[JOINT COMMITTEE PRINT]

IMPACT ON STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS OF REPLACING THE FEDERAL INCOME TAX

SCHEDULED FOR A HEARING

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON

MAY 1, 1996

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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104TH CONGRESS, 2D SESSION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on May 1, 1996, on issues relating to the impact on State and local governments and tax-exempt entities (other than qualified pension trusts) of replacing the Federal income tax. The hearing will focus on the effects of the following possible proposed replacement tax systems: (1) a national retail sales tax; (2) a value-added tax; (3) a consumption-based flat tax; (4) a cash flow tax; and (5) a "pure" income tax. Some of these proposals have been the subject of introduced legislation. On March 6, 1996, Messrs. Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump introduced H.R. 3039, the "National Retail Sales Tax Act of 1996." On May 26, 1994, Senators Boren and Danforth introduced S. 2160 (103rd Cong.), the "Business Transfer Tax," which is a subtraction-method, value-added tax. On July 19, 1995, Mr. Armey and Senator Shelby introduced H.R. 2060 and S. 1050, respectively. These bills provide consumption-based flat taxes. On April 25, 1995, Senators Nunn and Domenici introduced S. 722, the "USA Tax Act of 1995," which contains two consumption-based taxes—a cash flow tax on individuals and a subtraction-method, value-added tax on businesses. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes several aspects of present law and the various tax restructuring proposals with respect to State and local governments, tax-exempt entities, and tax-exempt financing.

Part I of this pamphlet is an overview of the discussions contained in the remainder of the pamphlet. Part II provides a description of certain present-law income tax provisions that apply to State and local governments and other tax-exempt entities. Part III contains summary descriptions of the various proposed replacement tax systems. Part IV is a discussion of particular issues confronting State and local governments and other tax-exempt entities under the proposed replacement tax systems. The Appendix presents data used in Charts 3, 4, and 5.

[1] This document may be cited as follows: Joint Committee on Taxation, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax* (JCS–4–96), April 30, 1996.

I. OVERVIEW

State and local governments and other tax-exempt entities

Under the present-law Federal income tax system, State and local governments themselves, as well as payments to such entities, are subject to special rules. State and local governments are not subject to tax on income derived from the exercise of any "essential governmental function," and individual taxpayers who itemize deductions may deduct State and local income, real property, and personal property taxes. Businesses generally are permitted to deduct such payments (as well as sales taxes) as ordinary and necessary business expenses. From a revenue standpoint, the majority of State and local revenues are derived from sources other than individual and corporate income taxes, but many of the States that do collect income taxes model their systems on the Federal income tax system. Thus, under current law, there is a close relationship between the Federal and State tax systems. Any reform of the Federal tax system would have significant corollary effects on State and local tax systems.

Non-governmental tax-exempt entities likewise are subject to special rules under present law. The nonprofit sector encompasses a wide variety of organizations, from social welfare organizations to social clubs to credit unions. These organizations generally are not subject to Federal income tax on dues and contributions they receive, as well as on other income that is substantially related to their exempt purpose. In addition, certain tax-exempt organizations also are exempt from tax on their investment income. Special rules apply to "charities" which, in exchange for satisfying more stringent qualification requirements, are eligible for additional benefits not available to other tax-exempt entities, such as tax-exempt financing and the ability to receive tax-deductible contributions. For most tax-exempt organizations, income that is derived from a regularly carried on trade or business that is not substantially related to the exempt purpose of the organization is subject to tax under the unrelated business income tax ("UBIT") rules. These rules also exempt certain enumerated types of income from the UBIT. The application of the UBIT rules, as well as the scope of the exemptions, are an ongoing source of controversy between exempt organizations and the Internal Revenue Service.

This pamphlet describes five alternatives to replace the current income tax system. These are (1) a national retail sales tax, (2) a value-added tax, (3) a consumption-based flat tax, (4) a cash flow tax and (5) a "pure" income tax. Other than the "pure" income tax, these alternative tax systems generally are consumption-based, rather than income-based, taxes. The major difference between a consumption-based tax and an income-based tax relates to the treatment of savings. Under an income-based tax, returns to savings (e.g., dividends, interest, and capital gains) generally are subject to tax; under a consumption-based tax, these returns generally are excluded from the tax base. The exclusion of returns to savings from the tax base may be accomplished by taxing consumption directly, excluding investment income from the base, or providing a deduction for increased savings. The current Federal "income" tax

contains some features that are consumption-based (e.g., the treatment of qualified retirement plans).

The various alternatives to replace the current income tax system will have different effects on State and local governments and other nonprofit entities. Activities of such entities raise particular issues under a consumption-based tax. For example, assuming a broad-based tax attempted to include the value added by governments or nonprofit entities in its base, difficulties in measurement may arise because these entities often provide goods or services on a free-of-charge basis or on a subsidized basis. In many cases, there is no identifiable transaction involving, or consumer of, government or nonprofit services. Taxation under a consumption-based tax regime of certain activities of governments and nonprofits, such as those currently taxed under the UBIT, may be accomplished under consumption-tax rules generally applicable to for-profit businesses. However, to the extent a government or nonprofit entity conducts different types of activities, it becomes necessary to apply different tax rules to each activity. The difficulties this presents exist to a degree under present law, and are not likely to be alleviated under a consumption-based system or a "pure" income tax to the extent special rules are provided to address issues peculiar to government- and nonprofit-provided goods and services. In addition, a shift to a consumption-based tax or a pure income tax could have a significant effect on charitable giving.

State and local government bonds

Present law exempts interest on debt of States and local governments from the regular individual and corporate income taxes. This exemption extends both to bonds issued to finance activities carried out and paid for by these governments, and to certain bonds issued by these governments acting as conduits to finance activities carried out and paid for by private parties. Interest on private activity bonds is tax-exempt only if the activity being financed is specified in the Internal Revenue Code.

Tax-exemption allows States and local governments to borrow at interest rates below the rates paid by corporations and the Federal Government; however, the capital markets direct only a portion of the benefit of tax-exemption to States and local governments. The balance of this Federal subsidy is received by investors, others involved in issuance of the bonds, and private borrowers in the case of private activity bonds. Adoption of a consumption tax or a pure income tax could be expected to eliminate the tax advantage currently enjoyed by State and local government bonds relative to other, currently taxable, debt of comparable risk. Proposals for a consumption tax would exempt interest income, from whatever source derived. A pure income tax would tax interest on tax-exempt debt the same as other capital income.

Transitional concerns arise with respect to the value of tax-exempt bonds issued before enactment of any tax reform proposal, particularly long-term bonds having fixed interest rates. In addition, questions arise about the fiscal impact on States and local governments from possible changes in interest expense relative to those that they historically have experienced. Longer-term effects from the elimination of tax-exemption on State and local govern-

ment bonds are difficult to predict because of broader economic changes that can be expected to accompany enactment of tax reform.

II. PRESENT LAW AND BACKGROUND

A. State and Local Governments

1. Treatment as nontaxable entities

Under section 115 of the Internal Revenue Code (the "Code"), State and local governments (as well as public utilities and the District of Columbia) are not subject to Federal income tax on income derived from the exercise of any "essential governmental function" or from any public utility. Section 115 also provides that income accruing to the government of any possession of the United States, or any political subdivision thereof, is not subject to Federal income tax. In addition, section 501(c)(1) provides tax-exempt status to certain entities organized under an Act of Congress which are instrumentalities of the United States.[2]

Historically, the term "essential governmental function" has been interpreted broadly. A wide range of activities of State or local governments has been determined under section 115 to be not subject to Federal income tax, even though many such activities significantly compete with private commercial ventures (e.g., hospitals and liquor stores).[3]

2. Deductibility of State and local tax payments

Tax payments made by individuals

An individual taxpayer who itemizes deductions for Federal income tax purposes (i.e., the individual does not claim the standard deduction) may deduct State and local income, real property, and personal property taxes paid or accrued during the taxable year, even if such taxes had not been incurred in a trade or business activity (sec. 164). Taxes paid as part of the acquisition or disposition of property (e.g., transfer taxes) generally must be capitalized. Under section 7871, Indian tribal governments are treated as States for purposes of the section 164 deduction.

Tax payments made by businesses

When computing taxable income for Federal income tax purposes, businesses generally are permitted to deduct as an ordinary

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[2] Although section 7871 provides that Indian tribes are treated as States for certain enumerated tax purposes (such as for issuance of certain tax-exempt bonds, certain excise tax exemptions, and eligibility to receive deductible charitable contributions), there is no specific statutory provision governing the Federal income tax liability of Indian tribes. However, the IRS has long taken the position that Indian tribes, as well as wholly owned tribal corporations chartered under Federal law, are not taxable entities and, thus, are immune from Federal income taxes. See Rev. Rul. 67–284, 1967–2 C.B. 55; Rev. Rul. 81–295, 1981–2 C.B. 15. More recently, the IRS has ruled that any income earned by an unincorporated Indian tribe or Federally chartered tribal corporation is not subject to Federal income tax, regardless of whether the commercial activities that produced the income are conducted on or off the tribe's reservation. See Rev. Rul. 94–16, 1994–12 I.R.B. 1, Rev. Rul. 94–65, 1994–42 I.R.B. 10. In ordinary matters not governed by specific treaties or remedial legislation, individual members of Indian tribes are subject to payment of Federal income tax (even if the income they receive is distributed to individual tribal members out of income otherwise immune from tax when first received by the tribe). See *Squire* v. *Capoeman*, 351 U.S. 1, 6 (1956).

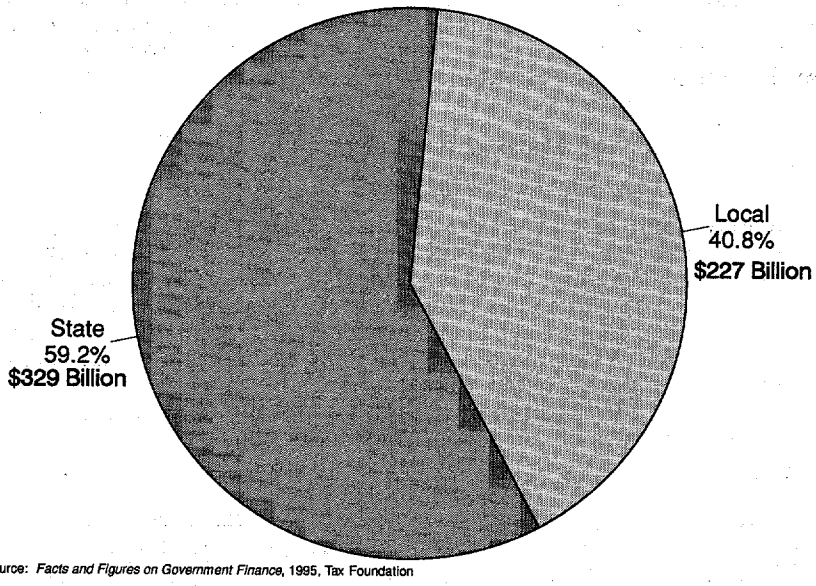
[3] Few activities conducted by governments have been found to be not related to their essential governmental functions. See *New York* v. *U.S.*, 326 U.S. 572 (1946)(upholding imposition of Federal income tax on sale of bottled water by State). A State-run liquor store generally would be an essential governmental activity, even though it is operated on a for-profit basis, because there is a governmental purpose in the State's operation of the venture (i.e., to assure compliance with State laws). See Rev. Rul. 71–131, 1971–1 C.B. 29. See also P.L.R. 9205020 (income of community mental health center that was State agency not subject to tax).

and necessary business expense under section 162 all tax payments (e.g., income, real property, personal property, and sales or use taxes) made to State and local governments during the taxable year. However, as with individuals, taxes paid as part of the acquisition or disposition of property generally must be capitalized.

3. Relationship between State and local government taxes and Federal tax system

Under present law, the majority of State and local tax revenues are derived from sources other than individual and corporate income taxes. Chart 1 below sets forth total State and local tax collections for 1992.

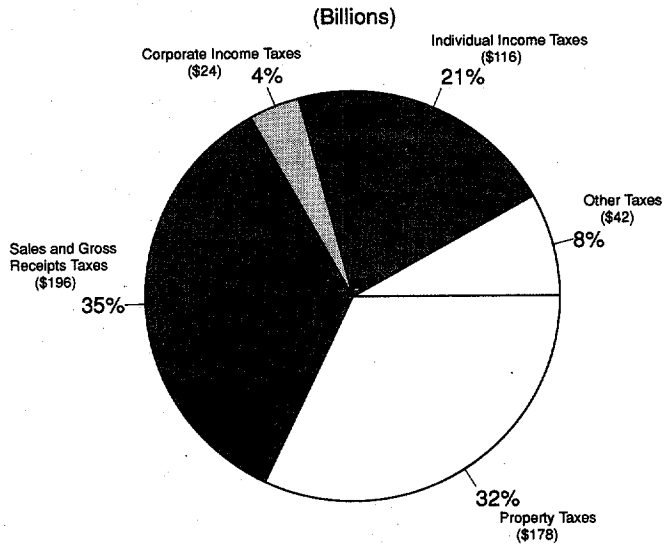
CHART 1--State and Local Tax Collections, Fiscal Year 1992
Total = $556 Billion



Source: *Facts and Figures on Government Finance*, 1995, Tax Foundation

Generally, as indicated in Chart 2 below, income taxes account for no more than 25 percent of State and local tax revenues, whereas sales and property taxes account for nearly 70 percent of all State and local tax receipts. Property tax revenues often are dedicated to a particular purpose, such as schools.

CHART 2--Composition of Combined State and Local Tax Collections, Fiscal Year 1992



Source: *Facts and Figures on Government Finance*, 1995, Tax Foundation

However, most of the States that collect individual and corporate income taxes model their State income tax systems after the Federal income tax system, although the degree of conformity varies widely. Table 1 below indicates the level of conformity between each State's income tax and the Federal income. Any significant restructuring of the Federal income tax system could have considerable corollary implications for such States.

Table 1. Degree of Conformity Between State and Federal Income Taxes

State income tax uses Federal adjusted gross income: Arizona, California, Connecticut, Delaware, District of Columbia, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Oregon, Virginia, West Virginia, and Wisconsin.

State income tax based on Federal taxable income: Colorado, Hawaii, Idaho, Minnesota, North Carolina, South Carolina, and Utah.

State income tax calculated as a percentage of Federal tax liability: North Dakota, Rhode Island, and Vermont.

Only certain interest and dividends are taxed by State: New Hampshire and Tennessee.

No conformity between State and Federal income taxes: Alabama, Arkansas, Mississippi, New Jersey, and Pennsylvania.

No State income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

Source: U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism,* 1995.

This State-Federal "piggyback" can take several forms. For example, taxable income for State purposes may be based upon Federal taxable income, or adjusted gross income for State purposes may be based upon Federal adjusted gross income. In addition, many State collection and enforcement initiatives rely on Federal efforts and information. Federal-State information sharing permitted under Code section 6103(d) forms a vital part of many States' enforcement of their income tax systems. Certain States have established joint collection operations to pool Federal and State enforcement resources.

B. Other Tax-Exempt Entities

1. Treatment of non-governmental tax-exempt entities

In general

The nonprofit sector in the United States includes a wide variety of organizations, the activities of only some of which are considered "charitable." At present, 25 different types of nonprofit organizations qualify for tax-exempt status under section 501(c) of the Internal Revenue Code. These include certain title and real property holding companies (sec. 501(c)(2)), social welfare organizations (sec. 501(c)(4)), labor, agricultural or horticultural organizations (sec. 501(c)(5)), trade associations (sec. 501(c)(6)), social clubs (sec. 501(c)(7)), cemetery companies (sec. 501(c)(13)), and credit unions (sec. 501(c)(14)). In addition, other Code sections provide general tax-exempt status for other entities, such as political organizations (sec. 527), qualified pension plans (secs. 401(a) and 501(a)),[4] and certain cooperatives (sec. 521). These tax-exempt organizations generally are not subject to Federal income tax on dues and contributions they receive from their members, as well as other income from activities that are substantially related to the purpose of their tax exemption. Tax-exempt organizations generally are not subject to Federal income tax on their investment income, although this general rule does not apply to certain organizations (e.g., social clubs described in sec. 501(c)(7), voluntary employee beneficiary associations described in sec. 501(c)(9), and political organizations described in sec. 527), which must pay Federal income tax on their investment income.

Charities

Organizations exempt from tax under section 501(c)(3)—generally referred to as "charities"[5]—must be organized and operated exclusively for certain enumerated charitable purposes. To qualify as a tax-exempt charity described in section 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational

[4] Pension plans are the subject of many special rules in the Code (e.g., sec. 457 provides special rules applicable to deferred compensation plans of State and local governments and other tax-exempt entities). Such rules are beyond the scope of this pamphlet, and will be the subject of a separate hearing.

[5] "Charities" described in section 501(c)(3) are divided into two categories: public charities and private foundations.

purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. No part of the net earnings of such an organization may inure to the benefit of any private shareholder or individual.[6] In addition, no substantial part of the activities of a 501(c)(3) organization may consist of carrying on propaganda, or otherwise attempting to influence legislation, and such organization may not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office.

In exchange for meeting the more stringent requirements under section 501(c)(3), charities are entitled to certain Federal tax (and other) benefits not available to other tax-exempt entities. Charities are entitled to receive gifts or contributions that are deductible by donors who itemize deductions. Charities also may use the proceeds of tax-exempt financing (discussed in more detail below) and are granted preferential postal rates. In contrast, other nongovernmental, tax-exempt organizations are eligible only for the exemption from Federal income tax.[7] Charities and certain other tax-exempt organizations may also qualify for exemption from State and local taxes, depending on the extent to which a State's tax system conforms to the Federal system.

2. Unrelated business income

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511–514).[8] The UBIT applies to all organizations that generally are exempt from Federal income under section 501(a) (other than certain U.S. instrumentalities created and made tax-exempt by a specific Act of Congress) and to State colleges and universities (sec. 511(a)(2)). Certain income, however, is specifically exempted from the UBIT, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 80-percent controlled subsidiaries (sec. 512(b)).[9] Other exemptions from the UBIT are provided for activities in which substantially all the work is performed by volunteers, income from the sale of donated goods, and certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization

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[6] This so-called "private inurement" rule also applies to certain other tax-exempt entities (e.g., 501(c)(6) business leagues).

[7] As an exception to this rule, certain contributions made to war veterans organizations, domestic fraternal societies, and member-owned cemetery companies are deductible as charitable contributions under section 170.

[8] Prior to the enactment in 1950 of the UBIT, an organization qualifying for tax-exempt status could receive tax-free earnings from operating a business so long as the business earnings were used to carry out the organization's exempt purposes. See, e.g., *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924); *C.F. Mueller Co. v. Comm'r*, 190 F.2d 120 (3d Cir. 1951). The legislative history of the 1950 Act states that "the problem at which the tax on unrelated business income is directed here is primarily that of unfair competition." H. Rpt. No. 2319, 81st Cong., 2d Sess. 36 (1950); Sen. Rpt. No. 2375, 81st Cong., 2d Sess. 28 (1950). See also *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986).

[9] In the case of social clubs (sec. 501(c)(7)) and voluntary employee beneficiary associations (sec. 501(c)(9)), the UBIT applies to all income of the organization other than certain "exempt function income," such as membership dues and fees. A principal effect of this rule is to subject the investment income of the social club or VEBA to the UBIT, unless such investment income is set aside to be used for a charitable purpose (sec. 512(a)(3)).

or State university (sec. 513(a)). In addition, special UBIT provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions (secs. 513(d), (f), and (h)).

Tax-exempt organizations are taxed on their unrelated business taxable income at the regular corporate tax rates (sec. 511(a)).[10] Unrelated business taxable income is computed by subtracting from gross income derived from a regularly carried on unrelated business the deductions generally allowed to taxable entities that are directly connected with the carrying on of the unrelated business. Each tax-exempt organization is allowed a specific deduction of $1,000 (sec. 512(b)(12)). In addition, such organizations generally may deduct up to 10 percent of their unrelated business taxable income for charitable contributions, whether or not the contributions are related to the carrying on of the unrelated business.

The Code also includes a so-called "fragmentation rule," which specifically provides that unrelated activities carried on for the production of income from the sale of goods or performance of services may separately be subject to the UBIT, even though carried on within a larger aggregate of similar activities or other endeavors that may be related to the organization's exempt purposes (sec. 513(c)). Under this fragmentation rule, each component part of revenue producing activities is to be examined separately to determine whether it gives rise to unrelated business income. For example, advertising activities do not lose their identity as a trade or business even though published the advertisements may be published in educational materials.[11] The fragmentation rule also applies to the sale of merchandise. Thus, if a tax-exempt organization operates a gift shop, each item sold is tested separately against the definition of an unrelated trade or business, and gross income (and directly connected deductions) from those items that do not qualify as substantially related to the organization's exempt purpose are taken into account in computing UBIT. The fragmentation rule also would apply in a case where a tax-exempt charity solicits payments that constitute a part-sale of an unrelated good or service and a part-gift (see further discussion below). The portion of a payment that qualifies as a contribution or gift made to a tax-exempt organization is not subject to the UBIT.

3. Treatment of contributions to charities and governmental entities

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charity described in section 501(c)(3) or a Federal, State, or local governmental entity. The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and

[10] Charitable and other generally tax-exempt trusts are subject to tax on their unrelated business taxable income under the rates generally applicable to taxable trusts (sec. 511(b)).

[11] See, e.g., *U.S. v. American College of Physicians*, 475 U.S. 834 (1986); Treas. Reg. sec. 1.513–1(d)(4)(iv)(examples 6 and 7).

170(e)).[12] In the case of a charitable contribution of inventory or other ordinary-income or short-term capital gain property, the amount of the deduction is limited to the taxpayer's basis in the property.[13] In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property (sec. 170(e)(1)(B)).

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the payor receives an economic benefit is not deductible under section 170, except to the extent that the taxpayer can demonstrate that the payment exceeds the fair market value of the benefit received from the charity.[14] To facilitate distinguishing charitable contributions from purchases of goods or services from charities, Congress enacted section 170(f)(8), which provides that no charitable contribution deduction is allowed for a separate contribution of $250 or more unless the taxpayer obtains a contemporaneous written substantiation from the charity (rather than relying solely on a canceled check) indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution. In addition, section 6115 requires that any charity that receives a *quid pro quo* contribution exceeding $75 (meaning a payment in excess of $75 made partly as a gift and partly as consideration for goods or services furnished by the charity) is required to inform the contributor in writing of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[15]

A transfer of property made by a business to a charity qualifies as either a charitable contribution or a deductible business expense, but not both. No deduction is allowed as a business expense under section 162 for any contribution that would be deductible as

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[12] Under the so-called "percentage limitation" rules, charitable contributions claimed by a taxpayer for any one taxable year may not exceed a certain percentage of the taxpayer's "contribution base" (defined as adjusted gross income (AGI) computed without regard to any net operating loss carryback to the taxable year). Contributions in any one taxable year in excess of the percentage limitation for that year may be carried forward and deducted over the five succeeding taxable years, subject to percentage limitations in those years (sec. 170(d)(1)). Contributions to public charities (and certain private operating foundations) of cash or ordinary income property are subject to a 50-percent limitation. In the case of a contribution of appreciated capital gain property or a contribution made to private foundations, a 30-percent limitation applies (sec. 170(b)(1)).

The maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)).

[13] Sections 170(e)(3) and 170(e)(4) provide an augmented deduction for certain corporate contributions of inventory for the care of the ill, the needy, or infants, and for certain scientific property constructed by the donor corporation and used by the donee for research.

[14] See Treas. Prop. Reg. sec. 1.170A–1(h); Rev. Rul. 67–246, 1967–2 C.B. 104. Certain small items and token benefits (e.g., key chains and bumper stickers) that have insubstantial value are disregarded, such that the full amount of the contribution may be deductible under section 170. See Treas. Prop. Reg. sec. 1.170A–13(f)(8); Rev. Proc. 90–12, 1990–1 C.B. 471; Rev. Proc. 92–49, 1992–1 C.B. 987.

[15] This disclosure rule does not apply in the case of a payment made to an organization that is organized exclusively for religious purposes if, in return for making the payment, the donor receives solely an intangible religious benefit that generally is not sold in commercial transactions outside the donative context (sec. 6115(b)).

a charitable gift under section 170 were it not for the percentage limitations contained in section 170 (sec. 162(b)). Likewise, a business transfer made with a reasonable expectation of financial return commensurate with the amount of the transfer is deductible only as a business expense under section 162.[16]

C. State and Local Government Bonds

1. Overview

The Code exempts interest on certain debt obligations of States, territories, and possessions of the United States from the regular individual and corporate income taxes (sec. 103).[17] [18] Interest on debt of local governments generally receives identical treatment to that provided for States. Interest on these "State and local government bonds" may, in certain cases, be includible in calculating the individual and corporate alternative minimum taxes.[19] Additionally, State and local government bond interest is included in determining whether a portion of Social Security benefits is taxable under the regular individual income tax.

The State and local government bond interest exemption applies to two principal types of bonds. First, interest is tax-exempt on bonds issued to finance public activities conducted and paid for by States and local governments themselves ("governmental bonds"). Examples of activities financed with governmental bonds are schools, courthouses, roads, public mass transit systems, and governmentally owned and operated water, sewer, and electric facilities.[20] States and local governments also may issue limited amounts of tax-exempt working capital debt to cover cash-flow shortfalls pending receipt of tax or other revenues ("TRANS"). Further, for Federal income tax purposes, interest paid by these governments under installment sales contracts and finance leases is treated as bond interest.

The second major category of State and local government bonds on which interest is tax-exempt consists of bonds issued by these governmental units acting as a conduit to provide financing for private persons ("private activity bonds"). Unlike governmental bonds, tax-exempt private activity bonds may only be issued for purposes specified in the Code.[21] The specified purposes generally relate to

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[16] See Rev. Rul. 63–73, 1963–1 C.B. 35.

[17] Indian tribal governments are treated as State governments for many purposes under the Code. Tribal governments may issue tax-exempt bonds to finance "essential governmental functions" of the tribe. These functions may not include any activity of a type not typically carried out by actual State governments. Additionally, with the exception of certain private activity bonds for manufacturing facilities that satisfy an employment test, tribal governments may not issue tax-exempt private activity bonds.

[18] Interest on the Federal Government's debt is taxable, but repayment is guaranteed by the United States. With the exception of State and local government bonds guaranteed under certain grandfathered programs that were in existence before 1985, interest on State and local government bonds is not permitted to be both tax-exempt and Federally guaranteed.

[19] Interest on private activity bonds is a preference item in calculating both the individual and corporate alternative minimum taxes. Interest on all tax-exempt bonds is included in calculating the adjusted current earnings preference of the corporate alternative minimum tax.

[20] State and local government bonds used to finance the acquisition of existing output (e.g., electric utility) property are treated as private activity bonds even if the property is to be governmentally owned and operated, unless (1) the same service was provided to the area to be served by the acquiring governmental entity during the 10-year period before the acquisition, or (2) the area to be served is contiguous to the annexing governmental unit, does not exceed 10 percent of the service area of the acquirer, and is annexed in a qualifying annexation.

[21] A limited number of provisions allowing issuance of State and local government bonds for private activities is contained outside the general Code authorizing provisions. These special

privately operated transportation facilities, privately provided municipal services, economic development, and certain social programs. The typical private activity bond issue involves a State or local government as a nominal borrower, with the funds being simultaneously re-lent to the ultimate private borrower. Repayment of most private activity bonds comes exclusively from the ultimate private borrower; bond documents may state that there is neither a legal nor a moral obligation of the issuing governmental unit to repay the bonds. In 1992, the most recent year for which data is available, approximately 23 percent of State and local government bonds issued were private activity bonds. There has been a steady decline in the portion of State and local government bonds that are private activity bonds since 1988 (the first year for which reliable Internal Revenue Service data exists) when 36 percent of total State and local government bond issuance was private activity.

