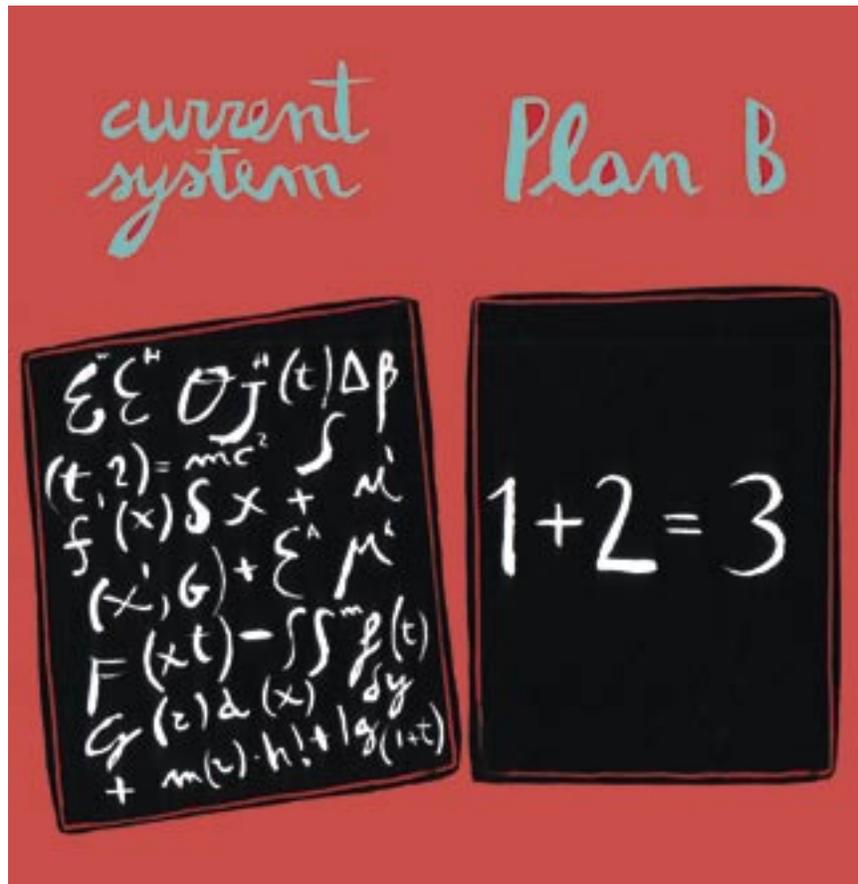


Chapter Seven

The Growth and Investment Tax Plan



Courtesy of Marina Sagona

The Panel evaluated a number of tax reform proposals that would shift our current income tax system toward a consumption tax. The Panel focused on consumption tax proposals that would collect taxes in a progressive manner. These proposals are designed to eliminate the disincentives to save and invest found in our current code, without dramatically altering the way the federal tax burden is shared.

The Panel considered a pure consumption tax that would completely eliminate the difference between the pre-tax and the after-tax return on new investment. It also considered a blended tax structure that would move the current tax system towards a consumption tax, while preserving some elements of income taxation. The Growth and Investment Tax Plan, which is one of the Panel's two recommendations, is an example of a blended structure. It would combine a progressive tax on labor income and a flat-rate tax on interest, dividends, and capital gains with a single-rate tax on business cash flow. Under this tax system, households would file tax returns and pay tax on their wages and compensation using three tax rates, ranging from 15 to 30 percent.

Most households would face lower marginal tax rates than they do under the current income tax system. In addition, the individual tax structure would accommodate the common elements described in Chapter Five, including the Work and Family Credits, the deduction for charitable gifts and health insurance, and the Home Credit. The Growth and Investment Tax Plan departs from a pure consumption tax by imposing a 15 percent tax on household receipts from interest, dividends, and capital gains.

Several panel members were concerned that the Growth and Investment Tax Plan would not move far enough towards a consumption tax because it retains a household-level tax on capital income. The Panel therefore developed a proposal for a consumption tax, referred to as the Progressive Consumption Tax Plan, which would not tax capital income received by individuals. Although the Progressive Consumption Tax Plan proposal did not emerge as a consensus recommendation, the interest in it led to substantial discussion.

Under the Growth and Investment Tax Plan, businesses would file annual tax returns. They would pay tax at a single rate of 30 percent on their cash flow, which is defined as their total sales, less their purchases of goods and services from other businesses, less wages and other compensation paid to their workers. Thus, businesses would be allowed an immediate deduction for the cost of all new investment. Non-financial businesses would not be taxed on income from financial transactions, such as dividends and interest payments, and would not receive deductions for interest paid or other financial outflows.

