full cost of government an identifiable and explicitly stated cost of producing a nation's goods and services.

A production tax of such nature does not, of course, have as one of its objectives the creation of any particular pattern of income distribution. In conventional terms, it is neither regressive nor progressive. A government wishing to pursue a particular target with regard to income distribution could not, as a practical matter, do so by means of VAT. That function has to be left to other taxes and other government measures, including expenditures policy.

Objecting to the value-added tax because it is passed on to the final consumer is not very meaningful. All business costs (whether for the use of labor, the use of capital, or for anything else) must ultimately be covered by prices charged for goods and services. VAT's burden thus turns out to be about the same as any other cost that is marbled uniformly throughout the production process. VAT, to repeat, is economically neutral.

Those who recognize VAT's potential for helping this country's trade position but who object to it for other reasons often argue that U.S. officials—instead of considering enactment of the levy—should concentrate on getting GATT rules renegotiated to permit the rebate to exporters of direct as well as indirect taxes. However, accomplishing such a change—even assuming a cooperative attitude on the part of our trading partners—is extremely hard to imagine.

That is because the treatment provided for in GATT rules is grounded in the characteristics of tax differences rather than being simply a matter of arbitrary edict. It is one thing to devise an equitable scheme for rebate to exporters of amounts representing excises or value-added taxes and quite another to figure out a way to do so in the case, say, of income taxes. One exporter may be a very profitable company paying considerable corporate income taxes while another may be losing money and thus paying no income taxes. Refunding corporate income taxes that have been paid on goods moving into export channels simply is not feasible, nor is the establishment of a border tax based on foreign levels. Similar difficulties—in fact somewhat more complicated—would arise in trying to develop a method for refunding payroll taxes to exporters or in establishing a compensatory border tax for foreign payroll taxes. GATT's prohibition on the rebate of direct taxes traces to these difficulties. If we are going to get help with our trade position comparable to that now enjoyed by nations using the VAT system, there really is no practical way to do so except by adopting VAT.

OPENING VAT'S SPIGOT

I would favor the introduction of VAT in the United States at a 10% rate, somewhat below typical European levels but high enough to generate a very sizable amount of revenue. A rate of 10% on a very broad base ought to provide at least $60 billion to the Treasury. It is my belief that half of this amount would best be used under a revenue-sharing program that would eliminate all state and local sales and use taxes. Under these circumstances, the upward pressure on prices caused by the introduction of VAT would be substantially lessened. Significantly, the substitution of a 10% VAT for existing sales and use taxes combined with the return of half of all VAT collections to states (with the Treasury doing the allocation on the basis of retail sales totals by states) would result in a substantial net increase of funds available for state and local use. The State of New York, for instance, would receive about 403% of its current state and local sales tax collections; and New Jersey about 410%. In Massachusetts and Pennsylvania, the revenue shared would be equivalent to about 560% and 190%, respectively, of the revenue now derived from sales and use taxes.

The other half of the Treasury's VAT receipts, or something over $30 billion, could very sensibly be used to initiate a dual-rate system for corporate profits taxation (with distributed profits made subject to a lower rate than undistributed profits) and to eliminate all federal excise taxes except those on tobacco, alcohol, and petroleum. This would be similar to actions aimed at reform and simplification that the British are proposing to take when VAT goes on the books in Britain.

Any funds remaining after these allocations would go into the Treasury to support budget programs generally. If the residual proved to be of any real size (or if at some future date the VAT rate were increased), further imrovement of the tax system could be achieved. Lifting some or all of the burden that local property taxation carries in supporting education is one obvious possibility. Stabilizing payroll taxes is another.

Collections from the 10% border tax that would be introduced simultaneously with the introduction of VAT should just about finance the 10% VAT rebate paid to exporters. The border tax combined with the rebate would stimulate U.S. manufacturing and exports, give jobs to American workers, and increase domestic investment of savings. This is just what VAT apparently has been doing for EEC member-state economies during the past several years. Again, the approach is provided for under GATT rules and hence its adoption would in no way open the U.S. to charges of pursuing a restrictive "beggar thy neighbor" policy. The United States would only be doing what its trading partners consider to be right, at least when *they* do it.

In order for the United States to move in the direction outlined above, a new philosophy of government finance, at least for most Americans, is required. Taxation must be seen as a necessary cost of production wherever production takes place and whatever is produced. There must be a perception also of the fact that inefficiencies and distortions can be minimized if a substantial portion of the necessary taxes is collected at each point in the production and distributive process at which value is added to goods or services. Finally, the harmonizing of our tax system with that of other nations must be seen as one of the adjustments necessary for preserving the benefits of an unfettered international movement of goods, services, and capital.

Statement of the Communications Workers of America on the Value-Added Tax

President Nixon, whose economic policies have resulted in high unemployment, record price levels and frozen wages, is now considering imposing a value-added tax on the already sagging shoulders of the American tax payer.

It is eminently clear to the Communications Workers of America that the value-added tax is a national retail sales tax, regressive and inequitable in character, that would fall hardest on middle and low income families. These families are suffering from the economic mismanagement of the Nixon administration and are caught between the twin pincers of inflation and recession.