Private activity bonds are classified into several major categories: exempt-facility bonds; qualified redevelopment bonds; qualified small-issue bonds; mortgage revenue bonds; qualified student loan bonds; bonds for charitable organizations exempt from tax under Code section 501(c)(3), and bonds for businesses located in Federal empowerment zones and enterprise communities. Because these bonds provide financing for private business or personal activities, are repaid or secured by private funds, and would not otherwise be subject to Federal restrictions, the Code includes detailed targeting provisions, much like those found in many direct Federal spending programs. Further, issuance of most private activity bonds is subject to annual State volume limitations. Table 2, below, provides data on private activity bond issuance, by purpose, for 1992.

purposes for which tax-exempt private activity bonds are authorized include bonds for certain volunteer fire departments, the Texas Veterans' Land Bond Program, the Oregon Small Scale Energy Conservation and Renewable Resource Loan programs, the Iowa Industrial New Jobs Training Program, and acquisition of the Long Island Lighting Company by the Long Island Power Authority.

Table 2.—Private Activity Bond Issuance, 1992

[Millions of dollars]

Bond purpose	Amount
Airports	$6,970
Docks and Wharves	857
Water	333
Sewage	129
Solid Waste Disposal	2,947
Multi-Family Rental Housing	5,560
Local Furnishing of Electricity and Gas	2,583
Local District Heating and Cooling	23
Hazardous Waste Disposal	21
Qualified Mortgage	8,052
Veterans' Mortgage	109
Small Issue	2,803
Student Loan	3,958
Qualified Redevelopment	88
Section 501(c)(3) Organization:	
Hospital	13,152
Non-Hospital	9,745
Total	$63,708

Source: Joint Committee on Taxation compilation of IRS Statistics of Income Division data.

Tax-exemption permits States and local governments to borrow at interest rates that are lower than those that otherwise would prevail. This interest rate differential provides an implicit Federal subsidy to the cost of State and local government borrowing. Therefore, the Code includes extensive arbitrage restrictions designed to ensure that State and local government bonds are not issued to exploit the interest rate differential between taxable and tax-exempt borrowing, and in the case of private activity bonds, to ensure that the benefit of tax-exemption flows to ultimate borrowers, and not to issuers or other intermediaries.

2. Private activities eligible for State and local government bond financing

In general

A State or local government bond is a private activity bond if either a private business test or a private loan test is violated. The private business test consists of two parts, both of which must be violated. The first part limits the amount of proceeds of a governmental bond issue that may be used for any private business use to no more than 10 percent of the proceeds.[22] For this purpose, use of bond-financed property is treated as use of bond proceeds. The second part of the private business test limits the amount of the direct or indirect security, or funds for repayment, of governmental bonds that may come from private business users to no more than

[22] The amount of private business use that is unrelated to any governmental activity financed with the same bond issue is limited to five percent of the proceeds (sec. 141(b)(3)).

10 percent. The private loan test limits the amount of bond proceeds that may be used to make loans to private persons to no more than five percent ($5 million, if less).

In most cases, private activity bonds are issued exclusively for a private capital financing purpose specified in the Code; therefore, classification as a private activity bond is clear. However, these rules also apply to bonds issued by State and local governments to finance a mix of governmental and private activities. In these mixed governmental/private activity cases, governmental units issuing tax-exempt bonds must carefully monitor activities being financed to ensure that the amount of private financing does not exceed the specified limits—which would result in the bonds being classified as private activity bonds.[23] Listed below are the activities which are eligible for tax-exempt private activity bond financing.

Exempt-facility bonds

Exempt-facility bonds are private activity bonds issued to finance certain privately operated transportation facilities (airports, ports, mass commuting facilities, and high-speed intercity rail facilities); municipal service facilities (water, sewage, solid waste, local furnishing of electricity or gas, environmental enhancement of hydroelectric dams, and local district heating and cooling facilities); hazardous waste disposal facilities; and multifamily rental housing. As stated above, the Code includes extensive targeting rules for most of these private facilities as a condition of receiving tax-exempt State and local government bond financing. The following examples illustrate these targeting rules.

Airports.—Bonds for airports are private activity bonds because they provide capital financing for airlines which have rights to the use of airport property that are preferential to those of the general public. These bonds are used to finance runways, airport terminals, airplane hangars and other storage facilities, parking lots and garages, internal road access systems, and land held for noise abatement purposes. The bonds may not be used to finance hotels located at airports, office buildings for private businesses such as airlines (e.g., an airline reservation system office building), rental car pick up and drop off lots, unrelated manufacturing facilities to be located on adjacent noise abatement land, or retail shopping areas in excess of the space needed to serve air passengers. While airport facilities are used (e.g., leased to) and commonly paid for by private users (i.e., airlines and their passengers), all property financed with these bonds must be owned for Federal income tax purposes by a governmental unit.

Ports.—Port bonds may be used to finance docks and wharves, dredging, and short-term transfer warehouses. These bonds may not be issued to finance long-term storage warehouses or any of the facilities that are specifically precluded from financing with airport bonds. Like airport facilities, all port facilities financed with tax-exempt State and local government bonds must be owned for Federal income tax purposes by a governmental unit, but the facilities may be leased to private businesses for their exclusive use.

[23] The private business uses financed as part of a governmental bond issue may not exceed 10 percent of the total amount financed, but the activities financed may be activities that could not be financed with separate issues of private activity bonds.

Privately operated mass commuting facilities.—Private activity mass commuting facility bonds may be used to finance land, rail facilities, and transportation terminals. These bonds may not be used to finance any rolling stock (i.e., rail cars or buses) or any commercial or manufacturing facilities adjacent to mass commuting facilities (e.g., a shopping mall adjoining a subway station). Like tax-exempt bonds used to finance airport and port facilities, tax ownership of all property financed with these bonds must be held by a governmental unit.

High-speed intercity rail facilities.—High-speed intercity rail facilities eligible for tax-exempt private activity bond financing are defined as property other than rolling stock for the "fixed guideway rail transportation of passengers and their baggage . . . at speeds in excess of 150 miles per hour between scheduled stops . . . ." (sec. 142(i)(1)).

Private water systems.—Water systems owned and/or operated by nongovernmental entities are eligible for State and local government bond financing if (1) the system serves the general public (rather than a limited group) and (2) the system's rates are established or approved by a governmental entity.

Solid waste disposal facilities.—Solid waste disposal facilities include privately owned and/or operated landfills and trash incineration facilities. To be eligible for tax-exempt bond financing, these facilities must process solid waste from the general public in their service area. Trash incineration facilities eligible for State and local government bond financing do not include turbines used to produce electricity from steam generated by the burning of waste.

Local furnishing of electricity or gas.—In general, tax-exempt State and local government bonds may not be issued to provide capital financing for investor-owned utilities. An exception allows private, for-profit electric and gas companies to receive tax-exempt financing if their service area is limited to either (1) a city and one contiguous county, or (2) two contiguous counties.[24]

Multi-family rental housing.—State and local government bond financing is available for rental housing that satisfies a low-income tenant occupancy requirement. Developers of housing receiving this financing must agree that either (1) 20 percent of the rental housing units will be occupied by tenants having incomes of 50 percent or less of the area median income where the project is located, or (2) 40 percent of the rental housing units will be occupied by tenants having incomes of 60 percent or less of the area median income where the project is located.[25] This low-income tenant occupancy requirement must be continuously satisfied for a minimum period of 15 years after the State and local government bonds are issued.[26] The Code includes extensive rules to ensure that developers comply with this requirement.

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[24] A non-Code exception expands this rule to include the Long Island Lighting Company (the service area of which includes a portion of a third county) and the Bradley Lake Hydroelectric Facility in Alaska.

[25] The 40-percent occupancy requirement is reduced to 25 percent in New York City.

[26] This requirement is relaxed in certain projects where rents charged to low-income tenants do not exceed 50 percent of the rent charged to other tenants and satisfy certain other criteria.

Qualified redevelopment bonds

Qualified redevelopment bonds are State and local government bonds issued for the redevelopment of private property in governmentally designated "blighted areas." In addition to any private revenues pledged to repayment of these bonds, the bonds must be backed by a pledge of governmental tax revenues. The term "blighted area" is defined as an area designated by a local government pursuant to a State statute as having excessive vacant or abandoned land and structures, substandard structures, or real property tax delinquencies. Designation of blighted areas is subject to limits on minimum size per area, and aggregate designations may not exceed areas comprising 20 percent of the assessed value of real property in the government's jurisdiction.

Qualified redevelopment bonds may only be used for acquisition of property; clearing, rehabilitation, and redevelopment activities; and expenses of relocating area residents. This tax-exempt financing may not be used for new construction or enlargement of existing buildings. Facilities such as golf courses, suntan parlors, racetracks, casinos and other gambling facilities, and liquor stores may not be financed with these bonds.

Empowerment zone and enterprise community business bonds

State and local government bonds may be issued to finance capital expenditures of certain businesses that are located in Federal empowerment zones and enterprise communities and that are of a type eligible for other tax incentives provided to empowerment zone businesses. The following types of business are not eligible for this tax-exempt financing: golf courses, country clubs, massage parlors, hot tub facilities, suntan parlors, gambling facilities (including race tracks), and off-site alcoholic beverage stores.

The amount of these bonds is limited to $3 million per business in any one zone. Businesses receiving this tax-exempt financing further are subject to a $20 million aggregate limit on such bonds for property in all zones and communities. Businesses receiving this tax-exempt financing must continuously qualify as a "zone business" throughout the term of the tax-exempt financing provided.

Qualified small-issue bonds

Qualified small-issue bonds are tax-exempt State and local government bonds used to finance private business manufacturing facilities or the acquisition of land and equipment by certain farmers. In both instances, these bonds are subject to limits on the amount of financing that may be provided, both for a single borrowing and in the aggregate. In general, no more than $1 million of small-issue bond financing may be outstanding at any time for property of a business (including related parties) located in the same municipality or county. This $1 million limit may be increased to $10 million if all other capital expenditures of the business in the same municipality or county over a six-year period are counted toward the limit. Outstanding aggregate borrowing under this program is limited to $40 million per borrower (including related parties) regardless of where the property is located. No more than $250,000 per

borrower ($62,500 for used property) may be used to finance depreciable farm property.

Property and businesses eligible for this financing are specified. For example, only depreciable property (and related real property) used in the production of tangible personal property is eligible for financing as a manufacturing facility. Storage and distribution of products generally is not treated as production under this provision. Agricultural land and equipment may only be financed for first-time farmers, defined as individuals who have not at any prior time owned farmland in excess of (1) 15 percent of the median size of a farm in the same county or (2) $125,000 in value.

Before 1987, qualified small-issue bonds also could be used to finance commercial facilities. In addition to general prohibitions on the tax-exempt private activity bond financing of certain facilities. Federal law precluded the use of qualified small-issue bonds to finance a broader list of facilities during that period. For example, no more than 25 percent of a bond issue could be used to finance restaurants, bars, automobile sales and service facilities, or entertainment facilities. No portion of these bond proceeds could be used to finance golf courses, country clubs, massage parlors, tennis clubs or other racquet sport facilities, skating facilities, hot tub facilities, or racetracks.

Mortgage revenue bonds

Present law authorizes issuance of two types of mortgage revenue bonds: qualified mortgage bonds and qualified veterans' mortgage bonds. Qualified mortgage bonds are bonds issued to provide below-market financing to first-time homebuyers having incomes below prescribed maximums and who purchase homes having purchase prices below prescribed maximums. Only principal residences may be financed with the proceeds of these bonds. If homebuyers sell the bond-financed homes within nine years after the loan is made, a portion of the subsidy provided by the tax-exempt interest rate is recaptured by the Federal Government. In addition to housing purchases, qualified mortgage bonds may be used to finance limited amounts of home improvement and rehabilitation loans.

Only five States are permitted to issue qualified veterans' mortgage bonds.[27] Unlike qualified mortgage bonds, qualified veterans' mortgage bond-financed loans are not restricted to first-time homebuyers satisfying income criteria, there is no limit on purchase price of homes that are financed, and there is no recapture of the Federal tax subsidy if the bond-financed property is sold early. Since 1984, issuance of these bonds is being gradually phased out. The phase-out is accomplished by (1) limiting issuance to States that had issued the bonds before 1985, (2) limiting each State's annual issuance to an amount not exceeding its historical issuance of the bonds, and (3) limiting eligibility for bond-financed loans to veterans who served on active duty before 1977 and who apply for a loan within 30 years after leaving active military service (January 31, 1985, if later).

[27] The States are Alaska, California, Oregon, Texas, and Wisconsin.

Qualified student loan bonds

Tax-exempt State and local government bonds may be issued to finance two types of student loans. First, loans that are regulated and guaranteed under the Higher Education Act of 1965 (the Federal GSL and PLUS loan programs) may be financed with proceeds of these tax-exempt bonds.[28] Second, States and local governments may issue these bonds to finance student loans under other, State programs if no loan exceeds the difference between the total cost of school attendance and other forms of student aid for which the student borrower is eligible.

Qualified 501(c)(3) bonds

States and local governments may issue tax-exempt bonds to finance activities of organizations that are exempt from income tax under Code section 501(c)(3). Unlike other private activity bonds, proceeds of these bonds may be used to finance working capital needs of these organizations. Subject to two general restrictions, any activity that is part of the exempt purpose of the organization may be financed. Each organization eligible for State and local government bond financing is limited to $150 million in outstanding non-hospital bonds at any time. (No limit is imposed on the volume of bonds for hospital facilities.) Additionally, qualified 501(c)(3) bonds may not be used to finance the acquisition of existing multifamily rental housing unless the property is substantially rehabilitated as part of the acquisition or the low-income tenant requirements applicable to exempt-facility bonds issued for this purpose are satisfied.

3. General restrictions on State and local government bond financing for private activities

Like many Federal direct spending programs, issuance of State and local government private activity bonds is subject to general restrictions on amount and use. The following discussion illustrates some of the major restrictions.

State volume limitations

Issuance of most tax-exempt private activity bonds is subject to annual per-State volume limitations. Each State (including local governments within the State) is allowed to issue an annual amount of these bonds not exceeding the greater of $50 per resident of the State or $150 million.[29] States may elect to carryover their unused private activity bond volume authority for designated activities for a period of up to three years. Bond authority that is not used within the carryforward period lapses.

The State volume limits do not apply to State and local government bonds for section 501(c)(3) organizations, for airports and ports, for governmentally owned (but privately operated) solid waste disposal facilities, for environmental enhancements of hydroelectric generating facilities, for governmentally owned (but pri-

[28] In general, all private activity bonds must be issued by a State or local government for interest to be tax exempt. An exception allows issuance of these bonds by specially chartered, private non-profit "qualified scholarship funding corporations."

[29] A portion of the private business use financed with certain larger (i.e., over $150 million) governmental bond issues also is subject to these volume limitations.

vately operated) high-speed intercity rail facilities,[30] and for qualified veterans' mortgage loans.[31]

Loss of interest deductions for business borrowers if use of financed property changes

Private persons that receive loans financed with tax-exempt State and local government bonds are permitted to deduct their interest expense as an ordinary and necessary business expense even though the recipient of the interest is not taxed on that income. Interest deductions are denied on these loans, however, if the private user ceases to use the property in a manner qualifying for tax-exempt financing. For example, if the owner of a bond-financed multifamily rental housing project no longer serves low-income tenants, interest on the bond-financed loans becomes nondeductible. Similarly, if a homeowner who receives qualified mortgage bond financing no longer uses the house as his or her principal residence (e.g., moves and rents the house), interest on the mortgage loan becomes nondeductible.

Other restrictions on private activity bonds

Among the other Federal restrictions applicable to private activity, but not to governmental, State and local government bonds are:

(1) A requirement that public notice be given and a hearing held before issuance of the bonds;
(2) A restriction on the costs of issuance (e.g., bond attorney and underwriter fees) that may be financed with bond proceeds to an amount not exceeding two percent of the bond issue;
(3) A minimum rehabilitation requirement for existing property that is acquired with State and local government bond proceeds; and
(4) A limit on the amount of land that may be financed with any single bond issue.

4. Arbitrage restrictions

The Code imposes arbitrage restrictions on all State and local government bonds. These restrictions are designed to prevent unnecessary Federal revenue losses from the earlier and larger than necessary issuance of these bonds. Absent such restrictions, bond issuers could incur debt at lower tax-exempt interest rates and invest the proceeds in taxable (e.g., U.S. Government) securities, or in the case of private activity bonds, could retain a portion of the interest subsidy rather than flowing it through to ultimate borrowers. The Code arbitrage rules require bond issuers to track the use of bond proceeds and the investment earnings on those proceeds.

In general, the rules provide that issuers are not permitted to earn profits on investments that are unrelated to the exempt purpose of the borrowing except during prescribed "temporary periods" and on investments in debt service reserve and current payment

[30] Bonds for privately owned high-speed intercity rail facilities must receive a State volume limit allocation equal to 25 percent of the bond amount.

[31] As noted above, qualified veterans' mortgage bonds are subject to separate volume limits based on historical State issuance as part of the 1984-enacted phase-out of that program.

funds. Additionally, unless bond proceeds are spent for the exempt purpose of the borrowing promptly, any permitted profits that are earned must be paid, or rebated, to the Federal Government. In 1994, the most recent year for which data is available, $388.5 million was received by the Federal Government in arbitrage rebate payments.

To ensure that ultimate borrowers receive the benefit of tax-exemption, bond issuers are restricted on the interest rates that may be charged on bond-financed loans. Unlike the restriction on pre-expenditure profits (which may be earned and rebated to the Federal Government in certain cases), these limits are structured as absolute ceilings, violation of which renders bond interest taxable retroactive to the date the bonds were issued.

III. DESCRIPTIONS OF TAX RESTRUCTURING ALTERNATIVES

The press release by the House Committee on Ways and Means announcing this set of tax restructuring hearings asked all witnesses to comment on the impact of certain basic tax reform proposals. These basic alternatives to replace the current tax system are: (1) a national retail sales tax; (2) a value-added tax; (3) a flat "consumption" tax; (4) a cash flow tax; and (5) a "pure" income tax.

This part of the pamphlet provides brief descriptions of these alternative tax systems. In some cases, the descriptions include summaries of introduced legislation; in other cases, the descriptions are based upon theoretical models of the tax systems. These descriptions provide a summary of the alternative systems and are not intended to provide detailed analyses of different aspects of the proposed systems. Such analyses will be provided in pamphlets to be prepared for separate hearings.[32]

Other than the "pure" income tax, the alternative tax systems discussed in this section are consumption-based, rather than income-based, taxes. The major difference between a consumption-based tax and an income-based tax generally involves the treatment of savings. Under an income-based tax, returns to savings (e.g., dividends, interest, and capital gains) generally are subject to tax. Under a consumption-based tax, returns to savings generally are excluded from the tax base. Such exclusion may be achieved by taxing consumption directly, excluding investment income from the tax base, or providing a deduction for increased savings.[33]

A. National Retail Sales Tax

1. In general

As the name implies, a retail sales tax is a tax imposed on the retail sales price (i.e., sales to consumers, but not sales of inputs to businesses) of taxable goods or services.

The Federal Government currently imposes excise taxes on various products and services.[34] However, these taxes generally apply to a narrowly defined class of goods and services, and generally are not imposed at the retail level. Rather, the present-law Federal excise taxes generally are imposed upon manufacturers (as in the case of the alcohol and tobacco excise taxes) or some other intermediate (pre-retail) stage of the distribution of a product (as in the case of the highway motor fuels tax), or are imposed upon both the consumers and business users of a good or service (as in the case of the communications services tax ("telephone tax") or the currently expired air passenger ticket tax).

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[32] See Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax* (JCS–3–96), April 23, 1996. Additional analysis can be found in Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS–18–95), June 5, 1995, and Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate*, American Institute of Certified Public Accountants, December 1995.

[33] For a further discussion of the distinctions between consumption-based taxes and income-based taxes and the equivalence among different types of consumption taxes, see Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* and the citations contained therein.

[34] See Joint Committee on Taxation, *Schedule of Present Federal Excise Taxes (As of January 1, 1994)* (JCS–5–94), June 28, 1994, for a listing of the various Federal excise taxes.

Most States and many local governments impose general sales taxes within their jurisdictions,[35] and all States impose some form of excise-type tax on specified goods or services. Although the typical State sales tax is familiar to most consumers and appears simple on its face, several issues may arise in the application of such a tax. First, State sales taxes generally are designed to apply to most tangible personal property and selected services purchased by consumers.[36] Certain sales to persons other than consumers (i.e., businesses) may be exempted from the tax in a variety of ways. Exemptions may be provided for goods acquired as "sales for resale," or for articles for use in manufacture, fabrication, or the processing of personal property for resale, if the article become incorporated in such property. Thus, persons who are not consumers may be subject to the sales tax in certain instances. For example, a furniture maker may be exempt from tax on lumber acquired to manufacture chairs, but would not be exempt from tax on a truck purchased to deliver the chairs to customers. Controversies often arise as to whether an article or a service (such as packaging or utility services) are incorporated into a good or not.[37] Most States also provide exemptions for acquisitions by the State and its political subdivisions, and charitable, religious, and educational organizations.[38] In order to address the regressivity of sales taxes, most States exempt food, but impose a tax on candy, soda and prepared meals, thus requiring subtle distinctions between taxable and tax-exempt items. Similarly, most States do not tax sales of intangible property, raising issues as to whether a particular item represents taxable tangible or tax-exempt intangible property.[39] Moreover, most States provide broad taxation of personal property, but only limited taxation of services, raising issues whenever a business provides both taxable goods and tax-exempt services to a customer. For example, an automotive repair shop typically provides both goods (replacement parts) and services (labor on installation of the parts) when it repairs an automobile. Further, a State's sales tax generally does not apply to goods shipped to out-of-State customers. In such cases, the customer likely is subject to a complementary "use" tax in his or her State of residence. However, there are significant compliance problems with State use taxes.[40] Several States

[35] It is reported that there are approximately 50,000 separate sales tax jurisdictions in the United States. *Wall Street Journal*, April 18, 1990, p. A1. Alaska, Delaware, Montana, New Hampshire, and Oregon currently do not have broad-based sales taxes. The District of Columbia has a sales tax.

[36] For a detailed discussion of State and local sales taxes, see, Jerome R. Hellerstein and Walter Hellerstein, *State Taxation (Vol. II: Sales and Use, Personal Income, and Death and Gift Taxes)* (Warren, Gorham, Lamont: Boston, MA) 1992.

[37] See, for example, *Sta-Ru v. Mahin*, 64 Ill. 2d 330 (1976) and *Burger King v. State Tax Commission*, 51 N.Y. 614 (1980) (whether paper and plastic cups and similar items purchased by a fast-food restaurant were subject to State sales taxes.)

[38] See, John Due and J. Mikesell, *Sales Taxation: State and Local Structure and Administration* (1983) pp. 78–80.

[39] See, for example, Robert W. McGee, *Software Taxation*, National Association of Accountants, 1984, chapters 1 and 3, for a discussion of the issues involved in the application of State sales taxes to transfers of computer software.

[40] The ability of one State to require an out-of-State retailer to collect that State's sales or use tax on sales into the State (generally through a mail-order catalog sales) is restricted by the Commerce Clause of the U.S. Constitution where the retailer has no physical presence in the State. See *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1976) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

mail use tax forms to all State income taxpayers and rely upon voluntary reporting of taxable out-of-State purchases.

2. Description of the "National Retail Sales Tax Act of 1996" (H.R. 3039)

Recently, there has been interest in replacing the U.S. income tax system with a Federal retail sales tax.[41] On March 6, 1996, Messrs. Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump, introduced H.R. 3039, the "National Retail Sales Tax Act of 1996". Following is a description of the bill.

In general

The bill would impose a tax at a rate of 15 percent on gross payments for the use, consumption, or enjoyment in the United States of any taxable property or service, whether or not produced or rendered within or without the United States. In general, the tax would be imposed and remitted by the seller of the taxable item. "Taxable property or service" would mean (1) any property (including leaseholds of any term or rents with respect to such property other than intangible property), and (2) any service (including any financial intermediation services). The tax would be due when payment for the taxable item is received, even if received pursuant to an installment method. Alternatively, the seller may elect to adopt an accrual method of accounting.

Tax would not be imposed upon any property or service: (1) purchased for resale; (2) purchased to produce taxable property or services; (3) exported from the United States for use, consumption, or enjoyment outside the United States; or (4) with respect certain de minimis amounts. Tuition for general primary, secondary, or university level education and job-related training courses would be treated as purchased to produce taxable property or services. Special rules would apply to property or services purchased for a dual use (i.e., both a taxable and tax-exempt purpose).

Specific rules for certain transactions

Specific rules would be provided for transactions involving governmental units and not-for-profit organizations, purchasers of principal residences, and financial intermediation services.[42]

Governmental units.—Any Federal, State, or local governmental unit or political subdivision would not be exempt from the tax on any sale, purchase, use, consumption, or enjoyment of a taxable good or service by the unit. In addition, an excise tax of 15 percent would be imposed on the wages of Federal, State, and local government employees; the tax would be collected from the governmental employers.

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[41] Senator Richard Lugar had proposed that the current Federal taxes be repealed and replaced with a retail sales tax that would be collected by the States on behalf of the Federal Government. *Washington Post*, April 20, 1995. For a discussion of similar proposals, see, Laurence J. Kotlikoff, "Economic Impact of Replacing Federal Income Taxes with a Sales Tax," published by the Cato Institute in December 1992, and Stephen Moore, "The Economic and Civil Liberties Case for a National Sales Tax," published for a Hoover Institution conference on May 11, 1995.

[42] Principal residences and other durable goods and financial intermediation services present special issues under most consumption taxes. These issues will be examined in future pamphlets devoted to these topics.

Not-for-profit organizations.—Dues, contributions, and payments to a qualified not-for-profit organization generally would not be subject to tax. However, payments to a not-for-profit organization would be subject to the tax if the property or service provided in exchange for the payment is not substantially related to the exempt purpose of the organization or is commercially available. The provision of property or personal services by a not-for-profit organization in connection with contributions or dues to the organization would be treated as a taxable transaction in an amount equal to the fair market value of the property or service. Property or personal services acquired by a not-for-profit organization for resale or use in the production of taxable property or services would not be subject to tax. For this purpose, a "qualified not-for-profit organization" generally would be an organization organized and operated exclusively as an organization generally described in present-law sections 501(c) (3), (4), (5), (6), (8) and (10) of the Code and no part of the net earnings of which inure to the benefit of any private shareholder or individual. In general, qualified not-for-profit organizations would apply for a qualification certificate from the appropriate State tax administrator.

Principal residences.—A purchaser may elect to pay the tax (plus simple interest computed at the rate imposed by section 6621 of the Code) in equal installments over a 30-year period with respect to property purchased and used as a principal residence. If the property is sold or ceases to be used as a principal residence by the purchaser before the close of the 30-year period, the unpaid balance of the tax would become payable within two years of such sale or cessation.

Financial intermediation.—The tax would be imposed upon explicitly and implicitly charged financial intermediation services. Explicitly charged financial intermediation services would include brokerage fees; explicitly stated banking, loan origination processing, documentation, credit check and other similar fees; safe-deposit fees; insurance fees (to the extent not allocable to the investment account of the underlying insurance policy); trustee's fees; and other financial service fees including mutual fund management, sales, and exit fees. Providers of these services would be subject to tax on the amount charged for the services. Implicitly charged financial intermediation services generally would be determined based upon the difference between the rate of interest earned on any underlying interest bearing investment and the interest paid on any underlying interest bearing debt.