This chapter begins by summarizing the key differences between income and consumption taxes and explaining the likely impact of consumption taxes on the rate of economic growth. It then describes the Growth and Investment Tax Plan, which offers many of the benefits of a consumption tax even though it retains some elements of income taxation. Next, the chapter explores how adopting the Growth and Investment Tax Plan would affect the distribution of the tax burden. Finally, a brief discussion of the Progressive Consumption Tax Plan considers both how it would differ from the Growth and Investment Tax Plan and how it would affect the saving and investment incentives facing households and firms.

Shifting the tax structure toward a consumption tax would represent a fundamental change in the U.S. tax system. Such a shift would raise a number of implementation issues, many of which are addressed in this chapter. Other issues related to implementation are discussed in more detail in the Appendix.

Comparison of a Consumption Tax with an Income Tax

The key difference between an income tax and a consumption tax is the tax burden on capital income. An income tax includes capital income in the tax base, while a consumption tax does not. Taxing capital income reduces the return to savings and raises the cost of future consumption relative to current consumption. This is likely to cause people to spend more and save less, thereby depressing the level of capital accumulation.

Our current tax system has both income tax and consumption tax features, such as the provisions that permit tax-free saving for retirement (e.g., IRAs and 401(k) plans) and other purposes. Yet the current tax code imposes a penalty on the return to many types of saving. It also taxes different types of investment at different rates, which leads to a misallocation of capital in the economy. Projects treated relatively favorably by the tax code, such as debt-financed investment, are encouraged relative to projects that are heavily taxed, such as equity-financed corporate investment. A consumption tax would not distort saving and investment decisions, and would treat all investment projects the same way.

Although a consumption tax would remove the tax bias against savings and level the playing field between different types of investments, it is important to recognize that an income tax and the type of consumption tax discussed here would both tax a significant portion of the return to capital. To understand why, it is helpful to distinguish four different components of the return to capital. The first is the “normal,” or risk-free, return that represents compensation for deferring consumption. This is sometimes described as the “return to waiting.” The second is the expected risk premium for a project with uncertain returns – the return to risk taking. The third component is “economic profit” and represents returns due to entrepreneurial skill, a unique idea, a patent, or other factors. This component is sometimes referred to as “supernormal returns.” The last component is the unexpected return from good or bad luck. This is the difference between the expected return at the start of an investment, and the after-the-fact, actual return.

A pure income tax and a “postpaid” consumption tax (described in Chapter Three) differ only in their treatment of the return to waiting. The other components of capital income are taxed similarly under both systems. The return to risk-taking and any additional returns that result from good or bad luck are treated similarly under both an income and consumption tax. In both cases, the government becomes a partner in the risks and rewards of the investment through increased tax revenues in the case of positive returns and reduced revenues if returns fall short of expectations. Supernormal returns are taxed equally under both a postpaid consumption tax and an income tax.

Removing the tax on the first component, the return to waiting, is the key to removing taxes from influencing savings and investment decisions. As discussed later in this chapter, recognizing that these other components of the return to capital are taxed under both an income tax and the type of consumption tax discussed here has important implications for the distributional effects of this type of reform.

Box 7.1. Differences in the Treatment of Returns to Business Investment Under a Consumption Tax and an Income Tax

To illustrate how a consumption tax treats normal returns differently than an income tax, consider an entrepreneur who has just earned \$100 and can invest in a new machine that will earn a risk-free 10 percent return one year from now. If the tax rate is 35 percent, under an income tax, the entrepreneur pays \$35 of tax on the \$100 of profits and has \$65 left to invest. In the next year, the investor earns \$71.50 and subtracts \$65 in depreciation for the cost of the machine (assuming for simplicity it is only good for one year), leaving taxable income of \$6.50. After paying \$2.28 in tax (35 percent of \$6.50) the entrepreneur would be left with \$4.22. The investor chooses between consuming \$65 today or \$69.22 in the future – an after-tax return of 6.5 percent.

In contrast, when new investments can be expensed, as under a consumption tax, the investor would choose between investing all \$100 in the machine or receiving \$65 after taxes for spending. If the entrepreneur invests, the entrepreneur would have \$110 in receipts in the next year, but no depreciation deductions. After paying \$38.50 in tax (35 percent of \$110), the investor will have \$71.50 left. Thus, the investor can choose between consuming \$65 today or \$71.50 in the future – an after-tax return of 10 percent.

To see how a postpaid consumption tax and an income tax treat supernormal returns equally, assume that the investment described above actually yields a return of 20 percent. Under an income tax, the investor now has \$78 in profit. After subtracting the \$65 depreciation allowance, the entrepreneur would have taxable income of \$13 – representing normal returns of \$6.50 plus an additional \$6.50 supernormal return. After paying \$4.55 in tax (35 percent of \$13), the entrepreneur would be left with \$8.45. Thus under an income tax, the investor chooses between consuming \$65 today or \$73.45 in the future – an after-tax return of 13 percent.