The value-added tax, in the form that it is currently under consideration by the administration, would amount to a 3 percent across-the-board tax on all consumer items, with the probable exception of food and medicine. Under this proposal, the poor citizen making only $5,000 a year, with five children, would bear the same tax assessment on products he purchases as the ultra-rich citizens making $500,000 a year with no children.

Thus, the value-added tax is blatantly contrary to the concept of progressive taxation—that is, taxation based on ability to pay—to which our revenue-raising laws are supposed to conform.

The value-added tax is a way for the Nixon administration to avoid initiating the authentic tax reform which America desperately needs. That is why the value-added tax is championed by those rich corporations and wealthy individuals who, while exploiting loopholes that serve as escape hatches from their own revenue-paying responsibility, chronically complain that the federal tax system overburdens them and treads too lightly on those whose incomes are modest.

Too often, we take for granted the fact that the average American taxpayer has never shirked his duty in supporting his government. He pays his income tax on each dollar that he earns and utilizes no depletion or depreciation gimmicks.

In contrast, many American corporations are freeloaders on our national scene, paying little in taxes and in some cases no tax at all. The U.S. Steel Corporation, the twelfth largest corporation in America and the largest dollar-value steel manufacturing company in the world, achieved a sales volume of almost $5 billion and paid not one penny of income tax in 1970. Standard Oil of New Jersey paid taxes last year at the rate of 10.8 percent on a net income of nearly $2.5 billion—less than the rate the average taxpayer paid last year if he earned $12,000. The Gulf Oil Company had a net income before taxes of nearly $1 billion in 1970, but paid taxes at the rate of 1.2 percent.

It is a stain on our national conscience that these corporations, pay such a minimal contribution to the federal treasury and indeed are even subsidized by our government through various forms of support for their expansion. Moreover, they contribute to the pollution of our environment causing even more expense for the taxpayer.

In addition to huge corporations, 300 Americans with incomes of over $200,000 in 1969 paid a federal income tax of exactly zero. Among the rich and super-rich, it has been estimated that about $70 billion of taxable income is escaping internal revenue obligations through tax loopholes. It is a form of cruel and unusual punishment for the government to coerce the average American into paying his taxes with the threat of prosecution, while his tax money goes to subsidize these tax escapers.

Proponents of the value-added tax have argued that it has proved to be an effective and efficient revenue-raising device in European countries. This assertion is subject to doubt.

The Europeans developed the value-added tax because they were trying to remedy two problems not applicable in the United States. First, they needed to replace a crazy-quilt turnover tax system under which they had been imposing a transactions levy not only on manufacturing but also on all sectors of distribution. Second, they had to cope with a tradition of widespread evasion of income tax payment by average citizens.

Moreover, the value-added tax as applied in Europe has triggered inflation. In Holland, when this tax was introduced a few years ago, they expected a price increase of 1.5 percent. In reality, prices skyrocketed by 5 percent during the first three months.

Belgium had planned to introduce the value-added tax on January 1, 1970, but on September 10, 1969, decided to postpone the plan for one year as at that time the national economy was in the midst of rapid expansion and rising prices.

The reason for fearing that adoption of the value-added tax would precipitate runaway inflation here is that it would initially cause the price of consumer goods to rise. This would set off a strong need for wage increases, and thus the spiral would ascend.

Congress needs to enact meaningful legislation that would close gaping tax loopholes, not a value-added tax. What we need in America is tax justice—legitimate revenue reform—not a 3 percent national sales tax.

The Communications Workers of America is unalterably opposed to the value-added tax for the simple reason that it would perpetuate our current misguided policy of taxing too many too much and too few too little.

Statement of the American Federation of Teachers on the Value-Added Tax

The Executive Council of the American Federation of Teachers at their meeting on February 5, 1972, gave full consideration to the proposed "value-added tax."

At the conclusion of their deliberation, they voted unanimously to oppose the institution of the value-added tax as regressive in nature and financially unsound. Additionally, the Council resented the implication of the Nixon Administration in proposing a special tax to support education.

Following full discussion, the Council approved unanimously the following statement:

AFT OPPOSES VALUE-ADDED TAX

The American Federation of Teachers, AFL–CIO, strongly opposes the Nixon Administration's proposed value-added tax. We resent the attempt to tie education to a regressive, unfair method of taxation which would further advance the Nixon "soak the poor" philosophy.

The value-added tax is not a new way of taxing—it is merely a different method collecting a sales tax. The burden of value-added tax falls entirely on the consumer, with all the regressive attributes of a sales tax. Moreover, the value-added tax would destroy the thin margin of equity that remains in the Federal tax structure.

As proposed this tax would single out education for special treatment. Revenue for education should be raised in the same manner that funds are raised for other social programs thru the existing progressive Federal tax structure. It is inappropriate to hide an unfair tax under the cloak of desperately needed educational funds.

The AFT will oppose any value-added tax proposed in Congress and will participate in the campaigns mounted against the value-added tax by the AFL–CIO and other segments of the labor movement.

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