Credits and rebates

The bill would provide credits with respect to sales of used property, property converted to business use, taxes collected on exempt purchases, administrative cost, compliance equipment costs, and over-collected taxes. These credits may result in a tax refund if the taxpayer files two consecutive tax reports with a credit balance. The used property tax credit is designed to alleviate the cascading of tax when taxable goods are acquired by a consumer, sold to a used goods dealer, and then resold by the dealer to another consumer. The business use conversion credit would allow a credit when a consumer devotes a previously taxed item to exclusive use

in the consumer's business. The administrative credit would be an amount equal to the greater of $100 or one-half of one percent of the tax remitted by the taxpayer. The administrative credit could not exceed 20 percent of the tax remitted, determined before the application of the credit. The compliance equipment cost credit would be an amount equal to 50 percent of the cost of equipment that a vendor must purchase to comply with the requirement (described below) that the amount of tax be stated and separately charged.

The bill would provide a family consumption rebate for each qualified family unit. The amount of the rebate would be 15 percent of the lesser of: (1) the poverty level of the family, or (2) the wage income of the family unit. The qualified family unit would be determined with respect to family members sharing a common residence. The poverty level would be the quotient of (1) the level determined by the Department of Health and Human Services poverty guidelines for family units of a particular size divided by (2) 85 percent. The size of the family unit would determined by including each spouse or head of household, child, grandchild, parent and grandparent. Family members would include certain students living away from home and exclude persons over the age of two without a bona fide Social Security number and unlawful residents of the United States. The rebate would be provided by adjusting the Social Security taxes to be withheld from the wages of employees.

Administration of the tax

The sales tax would be charged separate from the purchase price of each taxable sale. Vendors would be required to provide purchasers with a receipt that sets forth the tax-exclusive taxable item, the amount of tax paid, the tax-inclusive price of the taxable item, the tax rate, the date the item was sold, and the vendor's name and registration number.

Any person liable to collect and remit the tax who is engaged in an active trade or business would register with the appropriate taxing authority. Taxpayers would be required to pay the tax on or before the 25th day following the month in which the tax was collected, along with a report that sets forth the gross payment on taxable items for the month, the tax collected in connection with these payments, and the amount and types of credits claimed. Interest would apply to late payments. Civil or criminal penalties would apply to late filings; failures to register; and failures to collect, remit, or pay the tax.

The tax would be administered, collected, and remitted to the Federal Government by an administering State within which taxable items are used, consumed, or enjoyed. A State would be an administering State if it maintains a sales tax that significantly conforms to the Federal tax and enters into a cooperative agreement with the Secretary of the Treasury regarding the State's administration of the tax. Administering States would be allowed to retain one percent of the Federal tax as an administration fee. A conforming State may contract with another conforming State to administer its sales tax. The Secretary of the Treasury would administer the tax in jurisdictions that are not administering States, where the administering State has failed on a regular and sustained basis

to timely remit the tax to the United States, where the administering State has been adjudicated to have breached the cooperative agreement, and with respect to certain multistate vendors. Special rules would determine the situs of the use, consumption or enjoyment of a taxable item based on a destination principle. The Secretary of the Treasury would be required to issue guidance with respect to the tax and to establish an Office of Revenue Allocation to arbitrate claims and disputes among administering States.

Appropriations to the Internal Revenue Service ("IRS") would not be authorized after fiscal year 2000. An Excise Tax Bureau would be established to administer and collect Federal excise taxes formerly collected by the IRS; and the Social Security Administration would administer and collect payroll taxes.

B. Value-Added Tax

1. In general

A value-added tax ("VAT") generally is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. Although there are several ways to compute the taxable base for a VAT, the amount of value added generally can be thought of as the difference between the value of sales (outputs) and purchases (inputs) of an enterprise.[43]

The amount of value added may be determined under a VAT in a number of ways. The two most common methods are the credit-invoice method and the subtraction method.[44] The credit-invoice method is the system of choice in nearly all countries that have adopted a VAT,[45] while the subtraction method has been used in

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[43] Previous publications by the staff of the Joint Committee on Taxation have discussed some of the broad tax policy and economic issues to be considered in deciding whether a VAT should be enacted and have described the mechanics of various VAT systems. Numerous other publications also address these issues. See, e.g., Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*; Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS–6–91), May 30, 1991 (Part Three: "Discussion of Value-Added Taxes"), pp. 269–341; Joint Committee on Taxation, *Description of Tax Bills . . . S. 442* (Value Added Tax) . . . (JCS–11–89), May 11, 1989 (Part III.C., "Analysis of Specific Issues"), pp. 9–31; Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Vol. 3, "Value-Added Tax", (1984); Congressional Budget Office, *Effects of Adopting A Value-Added Tax*, February 1992; Government Accounting Office, *Value Added Tax: Administrative Costs Vary with Complexity and Number of Businesses*, GAO/GGD–93–78, May 1993; Alan Schenk, *Value Added Tax: A Model Statute and Commentary, American Bar Association Section on Taxation*, (1989); Martin A. Sullivan, *Flat Taxes and Consumption Taxes*, American Institute of Certified Public Accountants, December 1995; Lorence L. Bravenec, *Design Issues in a Credit Invoice Method Value-Added Tax for the United States*, American Institute of Certified Public Accountants, (1990); Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis*, (1992); Congressional Research Service, *Value-Added Tax: Tax Bases and Revenue Yields* (CRS Report 92–176E), November 23, 1992 (and publications cited therein); Charles E. McLure, Jr., *The Value-Added Tax: Key to Deficit Reduction?*, American Enterprise Institute for Public Policy Research, Washington, D.C. (1987); and Alan A. Tait, *Value Added Tax, International Practice and Problems*, International Monetary Fund, Washington, D.C. (1988).

[44] An addition method may also be used to compute value added. An addition method measures value added as the sum of wages, interest expense, and cash-flow profits of an entity (i.e., the returns to labor and financial capital of a business). The addition method is disfavored by some VAT commentators generally because of the difficulty in measuring cash-flow profits, but may have utility in certain instances (e.g., for measuring value added by a not-for-profit organization).

[45] It is reported that Japan imposes a version of an "accounts-based" subtraction method VAT. The Japanese VAT also has elements of the credit-invoice method. See, Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis* (1992), p. 80.

the States of Michigan and New Hampshire.[46] A subtraction-method VAT is also sometimes referred to as a business transfer tax.

2. Credit-invoice method VAT

Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate to the sales price of the good or service and the amount of tax generally is disclosed on the sales invoice. A business credit is provided for all VAT paid on all purchases of taxable goods and services (i.e., "inputs") used in the seller's business. The ultimate consumer (i.e., a non-business purchaser), however, does not receive a credit with respect to his or her purchases. The VAT credit for inputs prevents the imposition of multiple layers of tax with respect to the total final purchase price (i.e., "cascading" of the VAT). As a result, the net tax paid at a particular stage of production or distribution is based on the value added by that taxpayer at that stage of production or distribution. In theory, the total amount of tax paid with respect to a good or service from all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the VAT rate.

In order to receive an input credit with respect to any purchase, a business purchaser generally is required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. At the end of a reporting period, a taxpayer may calculate its tax liability by subtracting the cumulative amount of tax stated on its purchase invoices from the cumulative amount of tax stated on its sales invoices.

Example 1. Simple credit-invoice method VAT.—Assume a landowner sells felled trees to a paper mill for $1,000. The landowner had not been subject to tax with respect to anything used in the production of the trees. The paper mill processes the trees into rolls of paper and sells the rolls to a distributor for $1,300. The distributor cuts the rolls into sheets, packages the sheets, and sells the packages to a retail stationery store for $1,500. The retail stationery store sells the entire lot of packages to nonbusiness consumers for $2,000. The jurisdiction in question levies a broad-based VAT at a rate of 10 percent. The tax would be determined as follows:

Production stage	Sales		VAT on sales		VAT on purchases		Net VAT
Landowner	1,000 x .1	=	100	−	(0)	=	100
Paper mill	1,300 x .1	=	130	−	(100)	=	30
Distributor	1,500 x .1	=	150	−	(130)	=	20

[46] The subtraction method has also been proposed in several recent U.S. legislative proposals. See, e.g., the business tax components of the flat taxes proposed in H.R. 2060 and S. 1050 as introduced by Mr. Armey, and Senator Specter on July 19, 1995 (described below); the "Business Transfer Tax" of S. 2160 proposed by Senators Boren and Danforth on May 26, 1994; and the business tax component of the "USA Tax" proposed in S. 722 as introduced by Senators Domenici and Nunn on April 25, 1995 (described below). In addition, Mr. Gibbons, although he has not introduced legislation to date, has supported the adoption of a VAT in his testimony before the Bipartisan Commission on Entitlements and Tax Reform on October 6, 1994, the Committee on Ways and Means in 1995, and in various writings.

Production stage	Sales	VAT on sales	VAT on purchases	Net VAT
Retail store	2,000 x .1	= 200	– (150)	= 50
Total	.....	580	– (380)	= 200

Thus, a total of $200 of VAT is assessed and collected in various amounts from the four stages of production. If, instead of a VAT, the jurisdiction in question levied a retail sales tax at a rate of 10 percent, the total amount of tax also would be $200 ($2,000 sales times 10 percent), all collected by the stationery store at the retail level.

3. Subtraction-method VAT

Under the subtraction method, value added is measured as the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises. At the end of the reporting period, a rate of tax is applied to this difference in order to determine the tax liability. The subtraction method is similar to the credit-invoice method in that both methods measure value added by comparing outputs (sales) to inputs (purchases) that have borne the tax. The subtraction method differs from the credit-invoice method principally in that the tax rate is applied to a net amount of value added (sales less purchases) rather than to gross sales with credits for tax on gross purchases (as under the credit-invoice method). The determination of the tax liability of an enterprise under the credit-invoice method relies upon the enterprise's sales records and purchase invoices, while the subtraction method may rely upon records that the taxpayer maintains for income tax or financial accounting purposes.

Example 2. Simple subtraction method VAT.—Assume the same facts as in Example 1 above. The subtraction method VAT would operate as follows:

Production stage	Sales	– Purchases	=Value added	×rate	=VAT
Landowner ...	1,000	– (0)	= 1,000	× .1	= 100
Paper mill	1,300	– (1,000)	= 300	× .1	= 30
Distributor	1,500	– (1,300)	= 200	× .1	= 20
Retail store ...	2,000	– (1,500)	= 500	× .1	= 50
Totals	.....	.....	2,000	× .1	= 200

Comparing Examples 1 and 2, the credit-invoice and subtraction methods yield the same amounts of tax at the same levels of production.

4. Exclusions under a VAT

Most VATs adopted to date provide special treatment for imported and exported goods and services.[47] In addition, most VATs provide exclusions for various goods and services, or classes of taxpayers for economic, social, or political reasons. In addition, certain goods and services are excluded from the VAT due to difficulties in measuring either the amount of the value added or the element of consumption (as opposed to the investment element) with respect to the good or service.

Goods, services, or classes of taxpayers may be excluded from a VAT either by providing a "zero rating" or an exemption. There may be significant differences between these two alternatives, particularly under the credit-invoice method. If a sale is zero-rated, the sale is considered a taxable transaction, but the rate of tax is zero percent. Sellers of zero-rated goods or services do not collect or remit any VAT on their sales of those items, but are required to register as taxpayers. Sellers of zero-rated items are allowed to claim credits (and perhaps a refund to the extent the taxpayer does not have taxable sales) for the VAT they paid with respect to purchased goods and services.

Similarly, a seller of goods or services that is exempt is not required to collect any VAT on its sales. However, because such sellers are not considered taxpayers under the VAT system, they may not claim any refunds of the VAT that they may have paid on their purchases. In addition, under the credit-invoice method, purchasers of exempt goods or services generally are not allowed a credit for any VAT borne with respect to such goods or services prior to the exempt sale. Consequently, a VAT exemption, as opposed to a zero rating, in a credit-invoice system breaks the chain between inputs and outputs along the various stages of production and distribution and may result in a cascading of the tax (i.e., total tax collected from all stages of production would be greater than the retail sales price of the good times the VAT rate). For this reason, most VAT commentators, while recognizing that exemptions may be useful in easing the administrative and recordkeeping burdens of certain targeted taxpayers or transactions (such as small businesses or casual sales), prefer zero rating as the means of providing VAT relief under the credit-invoice method.

There is little practical experience available to assess how exclusions would operate under a subtraction-method VAT. It is, however, theoretically possible to design exclusions under either a subtraction method that replicate the effects of zero rating or exemptions under a credit-invoice VAT. Moreover, exemptions under the subtraction method may relieve the tax on the value added by the exempted activity, but do not result in the cascading that occurs with exemptions under the credit-invoice method.

5. Border adjustments

A VAT based on the destination principle imposes tax on imports and provides tax rebates on exports. These import charges and ex-

[47] See the following discussion for the general treatment of imported and exported goods and services under consumption taxes.

port rebates are commonly referred to as "border adjustments" and are a part of nearly all VAT systems currently in place.[48]

Under the border adjustments, exported goods would not be subject to the VAT through zero-rating the sale of exported goods (i.e., by applying a VAT rate of zero to exports, thus allowing the exporter to claim refundable credits for VAT paid with respect to the purchased inputs). On the other hand, importers would be subject to tax on the full value of imported goods (because inputs with respect to such products previously had not been subject to the U.S. VAT). Similar treatment would be provided for imported and exported services.[49]

Border adjustments are fully consistent with the General Agreement on Tariffs and Trade (GATT), as long as they do not discriminate against imports or provide over-rebates on exports. Relief from "indirect" taxes on exports does not constitute an illegal export subsidy, while relief from "direct" taxes (such as income taxes) is illegal. "Indirect" taxes are defined to include value-added taxes, and credit-invoice VATs have been accepted as border-adjustable under GATT. Although a subtraction-method VAT has the same base as a credit-invoice VAT, it is not clear whether a subtraction-method VAT is an indirect tax and whether border adjustments under the subtraction-method are GATT-legal.[50] Further, because there are no pure subtraction-method VATs currently in existence, there have been no GATT challenges or test cases with respect to the legality of subtraction method border adjustments.

C. Consumption-Based "Flat" Tax

1. In general

A "flat tax" generally is any tax system with only one marginal tax rate.[51] For example, one could construct a flat tax out of the current individual income tax by eliminating all but one marginal rate bracket and repealing provisions that impose higher marginal rates by reducing other deductions or exclusions (e.g., the personal exemption phaseout and the limitation on itemized deductions). While such a tax would be a flat tax on the basis of its single rate bracket, it would still contain dozens of tax expenditure provisions, including the home mortgage interest deduction, the charitable

[48] A more detailed discussion of border adjustments under a consumption tax will be provided in a pamphlet to be prepared for a future planned hearing.

[49] The cross-border provision of services presents difficult issues under any VAT. Services may be performed in whole or in part in one jurisdiction and used or providing benefits in another. Theoretically, (1) services performed by a person outside the United States but used or providing benefits in the United States would be subject to the United States VAT, (2) services performed by a United States person but used or providing benefits in a foreign country would not be subject to the United States VAT, and (3) the value of services used within and without the United States would be allocated between the two jurisdictions based on the relative values of such services. In the case of services, as demonstrated by the present-law income tax controversies surrounding Internal Revenue Code section 482, the identification, measurement, and valuation of use or the benefits provided is difficult. Certain services that are provided both within and without the United States, such as international transportation or communication, could be allocated pursuant to statutory (although somewhat arbitrary) ratios, as under the present-law income tax.

[50] See, e.g., George N. Carlson and Richard A. Gordon, "VAT or Business Transfer Tax: A Tax on Consumers or on Business?" *Tax Notes*, October 17, 1988, p. 329.

[51] A bracket with a marginal rate of zero could also be provided by allowing a standard deduction and personal exemptions. As long as only one bracket has a marginal tax rate greater than zero, the tax would commonly be referred to as a "flat tax."

contribution deduction, the deduction for State and local income taxes, the earned income tax credit, and the dependent care credit.

Many of the flat tax proposals that have been developed do more than simply apply one rate to the current individual income tax base. In addition, they redefine the base of the tax. As discussed above, there are two main approaches: a consumption base and an income base. The gross income of a taxpayer in any year can be thought of as the sum of the taxpayer's consumption and gross saving. The difference between these two approaches is in the treatment of saving. An income-based tax includes the return to saving in the tax base; a consumption-based tax does not.

2. Description of H.R. 2060 and S. 1050

There have been several consumption-based flat tax proposals introduced in recent Congresses.[52] On March 2, 1995, Senator Arlen Specter introduced S. 488. On January 4, 1995, Congressman Philip Crane introduced H.R. 214, "The Tithe Tax," in the House of Representatives. In the 103rd Congress, on January 26, 1993, Senator Jesse Helms introduced S. 188, "The Tithe Tax;" and on June 16, 1994, Congressman Richard Armey introduced H.R. 4585, "The Freedom and Fairness Restoration Act of 1994." House Majority Leader Armey modified his flat tax proposal and introduced H.R. 2060 on July 19, 1995. Senator Richard Shelby introduced a companion bill, S. 1050, in the Senate on the same date. The following discussion provides a description of H.R. 2060 and S. 1050.

Overview

H.R. 2060 and S. 1050 are based on a flat tax developed by Professors Robert Hall and Alvin Rabushka of Stanford University.[53] In general, the tax described in the bills is a consumption-based flat tax that is imposed at single rate upon individuals and businesses. An individual is taxed on the amount by which the individual's wages and distributions from qualified plans exceed the individual's standard deduction. The business activities tax is a subtraction-method VAT, with deductions for wages and contributions to retirement plans. The business activities tax proposed by the bills resembles a subtraction-method VAT, as described above. The difference between the bills' business activities taxes and a subtraction-method VAT is that the bills would allow businesses to deduct compensation expenses, while VATs generally do not allow compensation deductions. However, under the bills, the receipt of such compensation is subject to tax at the individual level at the same flat rate applicable to businesses. Thus, the combination of the business activities tax and the individual tax is roughly equivalent to a VAT. The combination of the individual and business taxes under H.R. 2060 and S. 1050 is not exactly equivalent to a VAT because of the allowance for standard deductions under the individual-level tax. Alternatively, the bills could be viewed as a VAT that provides individuals with built-in exemptions for a minimum

[52] These proposals are described as "flat taxes" because the taxes would be imposed at a single rate on taxable income. These flat taxes generally may be described as consumption-based because in determining taxable income, returns on investment assets would be excluded and businesses would be allowed to expense the cost of capital assets.

[53] See, Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill), 1983.

amount of consumption.[54] Following is a more detailed description of the bills.

Taxation of individuals

The bills would impose a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997) of the excess (if any) of: (1) certain earned income received during the taxable year over (2) the standard deduction for the year. For this purpose, earned income subject to tax would be wages paid in cash for services provided in the United States, distributions from retirement plans, and unemployment compensation.

Under the bills, the "standard deduction" would be the sum of a "basic standard deduction" plus the "additional standard deduction." As under present law, the amount of the basic standard deduction would be determined based on the individual's filing status as provided in Table 3 below. (For the sake of comparison, the amounts of standard deductions allowable under present law also are provided in the table.)

Table 3.—Comparisons of "Standard Deductions" Under H.R. 2060, S. 1050, and Present Law

Filing status[1]	H.R. 2060 and S. 1050 basic standard deduction	Present-law standard deduction[2]
Joint return	$21,400	$6,550
Surviving spouse	21,400	6,550
Head of household	14,000	5,750
Married filing separately	10,700	3,275
Single	10,700	3,900

[1] The determination of an individual's filing status under the bills is the same as under present law.

[2] The amounts in Table 1 provided above for the standard deductions apply for calendar year 1995. These amounts are indexed annually for inflation.

In addition, individuals who are blind or age 65 or older may increase their standard deductions under present law. These additional deduction amounts are not provided under the bills.

Under the bills, the "additional standard deduction" would be an amount equal to $5,000 multiplied by the number of dependents of the taxpayer. (Under present law, a $2,500 exemption amount is allowed for calendar year 1995 for the taxpayer, his or her spouse, and each dependent of the taxpayer. The exemption amounts are indexed annually for inflation.) Similar to present law, basic standard deduction and the additional standard deduction amounts under the bills would be indexed for inflation.

Taxable income of an individual would include the otherwise taxable income of his or her dependent children under the age of 14.

[54] As described by Robert E. Hall and Alvin Rabushka in "The Flat Tax: A Simple Progressive Consumption Tax," a paper prepared for a Hoover Institution conference of May 11, 1995, the exemption amounts of their proposed flat tax are intended to provide relief for lower income individuals under their consumption-based tax.

Taxation of business activities

The bills would impose a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997) of the business taxable income of a person engaged in a business activity. The tax would be imposed on the person engaged in a business activity, whether such person is an individual, partnership, corporation, or otherwise. For this purpose, "business taxable income" would mean gross active income reduced by specified deductions. "Gross active income" would mean gross receipts from (1) the sale or exchange of property or service in the United States by any person in connection with a business activity and (2) the export of property or services from the United States in connection with a business activity.

The bills would allow deductions for (1) the cost of business inputs for the business activity, (2) wages paid in cash to employees for the performance of services in the United States, and (3) contributions to qualified retirement plans or arrangements. For this purpose, "the cost of business inputs" would mean (1) the amount paid for property sold or used in connection with a business activity, (2) the amount paid for services (other than for services of employees, including fringe benefits), and (3) any excise tax, sales tax, customs duty or other separately stated levy imposed by a Federal, State, or local government on the purchase of property or service used in connection with a business activity (other than the flat tax).

If a taxpayer's aggregate deductions for any taxable year exceed its gross active income for the year, the amount of deductions allowed for the succeeding taxable year would be increased by the sum of (1) the excess, plus (2) the product of the excess and the three-month Treasury rate for the last month of the taxable year.

The bills would provide special rules for financial intermediation service activities and noncash compensation provided by employers not engaged in a business activity. The taxable income from the business activity of providing financial intermediation services would be the value of such services.

Governmental entities and other tax-exempt organizations would not be subject to the business activities tax. However, these entities would be subject to a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997), on the amount of remuneration for services performed by an employee other than wages, remuneration for services performed outside the United States, or retirement contributions to qualified plans or arrangements.

Treatment of qualified retirement plans

The bills would make several changes to the present-law treatment of qualified retirement plans. Specifically, the bills would expand the availability of qualified retirement plans by repealing nondiscrimination rules, contribution limits, excise taxes on premature distributions, and by removing restrictions relating to self-employed individuals and tax-exempt organizations and governments. The bills also would provide rules regarding the transfer of excess pension assets.

D. Cash Flow Tax

1. In general

A cash flow tax is a personal consumption tax imposed on the net cash flow of an individual taxpayer. The base of the tax is determined by subtracting a deduction for net increases in savings from the gross income of the taxpayer. Under a pure cash flow tax, withdrawals from savings and net borrowings would be treated as gross income. Thus, a cash flow tax differs from a consumption tax such as a retail sales tax in that the cash flow tax can be levied and collected from individual taxpayers rather than businesses. This personalization of the tax can measure the consumption of an individual taxpayer and allows the application of a progressive rate structure.

2. Description of the "USA Tax Act of 1995" (S.722)

Overview

On April 25, 1995, Senators Sam Nunn and Pete Domenici introduced a form of a cash flow tax in S. 722 (the "USA Tax Act of 1995"). In general, S. 722 would replace the current individual income tax with a "savings-exempt income tax"—a broader-based individual income tax with an unlimited deduction for net new saving. The tax would be imposed using a three-tier graduated rate schedule. In addition, S. 722 would replace the current corporate income tax with a subtraction-method VAT imposed on all businesses at a rate of 11 percent. Thus, in general, the bill would apply two different consumption-based taxes—a cash flow tax on individuals and a VAT on businesses. The bill also would provide individuals with a refundable credit against the individual tax for employee payroll taxes paid by them, and businesses with a credit against the business tax for employer payroll taxes paid by them. Following is a more detailed description of the bill.

Treatment of individuals under the "savings exempt income tax"

The individual tax, or "savings exempt income tax," would be a broad-based income tax with an unlimited deduction for new savings. In other words, it is a modified version of a personal consumption tax with one principal distinction. As discussed in more detail below, borrowing would not be included in income, but rather would only reduce (but not below zero) the net saving deduction. Thus, unlike a personal consumption tax, a net borrower would not pay tax on an amount greater than his income in a given year, even though the net borrowing reflects additional consumption. This additional consumption generally would be taxed as the loan is repaid.

The individual tax would have a three-tier graduated tax rate structure. As under present law, separate rate schedules would apply based on an individual's filing status. The rate structure would be phased-in from 1996 to 1999. After 1999, the individual income tax rate schedules under S.722 are shown in Table 4.

Table 4.—Individual Income Tax Rates Under S. 722[1]

If taxable income is	Then income tax equals
Single individuals	
$0–$3,200	8 percent of taxable income.
$2,200–$14,400	$320, plus 19% of the amount over $3,200.
Over $14,400	$2,560, plus 40% of the amount over $14,400.
Heads of households	
$0–$4,750	8 percent of taxable income.
$4,750–$21,100	$380, plus 19% of the amount over $4,750.
Over $21,100	$3,486.50, plus 40% of the amount over $21,100.
Married individuals filing joint returns	
$0–$5,400	8 percent of taxable income.
$5,400–$24,000	$432, plus 19% of the amount over $5,400.
Over $24,000	$3,966, plus 40% of the amount over $24,000.
Married individuals filing separate returns	
$0–$2,700	8 percent of taxable income.
$2,700–$12,000	$216, plus 19% of the amount over $2,700.
Over $12,000	$1,983, plus 40% of the amount over $12,000.

[1] The rate schedules are expressed in 1996 dollars and would be indexed for inflation beginning in 1997.

Gross income would be defined broadly to include salaries and wages, pensions, most fringe benefits, annuities, life insurance proceeds, alimony and child support payments, dividends, distributions from partnerships and proprietorships, rents, royalties, interest (other than tax-exempt interest), includible social security benefits, and proceeds from the sale of assets. Exclusions from gross income would be limited to tax-exempt bond interest,[55] gifts and bequests, certain government transfer and similar payments, certain health care payments and reimbursements, certain military pay and veteran's benefits, and a portion of social security payments (generally as under present law).

An individual would be allowed a deduction for any increase in his or her "net savings" during the year. "Net savings" would be the taxpayer's additions to qualified savings assets during the year over taxable withdrawals from qualified savings assets during the year. An annual decrease in net savings would constitute taxable income. Borrowing would not be treated as a withdrawal from saving, but generally would reduce (but not below zero) the amount of

[55] This exemption may be worth less than relative to present law, because the "tax" on taxable interest may be deferred under the savings deduction.

"net savings" that could be deducted in a taxable year.[56] In addition, "net savings" would be reduced by interest income on tax-exempt bonds.

Qualified savings assets would include stocks, bonds, securities, certificates of deposits, interests in proprietorships and partnerships, mutual fund shares, life insurance policies, annuities, retirement accounts, and bank, money market, brokerage and other similar money accounts. Qualified savings assets would not include investments in land, collectibles, or cash on hand.

Under the bill, in addition to certain itemized deductions (discussed below) each taxpayer would be entitled to two types of standard deductions: (1) a family living allowance, and (2) a personal and dependency deduction. The family living allowance and the personal and dependency deductions under the bill are comparable to the standard deductions and personal exemptions of present law, respectively.

The bill would continue to allow deductions for qualified home mortgage interest[57] and charitable contributions. In contrast to current law, these itemized deductions would be allowed in addition to the standard deduction, rather than in lieu of the standard deduction. Other deductions allowable under present law generally would be eliminated, such as itemized deductions for state and local taxes and medical expenses. The bill would allow a new deduction for certain qualified educational expenses. This deduction generally would be limited to $2,000 per eligible student per year, and to $8,000 in total per year.