Under the consumption tax, as before, the investor deducts the \$100 investment in the first year, but pays tax of \$42 (35 percent of \$120) in the next year. This leaves \$78 (\$120 less \$42) after taxes. The investor chooses between consuming \$65 today or \$78 in the future – a 20 percent after-tax return. However, the investor pays \$3.50 more in tax (\$42 less \$38.50 in the first consumption tax example) as a result of the project's supernormal returns. This additional tax represents 35 percent of the \$10 of supernormal returns. Thus, the consumption tax described in this example levies the same tax burden as the income tax on supernormal returns.

A Consumption Tax Would Encourage Economic Growth

Taxing consumption rather than income would remove the saving disincentives that are central to income tax systems. Although one cannot know with absolute certainty the effect of raising the return on private saving by lowering the tax burden, most economic models suggest that such a change would result in higher household saving and a greater level of capital accumulation. Allowing businesses to deduct the cost of new investment immediately, rather than to depreciate assets over time, would encourage new investment. It also would eliminate the tax-induced differences between before-tax and after-tax returns on investment projects that are found in our current system.

Numerous studies have evaluated the economic impact of replacing the current income tax with a consumption tax. These studies typically consider reforms that

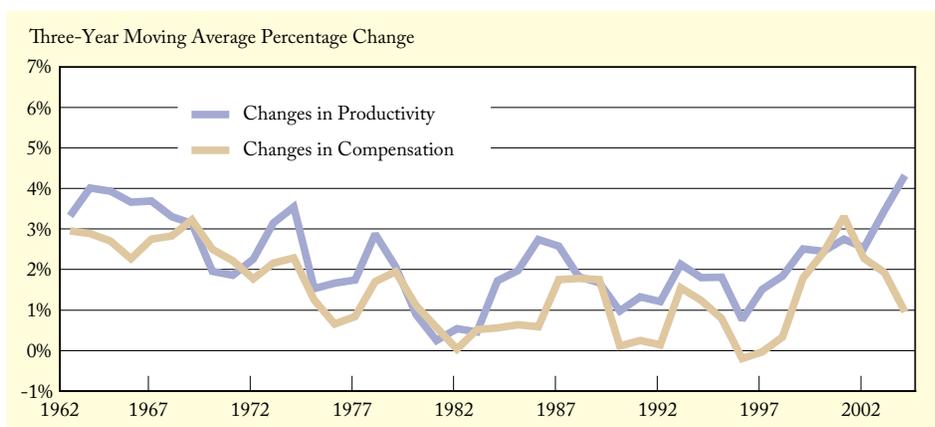
more closely resemble the Progressive Consumption Tax Plan, rather than the Growth and Investment Tax Plan discussed below. These studies use a range of different assumptions in analyzing tax reform, and they consider both the near-term and long-run consequences of modifying the tax structure. While the studies produce different estimates of how taxing consumption rather than income would affect economic growth, virtually all such studies suggest that the long-run level of national income would be higher. The Treasury Department used three different economic models to evaluate both the long-run and short-run effects of adopting the Progressive Consumption Tax Plan. Their findings suggested a long-run increase in economic activity of between 2 and 6 percent. These findings are broadly consistent with the results of previous economic analyses, most of which yielded estimates of at least a 3 percent increase in long-run output. Most of these models do not consider the potential efficiency gains that result from an improved allocation of capital across investments, but focus instead only on the benefits of lowering the overall capital tax burden. The potential economic gains from shifting to a consumption tax may therefore exceed these estimates.

To place these values in perspective, a 5 percent expansion of the U.S. economy in 2005 would increase Gross Domestic Product by over \$600 billion and would likely raise wages and compensation by over \$400 billion. Such an increase in economic output would improve living standards for most Americans.

The increased level of capital accumulation that would follow the adoption of a consumption tax is likely to result in more rapid productivity growth, which is the key to raising standards of living for American workers. Figure 7.1 shows the historical relationship between changes in wages and productivity growth. The two move closely together: wages grow when productivity grows, and wages stagnate when productivity falls.

Productivity growth ultimately depends on investments in human, physical, and intangible capital. Human capital investment is affected by the tax burden that

Figure 7.1. Productivity and Compensation Trends



Source: 2004 Economic Report of the President, Table B-49.

individuals expect to face after they have invested time and money to acquire skills that raise their earning capacity. Both the level and the progressivity of tax rates are important. Low marginal tax rates on labor income make it more attractive for individuals to make investments in education. In contrast, large differences in labor tax rates when individuals forego earnings to obtain new skills, and when they earn the return on those investments, can discourage human capital investment. All of the Panel's recommendations preserve incentives for human capital investment by avoiding increases in (and in many cases, reducing) the marginal tax rates on labor.