The bill would allow certain credits against the amount of tax due. First, a foreign tax credit would be allowed in a manner similar to present law. Second, a credit generally would be allowed for the employee share of payroll taxes paid by the taxpayer. Third, for low-income individuals, an earned income credit similar to present law would be allowed.

The bill provides certain transition rules (e.g., pre-transition recovery of basis) for purposes of the individual tax. A discussion of these rules is beyond the scope of this pamphlet.[58]

Business tax

The bill would impose a subtraction-method VAT on any business that sells or leases property or sells services in the United States. The tax would equal 11 percent of the "gross profits" of the business for the taxable year. "Gross profits" generally is the amount by which the taxpayer's taxable receipts exceed the taxpayer's business purchases for the taxable year. If the taxpayer's business purchases exceed its taxable receipts for the taxable year, the taxpayer generally would be entitled to a loss carryover to future taxable years. Employer payroll taxes paid by the business may be credited against the business tax.

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[56] Certain types of debt would not reduce deductible "net savings" in a taxable year, including mortgage debt on a principal residence, debt (of $25,000 or less) to purchase consumer durables, credit card and similar debts, and $10,000 of other debts.

[57] The home mortgage deduction generally would be the same as under present law, except that no deduction would be allowed for "home equity indebtedness." Cf. Sec. 163(h)(3).

[58] Transition issues under tax restructuring proposals will be the subject of a future staff hearing pamphlet.

"Taxable receipts" generally mean all receipts from the sale or lease of property, and the performance of services in the United States. The amount treated as taxable receipts from the exchange of property or services is the fair market value of the property or services received, plus any cash received. Taxable receipts do not include: (1) any excise tax, sales tax, customs duty, or other separately stated levy imposed by the Federal, a State, or a local government on property or services, or (2) financial receipts, such as interest, dividends, proceeds from the sale of stock or other ownership interests.

"Business purchases" generally mean any amount paid or incurred to purchase property, the use of property or services for use in a business activity in the United States other than: (1) compensation paid to employees; (2) payments for use of money or capital, such as dividends or interest, (3) life insurance premiums; (4) amounts paid for the acquisition of savings assets or financial instruments; and (5) amounts paid for property purchased or services performed outside the United States (unless treated as an import). The cost of a business purchase does not include any taxes other than any excise tax, sales tax, customs duty, or other separately stated levy imposed by the Federal, a State, or a local government with respect to the property or services purchased for use in a business activity. "Business activity" means the sale of property or services, the leasing of property, and the development of property or services for subsequent sale or use in producing property or services for subsequent sale. A business activity would not include casual or occasional sales of property.

The business tax generally is based on the destination principle—goods and services are subject to tax in the country in which they are used rather than in their country of origin. Under the destination principle, imported goods and services are subject to tax while exported goods and services are not.

In computing its gross profits, a taxpayer generally would be required to use an accrual method of accounting. For this purpose, an amount would not be treated as incurred earlier than when "economic performance" with respect to the item has occurred (Code sec. 461(h)). Businesses presently using the cash receipts and disbursements method, however, generally could continue to use that method. The Secretary of Treasury also could allow certain new businesses to use the cash method. The taxpayer's method of accounting could be changed only with the permission of the Secretary. Special accounting rules would apply with respect to property produced pursuant to long-term contracts.

The bill would impose the business tax on the provision of financial intermediation services. Special rules would apply to determine the taxable amount derived from financial intermediation services. In addition, the bill would permit the business user of financial intermediation services to deduct as business purchases any stated fees for such services and any implicit fees allocated and reported to it by the financial intermediary. The bill would provide a method (and reporting mechanism) for allocating the value of financial intermediation services among users of the services.

Government entities would not be subject to the business tax with respect to the following activities: (1) public utility services;

(2) mass transit services; and (3) any other activity involving an "essential governmental function." Any other government activity of a type "frequently provided by business entities" would be subject to tax. The governments of possessions of the United States would not be subject to the business tax.

The bill generally would exempt the following types of entities from the business tax: (1) instrumentalities of the United States, (2) organizations described in present-law section 501(c)(3),[59] (3) certain qualified benefit plans and trusts, (4) religious and apostolic organizations, (5) cemetery companies, (6) certain title and real property holding companies, (7) cooperative hospital service organizations, and (8) cooperative educational service organizations. These entities would be subject to the business tax only with respect to their business activities that would be subject to the unrelated business income tax ("UBIT") under present law. The taxable amount for a "UBIT activity" would be determined in the same manner as the taxable amount for any other business activity subject to the business tax.

Entities (other than those listed above) that are tax-exempt under present law would be fully subject to the business tax on transfers of property or furnishing of services, even if such activities are substantially related to what historically has been considered to be the exempt purposes of these organizations.

The bill would provide certain transition rules (e.g., recovery of pre-transition basis) for purposes of the business tax. These rules are beyond the scope of this pamphlet.

E. "Pure" Income Tax

1. In general

Under a "pure" income tax, all income would be subject to tax and deductions would be allowed only for expenses that are incurred in the production of income. Income would be recognized when earned and deductions generally would be matched with the accounting period in which the related income is recognized.

A significant portion of the current U.S. tax system generally is considered to be an "income tax."[60] Code section 61 subjects to tax "income from whatever source derived," except for certain items explicitly exempted or excluded by statute. However, the current Federal "income" tax has features that are consumption-based. For example, present law excludes from income contributions to, and earnings of, qualified retirement plans. These exclusions are features of a consumption-based tax because of their treatment of savings.

Similarly, the current Federal income tax allows certain deductions in a manner similar to the way such deductions are allowed under a consumption-based tax. For example, under a value-added tax or consumption-based flat tax, businesses are allowed to ex-

[59] The bill, however, would not exempt organizations that test for public safety or foster amateur sports competition.

[60] In 1994, 54.34 percent of Federal receipts came from individual and corporate income taxes, 36.69 percent came from payroll taxes, 4.39 percent came from excise taxes, and 4.58 percent came from other sources. Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems* (JCS–1–96), March 14, 1996, pp. 5–8.

pense the cost of property used in the business (such as machinery, equipment, real property, and inventory) in the year such costs are paid or incurred. Expensing is equivalent to excluding from tax the expected return from the property because the cost of such property is equal to the present value of the expected stream of income from the property. Under a "pure" income tax, costs of property that benefit future accounting periods are capitalized and recovered over such periods. Under present law, certain costs are expensed in the period they are incurred even though such costs may benefit future periods and would be capitalized under a "pure" income tax. Examples of such expenditures include up to $17,500 of the cost of tangible personal property of small business, the cost of clean-fuel vehicles and refueling property, intangible drilling costs, research and experimental expenditures, expenditures to increase the circulation of newspapers, magazines and periodicals, certain timber expenditures, certain expenditures of farmers, costs of removing architectural and transportation barriers to the handicapped and elderly, certain mining expenditures, and certain costs incurred by free lance authors, photographers, and artists. In addition, present law allows certain capitalized costs to be recovered more rapidly than would be allowed under a "pure" income tax. For example, present law allows the cost of tangible personal property to be depreciated using accelerated methods over periods that may be shorter than the useful lives of the property. Expensing or accelerated cost recovery is provided under present law for certain expenditures in order to simplify the tax accounting for such costs or to provide a tax benefit or incentive for particular activities or types of taxpayers.

Certain exemptions, exclusions, deductions, special rates, and credits are provided in the current Federal income tax largely to promote social, economic, or intragovernmental policies, rather than to contribute to a more accurate measure of economic income. Examples of such items include itemized deductions for medical expenses, home mortgage interest, charitable contributions,[61] State and local income taxes,[62] and property taxes; percentage depletion in excess of cost for natural resources; the exclusion from income for employer-provided health insurance; the exclusion of interest on State and local bonds; special rules applicable to military personnel; parsonage allowances for clergy; the special rate of tax on long-term capital gains; and most tax credits. Similarly, present law denies tax deductions for certain trade or business expenses for social policy reasons. Examples include the denial of deductions for penalties, fines, bribes, lobbying activities, and compensation in excess of $1 million for certain executives.

Several adjustments could be made to the present-law tax system to arrive at a more "pure" income tax. The base of the income tax could be expanded to be more comprehensive. A comprehensive income base would include income from all sources, whether labor income or returns to saving. Sources of income currently excluded from tax, such as employer-provided health insurance and interest

[61] Under one view, as discussed later in this pamphlet, deductions for charitable contributions are allowable in order to more properly measure the disposable income of the donee.

[62] Deductions also may be allowed for State and local income tax for income measurement purposes.

from State and local bonds, would be included in the base. Items currently given consumption-base treatment in the individual income tax would be put on an income base. For example, contributions by an employer on behalf of an employee to a qualified retirement plan would be taxed to the employee when the amount of the contribution is earned. Long-term capital gains would be treated the same as ordinary income. Present-law conventions that result in the deferral of income could be repealed in order to result in a more accurate measure of economic income. For example, under present law, capital gain on an investment generally is recognized when the investment is sold. Present law could be amended to require capital gains to be recognized as such income accrues by marking the investment to market on an annual basis. Such a proposal would raise administrative and liquidity concerns.

Under a more comprehensive income tax, deductions would be allowed only for expenditures that are incurred for the production of income. Thus, most present-law itemized deductions would be repealed. Deductions would be allowed to the extent necessary to accurately measure annual economic income. Thus, expenditures that benefit future accounting periods would be capitalized and recovered in the appropriate period. In general, the tax base for business income would more closely resemble the present-law corporate alternative minimum tax base.

2. Description of the "Ten Percent Tax Plan"

The Treasury Department described a more comprehensive income tax base in its study of tax reform in the early 1980s.[63] Portions of this were enacted as part of the Tax Reform Act of 1986, which broadened the tax base while lowering ordinary income tax rates. More recently, House Minority Leader Richard Gephardt has proposed an individual income tax (the "Ten Percent Tax Plan") with a more comprehensive base.[64] Under the proposal, interest income on State and local bonds, employer-provided fringe benefits (primarily health insurance), and employer pension contributions would be subject to tax. The foreign earned income exclusion (section 911 of the Code), deductions for IRA and Keogh contributions, and the deduction for self-employed health insurance would be eliminated. The only itemized deduction allowed under the plan would be the mortgage interest deduction. Deductions for investment interest and job-related expenses would be retained. The individual tax rates that would be applied to this expanded income base would be reduced from a range of 15 to 39.6 percent to a range of 10 to 34 percent. The special capital gains rate would be repealed. The proposal would repeal the child care and elderly credit while retaining the earned income and foreign tax credits.

F. Summary of Treatment of Various Items Under Alternative Tax Systems

Tables 5, 6, and 7 depict the treatment of certain common items of income and expense under various alternative tax systems.

[63] Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth, Vol. 1*, 1984.

[64] See, press release dated January 17, 1996. The "Ten Percent Tax Plan" has not been introduced as a bill nor has statutory language for the plan been released.

These tables describe how taxpayers would treat these items on their own tax return. The treatment of items under "national retail sales tax" is based upon H.R. 3039. The "value-added tax" is based upon the Business Activities Tax of S. 2160, as introduced. The "consumption-based flat tax" is based upon H.R. 2060 and S. 1050, as introduced. The "USA Tax" is based upon S. 722, as introduced. The description of the "pure income tax" is based upon a theoretical model for such a system.

Table 5.—Treatment of Income of Individuals Under Various Tax Systems

Item	National retail sales tax	Value added tax (VAT)	Consumption-based flat tax (Armey/Shelby)	USA tax Nunn-Domenici	Present law income tax	"Pure" income tax
Income:						
Wages/salaries	N/A	N/A	Includible	Includible	Includible	Includible
Retirement benefits (incl. inside build-up).	N/A	N/A	Includible when received	Includible when received	Includible when received	Includible when earned
Social Security benefits	N/A	N/A	Not includible	Partially includible	Partially includible	Includible
Unemployment compensation	N/A	N/A	Includible	Includible	Includible	Includible
Employer-paid health care	N/A	N/A	Not includible	Includible	Not includible	Includible
Dividends	N/A	N/A	Not includible	Includible	Includible	Includible
Interest	N/A	N/A	Not includible	Includible	Includible	Includible
Municipal interest	N/A	N/A	Not includible	Not includible	Not includible	Includible
Capital gains	N/A	N/A	Not includible	Includible	Includible	Includible
Business, farm, partnership, and subchapter S income.	N/A	N/A	Subject to business tax	Includible	Includible	Includible

Table 5.—Treatment of Income of Individuals Under Various Tax Systems—Continued

Item	National retail sales tax	Value added tax (VAT)	Consumption-based flat tax (Armey/Shelby)	USA tax Nunn-Domenici	Present law income tax	"Pure" income tax
Rental and royalty income	N/A	N/A	May be subject to business tax	Includible	Includible	Includible
Alimony	N/A	N/A	Not includible	Includible	Includible	Includible
Child support	N/A	N/A	Not includible	Includible	Not includible	Includible

Table 6.—Treatment of Deductions of Individuals Under Various Tax Systems

Item	National retail sales tax	Value-added tax (VAT)	Consumption-based flat tax (Armey/Shelby)	USA tax (Nunn-Domenici)	Present law income tax	"Pure" income tax
Deductions:						
IRA & savings contributions ...	N/A	N/A	Not deductible	Unlimited deductible for savings	Deductible within limits	Not deductible
Alimony	N/A	N/A	Not deductible	Deductible	Deductible	Deductible
Child support	N/A	N/A	Deductible	Not deductible	Not deductible	Deductible
Moving expense	N/A	N/A	Not deductible	Not deductible	Deductible within limits	Not deductible
Medical	N/A	N/A	Not deductible	Not deductible	Deductible	Not deductible
State/local taxes	N/A	N/A	Not deductible	Not deductible	Deductible	Not deductible
Real estate taxes	N/A	N/A	Not deductible	Not deductible	Deductible	Not deductible
Mortgage Interest	N/A	N/A	Not deductible	Deductible	Deductible	Not deductible
Investment Interest	N/A	N/A	Not deductible	Not deductible	Deductible within limits	Not deductible

Table 6.—Treatment of Deductions of Individuals Under Various Tax Systems—Continued

Item	National retail sales tax	Value-added tax (VAT)	Consumption-based flat tax (Armey/Shelby)	USA tax (Nunn-Domenici)	Present law income tax	"Pure" income tax
Charitable contributions	N/A	N/A	Not deductible	Deductible within limits	Deductible within limits	Not deductible
Casualty losses	N/A	N/A	Not deductible	Not deductible	Deductible within limits	Not deductible
Employee business expense.	N/A	N/A	Not deductible	Not deductible	Deductible within limits	Not deductible
Investment expense	N/A	N/A	Not deductible	Not deductible	Deductible within limits	Not deductible
Education expenses	N/A	N/A	Not deductible	Deductible within limits	Generally not deductible	Not deductible

Table 7.—Treatment of Businesses Under Various Tax Systems

Item	National retail sales tax	Value-added tax (VAT)	Consumption-based flat tax (Armey/Shelby)	USA tax (Nunn-Domenici)	Present law Income tax	"Pure" income tax
Income:						
Gross receipts from sales of goods/services.	Retail sales only	Includible	Includible	Includible	Includible	Includible
Interest	Not included	Not included	Not included	Not included	Includible	Includible
Dividends	Not included	Not included	Not included	Not included	Partially includible	Includible
Capital Gains	Not included	Not included	Not included	Not included	Includible	Includible
Proceeds from sales of business assets.	Not included	Includible	Includible	Includible	Includible	Includible
Rental and royalty income.	Not included	Included if trade or business	Included if trade or business	Included if trade or business	Includible	Includible
Deductions:						
Inventory	Not included	Deductible when acquired	Deductible when acquired	Deductible when acquired	Deductible when sold	Deductible when sold
Cost recovery of property.	Not included	Expensed when acquired	Expensed when acquired	Expensed when acquired	Depreciate over time	Depreciate over time
Payments to independent contractors.	Not included	Deductible	Deductible	Deductible	Deductible	Deductible

Table 7.—Treatment of Businesses Under Various Tax Systems—Continued

Item	National retail sales tax	Value-added tax (VAT)	Consumption-based flat tax (Armey/Shelby)	USA tax (Nunn-Domenici)	Present law Income tax	"Pure" income tax
Salaries/wages	Not included	Not deductible	Deductible	Not deductible	Deductible	Deductible
Retirement benefits..	Not included	Not includible	Deductible	Not deductible	Deductible	Deductible
Employee health benefits.	Not included	Not deductible	Not deductible	Not deductible	Deductible	Deductible
Taxes	Not included	Not deductible	Not deductible	Not deductible	Deductible	Deductible
Interest	Not included	Not deductible	Not deductible	Not deductible	Deductible	Deductible
Charitable contributions.	Not included	Not deductible	Not deductible	Not deductible	Deductible with limits	Deductible
Advertising	Not included	Deductible	Deductible	Deductible	Deductible	Deductible

IV. ANALYSIS

A. Effects of Tax Reform on State and Local Governments and Tax-Exempt Organizations

1. Overview of proposals

National Retail Sales Tax Act (H.R. 3039)

The National Retail Sales Tax Act (the "Act") generally imposes a 15-percent tax on gross payments for the use, consumption, or enjoyment in the United States of any taxable property or service. In general, tax would not be imposed upon any property or service purchased for resale, to produce taxable property or services, or for export. Tuition for general primary, secondary, or university level education and job-related training courses would be treated as purchased to produce taxable property or services.

The Act applies special rules to governmental units and nonprofit organizations. Federal, State, or local governmental units or political subdivisions would not be exempt from the tax on any sale, purchase, use, consumption, or enjoyment of a taxable good or service. In addition, an excise tax of 15 percent would be imposed on the wages of Federal, State, and local government employees.[65] Dues, contributions, and similar payments to a "qualified not-for-profit" organization generally would not be subject to tax. However, payments to such an organization would be subject to the tax if the property or service provided in exchange for the payment either is not substantially related to the exempt purpose of the organization *or* is commercially available. For this purpose, a "qualified not-for-profit organization" would be an organization organized and operated exclusively as an organization generally described in present-law sections 501(c) (3), (4), (5), (6), (8) and (10) of the Code and no part of the net earnings of which inure to the benefit of any private shareholder or individual. Qualified not-for-profit organizations would be certified by the appropriate State tax administrator. The provision of property or personal services by a qualified not-for-profit organization in connection with contributions or dues to the organization would be treated as a taxable transaction in an amount equal to the fair market value of the property or service. Property or personal services acquired by a qualified not-for-profit organization for resale or use in the production of taxable property or services would not be subject to tax.

Value-added tax

A VAT subjects the "value added" to tax. The amount of value added generally can be thought of as the difference between the value of sales (outputs) and purchases (inputs) of an enterprise. The amount of value added may be determined in a number of ways; the two most common methods are the credit-invoice method and the subtraction method.

Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate

[65] Subjecting retail sales made by Federal, State, and local government entities to tax and also subjecting wages paid to employees of such entities to a 15-percent excise tax could lead to a double tax on the value added by government employees to government goods and services sold to the public.

to the sales price of the good or service. A business credit is provided for all VAT paid on all purchases of taxable goods and services (i.e., "inputs") used in the seller's business. The ultimate consumer (i.e., a non-business purchaser), however, does not receive a credit with respect to his or her purchases. Under the subtraction method, value added is measured as the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises. The subtraction method differs from the credit-invoice method principally in that the tax rate is applied to a net amount of value added (sales less purchases) rather than to gross sales receipts with credits for tax previously paid on purchases (as under the credit-invoice method). An addition method may also be used to compute value added. An addition method measures value added as the sum of wages, interest expense, and cash-flow profits of an entity. Although generally disfavored by VAT commentators, this method may have utility in measuring the value added of a nonprofit organization.

Most VATs adopted to date provide exclusions for various goods and services, or classes of taxpayers for economic, social, or political reasons. In addition, certain goods and services are excluded from the VAT due to difficulties in measuring either the amount of the value added or the element of consumption (as opposed to the investment element) with respect to the good or service. As discussed more fully below, these considerations are particularly relevant in considering the proper treatment of governments and nonprofits under a VAT.

Consumption-based "flat" tax (H.R. 2060 and S. 1050)

In general, the tax described in H.R. 2060 and S. 1050 is a consumption-based flat tax that is imposed at a single rate upon individuals and businesses. An individual is taxed on the amount by which the individual's wages and distributions from qualified plans exceed the individual's standard deduction. The business activities tax proposed by the bills resembles a subtraction-method VAT, as described above, although the bills would allow businesses to deduct compensation expenses, while VATs generally do not allow compensation deductions.

Governmental entities and other tax-exempt organizations would not be subject to the general 20-percent business activities tax. However, these entities would be subject to a tax equal to 20 percent (as with the general business activities tax, the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1997) on the amount of employee fringe benefits.

USA Tax Act (S. 722)

In general, S. 722 would replace the current individual income tax with a broader-based individual income tax with an unlimited deduction for net new saving. In addition, S. 722 would impose a subtraction-method VAT on all businesses at a rate of 11 percent.

For purposes of the individual income tax, gross income would be defined broadly, but generally would exclude tax-exempt bond interest, gifts and bequests, certain government transfer and similar payments, certain health care payments and reimbursements, certain military pay and veteran's benefits, and a portion of social se-

curity payments (generally as under present law). The bill would continue to allow deductions for qualified home mortgage interest and charitable contributions. The bill also would allow a new deduction for certain qualified educational expenses; this deduction generally would be limited to $2,000 per eligible student per year, and to $8,000 in total per year. Other deductions allowable under present law generally would be eliminated, such as itemized deductions for state and local taxes and medical expenses.

The bill provides special rules regarding the application of the business tax to governments and nonprofit entities. In general, government entities would not be subject to the business tax with respect to the following activities: (1) public utility services; (2) mass transit services; and (3) any other activity involving an "essential governmental function." Any other government activity of a type "frequently provided by business entities" would be subject to tax. The governments of possessions of the United States would not be subject to the business tax.

The bill generally would exempt the following types of entities from the business tax: (1) instrumentalities of the United States, (2) certain organizations described in present-law section 501(c)(3), (3) certain qualified benefit plans and trusts, (4) religious and apostolic organizations, (5) cemetery companies, (6) certain title and real property holding companies, (7) cooperative hospital service organizations, and (8) cooperative educational service organizations. These entities would be subject to the business tax only with respect to their business activities that would be subject to the unrelated business income tax ("UBIT") under present law. The taxable amount for a "UBIT activity" would be determined in the same manner as the taxable amount for any other business activity subject to the business tax. Other entities that are tax-exempt under present law would be fully subject to the business tax on transfers of property or furnishing of services, even if such activities are substantially related to what historically has been considered to be the exempt purposes of these organizations.

"Pure" income tax

Under a "pure" income tax, all income theoretically would be subject to tax and deductions would be allowed only for expenses that are incurred in the production of income. Thus, certain exemptions, exclusions, deductions, special rates, and credits that are provided in the current Federal income tax largely to promote social, economic, or intragovernmental policies, rather than to contribute to a more accurate measure of economic income, would be eliminated. For individuals, examples of such items include itemized deductions for charitable contributions, State and local income taxes, and property taxes, and the exclusion of interest on State and local bonds. Entities that have tax-exempt status under present law would be subject to tax on their investment income, as well as income from commercial-type activities that currently may be exempt under other UBIT exceptions.

2. Conceptual issues in the treatment of State and local governments and tax-exempt entities under consumption-based taxes

In general

The taxation of government and nonprofit entities raises special issues concerning general social policy, administration and compliance, competitive equity, and intergovernmental relations.[66] As discussed further below, activities of nonprofit organizations that are subject to income taxation under present law as unrelated business income could be relatively easily brought under the business taxation regimes of the consumption-based proposals described in Part III above. It is the other activities of governments and nonprofit organizations that raise special issues. Under a VAT in particular, difficulties arise in the calculation of value added because government and nonprofit entities often provide goods or services on a free-of-charge or subsidized basis. In many cases, there is no identifiable transaction involving, or consumer of, government or nonprofit services.

One of the most fundamental issues in attempting to measure the value of governmental and nonprofit activities is when should government and nonprofit entities be regarded as producers of goods and services and when should they be treated as consumers? For example, from a purely theoretical standpoint, the government's national defense activities may be viewed alternatively as (a) the government *producing* a security service for its citizenry, or (b) the government (as agent for, or on behalf of, its citizens) *consuming* on a mutual basis products such as tanks, planes, and munitions, as well as soldiering services of individuals employed in the armed forces. In this regard, examination of VATs in other countries, suggested approaches by commentators, and legislative proposals reveals considerable diversity in conceptual approaches to the taxation of governments and nonprofits under a consumption-based tax.[67]

Principles of economic neutrality

In analyzing the application of a consumption-based tax to governmental and nonprofit activities, it is useful to examine two broad categories of activities of governments and nonprofit organizations: such entities (1) provide goods and services; and (2) make transfer payments to individuals.[68]

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[66] See U.S. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President, Volume 3, Value-Added Tax* (November 1984) ("1984 Treasury Report"), pp. 67–72; Tax Executives Institute, *Value-Added Taxes: A Comparative Analysis* (1992), pp. 29–31; Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS–6–91), p. 318.

[67] Compare the American Bar Association Model (the "ABA Model"), which treats governments and nonprofits as producers whenever more than a nominal charge is imposed, ABA Section of Taxation, *Value Added Tax: A Model Statute and Commentary* (Alan Schenk, Reporter) (1989), with McDaniel and Surrey, who generally treat governments and charities as the ultimate consumer, unless commercial-type goods are sold to identifiable consumers. McDaniel, Paul R. and Stanley S. Surrey, *International Aspects of Tax Expenditures: A Comparative Study*, pp. 91-93 (hereafter cited as "McDaniel and Surrey"). An example of an intermediate approach is Canada's goods and services tax ("GST"). Under the GST, charities are treated as consumers with regard to most of their services, which are VAT-exempt; however, charities also are treated as quasi-businesses and are allowed a 50-percent input credit.

[68] Of course, the government also collects taxes. The present discussion is about the uses of the government's resources rather than its source of funds.

Governmental or nonprofit provision of goods and services

Governments and nonprofits provide many goods and services. The sale of government publications and the construction and maintenance of roads provide examples of the provision of goods and services. Economic neutrality argues that if novels are to be subject to a consumption-based tax, then government publications should be subject to the consumption-based tax. Similarly, if the provision of railroad freight transportation services (virtually all privately provided) are to be subject to a consumption-based tax, then the provision of roadway transportation services should be subject to the consumption-based tax in order to achieve neutrality among competing sectors of the larger transportation industry.

The examples of the provision of roads and publications highlight the primary difficulty in applying a VAT, retail sales tax, or other consumption-based tax to the provision by governments and other nonprofit entities of goods and services—the pricing of such goods and services generally is not the same as the pricing of privately provided goods and services. The forces of demand and supply in the marketplace generally determine the prices of privately provided goods and services. In most cases, the government provides the services of the roadway free to users, unlike the railroad which, driven by the profit motive, charges a price determined by the economic forces of the marketplace. In private market transactions there is a clear discernable value that can provide the basis for taxation. With governmental provision of roads there is value (or else people would not use the roads) but value is not easily discernible. While governments and nonprofits provide many goods and services at zero price, in other cases, they may charge a fee for a particular good or service, as in the case of the government publication. Even so, the government may choose to price the publication below the price that a private publisher might choose. Unlike the example of the road, placing a price on the government publication would provide a basis for taxation but would not necessarily tax the full value of the publication. In both examples, the government can be thought of as providing an explicit subsidy to consumption of a particular good or service. To fully tax value, the subsidy must also be measured.

A further problem arises because, unlike most goods offered in the private market, many government and nonprofit goods and services are what economists call "collective" or "public" goods—that is, goods the benefits of which can be simultaneously consumed by all individuals rather than privately consumed by only one individual. For example, national defense is collectively consumed. Government publications, in contrast, are privately consumed. While collective goods have value, it may not be possible to conceive of the value being revealed by a market transaction.

Including the value of government-provided goods and services in the consumption tax base is less problematic under a consumed income tax or under a flat tax than under a retail sales tax or VAT. A consumed income tax generally treats payment of taxes to State and local governments as consumption and thereby subjects to tax the provision of State and local governmentally provided goods and services. A Hall-Rabushka-type flat tax would tax the wages of government employees. However, without special provisions, such a

flat tax may not reach the non-wage compensation of government employees. Nor, unlike a taxable business, would a flat tax necessarily apply to any cash surplus or interest expense the government or tax-exempt entity might generate or incur as part of its governmental purpose. A flat tax, therefore, may only partially tax the governmental provision of goods and services. However, as wage costs are the most significant portion of employee compensation, and as labor cost is the major source of value added by governments, the extent to which governmental provision of goods and services is untaxed may not be large.

There are two ways one could impose a retail sales tax or VAT on a good or service provided by a government or nonprofit. The first option is to impose the tax on the price charged by the government or nonprofit net of any implicit subsidy provided. The second option is to impose the tax on the market price of all similar transactions. If the government providing the subsidized good were a local government, and the Federal government imposed a retail sales tax or VAT, then, under the first option, there would be a built-in tax expenditure in favor of the local government's provision of the subsidized good equal to the tax rate multiplied by the implicit government subsidy. That is, the value of the subsidy would be untaxed. However, this built-in tax expenditure would keep the relative price of the subsidized and unsubsidized goods the same (i.e., the ratio of the subsidized prices to unsubsidized prices throughout the economy would remain the same) as it was prior to the adoption of the Federal consumption tax. Therefore, under the second option (i.e., imposing tax calculated on the basis of a presumed market price), to keep the relative price of the subsidized and unsubsidized goods equivalent, the local government would have to increase its subsidy by the amount of the subsidy multiplied by the tax rate. This is because, under the second option, the full value of the good or service, including any subsidy, is taxed.

In summary, economic neutrality argues that one does not want a consumption-based tax to distort the choice between privately provided goods and government- or nonprofit- (subsidized) provided goods. However, as noted above, a distinguishing feature of government- and nonprofit- provided goods and services is that their prices generally are not determined in the private market.

Governmental or nonprofit transfer payments

Social security payments and the AFDC program provide examples of government transfer payments. The government provides cash (or cash equivalent vouchers) to individuals who, in turn, make purchases in the private market. Such purchases made in the private market can be subject to a retail sales tax or VAT, so there is no need for special rules imposing the tax directly on social security checks *per se*. Similarly, if such government transfers are included in income for purposes of determining consumed income or if social security payments are treated similarly to private pensions under the flat tax proposed in H.R. 2060 (i.e., not taxed currently, but fully includible in income on receipt), then such government transfer payments are treated neutrally under the different types of consumption-based taxes.

A different analysis applies, however, to government activities undertaken in the *administration* of transfer payment programs. In providing cash to individuals, the government is acting no differently than a bank that gives cash to a customer making a withdrawal or taking out a loan. Also like a bank, the government will keep records of the account. In its role of record keeper the government is providing financial services. The neutrality arguments given above would suggest that the "financial services" involved in making transfer payments should be subject to a consumption-based tax. To exempt such services from the consumption-based tax would have the following consequences: (1) exemption might make public provision of certain financial services more desirable than private provision; (2) exemption might make public management of pension funds, social security, etc. appear "cheaper" and "more efficient" than private management; (3) exemption might make the Social Security Administration, an agency that largely provides financial services, appear to be a more efficient provider of government than the Defense Department, an agency that largely provides nonfinancial services (assuming that the latter's provision of "defense" is subject to the consumption-based tax). (See discussion below regarding inclusion of Federal government activities in a consumption tax base.)

Inclusion of governments and nonprofits in the tax base

The treatment of government and nonprofit entities is closely linked to the basic question of what is theoretically intended to be the taxable base of a consumption tax. If, as a starting point, the taxable base is defined as the value added with respect to all final goods and services in the economy, then value added by government and nonprofit labor and capital resources should be subject to tax. Under this view, any profits that could be obtained from government or nonprofit operations (even if forgone by the entity) theoretically should be included in the tax base. If governmental provision of goods and services were not subject to tax, there would be a bias towards organizing consumption through the governmental sector. For example, individuals would find it advantageous to ask their elected representatives to establish governmentally owned and operated grocery stores. Purchasing groceries through such a store would be exempt from tax, whereas purchasing groceries through a privately operated store would be taxable. Reorganizing the market place (and governments) to take advantage of a governmental imprimatur would reduce the tax base. Even so, viewing governments and nonprofits as taxable producers generally requires certain adjustments to the general tax structure because prices charged by governments and certain nonprofits for goods and services often do not accurately reflect value added.[69]

However, if the taxable base of a consumption tax is defined as value added *by businesses* with respect to all goods and services in

[69] In other words, use of general credit-invoice or subtraction-method VAT rules is inappropriate with respect to many goods and services provided by government and certain nonprofit entities because the value added by such entities is not accurately determined by reference to the sales price of goods and services they provide minus the cost of inputs upon which VAT previously has been paid. As discussed later, some government and nonprofit operations generally do not involve subsidies or valuation issues and would, therefore, be appropriately taxed under general consumption tax rules.

the economy from the first producers of raw materials through retail sellers (defined as firms that sell to nonbusiness users),[70] then it is possible to design a tax system under which governments and nonprofits generally could be viewed as "nonbusiness users" (i.e., consumers).[71] Under this view, sales to governments and nonprofits are *not* "inputs" in a business activity, but are treated as retail sales to a collective body of consumers, and any value added by government or nonprofit operations through collective use of the products purchased from vendors would not be subject to tax. In effect, government and nonprofit operations generally would be treated in a manner similar to self-provided services. Services are not subject to tax when provided by an individual to herself and her family (e.g., products purchased by an individual to protect herself and her home are subject to tax, but her self-provided services in using those products is not subject to additional tax). Likewise, government and nonprofit activities generally could be treated as *collective*, self-provided services provided by a community (e.g., individuals pool their resources through taxes or contributions[72] to provide community protection on a mutual, noncommercial basis). The National Retail Sales Tax reflects this approach in its treatment of certain qualified not-for-profit organizations by taxing sales to such organizations, but not taxing their sales (other than UBIT-type activities or sales of commercially available goods or services) and by exempting wages paid by such organizations, as well as contributions, gifts, and similar payments they receive, from tax.

The primary rationale for excluding self-provided services of individuals and informal groups from the base of a consumption tax is administrative (i.e., self-provided services are non-market transactions that are difficult *both* to monitor and to value). The monitoring aspect of this rationale does not apply with equal force in the case of transactions involving separate legal entities such as governments or nonprofits. Monitoring of government and nonprofit activities generally should be easier than monitoring individuals or informal arrangements. However, valuation difficulties remain. Although self-provided services among individuals and informal groups frequently involve noncash or barter transactions, many government and nonprofit operations do not involve a "sale" or identifiable transaction but are subsidized by general tax revenues, contributions, or grants. Moreover, due to the very nature of some government and nonprofit services, no market is involved (e.g., environmental regulation). Thus, it could be argued that, for theoretical and administrative reasons, governments and nonprofits should be treated as ultimate consumers, except when they conduct commercial ventures with identifiable individual consumers.[73]

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[70] See Weidenbaum, Murray, David Raboy, and Ernest Christian, *The Value-Added Tax: Orthodoxy and New Thinking*, p. 47 (1989) ("a pure VAT ultimately applies to the value added by every business from the first producer of raw materials through the retail seller (i.e., the company which sells to a non-business user)"). The authors explicitly do not address the complex issues raised in the treatment of governments and nonprofits. *Id.*, p. xvi.

[71] As under the present-law Federal income tax, the view could be adopted for consumption tax purposes that activities undertaken without a profit motive generally do not constitute a "trade or business."

[72] Most VATs in other countries, as well as commentators on the subject, treat contributions, gifts, and similar transfers made in a nonbusiness context as nontaxable transactions. See McDaniel and Surrey, pp. 69–70.

[73] See McDaniel and Surrey, pp. 73 and 92. Self-provided services generally are not subject to VAT when provided by a group that is not regarded as a separate legal entity (e.g., a family

When governments and nonprofits are viewed as collective consumers such that their operations (other than unrelated business activities) constitute mutual self-provided services rather than taxable business transactions, sales of goods and services *to* such entities should be taxed. For example, a sale of a police vehicle to a local government would be subject to VAT (as if the vehicle were sold to any other consumer), even if there is no attempt to capture any value added by the government's deployment of the vehicle. Taxing sales *to* governments and nonprofits, therefore, ensures neutrality in the consumption tax treatment of goods sold to individual consumers and goods sold to collective consumers.[74] The government (or nonprofit) is viewed as an agent purchasing on behalf of its citizens (or taxpayers/beneficiaries).[75]

Significantly, under this view, the government (or nonprofit) is consuming not only tangible goods sold to it by vendors, but also labor services performed by independent contractors or employees. It is well understood that purchases of independent contractor services are subject to tax under a VAT regime. However, labor services provided by employees *of a business* are not directly subject to tax in a VAT regime (i.e., the provision of employee services is not a taxable transaction), because the value added by such employee services indirectly is captured when measuring the business' output by its sales and not allowing a deduction for employee wages. In contrast, where employment services are provided in a *nonbusiness* setting (e.g., an individual hires an employee to perform personal services, such as a maid, chauffeur, security guard, or tutor), the proper treatment is to subject the sale of such employee services to tax.[76] In other words, a nonbusiness employer consumes the services of its employees. Therefore, if governments

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or neighborhood). Consequently, if government and nonprofit entities were viewed as taxable *producers*, as opposed to collective consumers, then the same services that could escape tax when provided by individuals to themselves, their families, or through other informal arrangements would be subject to tax when provided by a government or nonprofit. In effect, the legal form of an undertaking could dictate its tax treatment. For example, is it appropriate to try to capture the total value added in the case of a barn built under the auspices of a church or other entity, but tax only the materials if the same barn is built by an informal group of neighbors? But see McDaniel and Surrey, p. 77 (exclusion from tax base of self-provided services should apply only to "activity customarily carried on by individuals in and around their own households").

[74] This neutrality is necessary to prevent distortions in the manner in which goods are purchased. Absent taxation of government and nonprofit purchases, individuals would have an incentive to purchase goods or services through their collective agents (i.e., though governments and nonprofits) rather than individually purchasing *on a tax-inclusive basis* the same (or substitutable) goods or services. For instance, if government purchases of goods and services for use in trash collection were not subject to tax, then individuals would have a incentive arising out of the preferential tax treatment to vote that such purchases be made on their behalf by their local government (or could use a nonprofit entity in a like manner), rather than individually contracting with a commercial trash-removal company. Likewise, individuals would have an incentive to turn over to governments or nonprofits additional purchasing authority customarily exercised by individuals.

[75] If governments are viewed as agents acting on behalf of consumers generally, it still is appropriate to levy the consumption tax on the government itself when it carries out governmental functions, because it is impractical to apportion tax among consumers who benefit from the acquisitions (McDaniel and Surrey, p. 92).

[76] See McDaniel and Surrey, p. 74. Some commentators ignore the distinction between employment in a trade or business context and employment in a personal, nonbusiness context. (See ABA Model Statute and Commentary, pp. 32 and 41). However, the distinction is necessary to preserve neutrality in the tax treatment of comparable transactions. If the distinction between business and personal employees were ignored, for example, a household directly employing a maid would not pay tax on the value of services provided, whereas the value of comparable services provided by independent contractors would be subject to tax. Thus, when an employee renders services *not* in furtherance of a trade or business, the proper consumption tax treatment is that the employment *itself* constitutes a taxable trade or business.

and nonprofits are treated as collective, nonbusiness consumers, they should be treated (as should individual employers of personal-service workers) as consuming the services of their employees.[77] Treating governments and nonprofits as nonbusinesses that consume the services of their employees would result in a tax burden being imposed on such entities that is equivalent to an approach under which the entities are viewed as businesses but (for reasons of practical administration of the tax) only their labor costs are taken into account as the proxy for value added by government or nonprofit activities. This approach is often referred to as an "addition-method VAT."

Narrowing the consumption tax base

If a broad-based consumption tax that includes all government and nonprofit activities is deemed politically infeasible or otherwise undesirable, it is possible to construct a narrower taxable base. This narrower base can be constructed by removing either certain types of governmental or nonprofit entities or certain types of activities from the broad base, or a combination of the two approaches.

Exclude certain types of nonprofit and governmental entities from the VAT base

One way to narrow the tax base is to exclude certain types of entities. Grounds for exclusion may derive from social objectives or political realities. For example, it would be possible to invoke a social policy rationale for excluding charitable organizations, educational institutions, or medical services from a consumption tax base. Most State retail sales taxes exempt acquisitions by States and localities, and by charitable, religious, and educational organizations. The flat tax proposal of H.R. 2060 and S. 1050 exempts from the business activities tax all activities conducted by governmental entities and other present-law, tax-exempt organizations.[78] In contrast, the business component of the USA Tax generally would exempt from taxation only the following subset of the entities that have tax-exempt status under present law: (1) instrumentalities of the United States; (2) most charities described in section 501(c)(3);[79] (3) certain qualified benefit plans and trusts; (4) religious and apostolic organizations; (5) cemetery companies; (6) certain title and real property holding companies; (7) cooperative hospital service organizations; and (8) common investment funds for educational organizations. As under present law, such entities would be subject to tax only with respect to their unrelated business activities.

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[77] If governments and nonprofits were treated as "ultimate consumers" yet not as consuming the services of their own employees, then decisions of government and nonprofit managers could be distorted in favor of hiring in-house employees (on a tax-free basis) rather than utilizing outside firms or independent contractors (which would be subject to tax).

[78] Because such entities are not subject to a business level tax and fringe benefits are not subject to the flat tax imposed at the individual level (as are wages), a special provision of the bill imposes a 20 percent tax on fringe benefits paid to employees of such entities.

[79] The USA Tax includes a special rule providing that an organization shall *not* be entitled to tax-exempt status as an "educational organization" if a substantial amount of its activities and funds are devoted to (1) conducting seminars and other similar programs, (2) conducting research to educate Congress or the general public about public policy issues, (3) producing books and pamphlets, or (4) a combination of activities described in (1), (2), or (3).

A Federal consumption tax (no matter the scope of its base) may be perceived by some as invading an area of sales taxation traditionally reserved for States and local governments. Including State and local governments in the tax base may add fiscal insult to political injury. In addition to sparking political objections, subjecting all State governmental activities to a Federal consumption tax may raise constitutional questions under the so-called "doctrine of intergovernmental tax immunity." Historically, this doctrine was viewed as providing immunity from Federal tax for State governmental (as opposed to proprietary) activities.[80] However, in recent years, the Supreme Court has narrowed the scope of the doctrine, holding that "at least some nondiscriminatory federal taxes can be collected directly from the States even though a parallel State tax could not be collected directly from the Federal Government."[81] Nonetheless, it is uncertain whether a Federal consumption-based tax imposed directly on States—as opposed to a tax imposed on identifiable consumers of goods and services under the same general rules applicable to all businesses, but merely collected by the State—would be a valid, nondiscriminatory tax under the doctrine of intergovernmental tax immunity as interpreted in the modern era.[82]

Regardless of whether States and local governments are included in the consumption tax base, it may also be appropriate to consider the desirability of including the Federal Government itself in the base. This decision turns not so much on constitutional grounds as on policy considerations. It may appear administratively redundant for the Federal Government to tax itself on its value added. The Federal Government would be seen as "taking the money out of one pocket and putting it into another pocket." Nevertheless, it may still be desirable to include the Federal Government in the tax base. Requiring each Federal agency to remit tax on employee compensation costs to the Treasury would remove incentives for particular agencies to use their budgets to hire in-house employees (on a tax-free basis) rather than independent contractors.

In addition, because of perceptions, failure to include the Federal Government in the consumption tax base may distort economic choices as between the public and private sectors. If the Federal Government were excluded from the tax base, goods and services provided by it would appear relatively cheaper than comparable goods and services provided (on a tax-inclusive basis) by the private sector. This perception could create a bias in favor of the public sector.

Absent application of a consumption-based tax to the Federal provision of goods and services, the Federal Government would look smaller or more efficient than it otherwise might, and would appear smaller than State and local governments that might undertake some of the same activities (e.g., highway construction). To impose tax on some Federal provision of goods and services and exempt Federal provision of other goods and services could distort the perception of the true size of different functions within the Federal government.

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[80] See *New York v. United States*, 326 U.S. 572 (1946).
[81] *South Carolina v. Baker III*, 485 U.S. 505, footnote 13 (1988).
[82] *Id.* See also 1984 Treasury Report, p. 69.

An example of an approach that would tax Federal and State governments is the National Retail Sales Act, which provides that Federal, State, and local governmental units would not be exempt from tax on any sale, purchase, use, consumption, or enjoyment of a taxable good or service by the unit. In addition, the Act would impose a separate excise tax on wages paid by such governmental units.

Distinguishing among activities conducted by nonprofit and government entities

Exclude certain nonprofit and governmental activities from the VAT base

In lieu of (or in addition to) excluding certain types of nonprofit or governmental *entities* from a consumption tax base, it is also possible to narrow the tax base by excluding certain government and nonprofit *activities*. Such an approach focuses not on the nonprofit nature of the organization, but rather on the particular activities it performs.[83] VATs in some countries adopt this approach and distinguish between charitable activities and other nonprofit ventures.[84]

The National Retail Sales Tax Act incorporates both types of limits by exempting from tax certain activities of a limited group of entities. The Act would provide that payments to certain types of nonprofit organizations (generally, those organizations described in present-law sections 501(c) (3), (4), (5), (6), (8), and (10)[85]) are subject to tax if the good or service provided in exchange for the payment either (1) is not substantially related to the exempt purpose of the organization, or (2) is commercially available. All other payments to this subset of nonprofit organizations would be exempt from the retail sales tax.

An alternative approach would be to specifically enumerate by statute or regulation particular activities that would, or would not, be subject to tax. With respect to State and local governmental entities, the USA Tax Act would focus on the nature of the activity conducted by the organization, and would exempt the following activities of governmental entities from tax: (1) public utility services; (2) mass transit services; (3) any other activity involving an "essential governmental function." Other State and local governmental activities of a type "frequently provided by business entities" would be subject to tax. This contrasts with the subtraction-method VAT

[83] To the extent noncharities conduct charitable-type activities, it would be possible to tax such activities under the regime applicable to charitable activities. This approach would be analogous to the present-law treatment of fraternal societies, which are eligible to receive tax deductible contributions used exclusively for charitable purposes (sec. 170(c)(5)).

[84] For example, Canada provides an exemption from VAT and a 50-percent input rebate for most goods and services provided by charities (except for certain items such as gift-shop sales, admission to theaters, restaurants, and gambling). Other nonprofit organizations' goods and services generally are taxable, although a few items (such as amateur performances or relief of poverty) are exempt from VAT (and eligible for the 50-percent input rebate if the organization receives at least 40 percent of its funding from government sources). In contrast, the New Zealand VAT, on its face, does not distinguish charities from other nonprofits. However, a VAT exclusion effectively applies in New Zealand to the extent that activities are funded by donations for which consideration is not involved (which generally occurs only with charitable-type activities).

[85] Under the National Retail Sales Act, the determination whether a particular entity meets the criteria of a "qualified not-for-profit organization" would be made at the State, rather than the Federal, level. In practice, this could lead to considerable disparity among States with respect to the Federal tax treatment of organizations conducting similar activities.

proposed in S. 2160, under which government entities (Federal, State, and local) would be fully subject to tax with respect to the following activities: (1) public utility services, (2) mass transit services, (3) postal services, and (4) any activity not involving an "essential governmental function" within the meaning of present-law section 115.[86] Other government activities would not be subject to tax, with the exception of certain "self-consumption" activities made subject to tax by regulation.[87] If a government entity did not separately charge customers for the taxable service (e.g., if utility services were not separately charged but were included with property taxes), then gross receipts subject to tax under S. 2160 would be determined on the basis of fair market value of the taxable service. Charities described in section 501(c)(3) would be fully subject to tax only with respect to their trade or business activities presently subject to the UBIT (other than debt-financed investment income). Charities (like governments) would be partially subject to tax with respect to their self-consumption of goods and services, to the extent so provided by regulations, based on the estimated fair market value of the self-consumed good or services. Nonprofits (other than charities) would be fully subject to tax under S. 2160 on their sales of goods or services, regardless of whether such sales historically have been considered to be the related to the nonprofit purpose of the organization.

In theory, the central concern underlying the question whether or not to include a government or nonprofit service should be whether the inclusion (or exclusion) from the tax base will distort consumer choices.[88] In other words, if a particular government or nonprofit good or service is not subject to tax, will consumers have an incentive either to (a) purchase fewer comparable goods or services from for-profit businesses or (b) substitute government and nonprofit goods or services for different for-profit sector products?

Some government and nonprofit activities benefit the general public and are not substantially similar to services provided by for-profit firms (e.g., national defense, law enforcement, and general public regulation). In general, such government and nonprofit activities—referred to below as "public enterprises"—could be zero-rated or exempted without distorting consumer choices.[89] In a VAT

[86] The amount of government revenues subject to tax would be computed by subtracting from gross receipts derived from taxable government activities only those expenses incurred by governments to purchase goods or services used in, or otherwise allocable to, such taxable activities. The Secretary would have authority to prescribe by regulation methods for allocating government purchases of goods or services between taxable and nontaxable activities.

[87] Under S. 2160, government entities would be partially subject to tax with respect to their "self-consumption" of goods or services, to the extent so provided by regulations, to discourage vertical integration by governments that could distort competition. If so provided by regulation, "self-consumption" goods or services—meaning certain goods or services produced and consumed by the government itself as part of offering a final, nontaxable good or service—would be subject to tax. In such cases, taxable income would be calculated by subtracting from the fair market value of the self-consumed goods or services the cost of inputs allocated to such self-consumed goods or services.

[88] The general EEC approach is to exempt governmental authorities from the VAT base with respect to activities or transactions in which they engage as "public authorities" but to treat such entities as taxable "where treatment as nontaxable persons would lead to significant distortions of competition." Tait, Alan A., *Value Added Tax: International Practice and Problems*, pp. 76-77 (1988).

[89] In lieu of zero-rating public enterprises, such enterprises could be deemed to be VAT-exempt; thus, the inputs purchased by a government or nonprofit for use in public enterprises would be subject to VAT. The exemption approach is consistent with a view of the nonprofit or government itself as the ultimate consumer and with the objective of a broad-based VAT. It

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regime, by zero-rating "public enterprises," value added by government or nonprofit employees in carrying out such enterprises would be excluded from the VAT, and governments and nonprofits could claim refunds for VAT previously paid on their purchases from private-sector vendors of goods or services used to conduct "public enterprises."

Definitional issues

Crafting a narrow-based consumption tax on the basis of the type of activity conducted requires the resolution of difficult definitional issues. At the outset, for example, it is necessary to distinguish between "public enterprises" and "commercial activities." The National Retail Sales Tax Act, for example, grants only limited tax benefits to certain "qualified not-for-profit organizations," because any payment received by such organizations for a good or service that is "commercially available" would be fully subject to the retail tax. Such a rule could be interpreted broadly, potentially leading to taxation of virtually all nonprofit health care services because such services also are offered by for-profit health care providers.

Inevitably, there will be arbitrariness in drawing a line of demarcation between "public enterprises" and "commercial activities" and in characterizing particular activities as falling on one side of the line or the other. For example, the USA Tax specifically lists public utility services and mass transit services as being "essential governmental functions" exempt from tax, whereas the subtraction-method VAT of S. 2160 goes in the opposite direction by specifically characterizing the same government services as taxable.

One theoretical basis for distinction could be that goods and services derived from "commercial activities" generally are consumed by identifiable consumers, whereas goods and services derived from "public enterprises" generally are consumed on a collective basis. On some level, however, there are identifiable consumers of all goods and services. Thus, the real issue becomes at what point the identification of a consumer and determination of the amount of a given good or service consumed by such consumer becomes so administratively burdensome as to outweigh the advantages of including the transaction in a broad consumption tax base. Accordingly, one way to draw the line of administrative feasibility is to ask whether it is *possible* to purchase such good or service on an

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also would be administratively simple. However, VAT exemption may be politically difficult because the Federal Government would be taking money from State and local governments for their purchases of items used in the provision of essential government functions. In addition, subjecting capital inputs to VAT while exempting government (or nonprofit) labor inputs would favor government (or nonprofit) activities that are labor-intensive—rather than capital-intensive activities with inputs subject to tax. It would also encourage the government (or nonprofit) to integrate vertically and produce goods and services in-house for self-consumption that would not be subject to tax. Such tax-motivated self-consumption by public enterprises could distort competition by placing outside vendors, who would be subject to VAT, at a competitive disadvantage.

Canada's GST reflects a hybrid approach to the above options in the case of charities. The provision by a charity of some items (e.g., medical devices and basic groceries) is zero-rated (and full input credits may be claimed by charities), while most charitable goods and services (e.g., health services, educational services, legal aid services) are labeled "VAT-exempt" but a 50-percent rebate may be claimed by charities for VAT paid on inputs. This approach represents a compromise between zero-rating and VAT-exemption. Sales by charities of some other items (gift-shop sales, restaurant sales, gambling) are subject to the general 7-percent GST, but not if the activity is run by volunteers or the good or service is sold at a price not exceeding its direct cost (in which case, the sale is viewed as "VAT-exempt" and is eligible for the 50-percent input rebate).

individual basis. In some cases, (e.g., national defense, general public regulation), the answer is generally no; therefore, such goods and services could be zero-rated (or exempted) as derived from a public enterprise.

Another basis for distinguishing public enterprises and commercial activities is to ask whether or not goods and services derived from a public enterprise are substantially similar to private sector goods; in other words, is there competition? This approach was adopted in the 1984 Treasury Report which concluded that the basic rule should be that "essentially commercial activities" of governments and nonprofits should be subject to VAT if such activities are taxable when provided by private, for-profit firms.[90] However, determining the existence of private-sector competition may be difficult, particularly if the services offered by the public and private sectors are similar, but not identical. In such cases, the characterization of the government or nonprofit service at issue becomes critical. For instance, if all railways are State-owned (but all buses and trucks are privately owned) is the State in the railway business or the transportation business? In the former case, there could be said to be no competition, while in the latter case, there could be said to be significant private-sector competition.[91]

Yet another method of determining the existence of competition would be to inquire whether an individual can substitute private-sector goods or services for those derived from public enterprises. Again, the efficacy of this analysis depends largely on the characterization of the services at issue. For example, do the police primarily provide personal protection or general law enforcement? The former could be purchased from the private sector, the latter generally could not.