The incentive for businesses and individuals to invest in physical and intangible capital is affected by the difference between the before-tax and the after-tax return to new investments. Taxing business investment reduces the aggregate stock of capital that is available to raise worker productivity. Moreover, under the current tax system, investments in physical capital, such as plant and equipment, are taxed at substantially higher rates than investments in marketing, research and development, and other intangibles. Business investments are also taxed much more heavily than investments in owner-occupied housing. This uneven tax treatment of investment leads to an inefficient allocation of investment resources.

An Overview of the Growth and Investment Tax Plan

The Growth and Investment Tax Plan would raise revenue in a progressive fashion, while preserving many of the important features found in our current income tax. It would provide work incentives to low-income taxpayers through Family and Work Credits and encourage home ownership and charitable giving. Like the Simplified Income Tax, it would eliminate the worst features of our current income tax system, such as targeted tax benefits, phase-outs, and the AMT. It would simplify the tax system for individual taxpayers using an approach that is similar to the Simplified Income Tax Plan by incorporating a number of elements that are common to both plans.

Table 7.1. Growth Investment Tax Plan for Households

Households and Families	
Tax rates	Three tax brackets: 15%, 25%, 30%
Alternative Minimum Tax	Repealed
Personal exemption	Replaced with Family Credit available to all taxpayers: \$3,300 credit for married couples, \$2,800 credit for unmarried taxpayers with child, \$1,650 credit for unmarried taxpayers, \$1,150 credit for dependent taxpayers; additional \$1,500 credit for each child and \$500 credit for each other dependent
Standard deduction	
Child tax credit	
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is \$3,570; with two or more children is \$5,800
Marriage penalty	Reduced. Tax brackets and most other tax parameters for couples are double those of individuals
Other Major Credits and Deductions	
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about \$227,000 to \$412,000)
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be \$5,000 for an individual and \$11,500 for a family)
State and local taxes	Not deductible
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans
Individual Savings and Retirement	
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Save at Work accounts would be "prepaid" or Roth-style)
Defined benefit plans	No change
Retirement savings plans	Replaced with Save for Retirement accounts (\$10,000 annual limit) available to all taxpayers
Education savings plans	Replaced with Save for Family accounts (\$10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers
Health savings plans	
Dividends received	Taxed at 15% rate
Capital gains received	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than \$44,000 in income (\$22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation

For businesses, the Growth and Investment Tax Plan would establish a more uniform tax on investment by allowing immediate expensing of business assets and eliminating interest deductions. One measure that economists often use to describe the net effect

of the tax system on investment incentives is the “marginal effective tax rate.” This yardstick is not the statutory tax rate, but rather a measure of the difference between an investment’s pre-tax and after-tax return. The higher the marginal effective tax rate, the lower the after-tax return relative to the pre-tax return, meaning that some investors would not undertake an investment because of the tax burden. If the effective tax rate is zero, any project that an investor would choose to undertake in a world without any taxes would still be undertaken in a world with taxes.

Table 7.2. Growth and Investment Tax Plan for Businesses	
Small Business	
Tax rates	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Business cash flow tax
Investment	Expensing of new investment
Large Business	
Tax rate	30%
Investment	Expensing for all new investment
Interest paid	Not deductible (except for financial institutions)
Interest received	Not taxable (except for financial institutions)
International tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed

Under the current income tax system, effective tax rates differ widely across assets and across projects that are financed in different ways. The average marginal effective tax rate on all types of business investment under the policy baseline is approximately 22 percent. The Growth and Investment Tax Plan would lower the marginal effective tax rate to 6 percent and equalize the tax burden on different types of investments. The Panel is confident that the very substantial reduction in the tax burden on investment would stimulate capital formation, keep American capital that would have gone to other countries at home, and attract foreign capital to the United States.

The Growth and Investment Tax Plan for Households

For households, the Growth and Investment Tax Plan is nearly identical to the Simplified Income Tax. Under the Growth and Investment Tax Plan, households would be taxed on their wages, salaries, and other compensation. The Growth and Investment Tax Plan would incorporate the newly designed ways to help taxpayers receive tax benefits for home ownership, charitable giving, and health insurance coverage described in Chapter Five. It would incorporate the Family and Work

Credits, which would provide a tax threshold that is identical to the tax threshold under the Simplified Income Tax. Like the current system, the Growth and Investment Tax Plan would share the burdens and benefits of the federal tax structure in a progressive manner.

Under the Growth and Investment Tax Plan, wages, compensation, and other compensation would be taxed at three progressive rates of 15, 25, and 30 percent, instead of the six rates used in our current system. As summarized in the Table 7.3, the rate brackets for married taxpayers are exactly twice the amounts for unmarried taxpayers, which would reduce the marriage penalties.

Tax Rate	Married	Unmarried
15%	Up to \$80,000	Up to \$40,000
25%	\$80,001 - \$140,000	\$40,001 - \$70,000
30%	\$140,001 or more	\$70,001 or more

An income tax collects more taxes from a family that saves for the future than it would from an identical family that spends the same amount today. The Growth and Investment Tax Plan would reduce, but not eliminate, this distortion. The Progressive Consumption Tax Plan discussed below, in contrast, would eliminate the tax burden on capital income and thereby make a family's tax burden independent of when they choose to spend their earnings.

The Growth and Investment Tax Plan deviates from a traditional consumption tax by imposing a low-rate tax on all household capital income, while also retaining a system of tax-exempt saving accounts that would enable many households to avoid taxation altogether on returns to savings. All dividends, interest, and capital gains on assets held outside these accounts would be taxed at a 15 percent rate. Under current law, dividends and capital gains are taxed at a maximum rate of 15 percent, while interest is taxed at ordinary income tax rates. Lowering the household-level tax on interest income would further reduce the incentive for families to spend now instead of saving more.

The Growth and Investment Tax Plan would incorporate the Save for Retirement and Save for Family accounts proposed as part of the Simplified Income Tax. In addition, the refundable Saver's Credit would provide a match for contributions made by low-income taxpayers.

The Growth and Investment Tax Plan also would provide employer-sponsored retirement accounts that are similar to the Save for Work accounts under the Simplified Income Tax. However, the Save at Work accounts under the Growth and Investment Tax Plan would be "pre-paid," meaning that contributions to these

accounts would be made on an after-tax basis like a Roth IRA. This change would not affect balances in existing pre-tax retirement accounts, which would continue to be tax-free until withdrawn. Allowing future contributions to employer-sponsored accounts to be made on an after-tax basis under the Growth and Investment Tax Plan would provide a uniform treatment of all tax-free saving.

As with the Simplified Income Tax, these savings accounts would ensure that most American families would be able to save for retirement, housing, education, and health free of taxes. Given the opportunity and flexibility of these savings accounts, the Panel expects that relatively few families would pay the 15 percent tax on interest, dividends, and capital gains that would apply to assets held outside these accounts.

Box 7.2. Save at Work Accounts Under the Growth And Investment Tax Plan

The Growth and Investment Tax Plan incorporates back-loaded, or Roth-style Save at Work accounts. These accounts would be similar to recently enacted provisions that will permit taxpayers to make after-tax contributions to their 401(k) and 403(b) accounts beginning next year.

The Growth and Investment Tax Plan differs from the Simplified Income Tax, which provides pre-tax Save at Work accounts that are structured like traditional IRAs and provide a tax deduction for contributions and tax all withdrawals as ordinary income. If a household's marginal tax rate is the same when contributions are made and withdrawn, the two structures offer the opportunity to accumulate assets at the before-tax rate of return. The Roth-style approach has the advantage of being simpler because the traditional IRA approach involves claiming a deduction when money is contributed and reporting income when the money is withdrawn.

These approaches yield different revenue implications over the ten-year budget window. The revenue cost of traditional IRA accounts is recorded "up front," when contributions are made. With Roth-style accounts, the pattern is reversed – there are no up-front revenue costs because contributions are included in taxable income. The discussion in Chapter Four noted that retirement saving programs affect revenues over horizons as long as three or four decades. The Simplified Income Tax Plan's Save at Work accounts would raise less tax revenues during the ten-year budget window than those of the Growth and Investment Tax Plan, even if identical amounts were contributed to these accounts. The Growth and Investment Tax Plan would raise less revenue from these accounts in the years beyond the budget window. It is worth noting that other provisions of the Growth and Investment Tax Plan have the opposite effect – expensing of new investment, for example, overstates revenue losses because deductions are shifted inside the ten-year budget window.

The Panel supports the use of Roth-style accounts in the Growth and Investment Tax Plan on policy grounds. The availability of the tax revenue from the Roth-style approach also made it possible to set the corporate and individual income tax rates lower than they would have been if the traditional IRA structure had been used. Nevertheless, the use of Roth-style accounts is not an essential feature of the plan, and it could be implemented with the traditional IRA-style accounts. If policymakers made the decision to use that structure, the tax rates would need to be higher in order to achieve revenue neutrality.

Figure 7.2. Tax Return for the Growth and Investment Tax Plan

Form 1 U.S. Individual Tax Return **200X** OMB No. 1545-0047

For the year Jan. 1-Dec. 31, 200X, or other tax year beginning 200X, ending 200X

Label (See instructions on page xx.) Use the IRS label. Otherwise, please print or type.

L A B E L H E R E

Your first name and initial Last name Your social security number
 If married, spouse's first name and initial Last name Spouse's social security number
 Home address (number and street); if you have a P.O. box, see page xx. Apt. no.
 City, town or post office, state, and ZIP code. If you have a foreign address, see page xx.

▲ Important! ▲
 You must enter your SSN(s) above.

Taxable Amount
 Attach Form(s) W-2 here. Also attach Forms W-20 and 1099-R if tax was withheld.