A variation on this method would be to determine that there is no private sector competition if either (a) individuals cannot abstain from consuming the goods or services or (b) governments or nonprofits have little discretion in the provision of a good or service. Some might argue that, with respect to some government and nonprofit activities, there is no direct "consumption" as that term customarily is used because persons have little individual discretion whether or not to consume the government or nonprofit activities. Thus, the relevant inquiry would be whether an individual can opt out of consumption of the services. The answer is fairly clear in certain instances, such as police and fire protection (where individuals cannot opt out of the system), but less clear in others, such as public schools (because individuals generally are required to support public schools regardless of whether they have children attending such schools). With respect to the alternative of focusing on the discretion of the provider, it could be claimed that there is little discretion in the government's general provision of certain services (e.g., law enforcement), although this view could change over time

[90] 1984 Treasury Report, pp. 68–71. The 1984 Treasury Report listed as examples of goods and services that should be subject to VAT: sales of electricity by government-owned utilities, alcoholic beverages by State liquor stores, prints by government art museums, highway toll roads, and parking garages (but presumably not parking meters). The 1984 Treasury Report acknowledged, however, that "borderline" cases would include fees for issuing government licenses, sales of government documents, and certain postal delivery charges.

[91] Tait, pp. 76–77.

and may not apply to all facets of the government activity.[92] Moreover, focusing on the discretion of the provider is a less useful approach in the case of a private, nonprofit entity, which generally must conduct certain activities if required by its own articles and by-laws.

Another basis for determining the existence of competition between the public and private sectors could focus on whether there is a *separate* charge or fee for the service. In the case of services provided by governments, this approach generally would parallel present-law rules governing whether or not a payment is deductible for individual Federal income tax purposes as a government-imposed "tax," as opposed to a nondeductible payment for services. However, these rules do not always lead to consistent results. For example, many municipalities finance garbage collection out of general tax revenue with no separate charge imposed on the users. Other municipalities do charge separately for the service, and users are charged for all garbage collection provided by private firms. Applying a VAT or retail sales tax to either of these charges when garbage disposal financed by general tax revenue would not be subject to the tax, may be viewed in inequitable.[93] Under a VAT in particular, if separate-charge transactions were subject to tax while all other government and nonprofit services were tax-exempt, an anti-abuse rule would be required to prevent governments and nonprofits from merely imposing a nominal fee when providing their services (and claiming that this nominal fee was "consideration") and thereby attempting to claim a refund for excess input credits. The subtraction-method VAT in S. 2160 contains such an anti-abuse rule for government-provided goods or services (but not for other nonprofit goods or services sold at a loss).

Unrelated business activities

Regardless of whether all or some governments and nonprofit entities were excluded from the base of a consumption tax on an organizational basis or whether only certain activities conducted by such organizations were excluded, it would be appropriate to calculate value added from their unrelated business activities and tax it. Thus, unrelated trade or business activities conducted by nonprofit entities[94] and commercial activities undertaken by a govern-

[92] See *South Carolina v. Baker III*, 485 U.S. 505, footnote 14 (1988) (noting that there is no unchanging line of demarcation between essential and non-essential governmental functions; many governmental functions of today have at some time in the past been non-governmental). Focusing on the discretion of the government entity in providing a particular service or good would be somewhat parallel to the approach under present-law section 115 of the Internal Revenue Code, where income accruing to a State or local government is not subject to Federal income tax if derived from the exercise of an "essential governmental function." However, under such an approach, there could be State activities that significantly compete with private entities but might not be subject to VAT because they arguably are part of an essential governmental function (e.g., the county hospital). Although some commentators argued that the principle codified in section 115 for essential State governmental function income was constitutionally mandated (see Boehm, R.T. "Taxes and Politics," 1967 *Tax Law Review*, pp. 369, 372–73), the Supreme Court has more recently rejected the view that all State "essential" or "governmental," as opposed to "proprietary," activities enjoy blanket immunity from direct Federal taxation. See *South Carolina v. Baker III*, footnote 13.

[93] 1984 Treasury Report, p. 68.

[94] It may not be appropriate to transpose the UBIT rules in their entirety to a consumption-based tax regime. For example, the UBIT rules tax debt-financed investments, which should not be subject to tax under a consumption-based tax. In addition, for social-policy and administrative reasons, the UBIT rules contain exceptions for certain unrelated activities (e.g., bingo). It may or may not be appropriate to provide comparable exceptions in a new regime. In addition, the UBIT rules do not apply to a business activity that is not regularly carried on, but is con-

mental entity that are not related to an essential governmental function (as defined in section 115 of the Internal Revenue Code) could be included in a consumption tax base.

In theory, a nonprofit undertakes its related-function activities with a nonprofit objective (at least over the long term). Thus, prices charged (if any) for a related-function good or service often do not reflect a profit element (or are subsidized by contributions). In contrast, unrelated business activities, by definition, do not directly further a nonprofit or governmental purpose, but generally are undertaken to provide a source of revenue for the entity. Consequently, prices charged for unrelated goods and services (as with any for-profit venture) should accurately reflect market value. For example, the USA Tax subjects otherwise exempt entities to the general business activities tax on their unrelated business income.

Treatment of donated goods and services

Donations of business goods and services

In general, a consumption tax should apply to donations by businesses to governments and nonprofits of goods customarily sold by the business donors to ensure that the value added by a business in connection with such goods (prior to donation) is included in the tax base.[95] For consumption tax purposes, the transaction should be taken into account at its fair market value, even if the donor's deduction for Federal income tax purposes is limited to its adjusted basis or some other amount less than fair market value.[96] Conceptually, the transaction can be viewed as a sale by the business of the item to the government or charity, followed by an immediate cash donation of the sale proceeds back to the government or nonprofit.[97]

Consequently, the consumption tax base would include the value added by a business in connection with goods destined for charitable beneficiaries regardless of whether the business pursues its philanthropic objectives by (a) donating inventory to an unrelated charity or (b) establishing a related charity to manufacture and distribute such goods directly. Thus, when a business donates inventory to a charity, the customary profit element would be subject to consumption tax because the tax liability is calculated based on the fair market value of the donated goods. In contrast, if the same business established a charity to manufacture and distribute the same goods, then any forgone profit element generally may not be included in the tax base.[98]

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ducted on only a sporadic or occasional basis (e.g., an annual fundraising dance). This test could continue to apply for administrative convenience, parallel to a rule common to many VAT regimes that exempts so-called "casual sales" by individuals from tax.

[95] This rule ensures consistent treatment between charitable activities generally funded by cash donations and those that can be funded by in-kind donations of business goods.

[96] See Internal Revenue Code section 170(e).

[97] See McDaniel and Surrey, pp. 71–72.

[98] Some commentators contend that there is a potential cascading of tax if business gifts are treated as taxable transactions for VAT purposes. This argument is based on the possibility that, when a business donates some goods and sells the remaining goods, the price of the goods sold will be adjusted upward to reflect the value added with respect to all goods produced by the donor. However, it could be argued that, in theory, the price of the goods actually sold by a business should reflect the market value of such goods (based on the demand of purchasers), regardless of the seller's philanthropic activities. The EEC Sixth Directive takes an intermediate approach—business gifts are treated as taxable transactions based on the donor's *cost* of the do-

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A similar approach could be adopted in cases of donated services. Ideally, donated business services should be subject to consumption tax to avoid disparity in the treatment of charitable activities that are capital intensive and those that are labor intensive. Moreover, if donated business goods, but not donated business services, were subject to tax, tax liability could depend on the form of a business donation (i.e., did the business donate goods or the labor to produce such goods?).

If included in the consumption tax base, however, donated business services present slightly different issues than do donated goods. First, monitoring of donated services (e.g., the hours worked or quality of services) could present administrative problems.[99] In addition, valuation issues will be more problematic in cases of donated services than in cases involving donated goods. To address this valuation problem, it appears more appropriate to use labor costs, rather than fair market value, to compute tax liability of the business making the donation.[100] However, it may be inappropriate to use labor costs as a proxy for value added by business donations of services when the services donated have no direct connection with the customary services provided by an employee (e.g., an executive is given time off, with pay, to volunteer in a soup kitchen or tutor children). Compensation costs may not be an appropriate proxy for the value added, but this could depend on how close the nexus is between an employee's customary job responsibilities and her volunteer activities (e.g., an engineer teaches a high school science class). In cases where the nexus is insufficiently close, the donated services should be treated as if nonbusiness, volunteer services were donated (see below).

Donations of non-business goods and services

Generally, goods or services donated by persons not in the trade or business of selling such goods or services would be excluded from the consumption tax base. For administrative reasons, goods or services produced outside a business context are generally excluded from the tax base either as casual sales or as self-provided services. Conceptually, the act of giving itself produces no additional consumption or value added in society beyond the use of the property by the donor and donee.[101] Thus, the consumption tax base would not include the value added by nonprofit organizations from the efforts of volunteers who are not ordinarily in the business of selling the services that are provided free-of-charge to the charity. The tax base would include, however, the value added with

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nated goods. This produces the same result as denying the business an input credit, in effect, treating the business as if it had consumed the inputs in the non-business activity of gift-giving. See also McDaniel and Surrey, pp. 71-72 (donations of business inventory could be taxed based on the market value of such donations or, alternatively, the donor could be taxed based on its cost or simply denied an input credit with respect to gifts).

[99] Such administrative issues do not exist under current law because, for Federal income-tax purposes, no charitable contribution deduction is allowed for the value of donated services, nor is the value of such services included in the donor's income.

[100] When services are donated by a sole proprietor, however, labor costs (as opposed to fair market value) may be difficult to measure. Donated services by a sole proprietor could, therefore, be taken into account for consumption tax purposes based on the donor's customary hourly rate. In contrast to the treatment of corporations that donate the time of their employees (where tax could be based on labor costs), this approach for philanthropic sole proprietors would include in the tax base both imputed labor costs and forgone profit with respect to their donated services.

[101] See McDaniel and Surrey, p. 69.

respect to goods *purchased* and donated by individuals, because the donor presumably would have paid tax with respect to the donated item prior to the donation.

A consequence of this approach is that value added by a charity that uses cash contributions to hire its own employees or purchase goods from outside vendors could be subject to tax, but such value added would not be taxed if individuals donated comparable volunteer services (or self-created goods) to the charity. Under the nonprofit-as-producer model, this may be viewed as a discontinuity. However, under the nonprofit-as-consumer model, volunteer services (or self-created goods) donated to a charity may be viewed as the charity consuming what ordinarily would be nontaxable self-provided services (or self-created goods) by an individual not engaged in a trade or business.

Accounting and administrative issues

If some government and nonprofit activities are subject to tax while others are exempt (as, for example, is the case under the USA tax and the subtraction-method VAT in S. 2160), entities that engage in both types of activities will need to allocate their purchases of goods and services between the two types of activities. The factual issues that will arise are similar to those under present-law UBIT rules for income tax purposes.[102] In addition to allocation issues, subjecting previously exempt entities to tax will entail additional compliance and reporting burdens for such entities. For example, the National Retail Sales Tax requires the amount of tax to be separately stated and charged.

Difficult administrative issues will arise in allocating labor costs if particular government or nonprofit employees have responsibilities with respect to taxable as well as nontaxable activities. The preferred approach may be to allocate to taxable activities labor expenses of only those individuals whose predominant job responsibilities involve such activities.

Special issues raised by particular nonprofit activities

Particular activities frequently associated with government and nonprofit entities may raise special issues under a narrow-based consumption tax. For example, special treatment could be provided for a particular good or service, regardless of whether offered by a government, nonprofit, or for-profit entity. Alternatively, special treatment could be provided for particular activities of government and/or nonprofit entities, but not for the same activities conducted by for-profit firms. Using a nonprofit-as-consumer model, the question follows: When is it desirable to encourage (and subsidize) through the tax system collective consumption of particular goods or services?

Education

If society decides to encourage the consumption of educational goods and services, that decision could be reflected in special consumption tax rules. In that case, it must be determined whether

[102] As under the UBIT rules, nonprofits would have an incentive to allocate inputs to taxable unrelated activities in order to minimize the net amount subject to tax. See *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984).

such rules should apply equally to all educational services provided by government, nonprofit, and for-profit entities. With respect to a consumption-based tax, some commentators conclude that all educational services should be excluded, regardless of the legal status of the provider.[103] However, it could be argued that a tax exclusion is appropriate for educational activities of government entities (to encourage consumption through public schools), but not for private nonprofit or for-profit institutions.[104]

Educational services present additional complexity because they involve both investment and consumption elements. To the extent that education is regarded as personal consumption, then tax generally should be imposed on the costs (tuition, books, etc.) of acquiring the education. Some commentators take the position that, with respect to nonprofessional, general education, the personal element so predominates that the entire cost may be viewed as consumption, and for administrative reasons, taxed at the time of acquisition.[105]

Conversely, some outlays for education also can be viewed as contributing to human capital formation (i.e., "investment"), suggesting that tuition charges should not be subject to a consumption tax. For example, the National Retail Sales Tax treats tuition for general primary, secondary, or university level education and for job-related training all as being inputs to produce taxable property or services in a later period. This effectively treats the purchase of education as a tax-exempt, wholesale transaction.[106]

In addressing the consumption-versus-investment issue, it may be desirable to distinguish between compulsory and elective education, the latter perhaps involving more consumption in the usual sense. However, it may be most appropriate to use the investment model for professional or vocational education (even if elective) in a trade or business already engaged in by the student, and to exclude the costs of such education from a consumption tax base.[107]

Medical goods and services

Medical goods and services often are exempt from VAT in other countries. The removal of medical goods and services from the VAT

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[103] See 1984 Treasury Report, pp. 56–57 ("As a matter of both social and economic policy, tuition charges should not be subject to value-added taxation.") VATs in other countries generally exempt educational services from tax even if provided by a for-profit institution. Tax Executives Institute, *supra*, p. 93. The EEC Sixth Directive provides an exemption for education, including tuition and the supply of goods and services closely related to education. As a result, the student pays no tax for the goods and services provided by the educational institution, but the institution itself is denied an input credit. McDaniel and Surrey, p. 81.

[104] But see 1984 Treasury Report, p. 75 (noting that "[i]f public education were not taxed, consumers of private education would object to taxation of the tuition charges, especially since many private schools have religious affiliations, formal or otherwise").

[105] McDaniel and Surrey, *supra*, pp. 79–81. The authors further conclude that a stronger case can be made for exclusion from the tax base of costs of acquiring professional or vocational education (e.g., law or medical school), but there remain significant personal elements in the education (e.g., intellectual challenge, prestige, personal satisfaction).

[106] The USA Tax would provide a deduction to individuals (limited to $2,000 annually per student) for post-secondary tuition. However, the business component of the USA Tax removes a subsidy that otherwise would apply to some nonprofit educational organizations by attempting to draw a distinction among so-called "think tanks" and other schools exempt under present-law section 501(c)(3). The USA Tax does this by including a special rule denying tax-exempt status as an "educational organization" to a nonprofit organization if a substantial amount of its activities and funds are devoted to conducting seminars and other similar programs, conducting research to educate Congress or the general public about public policy issues, or producing books and pamphlets.

[107] McDaniel and Surrey, pp. 79–81.

base generally does not depend on whether such goods and services are offered by government, nonprofit, or for-profit entities. Some countries, such as Canada, differentiate among types of medical care by zero-rating the provision of medical devices and prescription drugs but not medical services. It would also be possible to attempt to differentiate elective from non-elective medical services and goods.[108]

The 1984 Treasury Department study notes that it may be desirable to provide special treatment for medical services as a matter of social policy, regardless of whether such services are provided by nonprofit or for-profit entities. Under a VAT regime, exempting all medical services from a VAT, rather than zero-rating such services, would place some tax on the services, but less on medical services that are labor intensive. The Treasury Report goes on to state that the case for zero-rating is probably stronger for hospitals than for the professional services themselves, as purchases generally are a more significant element in the total cost of hospital care than of physicians' services. However, such differential treatment could encourage the provision of medical services in a hospital, rather than in an office setting.[109]

Religious goods and services

Special consumption tax treatment of religious organizations is not constitutionally required. The Supreme Court has held that the First Amendment does not bar collection of sales tax on religious goods and services, so long as the tax is nondiscriminatory.[110] Nonetheless, policy makers may decide to provide special rules for nonprofit religious organizations. Such treatment appears to be constitutionally permissible so long as the special rules promote a secular purpose and are not based solely on religious content.[111]

To some extent, the treatment of religious organizations for consumption tax purposes presents issues parallel to those raised under the Federal income tax with respect to such organizations. For example, certain parsonage allowances are not included in the Federal income tax base. Similarly, certain compensation costs for the clergy could be excluded from the consumption tax base probably without creating a significant tax-avoidance incentive for churches to hire more clergy rather using outside vendors subject to tax. Also, payments made in a religious context often raise difficult factual issues regarding characterization of the payments as "donations" (or, in part, as "donations") or as consideration in a sale transaction that should be included in a consumption tax base, even if most religious activities are not subject to the tax. The proposed National Retail Sales Tax includes a specific rule that would require separation of such a transaction into two components and application of the retail sales tax to the sale transaction based on the fair market value of the good or service provided to the donor.

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[108] See Code section 213(d)(9) (denying an income tax deduction for cosmetic surgery or other similar procedures).

[109] 1984 Treasury Report, p. 56.

[110] See *Jimmy Swaggart Ministries v. Board of Equalization*, 110 S. Ct. 688 (1990).

[111] See *Texas Monthly Inc. v. Bullock*, 489 U.S. 1 (1989) (Texas sales tax exemption for religious periodicals that promulgate the teaching of the faith but not other periodicals held unconstitutional under the Establishment Clause of the First Amendment).

3. Conceptual issues in the treatment of State and local governments and tax-exempt entities under a "pure" income tax

Under a "pure" income tax, State and local governments and other nonprofit entities generally would not be subject to tax on dues, contributions, and similar payments received (because the act of giving itself merely transfers income rather than producing additional income to society).[112] However, such organizations would, in theory, be taxed on all other receipts, including investment income and any income from the provision of goods or services. Thus, activities that might be characterized as "commercial type" activities, whether or not related to the exempt purpose of the tax-exempt organization or constituting the exercise of an essential governmental function, would be subject to tax. However, to the extent governments and nonprofit organizations generally provide goods and services at or below cost, there would be no "income" to tax. In practice, such treatment generally would resemble the present-law treatment of social clubs and political organizations; a tax is levied on investment income, but dues and contributions are treated as nontaxable, gratuitous transfers.

Because the above approach essentially represents a shifting of the current UBIT boundaries (i.e., by including more profit-making activities in the tax base), many of the problems that exist under the present-law UBIT regime would continue, and perhaps be exacerbated. For example, the allocation of deductions among different activities would raise difficult accounting and compliance issues as organizations would attempt to offset taxable income. If such an allocation were not required, however, then nonprofit organizations would, in essence, be allowed an unlimited deduction for current expenses related to revenue-losing (presumably charitable) activities.

4. Relationship between State and local taxes and the Federal tax system

Administrative and compliance issues

Because most of the States that collect individual and corporate income taxes model their State income tax systems after the Federal income tax system, any significant restructuring of the Federal income tax system could have considerable corollary implications for such States.

For example, for States that collect individual and corporate income taxes, the elimination of a Federal income tax and replacement with a consumption-based tax would entail a considerable increase in the complexity and expense of administering a State income tax system. It also would impose significant compliance burdens on individual and business taxpayers forced to comply with divergent Federal and State systems. The increased complexity and cost at the State level could offset any simplification achieved at

[112] With respect to tax receipts of State and local governments, the portion of taxes that are used to provide transfer payments should, in theory, not be included in a "pure" income tax base (i.e., society has collectively decided through its representatives to make contributions among its citizens). Tax receipts used to fund other government functions theoretically could be included in a "pure" income tax base.

the Federal level. The issue would, of course, be alleviated to the extent States elect to conform to the new Federal system.

Somewhat different issues arise if the Federal income tax is replaced with a retail sales tax, as proposed in the National Retail Sales Act of 1996. In effect, the Federal system would be modeled after existing State sales tax systems. Under the proposed retail sales tax, States would act as collection agents for the Federal Government if their tax system significantly conforms to the Federal tax and they enter into a cooperative agreement with the Secretary of Treasury. Conforming States also could administer other conforming States' Federal retail sales tax. The Federal Government would administer the tax in non-conforming States.

A retail sales tax can be implemented relatively quickly by having the Federal Government piggy-back on the tax experience of State and local governments.[113] This experience should indicate who the taxpayers would be under a Federal retail sales tax and perhaps also provide a source of trained tax administrators for the Federal government. A Federal retail sales tax need not utilize the same tax base as that used by any State or local government, and, in fact, a Federal tax might well utilize a base broader than used by any State or local tax. The Retail Sales Tax Act, for example, would include a broader range of goods and services than are included in most current State and local sales tax bases. The implementation might be slowed if the tax base for a Federal retail sales tax is substantially different from that used by any State or local government.

Although tax collection and administration synergies may develop if both the States and the Federal Government have retail sales taxes, this does not mean that one government could or should be the tax collector for the other. First, it is likely that the bases of the tax would be different. Indeed, five States have no general sales taxes at all. Second, if the States were to collect the Federal tax, similarly-situated taxpayers may be treated differently to the extent that one State's enforcement and collection efforts or interpretation of the Federal law is different than that of another State. If the Federal Government were to collect the States' taxes, the Federal Government would become involved in disputes as to the proper allocation of the tax with respect to interstate transactions. Further, there are no indications that demonstrate that integrated collection would be successful. Many States impose income taxes that are based on Federal income tax law or concepts. Yet, the collection and enforcement of Federal income taxes are separate from that of State income taxes. Similarly, Canada imposes a federal credit-invoice VAT and the various provinces impose consumption taxes. Canadian law explicitly allows the federal government to collect the provincial taxes on behalf of the provinces, but only one province has elected this option.

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[113] For a discussion of Federal and State intergovernmental issues with respect to a consumption tax, see Charles E. McLure, Jr., "State and Local Implications of a Federal Value-Added Tax," *Tax Notes*, 1517, March 28, 1988.

Effects on State and local revenues

In general

Traditionally, State and local governments have imposed retail sales taxes on goods and services acquired within their jurisdiction. Imposition of a Federal VAT, for example, and the method used to compute the tax would have a direct effect on State revenues. First, a determination must be made whether the taxable base for the Federal VAT includes separately-stated State or local taxes. Second, if the Federal VAT is determined under the credit-invoice method, State and local governments must determine whether their taxable bases include the Federal tax (assuming that nothing in the Federal statute preempts State and local governments from "piggybacking" the Federal VAT). However, if the Federal VAT is determined under the subtraction method, the Federal VAT may be incorporated into the price of the good or service under market forces and the State and local tax would be automatically piggybacked upon the Federal tax. Finally, the administrative and compliance issues discussed above may also have an effect on State and local revenues.

Elimination of deductibility of State and local taxes under tax reform proposals

Overview

The staff of the Joint Committee on Taxation estimates that for 1995 nearly 28 million tax return will claim more than $114 billion dollars in deductions for State and local income taxes paid and that nearly 30 million tax returns will claim more than $65 billion dollars in deductions for property taxes paid. (See Tables 8, 9, and 10.)

Table 8.—Tax Returns Claiming an Itemized Deduction For State and Local Income Taxes Paid

[1995 Projections]

Income category[1]	Number of tax returns (thousands)	Dollars claimed (millions)
Less than $10,000	75	$49
$10,000 to $20,000	491	290
$20,000 to $30,000	1,446	1,271
$30,000 to $40,000	2,788	3,424
$40,000 to $50,000	3,417	5,894
$50,000 to $75,000	8,309	19,822
$75,000 to $100,000	5,424	19,139
$100,000 to $200,000	4,544	26,802
$200,000 and over	1,327	37,495
Total	27,819	$114,186

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable Social Security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Note: Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

Table 9.—Tax Returns Claiming an Itemized Deduction For Real Property Taxes Paid

[1995 Projections]

Income category[1]	Number of tax returns (thousands)	Dollars claimed (millions)
Less than $10,000	120	$245
$10,000 to $20,000	678	1,202
$20,000 to $30,000	1,662	2,809
$30,000 to $40,000	2,892	4,588
$40,000 to $50,000	3,615	5,741
$50,000 to $75,000	8,722	15,521
$75,000 to $100,000	5,810	12,356
$100,000 to $200,000	4,918	14,639
$200,000 and over	1,440	8,377
Total	29,858	$65,479

[1]The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable Social Security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Note: Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

Table 10.—Tax Returns Claiming an Itemized Deduction For Other State and Local Taxes Paid

[1995 Projections]

Income category[1]	Number of tax returns (thousands)	Dollars claimed (millions)
Less than $10,000	58	$27
$10,000 to $20,000	328	135
$20,000 to $30,000	841	317
$30,000 to $40,000	1,668	646
$40,000 to $50,000	2,059	673
$50,000 to $75,000	4,985	1,787
$75,000 to $100,000	3,429	1,506
$100,000 to $200,000	2,901	1,563
$200,000 and over	823	1,001
Total	17,094	$7,656

[1]The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance, employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable Social Security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Note: Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

Several rationales are given to justify the present-law deductions. Some argue that it is inappropriate to pay Federal income tax on State and local taxes, and that present-law deductions provide relief against double taxation. Others suggest that paying State and local taxes reduces a taxpayer's ability to pay additional taxes and that the present-law deductions help the Federal income tax arrive at an appropriate measure of ability to pay. Others suggest that permitting deductions for some taxes and not other taxes (e.g., State and local sales taxes) provides an encouragement to use income and property taxes in lieu of sales taxes. Still others suggest the present-law deductions promote comity among the various levels of government in our federal system.

The deductions for State and local taxes are available only to the approximately one-third of taxpayers who itemize their deductions. Taxpayers who itemize tend to be higher-income taxpayers. As with any tax deduction or credit, the price of an activity that receives the tax incentive is reduced. For example, for a taxpayer in the 28-percent tax bracket, a $1,000 State income tax payment reduces taxable income by $1,000 and thereby reduces Federal income tax liability by $280. As a consequence, the $1,000 State income tax payment reduces the taxpayer's after-tax income by only $720. Economists would say that the effective tax rate of the State income tax was reduced to $720, or reduced by 28 percent. Some criticize the present-law deductions for State and local taxes because, like other itemized deductions, the deduction for State and local taxes provides greater relative benefits to higher income individuals than to lower income individuals due to the graduated tax rates. Critics also observe that the deduction provides greater benefits to taxpayers in high-tax communities than in low-tax communities.

Possible effects of tax reform proposals

Each of the flat tax, the VAT, the retail sales tax, the USA Tax and the pure income tax would eliminate deductions for payments of State and local taxes. Elimination of the present-law deductions for certain State and local taxes would increase the burden of those taxes for those taxpayers who itemize under present law. Taxpayers who claim the standard deduction would not be directly affected. The aggregate effect of such an increase in burden would be greater in those communities with high-tax burdens than in those communities with low-tax burdens.

An increase in State and local tax burdens may put political pressure on State and local governments to reduce taxes. Also, as discussed above, if the Federal income tax is replaced, continued reliance on a State or local income tax in the absence of a Federal income tax may reduce compliance at the State and local level leading to a loss in revenues. A reduction in taxes may necessitate a reduction in public services. Proponents of tax reform argue that the switch to a consumption-based tax (in the case of the flat tax, the VAT, the retail sales tax, and the USA Tax) or the reduction in marginal tax rates possible under a pure income tax will increase the rate of growth in the economy. A more rapidly growing economy would expand the existing State and local tax bases, ena-

bling those governments to maintain their level of services while providing tax relief.

To the extent that Federal tax deductibility encourages State and local governments to rely on certain taxes (e.g., income taxes) at the expense of other revenue sources (e.g., user fees), elimination of the present-law deductibility may cause State and local governments to choose a different mix of revenue sources. On the other hand, the experience of the past nine years does not appear to bear out the predictions of some observers that the elimination of deductibility of State and local sales taxes as a part of the Tax Reform Act of 1986 would induce States and local governments to eschew sales taxes in favor of income taxes or gross receipts tax, both of which had the advantage of being deductible by either the individual or the business.