1 Wages, salaries, tips, etc. Attach Form(s) W-2 1
 2 Business cash flow. Attach Schedule 1 2
 3 Taxable interest and dividends 3
 4 Gains or (losses) 4
 5 Taxable distributions (retirement and savings) 5
 6 Social security benefits 6
 7 Other income. List type and amount 7
 8 Total cash flow. Add lines 1 through 7 8
 9 Charitable contributions 9
 10 Multiply line 9 by 1% (01) 10
 11 Subtract line 10 from line 9. If zero or less, enter -0- 11
 12 Social security benefits deduction 12
 13 Health insurance deduction 13
 14 Add lines 11 through 13 14
 15 Taxable amount. Subtract line 14 from line 8. If zero or less, enter -0- 15

Tax and Credits

16 Tax (see page xx) 16
 17 Home credit (see page xx) 17
 18 Subtract line 17 from line 16. If zero or less, enter -0- 18
 19 Family credit. Attach Schedule A if required 19
 20 Subtract line 19 from line 18. If zero or less, enter -0- 20
 21 Self-employment tax 21
 22 Other taxes. Attach Schedule O 22
 23 Total tax. Add lines 20 through 22 23

Payments

24 Federal tax withheld 24
 25 Work credit 25
 26 Estimated tax and other payments 26
 27 Total payments. Add lines 24 through 26 27

Refund or Amount You Owe

28 Amount overpaid. If line 27 is more than line 23, subtract line 23 from line 27. If you want to use direct deposit, attach Form XXXX 28
 29 Amount of line 28 you want applied to your 200Y estimated tax 29
 30 Amount you owe. If line 23 is more than line 27, subtract line 27 from line 23 30

Sign Here
 Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature Date Your occupation If married but not filing with spouse, check here
 Spouse's signature, if filing with spouse, both must sign. Date Spouse's occupation Daytime phone number () - () - ()

Paid Preparer's Use Only
 Preparer's signature Date Check if self-employed Preparer's SSN or PTIN
 Firm's name (or yours if self-employed), address, and ZIP code EIN
 Phone no. () - () - ()

For Disclosures, Privacy Act, and Paperwork Reduction Act Notices, see page xx. Cat. No. 00000A Form 1 200X

The Growth and Investment Tax Plan would make computing taxes dramatically simpler than our current system and would significantly reduce the amount of information required to be gathered and retained by taxpayers and collected and processed by the IRS. Like the Simplified Income Tax Plan, individual tax returns would be shorter and simpler and would free of the parallel tax structure created by the AMT. The new tax return that would be used under the Growth and Investment Tax Plan would be easy to understand, and would be no longer than one page, as shown in Figure 7.2.

The Growth and Investment Tax Plan for Businesses

The Growth and Investment Tax Plan would impose a flat tax on all business cash flow, defined as sales or receipts less the cost of materials, labor services, and purchases of business assets. The Growth and Investment Tax Plan would modify the current corporate income tax base in four important ways. First, businesses would be allowed to write-off immediately, or “expense” their capital expenditures. Second, for non-financial firms, financial transactions would be excluded from the cash flow computation. Businesses generally would not be entitled to deduct interest paid or be required to include interest and dividends received and capital gains on the sale of financial assets. Special rules would apply to businesses that provide financial services. Third, firms that generate losses would be allowed to carry them forward and to offset them against future tax liability. In contrast to the current tax system, however, losses would accrue interest when carried forward. Finally, international transactions would be taxed under the “destination basis” principle. The cash flow tax would be rebated on exports, and imports would not be deducted from cash flow. The Panel embraced the destination-based system because it is consistent with the use of domestic consumption as the tax base and because it is easier to administer than any other alternative.

Business Cash Flow Taxed Once at a Flat Rate

The Growth and Investment Tax Plan would apply a flat 30 percent tax on all businesses other than sole proprietorships, regardless of their legal structure. Removing the tax differential among business entities would eliminate economic inefficiency caused by the double tax on corporate firms that are unable to take advantage of flow-through treatment under current law for non-corporate organizational forms, such as limited liability companies (LLC), partnerships, or S corporations. The net positive cash flow of flow-through entities would be taxed at the business tax rate, although owners of these entities could report and compute the tax on business cash flow on a separate schedule of their individual returns. Similarly, the net positive cash flow of sole proprietorships would be reported on the tax return of its owner, but would be taxed at the graduated individual rates.

By focusing on cash flow, the new tax base would discard the complicated accounting rules that currently attempt to match income with deductions. Instead, for most businesses the tax base would be the difference between cash received and cash paid out. The business tax would resemble a “subtraction method” value-added tax (VAT), with the important exception that wages and other compensation would be a deductible expense.

Box 7.3. What is the Subtraction Method?

The business tax would be imposed on the difference between receipts and outlays – net cash flow. This is often referred to as the “subtraction method” because businesses subtract all expenses from receipts. It is one of two methods used to implement VATs. The other method is the credit or credit-invoice method. In that method, a business is taxed on all receipts but receives a credit for the amount of tax paid by the seller on the business’ purchases. While the credit method is based on transactions and the subtraction method is based on the aggregate accounts of a business, in practice, the two methods are virtually identical – the subtraction method aggregates all expenses and receipts during the year into accounts made up of individual transactions, while the credit method starts with transactions, but businesses must ultimately aggregate transactions into accounts to file returns.

Any amount deducted under the subtraction method can be converted to an equivalent credit and vice versa. Suppose a business spends \$100 on supplies and the tax rate is 35 percent. Under the subtraction method, the business gets a deduction of \$100, saving it \$35 in taxes that would otherwise be due. On the other hand, under the credit method the business would not be allowed to subtract the \$100 of purchases, but would be given a \$35 tax credit.

Most countries with credit method taxes require invoices to help ensure that a buyer only receives a tax credit if the seller in fact pays tax on the sale. The Growth and Investment Tax Plan, although implemented using the subtraction method, would similarly require that deductible purchases be allowed only from businesses that are subject to the tax, and that these purchases be substantiated. For example, goods or services received from foreigners, who are not taxed in the United States, would not be deductible.

The Growth and Investment Tax Plan would be implemented using the subtraction method because it is closer to current law methods of accounting, which would reduce the costs of switching tax systems.

The flat-tax rate of 30 percent on business cash flow would be the same as the top tax rate under the household tax, reducing tax planning strategies aimed at shifting income between the business and individual tax bases.

Expensing for All Business Investments

The Growth and Investment Tax Plan would enhance investment incentives by lowering the effective tax rate on new investment. It also would reduce distortions under current law that suppress and misallocate capital investment due to different tax rates across different types of business assets.

Our current depreciation system permits businesses to deduct the cost of their new investments from their taxable income over time. Although accelerated depreciation and expensing of some assets under our current system lowers the tax burden on returns from new investment, depreciation deductions provide an imperfect mechanism for measuring the actual decline in value of an asset. Current depreciation rules result in effective tax rates that differ substantially among different types of assets. Mismatches between the actual decline in the value of assets, or economic depreciation, and tax depreciation may discourage new investment in plant and equipment and distort the allocation of investment across asset classes.

Current-law tax depreciation also fails to account for inflation. Businesses claim tax depreciation based on an asset's nominal purchase price, even though inflation may have increased its replacement cost. This means that investors do not recover the full value of their investments. The current income tax leads businesses to forego investing in some projects that would have a positive net present value in a world without taxes, but that fail to earn enough to cover both taxes and the required return to investors. With a pure consumption tax, any project that is attractive in a no-tax world remains attractive.

The Growth and Investment Tax Plan would encourage new investment by replacing the patchwork of current incentives and credits with a simple rule: all business investment can be expensed the year when it is made. Moving from depreciation allowances to expensing would lower the tax burden on the returns to new investment and level the playing field across different types of business assets. With expensing, each dollar spent on a new investment asset would generate a deduction worth one dollar, regardless of the asset's type. It would also substantially simplify business taxes by eliminating the need to maintain detailed depreciation schedules and accounting for asset basis.

Because the Growth and Investment Tax Plan retains a low-rate tax on dividends, interest, and capital gains at the household level, it continues to place a tax burden, estimated by the Treasury Department to be approximately 6 percent, on all types of investment. Nevertheless, many projects that are not economical to undertake under the current income tax system would generate an acceptable after-tax return under the Growth and Investment Tax Plan.

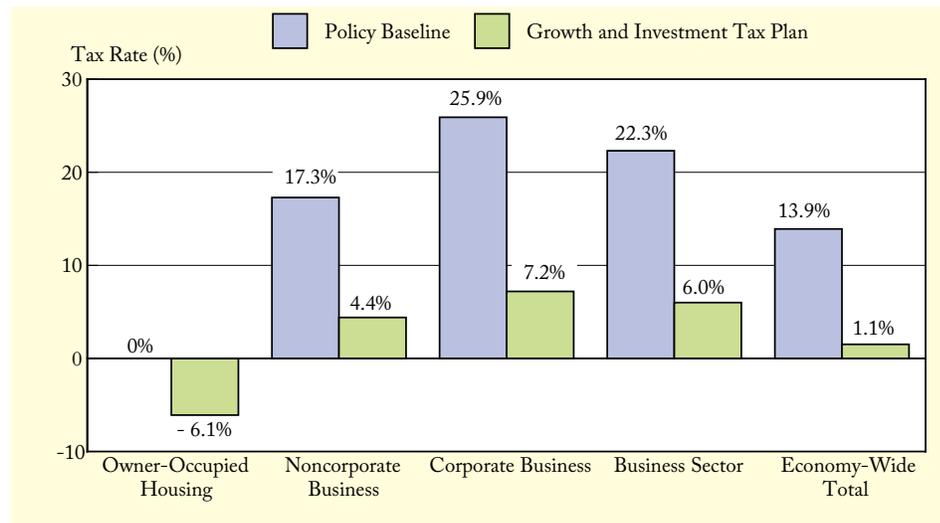
Consistent Treatment of Financial Transactions

The business tax base under the Growth and Investment Tax Plan would not include financial transactions, such as interest paid and received. The elimination of interest deductibility would equalize the tax treatment of different types of financing and would reduce tax-induced distortions in investment incentives. Current law places a lower tax burden on firms that have access to debt financing than on those that use the equity market to finance new projects.