5. Analysis of charitable donations and tax reform

Overview

Between 1984 and 1993 total individual donations to charity grew from $87.44 billion to $102.55 billion, while corporate donations declined from $6.70 billion to $5.92 billion. (See Table 11.)

Table 11.—Individual and Corporate Charitable Donations, 1984–1993

[Billions of dollars]

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Individual donations:										
Itemized deductions claimed for charitable donations	42.12	47.96	53.82	49.62	50.95	55.46	57.24	60.58	63.84	68.35
Total individual donations	87.44	86.25	94.34	96.55	101.71	105.92	104.27	103.93	103.04	102.55
Corporate donations:										
Deductions claimed for charitable donations	4.06	4.47	5.18	4.98	4.89	4.89	4.75	4.76	5.52	6.40
Total corporate donations	6.70	7.09	7.14	7.33	7.14	6.96	6.71	6.52	6.15	5.92

Source: Individual itemized deductions and corporate deductions taken from Internal Revenue Service *Statistics of Income* data. Total individual donations and total corporate donations taken from *Giving USA*. All tabulations done by staff of the Joint Committee on Taxation.

While the level of individual donations is reported to have declined since 1989, individual donations claimed as itemized deductions on individual tax returns has grown in every year, excepting 1986 and 1987.[114] The level of individual donations claimed as itemized deductions has grown more rapidly than the rate of inflation over this period. The staff of the Joint Committee on Taxation estimates that, for 1995, 30.5 million taxpayers will claim more than $68 billion in charitable deductions. (See Table 12.)

Table 12.—Tax Returns Claiming an Itemized Deduction For a Charitable Contribution

[1995 Projections]

Income category[1]	Number of tax returns (thousands)	Dollars claimed (millions)
Less than $10,000	100	$53
$10,000 to $20,000	603	523
$20,000 to $30,000	1,655	1,841
$30,000 to $40,000	3,027	3,848
$40,000 to $50,000	3,686	5,043
$50,000 to $75,000	8,981	13,862
$75,000 to $100,000	6,000	11,440
$100,000 to $200,000	5,031	14,127
$200,000 and over	1,466	17,630
Total	30,549	$68,367

[1]The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable Social Security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

ANote: Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

One rationale underlying the charitable contribution deduction is that income given to a charity should not be taxed because it does not enrich the giver. As with any tax deduction or credit, the price of an activity that receives the tax incentive is reduced. For example, for a taxpayer in the 31-percent tax bracket, a $100 cash gift to charity reduces his taxable income by $100 and thereby reduces tax liability by $31. As a consequence, the $100 cash gift to charity reduces the taxpayer's after-tax income by only $69. Economists would say that the "price of giving" $100 cash to charity is $69. With gifts of appreciated property, if a fair-market value deduction is allowed (while the accrued appreciation is not included in income), the price of giving $100 worth of appreciated property is as low as $41.[115] The price of giving varies inversely with marginal

[114] Most analysts attribute the high level of donations in 1986 followed by the lower level of donations in 1987 to the anticipation and enactment of the Tax Reform Act of 1986.

[115] This assumes that the property has a basis of zero and is computed as follows: $100 minus $28 (tax avoided from non-recognition of built-in capital gain) minus $31 (tax saved from deduction for fair-market value). This "price of giving" figure assumes that the taxpayer would sell the appreciated property (and pay tax on the built-in gain) in the same year of the donation

tax rates because the price of giving is determined by one minus the taxpayer's marginal tax rate.

While factors other than tax benefits also motivate charitable giving, the preponderance of evidence suggests that the itemized charitable deduction has been a stimulant to charitable giving, at least for higher-income individuals. Accordingly, the philanthropic community and others who believe that the present-law deduction serves a social purpose are concerned about the potential effects of tax reform proposals on the level of giving.

Some who support Federal tax incentives to encourage charitable contributions nonetheless question the structure of the present-law deduction. Thus, some suggest that the deduction is inefficient because, in addition to stimulating giving, the deduction also is available for donations that would have been made absent any subsidy. Second, like other itemized deductions, the charitable deduction provides greater benefits to higher income individuals than to lower income individuals. Because educational and cultural institutions typically receive more of their support from higher-bracket taxpayers, while lower-bracket individuals tend to target their giving to religious institutions, the structure of the tax benefit may be viewed as having a more favorable impact on universities, museums, etc. than on religious and similar organizations.

The full deductibility of charitable contributions (at least, other than of untaxed appreciation) may be justified as consistent with a theoretically "ideal" income, or consumption-based, tax system, wholly apart from any incentive effect or intent to encourage charitable giving. In this view, the gratuitous transfer of funds from an individual to a charity should not be treated as a personal consumption of income that should be subject to tax even under a theoretically pure, broad-based income or consumption tax. Alternatively, one could view charitable giving as a purely personal expenditure, a deduction for which would be denied under either an ideal income or a consumption-based tax.

The flat tax, the VAT, and the pure income tax eliminate all deductions for charitable donations. The retail sales tax would not tax gifts to charity as purchases of goods. The USA Tax retains a deduction for charitable donations under the individual tax.

Tax reform and charitable contributions

The flat tax, the VAT, the retail sales tax and charitable contributions

Donations of cash or goods

In general, the effect of replacing the current income tax with a consumption-based flat tax, the VAT, or the retail sales tax may depend in part on how each of these taxes would treat purchases of goods and services by charitable organizations and whether the treatment accorded purchases by charitable organizations affects the perceptions of would-be donors. None of the consumption-based

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if the property was not given to charity. However, a higher "price of giving" would be derived if it is assumed that, had the taxpayer not donated the property, he would have retained the asset until death (and obtained a step-up in basis) or obtained benefits of deferral of tax by selling the asset in a later year. A lower price of giving would be calculated if it were assumed that the taxpayer were otherwise in a higher marginal tax bracket.

flat tax, the VAT, or the retail sales tax would tax gifts made to charitable organizations, but all would tax purchases of goods by individuals. The flat tax, the VAT, and the retail sales tax reach this result by eliminating deductions at the individual level and by generally taxing the production or sale of all goods purchased by individuals.

Assume that under a VAT or retail tax the tax rate is 15 percent.[116] By giving $100 to charity an individual forgoes $86.96 of personal consumption. If the individual had purchased goods costing $86.96, a 15-percent sales tax or VAT would be imposed raising the individual's total outlay on the goods to $100. Thus, the price of giving to charity under a VAT or retail sales tax is determined as one divided by one plus the sales tax rate (i.e., 1/(1+t)). Depending upon whether the taxpayer itemizes charitable deductions under current law, the taxpayer's marginal tax rate under current law, and the rate of the VAT or sales tax, the taxpayer may see the price of giving rise or may see the price of giving fall. For taxpayers who currently do not itemize deductions, their price of giving would fall, as all of their non-charitable expenditures would be subject to the consumption-based tax. A taxpayer in the 31-percent tax bracket would see the price of giving increase if the current income tax were replaced with a 15-percent VAT or retail sales tax.

How taxpayers respond to changes in the price of giving would, in part, determine the effect of the VAT, the retail sales tax, and the flat tax on charitable giving. As reported above, economic studies generally have established that charitable giving responds to the price of giving. The reduced price of giving for taxpayers who do not itemize under present law may lead to an increase in charitable donations. The increased price of giving for other taxpayers may be expected to reduce charitable giving. Depending upon the rate of the replacement tax, high-tax bracket itemizers under current law may be more likely to see their price of giving increase. While the economic literature suggests that individuals alter their giving in response to changes in the price of giving, there is less consensus as to how large the changes in donations would be.[117] To the extent that such itemizers are higher-income taxpayers, charities whose patrons are higher-income (e.g., universities and hospitals) might be more adversely affected than religious organizations.[118]

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[116] The case of the flat tax will be discussed below.

[117] See, Charles Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago: University of Chicago Press), 1985, for a review of the literature. Martin Feldstein and Charles Clotfelter, "Tax Incentives and Charitable Contributions in the United States," *Journal of Public Economics*, 5, 1976, argue that the deduction for charitable contributions induces charitable contributions in amounts exceeding the revenue lost to the government from the tax deduction. More recently, William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," *Journal of Political Economy*, 103, August 1995, pp. 709–738 argues the opposite. Randolph argues that earlier studies inadvertently confused timing effects that may be the result of an individual taxpayer's circumstances in a particular year or the result of changes from one tax regime to another with the permanent effects. Randolph's estimates suggest that on a permanent basis, charitable donations are much less responsive to the tax price than previously believed. Clotfelter, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective," in Joel Slemrod, ed., *Do Taxes Matter? The Impact of the Tax Reform Act of 1986* (Cambridge, MA: The MIT Press), 1990, pp 203–235, at p. 228, points to the surge in giving in 1986 prior to enactment of the Tax Reform Act of 1986 as evidence of the tax-sensitive timing of gifts.

[118] See, Charles Clotfelter, "The Impact of Tax Reform on Charitable Giving: A 1989 Perspective."

An additional consideration in assessing the effect of replacing the current income tax with a VAT, a retail sales tax, or a flat tax on charitable donations involves how purchases of goods and services by the charitable organization are treated under the tax. For example, H.R. 3039 would impose the sales tax on goods and services purchased by the charitable organization but not on services provided by the organization. That is, if a charitable organization contracted with a physician to give immunizations to needy individuals the cost of the physician's services and the serum would be subject to sales tax. If the charitable organization employed its own in-house physician and manufactured its own serum, the immunizations would not be subject to tax. In this sense, if an individual makes a contribution to a charitable organization of $100 and the charitable organization purchases serum (a transaction subject to tax), the individual has forgone (assuming a 15-percent tax rate) $86.96 of other goods to provide $86.96 of serum to needy people, because the charitable organization has to pay sales tax on the serum purchase. If individuals perceive this to be the outcome, they would see that their price of giving is $1 of forgone consumption per dollar of giving when the funds are used to purchase taxable goods or services but is less than $1 of forgone consumption per dollar of giving if the funds are used to provide tax-exempt services. If individuals perceive this effect, then more individuals among those who currently itemize charitable deductions may have their price of giving increase and fewer individuals among those who do not currently itemize charitable donations may have their price of giving decrease. Both outcomes may reduce charitable donations to some extent.

Similarly, if the VAT applies to purchases of goods and services purchased by charitable organizations, individuals may see that their price of giving is $1 of forgone consumption per dollar of giving when the funds are used to purchase taxable goods or services but is less than $1 of forgone consumption per dollar of giving if the funds are used to provide tax-exempt services. If purchases of goods and services by charitable organizations are exempt from tax, which might be administratively difficult to achieve,[119] the price of giving would be one divided by one plus the sales tax rate (i.e., 1/(1+t)), as described above.

Because the flat tax imposes tax at both the business level and the individual level, it may be particularly difficult to exempt the purchase of goods and services by charitable organizations from the tax. To the extent that employees of charitable organizations also would be subject to the individual level tax under the flat tax,[120] tax would be imposed on services provided by the organization. This may make it more likely the price of giving becomes $1 of forgone consumption per dollar of charitable donation, regardless of how the charitable organization spends its donations.

In addition to the price of giving, the economics literature also identifies the importance of income to charitable giving. As income

[119] See, Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*, (JCS–18–95), June 5, 1995, for a discussion of exempting certain sales under a subtraction-method VAT.

[120] The value of certain fringe benefits of employees of charitable organizations also may be subject to a separate tax under the flat tax.

grows, charitable giving grows. Advocates of the flat tax, the VAT, and the retail sales tax argue that replacing the current income tax with these tax structures will generate more income growth. Economic growth would be expected to produce greater charitable contributions.

Donations of time

The flat tax, the VAT, and the retail sales tax also generally treat labor contributed to exempt organizations differently than does the present law income tax or would a pure income tax. Under present law, if a taxpayer works for one hour and is paid a wage, w, and then donates those earnings to a charitable organization, as explained above the cost of that donation is $w(1-t)$, where t is the taxpayer's marginal tax rate. Similarly, if the individual donates one hour of time to the charitable organization, the taxpayer has forgone payment of his or her normal wage, w. Had the charitable organization paid the taxpayer the wage, w, the taxpayer would have been liable for a tax of wt. Hence, by donating his or her time, the taxpayer has only given up an after-tax wage of $w(1-t)$. Thus, under an income tax, in the case of an itemizer, the price of donating time is the same as the price of donating cash. In the case of a non-itemizer, the price of donating time is $w(1-t)$, which is less than the price of donating cash.

Under the VAT and retail sales tax an hour's wage, w, can purchase $w/(1+t)$ of goods or services, while an hour's work donated to a charitable organization can produce w-worth of services to the charitable organization. Under the flat tax, an hour's worth of work yields $w(1-t)$ in takehome pay, where t is the flat tax rate. An hour's worth of donated labor to a charitable organization produces w-worth of services to that organization. In both cases, the price of donating an hour's worth of work is less in forgone consumption than the charitable organization receives in value of donated service. The discussion of the donation of cash or goods suggested that under the VAT, the retail sales tax, and the flat tax, individuals might perceive that the price of giving to charity was $1 of forgone consumption for one dollar given to charity. Thus, unlike the income tax for those who itemize charitable deductions, donation of time may be relatively favored compared to donations of cash or goods. There is little evidence on whether such "prices" have an effect on the donation of time by individuals. The extent to which there is any effect on donations of time would depend upon how the tax rates under the flat tax, the VAT, or the retail sales tax compared to the income tax rate of different individuals under present law. If tax reform leads to increased growth in wages, this too may exert an effect on individuals' decisions to donate time to charity in lieu of using their time to increase their earnings.

The USA Tax and charitable contributions

The USA Tax would retain a deduction for charitable contributions under the individual tax. If the taxpayer is in the 40-percent tax bracket under the USA Tax, by giving $100 to charity the taxpayer forgoes $71.43 of personal consumption. If the taxpayer had purchased goods costing $71.43, the 40-percent tax applied to his income less his saving (*i.e.*, his expenditures) would raise his gross

outlay for the goods to $100. Thus, the price of giving to charity under the USA Tax is determined as one divided by one plus the marginal tax rate (1/(1+t)). Under the USA Tax different taxpayers will face different tax prices for giving to charity. Thus, some taxpayers may see their price of giving increase relative to present law while others see their price of giving decrease. These changes in the price of giving to different individuals could lead an increase or decrease in overall giving, subject to the uncertainties of the responsiveness of charitable giving to its price as discussed above. Advocates of the USA Tax argue that replacing the current income tax with USA Tax will generate more economic growth. Economic growth would be expected to produce greater charitable contributions.

The pure income tax and charitable contributions

The pure income tax would eliminate the charitable deduction and would tax the income of all producers regardless of whether the income was earned from sales to charitable organizations or other persons. By eliminating the deduction for charitable contributions the price of giving $100 is $100 in forgone other expenditures. Absent other changes, an increase in the price of giving would be expected to reduce charitable giving and reduce it the most where the price increases the most, among higher-income taxpayers. However, advocates of a pure income tax argue that replacing the current income tax with a pure income tax will permit tax rates to be lowered. Lower tax rates may generate more economic growth. Economic growth would be expected to produce greater charitable contributions.

Tax reform, charitable donations and simplicity

Under present law, compliance problems result from allowing deductions for relatively small contributions. The donor may not have records for many of his or her gifts, which may be in cash, and the IRS, as a practical matter, is not able to audit a large volume of relatively small contributions. (IRS compliance data indicates that in 1979, overstated cash contributions totaled about $2 billion, or 11 percent of claimed cash donations.) Also, the donor may list payments to charitable organizations as contributions that properly constitute, in whole or in part, payments for goods and services received (e.g., books, meals, etc. offered in return for "donations" of specified amounts). Congress addressed this issue in 1993, by requiring charities to inform donors as to what portion of a part-sale, part-gift transaction is deductible as a charitable contribution. However, this information disclosure requirement applies only to transactions exceeding $75. By eliminating deductibility of charitable contributions, the flat tax, the VAT, the retail sales tax, and the pure income tax would alleviate recordkeeping and other tax compliance burdens for taxpayers, and administration and enforcement burdens for the IRS. By retaining the charitable deduction, the USA Tax generally would retain the compliance and administrative burdens of present law.

Tax reform and charitable organizations

In response to the various tax reform proposals that could adversely affect charitable giving, the nonprofit sector argues that voluntary organizations supported by charitable contributions are indispensable to our society, and that their development should be encouraged by the tax system. Thus, charitable organizations are described as providing many services at little or no cost that otherwise would have to be provided by government at full cost to taxpayers, and as being free to innovate and experiment in carrying out charitable functions and to espouse unpopular causes or minority viewpoints. These important functions can best be performed, it is argued, by the private sector without direct governmental involvement other than through tax incentives for giving. Thus, support of philanthropy may be considered so important a social policy objective that it outweighs otherwise applicable tax policy objectives of equity, efficiency, and simplification.

B. Effects of Tax Reform on State and Local Government Bonds

1. Overview

The present-law exemption from income for interest paid by issuers of tax-exempt State and local government bonds creates an implicit subsidy from the Federal Government to the issuer of the bond. By granting tax exemption, the Federal Government forgos tax on interest income, while the exemption permits the issuer to pay interest to lenders at rates less than that paid by other borrowers. The interest subsidy serves to lower the cost of capital to the borrower. The subsidy to borrowers is not fully efficient. That is, the reduction in interest expense to the borrower generally is less than the tax revenue the Federal Government would have collected from lenders if the borrower had borrowed the same amount of funds at fully taxable interest rates. Some analysts argue that this inefficiency redounds primarily to higher-income taxpayers and, thereby, reduces the progressivity of the present tax system.

The flat tax, a VAT, and a retail sales tax would eliminate the tax-exemption for interest from State and local government bonds by eliminating the taxation of all interest, and other capital income, at the individual level. A pure income tax would eliminate the relative advantage from tax exemption for interest income from tax-exempt bonds by taxing equally interest, from all sources, as well as other capital income. The USA Tax would retain a preference for tax-exempt bonds by excluding the interest income from the cash receipts of individuals while permitting the purchase of State and local government bonds to qualify as an exempt form of saving. Regarding tax-exempt State and local government bonds, the USA Tax would raise issues similar to those that exist under present law.

Elimination of the tax exemption for interest from State and local government bonds under either the consumption-based taxes or a pure income tax generally would raise the relative cost of borrowing by those borrowers that currently may invest in tax-exempt State and local government bonds. Elimination of the tax exemption also may increase the absolute borrowing costs of those bor-

rowers that currently may receive this financing. Elimination of the tax exemption on outstanding State and local government bonds may lead to a capital loss for holders of that debt. An increase in interest paid on newly issued State and local government bonds may affect the ability of States and local governments (and other entities receiving financing provided by these bonds) to undertake capital projects. Elimination of the exemption for interest on State and local government bonds may, however, improve the equity of the tax system compared to present law. On the other hand, tax reform may lead to increased saving in the economy and result in a general reduction in interest rates. Such a reduction in interest rates may leave those borrowers who currently receive tax-exempt financing no worse off than under present or past market conditions. These issues are discussed in more detail below.

2. Issues relating to State and local government bonds under present law

Implicit Federal subsidy of tax-exempt finance

Tax-exempt financing provides a Federal subsidy to at least two parties to each transaction—the borrower (the State and local government in the case of governmental bonds or a private person in the case of private activity bonds) and the bond investor (the lender).[121] The borrower receives a Federal subsidy equal to the difference between the tax-exempt interest rate paid and the taxable bond rate that otherwise would be paid.[122] For example, for November 1995, high-grade State and local government bonds were priced to produce average yields of 5.61 percent, while comparably rated corporate bonds (Aaa-rated) were priced to produce average yields of 7.02 percent,[123] producing a ratio of tax-exempt to taxable rates of 80 percent. The subsidy was equal to 1.41 percentage points (141 basis points) or 20 percent of the taxable rate.

Chart 3 plots the average bond yields for the period 1960 through 1993. The yields plotted are yields to maturity[124] on 10-year Treasury bonds; 10-year, prime-grade State and local government bonds; and 10-year, AA-rated newly issued corporate bonds (in this case, industrial corporations).[125] Because repayment of debt issued by the Federal Government is backed by the full faith and credit of the United States, investors consider Federal Government bonds safer than bonds issued by other borrowers and generally require a higher interest rate, or risk premium from other borrowers. On the other hand, interest paid on Treasury bonds[126] and cor-

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[121] These subsidies are in addition to any benefits received by facilitators of the transaction, such as bond counsel and underwriters.

[122] If the borrower is a taxable person, the borrower may deduct interest costs, whether the interest income is taxable or tax exempt to the lender.

[123] U.S. Congress, Joint Economic Committee, "Economic Indicators," December 1995.

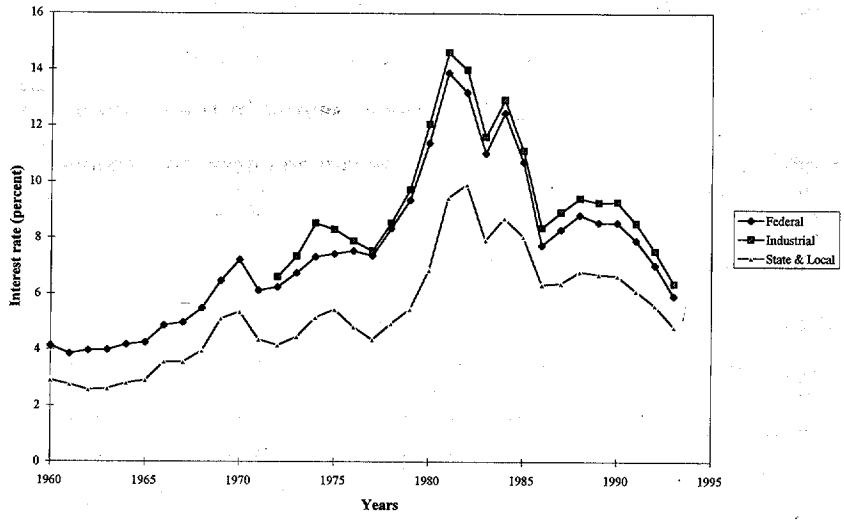
[124] If a bond has a face value of $1,000 and a coupon rate of seven percent it will pay the holder of the bond $70 in interest (the coupon) per year and $1,000 upon maturity. As interest rates and other economic factors in the economy change, the market value of the bond may be more or less than $1,000. The yield to maturity is calculated as that discount rate such that the present value of the coupon payments plus the return of principal (the $1,000 upon maturity) equals the current market value of the bond.

[125] Data from Salomon Brothers, "Analytic Record of Yields and Yield Spreads." The Salomon Brothers data does not contain information on corporate bonds prior to 1972. Data underlying Chart 3 is in Appendix Table A–1.

[126] Interest on Federal Government debt is exempt from State income taxation.

porate bonds is taxable. The chart displays the expected pattern: corporate yields exceed Treasury yields and Treasury yields exceed tax-exempt State and local government bond yields.

Chart 3.--Bond Yields 1960 - 1993



Source: Salomon Brothers Inc., "Analytic Record of Yields and Yield Spreads."
Notes: 1. Yields on 10-year maturities.

The bond investor also receives a Federal subsidy from tax-exempt financing equal to the difference between the tax-exempt interest rate and the after-tax yield on a comparable taxable investment. In many cases, the bond investor's subsidy is greater than the subsidy received by the borrower. The marginal tax rate of the bond investor determines the extent of the subsidy.

Table 13 below illustrates that an investor in the 39.6-percent marginal tax bracket would receive a 6.04-percent after-tax yield on a 10-percent taxable bond. This taxpayer would receive a higher effective yield from any tax-exempt bond with an interest rate of more than 6.04 percent than from a taxable bond yielding 10 percent. If the ratio of tax-exempt to taxable interest rates were .65, assuming a 10-percent taxable yield, a tax-exempt State or local government bond would pay 6.5 percent interest. In this case, the 39.6-percent marginal tax rate taxpayer would receive a subsidy of 0.46 percentage points on the yield (6.5 minus 6.04 percent after-tax income on the taxable bond), resulting in 7.6 percent more after-tax interest income than if a taxable bond had been purchased.

Table 13. After-Tax Yield on Taxable Bonds, By Marginal Rates

[In percentages]

Investor's marginal tax rate[1]	Taxable Bond yields (in percentages)					
	10	9	8	7	6	5
39.6	6.04	5.44	4.83	4.23	3.62	3.02
36.0	6.40	5.76	5.12	4.48	3.84	3.20
31.0	6.90	6.21	5.52	4.83	4.14	3.45
28.0	7.20	6.48	5.76	5.04	4.32	3.60
15.0	8.50	7.65	6.80	5.95	5.10	4.25

[1] An investor's effective marginal Federal income tax rate on interest income may exceed these statutory tax rates if the investor is subject to the limitation on itemized deductions, the phaseout of personal exemptions, or the partial inclusion of social security benefits in taxable income.

Source: Joint Committee on Taxation.

It is always profitable for a taxpayer to purchase a tax-exempt bond rather than a taxable bond if the interest rate paid by the tax-exempt bond exceeds the taxable interest rate multiplied by one minus the taxpayer's marginal tax rate.[127] Under the current income tax system with increasing marginal tax rates, the interest saving to the borrower generally will be less than the forgone tax revenue to the Federal Government unless the percentage subsidy in the yield spread is equivalent to one minus the highest marginal rate of income tax. To the extent that this condition does not hold, and historically it has not held, the subsidy to borrowers is inefficient in terms of forgone Federal revenue.

Effects on the market allocation of capital

Tax-exempt bonds change the allocation of capital by encouraging investment in projects eligible for tax-exempt financing at the expense of other investments. To some extent, this change is an intended result. As explained in more detail below, the tax exemption may encourage more investment in those projects financed with tax-exempt bonds and less investment in those projects not financed with tax-exempt bonds than would otherwise occur. Economists argue that such a distortion creates an inefficient capital market and less aggregate investment when capital is scarce.

The use of tax-exempt state and local government bonds for private activities increases the competition for the limited pool of assets available for investment in tax-exempt obligations generally. The overall result is higher interest rates on tax-exempt state and local government bonds generally, including bonds issued for traditional governmental activities, as issuers of this debt must bid funds away from other uses. In addition to changing market allocation between competing investment purposes, tax-exempt State and local government bonds may change the allocation of funds between persons eligible to receive tax-exempt financing (including

[127] If the taxpayer's marginal tax rate is t, taxable interest rates are r, and tax-exempt interest rates are r_{te}, then the taxpayer should purchase the tax-exempt bond if $r_{te}>(1-t)$. This assumes that the investor considers the taxable and tax-exempt bond to be of comparable risk.

certain tax-exempt charitable organizations, businesses, and individuals eligible for private activity bond financing) and other, ineligible persons. Also, by increasing the demand for bond-financed property, tax-exempt financing may encourage increases in the prices of this property.

Effect on fairness of the tax system

Households, businesses, and mutual funds holding tax-exempt State and local government bonds represent investors who have found tax-exempt yields more attractive than the after-tax yields on taxable investments. The widespread use of tax-exempt State and local government debt raises questions about the fairness of the tax system. This issue arises both with respect to tax-exempt borrowers and with respect to investors in tax-exempt bonds.

Some persons suggest that by reducing the costs of capital to some businesses, tax-exempt State and local government bond financing for private activities puts at a disadvantage businesses that must pay taxable market interest rates. The loss of fairness (or its perception) becomes more important to business as firms in closely related lines of business in the same marketing areas pay different interest rates as a result of the nonmarket decisions that determine which receives tax-exempt financing.

Similarly, as explained above, investors in tax-exempt State and local government bonds gain after-tax income advantages that are inconsistent with the tax policy concepts of ability-to-pay and fairness-of-tax-burden within (and between) income classes. On the other hand, a basic principle of Federal tax law also is that no person need pay more taxes than the law requires. Reduction of tax liability through investment in tax-exempt bonds is in this respect no different from any other considerations (deductions, etc.) that may reduce taxable income. In addition, as the data in Chart 3 reveal, investors in tax-exempt bonds pay an "implicit" tax to the issuer or to intermediaries involved in issuance of these bonds by accepting a lower interest rate than otherwise available. The discussion above suggested that the interest subsidy is not fully efficient because the interest subsidy to the borrower generally is less than taxes forgone to the Federal government. This implies that the implicit tax paid is less than that which would be due in the absence of tax-exemption. On the other hand, the issuance of tax-exempt State and local government bonds to finance governmental activities involves the provision of public goods to all people. Consideration of the incidence of the public benefits together with the incidence of the tax benefit may mitigate some of the concerns of unfairness that may arise from consideration of the incidence of the tax benefit alone.

3. Tax reform and borrowing costs for State and local government bonds

Overview

If taxpayers respond to taxes, or the lack thereof, by shifting funds in search of the highest net return, one should expect that if tax reform creates a tax system that exempts all investment return from tax: (1) the interest paid by State and local government

borrowers would rise to equal that of other comparable-risk borrowers, and (2) the value of taxable securities likely will rise and the value of tax-exempt securities likely will fall.

Upon elimination of the income tax, current high-coupon taxable bonds would offer a superior net yield compared to lower-coupon tax-exempt State and local government bonds. Investors would sell the latter to acquire the former. The prices of State and local government bonds would fall as they are sold on the market while the prices of taxable bonds would rise with the increase in demand.

Consumption-based taxes

As explained above, tax-exemption provides an implicit Federal subsidy to State and local borrowing costs. The flat tax, a VAT, and a retail sales tax would eliminate the current preferential tax-exemption for interest on State and local government bonds by eliminating the taxation of all interest, and other capital income, at the individual level. Removal of the implicit Federal interest rate subsidy for this debt likely would cause State and local government borrowing costs to rise.

Basic analysis of tax reform and State and local government interest cost.

To simplify analysis, assume there are two types of bonds: taxable and tax-exempt. Further assume that the total supply of monies invested in bonds is fixed. (This is probably a reasonable short-run assumption.) Assume there is one marginal tax rate,[128] t, and that investors seek to maximize their net, after-tax return. Further assume in each market that the demand for funds by borrowers increases as the interest rate they must pay falls. This assumption means that as the supply of funds available to either market increases, borrowers in that market will be able to borrow at lower interest rates.

Assume both tax-exempt and taxable bonds have fixed (perhaps different) coupon rates. Price differences of the two types of bonds determine the bonds' yields or the interest earned by a purchaser of the bonds (designated r for taxable bonds and r_{te} for tax-exempt bonds). As explained above in footnote 127, the taxpayer should purchase the tax-exempt bond if $r_{te} > r(1-t)$. In equilibrium, the yield on tax-exempt bonds, r_{te}, must equal $r(1-t)$, the yield on taxable bonds, r, less any taxes owed on taxable bonds. If this were not true investors would move money into the market with the higher net return and out of the market with the lower net return. The influx of money in the one market (an increase in demand) would drive down yields while the outflow from the other market (a decrease in demand) would cause yields to rise. Investors shifting their funds between the two markets determines the yields in each market at which all bonds are held by some investor.

The flat tax, the VAT, and the retail sales tax eliminate all individual level taxes on interest income. At the instant that all taxes

[128] This discussion ignores multiple marginal rates, but this simplifying assumption has no substantial effect on the ensuing analysis. As explained above, the graduated marginal rates serve primarily to affect the amount of tax benefit available to an investor who is not on the margin between choosing between a taxable instrument and a tax-exempt instrument. That is, the graduated marginal rates generally only affect the efficiency of the interest subsidy.

are removed on interest income the net yield to "taxable" bonds which previously was $r(1-t)$ instantly rises to r. This is superior to the yield to holding "tax-exempt" bonds, r_{te}. Holders of tax-exempt bonds are earning lower returns than holders of "taxable" bonds. Holders of tax-exempt bonds would be expected to sell off tax-exempt bonds and buy taxable bonds. This removes money from the tax-exempt market and as money leaves that market prices fall and yields must rise or more money will depart. Sellers of tax-exempt State and local government bonds can be expected to take their cash and attempt to buy taxable bonds to earn higher yields. As money comes into the taxable market, the price of these now more desirable bonds rises, depressing yields.

This analysis predicts that interest rates on currently taxable bonds e.g., Federal Government and corporate bonds will fall, that interest rates on currently tax-exempt State and local government bonds will rise, and that under tax reform, interest rates for all bonds will be the same (adjusting for risk). The extent to which interest rates on State and local government bonds rise and the interest rates on Federal Government and corporate bonds fall depends upon the relative size of the two markets and differences in demands for the different types of bonds. The Board of Governors of the Federal Reserve System reports that at the close of 1994, the household sector held $387.6 billion in tax-exempt securities and at the same time held $184.2 billion of corporate and foreign debt, $188.5 billion of mortgages,[129] and $1,087.9 billion of Federal Government debt.[130] These figures would suggest that the outstanding amount of State and local government bonds is approximately 21 percent of all debt directly held by the household sector. In addition, the household sector held $2,885.9 billion of corporate equities and $1,067.2 billion of mutual fund shares. Mutual fund shares represent holdings of equity mutual funds, taxable bond mutual funds, and State and local government bond mutual funds. If taxpayers view State and local government bonds as substitutes for equity investments, and if it were assumed that all mutual fund shares represented holdings of State and local government bonds, then State and local government bonds represent 25 percent of debt and equity held by the household sector.

The preceding data represent the value of the stock of outstanding assets held by the household sector. Another way to evaluate the relative size of the State and local government bond market compared to that for currently taxable securities is to examine the "flow" of new issues into the market. In 1994, the trade publication, *The Bond Buyer*, reported total issuance of tax-exempt bonds and notes at $204.4 billion.[131] By contrast, in 1994, the Federal Government refinanced more than $900 billion of its outstanding debt[132] and sold more than $100 billion of bonds, notes, and bills to finance that year's deficit. By either measure, the State and local

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[129] These are mortgages held by households as lenders. Households also had gross mortgage liabilities in excess of $3 trillion at the close of 1994.

[130] Board of Governors of the Federal Reserve System, "Balance Sheets for the U.S. Economy, 1945-1994," *Flow of Funds*, C.9, June 8, 1995, p. 25. These data exclude $145.2 billion in large time deposits and $353.1 billion in money market fund shares.

[131] *The Bond Buyer 1995 Yearbook* (New York: International Thomson Publishing Corporation), 1995, p. 16. The figures reported include refunding bonds.

[132] Department of the Treasury, Office of the Secretary, *Treasury Bulletin*, March 1995, Table FD-5, p. 36. Some Federal debt is held in government accounts.

government bond market is small relative to the market for securities that are taxable under present law. The relative smallness of the State and local government bond market might suggest that it is more likely that, after enactment of a consumption-based tax, interest rates will equilibrate at levels closer to the current level of interest rates in the taxable market than at those levels of interest rates currently available to State and local government borrowers.

The preceding basic analysis suggests that elimination of the preferential treatment of State and local government bonds will make those bonds a less attractive investment in the future. As investors seek higher returns they will be less inclined to purchase State and local government bonds. This reduction in demand for State and local government bonds may cause interest rates on State and local government bonds to rise while interest rates on other bonds fall. However, this basic analysis does not account for possible changes in the level of domestic saving, changes in the demand for investment goods, and possible international capital flows.

Changes in national saving and State and local government interest costs.

The discussion above assumes no other changes resulting from tax reform. Proponents of adoption of consumption-based taxes suggest that the supply of monies (saving) may increase upon elimination of the present-law income tax.[133] This would imply that all bond yields could fall (and bond prices rise). However, there would still be the relative shift out of tax-exempt investments, into taxable investments. Theory does not predict whether an economy-wide increase in savings would increase the absolute demand for "tax-exempts" in a magnitude sufficient to offset the fall in demand fall "tax-exempts" relative to "taxables." Such an absolute increase would be necessary for tax-exempt borrowers to be no worse off after the tax reform than before the tax reform. Whether the growth in the supply of saving would offset the relative revaluation would depend upon the magnitude of the aggregate saving response.

Changes in the demand for investment goods and State and local government interest costs.

An additional consideration in this regard is that tax reform might increase the demand for investment goods and thereby increase the demand for investment funds. Martin Feldstein recently suggested that the increase in demand for investment goods in response to the shift to a consumption tax could lead to short- and long-run increases in interest rates.[134] Such an outcome would mitigate any general reduction in interest rates that might result from increased saving.

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[133] For a discussion of the effects of substituting a consumption-based tax for the current income tax see, Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS–18–95), June 5, 1995, p. 68.

[134] Martin Feldstein, "The Effects of a Consumption Tax on the Rate of Interest," National Bureau of Economic Research Working Paper #5397, December 1995.

International capital flows and State and local government interest costs.

Both the basic analysis and the discussion of the effects of changes in national saving (immediately above) assume that the United States is a closed economy. If financial capital flows freely across borders, the results of neither the basic analysis nor the increased saving analysis may hold. If the United States is a sufficiently small part of the world capital market,[135] pre-tax domestic interest rates for Federal Government and corporate bonds, r, may be set in the world market. If domestic yields fall, as suggested by the basic analysis, investors could invest abroad and earn a higher rate of return. As investment goes abroad, the demand for domestic investment falls, leading to an increase in domestic interest rates for Federal Government and corporate bonds. Equilibrium would return only when domestic interest rates on Federal Government and corporate bonds return to their initial level, r.[136] If this were the case, elimination of tax-exemption for State and local government bonds would not be expected to lower the yields on those bonds that are taxable under present law. In this circumstance, yields on what previously would have been tax-exempt bonds would have to rise to the world rate of interest, r. Even if the United States' saving rate increased in response to the imposition of the consumption-based tax, yields on what previously would have been tax-exempt bonds would have to rise to the world rate of interest, and yields on Federal Government and corporate bonds would remain at the world rate of interest, or else the increased saving would flow abroad into higher yielding foreign instruments.

Interest rate changes and State and local government capital spending.

Advocates of the present-law tax exemption for interest on State and local government bonds emphasize its importance to the abilities of those governments to finance capital projects. Because some State and local government capital investments, such as highways and schools, produce benefits that spill beyond the borders of the community undertaking the project, proponents argue that the implicit Federal subsidy from the tax-exemption is an appropriate policy response to help ensure that the costs of those projects are borne more widely than by the residents of community undertaking the project. Advocates of the present-law exemption point out that elimination of the exemption would impose significant increases in financing costs on States and local governments that already are fiscally strapped. For example, above it was reported that the interest subsidy (measured relative to Aaa corporate bonds) is approximately 1.5 percentage points. If State and local government borrowers had to pay an additional 1.5 percentage points on the $204 billion in bonds issued in 1994, State and local governments would require an additional $3.1 billion in revenues per year over the life

[135] The United States owns a large share of the world's capital. On the other hand, the United States' contributions of new capital (saving) are meager in comparison to the rest of the world.

[136] Domestic investors may not find this profitable depending upon the extent to which the interest earnings of U.S. residents are taxed by foreign governments, but any decline in U.S. yields could prompt foreign investors to remove their funds from the U.S. market. The result would be market pressure to return U.S. yields to the world rate of interest.

of the bonds to service the increased interest costs. This additional revenue requirement would increase through time as more bonds are issued in future years. Inability to finance these costs exclusively at the State and local government level could lead to the curtailment of certain public investments or services.

Other analysts observe that current interest rates in the taxable market are below rates at which State and local governments have borrowed in the past. Chart 3 reveals that taxable yields today are below the tax-exempt yields that prevailed at any time during the 11-year period 1980-1990. They argue that States and local governments were able to make capital investments during that period and would be better able to do so with the present's lower taxable interest rates.

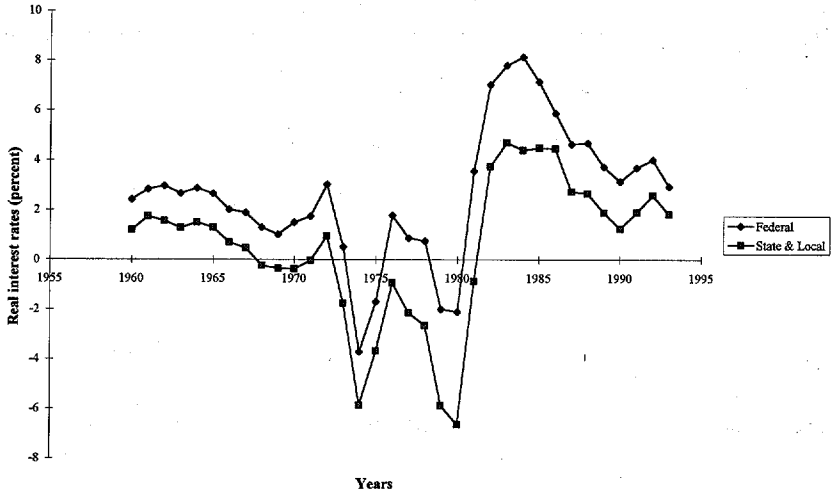
However, the yields in Chart 3 are nominal yields. While the nominal tax-exempt interest rates were high in the 1980s, this does not necessarily mean that municipalities' "real" borrowing costs were high in the 1980s. Part of the reason that nominal borrowing costs were high is because inflation and, more importantly, expected future inflation were high in the 1980s, particularly in the first few years of the decade. If State and local government officials believed, as did many market participants, that high rates of inflation would continue, they could have rationally forecast that the real borrowing costs in the early 1980s were low, despite the high nominal interest rates. High future inflation would have meant increased future nominal yields from sales, income, and property taxes as inflation pushed up general prices, earnings, and property values. Thus, high nominal interest rates could have been paid off with inflated future tax dollars.[137] To attempt to account for this, Chart 4 subtracts the one-year annual inflation rate from the nominal Treasury and State and local government bond yields to calculate "real" interest rates.[138] Chart 4 shows "real" State and local government borrowing costs also were high during the early 1980s.[139] Current taxable interest rates would offer a lower real cost of funds than did tax-exempt rates during that period.

[137] Since the inflation rate fell dramatically in response to monetary policy in the early 1980s it is likely that the *ex post* real borrowing costs were quite high.

[138] In fact, this calculation of "real" interest is incorrect because it compares the nominal yield on a 10-year bond (which would have imbedded in it the *ex ante expected* 10-year annualized inflation rate) to the actual, or *ex post*, one-year inflation rate. It is difficult to correct this measure, because analysts cannot observe the *ex ante expected* 10-year annualized inflation rate. Because the inflation rate fell dramatically in response to monetary policy in the early 1980s, it is likely that the *ex post* real borrowing costs were quite high.

[139] Data underlying Chart 4 are in Appendix Table A.1.

Chart 4.–"Real" Federal Government and State and Local Government Bond Yields, 1960-1993

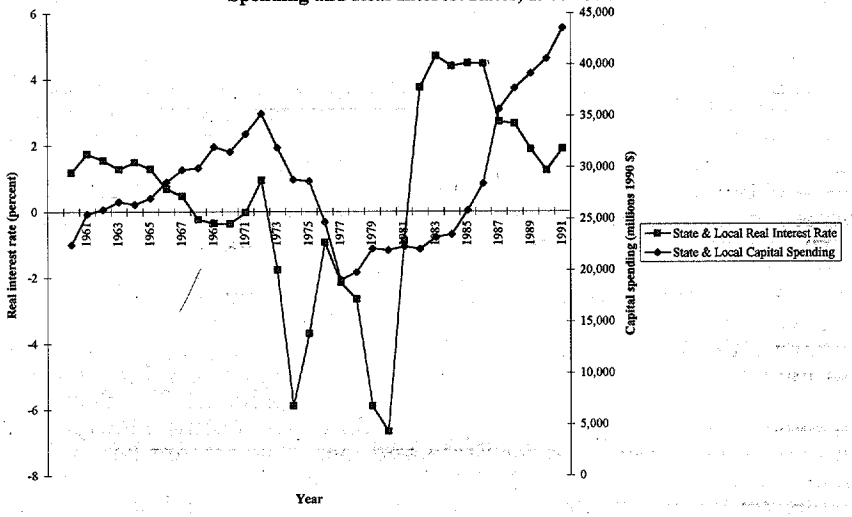


Source: JCT calculation.
Notes: 1. Yields on 10-year maturities adjusted for inflation.

The extent to which removal of the tax preference for State and local government debt affects State and local government capital spending depends, in part, on the responsiveness of capital spending to costs of borrowing. If State and local governments reduce their capital budgets significantly in response to increases in interest rates, capital spending could be affected by the loss of the tax preference. However, the evidence on the strength of this effect is unclear. Chart 5 plots real State and local government interest costs (as calculated for Chart 4) against real State and local government capital expenditures on highways, roads, bridges, airports, mass transit, water transit, rail transit, water supply, water resources, and wastewater treatment.[140]

[140] Chart 5 reports State and local capital expenditures for these categories in real 1990 dollars. Source: Congressional Budget Office, "Public Infrastructure Spending and Analysis of the President's Proposals for Infrastructure Spending from 1996 to 2000," June 1995. Data underlying Chart 5 are in Appendix Table A.1.

Chart 5.-- Real State and Local Government Capital Spending and Real Interest Rates, 1960-1993



There appears to be no consistent relationship between interest costs assumed by State and local governments and capital spending by State and local governments. However, capital spending may be determined by demographic changes, other available Federal subsidies, and other factors that may mask any effect that interest costs have on State and local government capital spending decisions. Chart 5 does not attempt to control for such factors.

Even if States and local governments do not significantly adjust their capital spending in response to interest rate changes, higher interest rates will result in an increase in the cost of debt-financed capital spending. To the extent that capital spending is constrained by the amount of funds available for State and local government spending, higher interest rates will result in a reduction in the amount of capital spending that is put in place, as more of the available funds are devoted to debt service rather than construction finance. Proponents of tax reform argue that a switch to a consumption-based tax from the current income tax will increase the rate of growth in the economy. A more rapidly growing economy would expand the existing State and local government tax bases, enabling those governments to under take more capital spending and service higher interest costs should interest expense rise.

Other effects of tax reform.

The consumption-based taxes, by eliminating the taxation of all interest income, generally would eliminate the inefficiency inherent to present-law State and local government bond finance. By treating the interest from all debt equally, perceptions of unequal treatment of individuals also would be eliminated. Elimination of the preferential treatment of State and local government bonds also would eliminate the extra costs State and local governments must

incur to assure that their securities are in compliance with the requirements for present-law preference.

Pure income tax

If a pure income tax were adopted, an outcome similar to that described above for consumption-based taxes would be expected. A pure income tax would eliminate the tax-exemption for interest income for State and local government bonds by taxing equally interest income, from any source, as well as other capital income. At the instant the pure income tax is imposed, the taxation of interest on State and local government bonds would reduce the after-tax return to holding these bonds. If previously the taxpayer were indifferent between holding State and local government bonds and Federal Government and corporate bonds (taxable under present law), the Federal Government and corporate bonds would now offer a higher after-tax return. The taxpayer could be expected to reduce its demand for State and local government bonds and increase its demand for Federal Government and corporate bonds. The decrease in demand for State and local government bonds could be expected to drive up interest rates for State and local government borrowing. The increase in demand for Federal Government and corporate bonds could be expected to reduce interest rates for Federal Government and corporate bonds.

If the pure income tax reform were accompanied by lower tax rates, the after-tax rate of return to all investments may rise. As discussed above relating to consumption-based taxes, domestic saving may increase in response to higher after-tax returns. This may or may not put downward pressure on all interest rates.

As under the consumption-based taxes, a pure income tax generally would eliminate the inefficiency inherent to present-law State and local government bond finance. By treating the interest from all debt equally, perceptions of unequal treatment of individuals also would be eliminated. Compliance costs by States and local governments also may be reduced.

USA Tax

The USA Tax would permit the purchase of State and local government bonds to be excluded from the individual tax base as a form of new saving, but generally would not include interest earned on such bonds as income as long as the individual had net new saving in excess of State and local government interest received.[141] As such, one would expect that State and local government interest costs would remain below those of the Federal Government and corporate borrowers. In this regard, the USA Tax would retain the general features and policy issues of present law. On the other hand, the USA Tax also would eliminate the taxation of the return to new saving. This would reduce the benefit of State and local government bonds' tax exemption relative to other investment instruments. This might narrow the spread between State and local government interest costs and the interest costs of those borrowers who currently issue taxable debt. To the extent that the USA Tax

[141] If new saving is less than State and local government bond interest received, the new saving deduction would be reduced by the difference between otherwise qualifying new saving and the State and local government bond interest received.

reduced the taxation of income from saving, it also could lead to an increase in saving which, as discussed above, may have further ramifications for the interest costs of States and local governments. By retaining a graduated rate structure, the USA Tax may retain some of the inefficiency and perceived unequal treatment of individuals that exists in State and local government finance under present law.

4. Transitional issues in tax reform and State and local government bonds

Most of the preceding discussion is relevant to what one can expect the market for new issues of State and local government bonds to look like in comparison to the market for new issues of Federal Government and corporate debt after adoption of a consumption-based flat tax, a VAT, a retail sales tax, or a pure income tax. The discussion is also relevant to one of the transition issues in moving from an income tax with an exemption for interest on State and local government bonds to a either a consumption-based tax or a pure income tax with no such tax preference.

New debt issued by a State or local government (or Federal Government or corporation) is perfectly substitutable for the State or local government's (or the Federal Government's or the corporation's) outstanding debt in an investor's portfolio. There is no difference in risk because it is the same issuer. This ensures that the market yields on old debt must equal market yields on new debt.[142] The only thing that might have changed is the economic environment in which the debt was, or is to be, issued. If old debt has fixed coupon payments, yield is equilibrated through changes in the price of bonds. Thus, if interest rates that States and local governments must pay rise as a result of the loss of tax exemption, the value of State and local debt outstanding at the time of the loss of tax exemption must fall.

At the close of 1995, tax-exempt yields on longer term bonds were approximately 5.5 percent, while yields on Aaa corporate bonds were 6.85 percent. The basic analysis suggested that yields on State and local government bonds would rise and yields on corporate bonds would fall upon the enactment of a consumption tax. The open economy analysis suggested that State and local government bond yields might rise to the current value of corporate bond yield, while corporate bond rates remain unchanged.

Table 14 below makes some illustrative calculations. Consider two State or local government bonds, each with $100 face value and $5.50 coupons redeemable annually for 10 years and 30 years respectively. Each will have a value of $100 in the current market (5.5 percent interest rates for State and local bonds). Similarly assume a 10-year and 30-year corporate bond with coupons of $6.85 per year. These will trade at $100 in the current market (6.85 percent interest rates for taxables). Table 14 below outlines the market value of the State and local government and corporate bonds under three new equilibrium interest rates: 6 percent, 6.5 percent,

[142] This discussion also assumes that the newly issued debt is issued to have the same maturity as the outstanding debt to which it is being compared.

and 6.85 percent. The former two choices are 88 percent and 95 percent of the assumed taxable yield.

Table 14.—Post-Tax Reform Values of Bonds Whose Current Market Value is $100 at a Current Taxable Interest of 6.85 Percent

Post-reform interest rate (percent)	State and local 10-year maturity	State and local 30-year maturity	Corporate 10-year maturity	Corporate 30-year maturity
6.00	96.32	93.12	106.26	111.70
6.50	92.81	86.94	102.52	104.57
6.85	90.45	82.99	100.00	100.00

The case in which the post-tax-reform interest rate remains at 6.85 percent suggests capital losses by holders of State and local government bonds of 10 percent or more of the current market value of those bonds. However, even the cases where interest rates fall are consistent with double-digit losses on bonds with long maturities.

One might argue that loss in market value is irrelevant if the bond holder intends to hold the bond to maturity—that the bondholder would collect his coupons and the $100 upon maturity and the intervening decline in market value will not matter. This assumes that there would be no price effects from the consumption tax. If the imposition of the consumption tax resulted in a one-time increase in the price level, then the purchasing power of each of the coupons as well as the $100 face value is reduced. Thus, even if interest rates fell to 5.5 percent (the current State and local government bond interest rate), but there was a one-time increase in prices, the bondholder would still experience a real capital loss. (The illustrative calculations above do not account for a one-time increase in the price level.)[143]

[143] Additional transition issues will be discussed as part of a pamphlet related to a future hearing to be scheduled by the Committee on Ways and Means to examine issues related to transition.

APPENDIX:

Appendix Table A.1.—Data Used for Charts 3, 4, and 5

Year	Interest on 10-year U.S. government bonds (percent)	Interest on 10-year industrial bonds (percent)	Interest on 10-year state and local bonds (percent)	Real Interest on 10-year U.S. government bonds (percent)	Real interest 10-year state and local bonds (percent)	State and local capital expenditure (millions of 1990 dollars)
1960	4.13	.....	2.90	2.4	1.18	22,497
1961	3.84	.....	2.75	2.8	1.74	25,478
1962	3.96	.....	2.55	3.0	1.55	25,910
1963	3.98	.....	2.60	2.7	1.28	26,678
1964	4.17	.....	2.80	2.9	1.49	26,389
1965	4.25	.....	2.90	2.6	1.29	27,015
1966	4.86	.....	3.55	2.0	0.69	28,570
1967	4.97	.....	3.55	1.9	0.46	29,779
1968	5.48	.....	3.95	1.3	−0.24	29,956
1969	6.46	.....	5.10	1.0	−0.36	31,987
1970	7.21	.....	5.35	1.5	−0.37	31,517
1971	6.11	.....	4.35	1.7	−0.03	33,256
1972	6.23	6.60	4.15	3.0	0.94	35,219
1973	6.73	7.33	4.45	0.5	−1.77	31,908
1974	7.31	8.51	5.15	−3.7	−5.89	28,797
1975	7.42	8.29	5.44	−1.7	−3.69	28,654
1976	7.53	7.88	4.82	1.8	−0.94	24,672
1977	7.36	7.53	4.35	0.9	−2.15	19,063
1978	8.33	8.53	4.93	0.7	−2.66	19,795
1979	9.34	9.72	5.45	−2.0	−5.90	22,063
1980	11.38	12.05	6.84	−2.1	−6.66	21,940
1981	13.88	14.61	9.43	3.6	−0.89	22,281
1982	13.18	13.98	9.90	7.0	3.74	22,051

APPENDIX:—Continued

Appendix Table A.1.—Data Used for Charts 3, 4, and 5

Year	Interest on 10-year U.S. government bonds (percent)	Interest on 10-year industrial bonds (percent)	Interest on 10-year state and local bonds (percent)	Real Interest on 10-year U.S. government bonds (percent)	Real interest 10-year state and local bonds (percent)	State and local capital expenditure (millions of 1990 dollars)
1983	11.01	11.60	7.91	7.8	4.70	23,182
1984	12.45	12.91	8.71	8.1	4.39	23,492
1985	10.70	11.11	8.04	7.1	4.48	25,811
1986	7.73	8.35	6.32	5.9	4.46	28,429
1987	8.29	8.91	6.37	4.6	2.72	35,655
1988	8.82	9.40	6.79	4.7	2.65	37,684
1989	8.55	9.26	6.69	3.7	1.87	39,117
1990	8.54	9.28	6.64	3.1	1.24	40,560
1991	7.90	8.52	6.10	3.7	1.89	43,527
1992	7.02	7.53	5.59	4.0	2.58	.....
1993	5.92	6.36	4.81	2.9	1.82	.....

Sources: Salomon Brothers, "Analytic Record of Yields and Yield Spreads"; Congressional Budget Office, "Public Infrastructure Spending and Analysis of President's Proposals for Infrastructure Spending from 1996 to 2000," June 1995; and staff of Joint Committee on Taxation calculations.