Eliminating the business interest deduction for non-financial firms is an essential component of the Growth and Investment Tax Plan. Allowing both expensing of new investments *and* an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity. Moreover, retaining interest deductibility would preserve differences in the tax burdens on debt-financed and equity-financed projects, thereby retaining distortions across asset and firm types. The Growth and Investment Tax Plan would eliminate the complicated distinctions between debt and equity finance and remove the tax system as a factor in firms' capital structure decisions. Removing the tax advantages of corporate debt also eliminates the tax code's incentive for firms to increase their debt load beyond the amount dictated by normal business

conditions. Figure 7.3 summarizes how the combination of expensing and more equal treatment of interest and dividends provides a lower, more uniform tax burden on the returns of marginal business investments.

Figure 7.3. Comparison of Effective Tax Rates on Different Types of Investment



Note: The tax rates for the policy baseline assume, among other things, that the 2001 and 2003 tax cuts will be made permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a \$5,000 limit) would be enacted.

Source: Department of the Treasury, Office of Tax Analysis.

Excluding financial transactions from the business tax of the Growth and Investment Tax Plan would create special difficulties in the case of businesses that provide financial services. To prevent distortions, financial services should be taxed like any other business good or service. The taxation of financial services is complicated, however, because “implicit fees” are typically imbedded in interest rate spreads and financial margins. For example, a bank typically pays interest to depositors at a lower rate than it collects from mortgage borrowers. Both of these transactions include two components – a service fee and a financial cost related to the use of money – that are included in a single payment of “interest.” The problems with separating the components of financial services are not unique to a consumption tax – income taxes also do not properly tax financial services, but the under-taxation is more visible in a consumption tax. As a result of this conceptual difficulty, countries that administer VATs have adopted special regimes for financial services, with most exempting financial services from the VAT tax base.

The Panel determined that financial services should be taxed under the Growth and Investment Tax Plan. Exempting financial services from tax leads to a number of economic distortions and creates compliance and administrative difficulties. Absent special rules, however, businesses that primarily provide financial services would have perpetual tax losses under the Growth and Investment Tax Plan. This would occur because the cash flow tax base for these financial firms would not include the

revenues that they generate from lending and investing at rates above their cost of funds, but it would allow a deduction for the cost of compensation for workers as well as other purchases.

The Panel considered several options for the taxation of these firms, and recommends an approach under which financial institutions would treat all principal and interest inflows as taxable and deduct all principal and interest outflows. Customers would disregard financial transactions for tax purposes. To prevent the over-taxation of business purchases of financial services, financial institutions would inform business customers of the amount of financial cash flows that are attributed to deductible financial intermediation services. This amount would be deductible as an expense in computing the business customer's taxable cash flow under the Growth and Investment Tax Plan. Rules would be required under this regime to identify which businesses should be subject to the financial institutions regime, especially in the case of businesses that have both financial and non-financial business activities. In addition, an interest rate that would be used as a proxy for the "financial cost" component of financial cash flows would have to be established to determine the value of the separate taxable service component; the simplest approach would be to compare financial inflows and outflows to a single, short-term inter-bank interest rate.

The Panel recognizes that before implementing the Growth and Investment Tax Plan, it would be wise to consider alternative tax rules for financial firms and their potential impact on incentives for firm behavior. The Panel has identified some possible alternatives, which are discussed in more detail in the Appendix.

The Treatment of Tax Losses

The current tax system limits refundability of tax losses because of concerns that such losses can be generated through non-economic, tax-sheltering activity. Firms currently are allowed to carry back losses and to claim refunds for taxes paid in prior years, and to carry losses forward to offset tax liability in future years. Firms that in prior years earned positive income that exceeds their current losses, or that will earn such income in the future, will eventually be able to use their tax losses.

When losses are not refundable, but firms are taxed when they have positive cash flows, the tax system discourages risky ventures with substantial loss possibilities. In effect, such tax rules provide the government with a larger share of favorable returns than of adverse returns, which reduces the after-tax return to undertaking such an investment.

Denying current refunds of losses raises the effective tax rate on marginal investments relative to a system that features refundable losses. Consider a start-up firm that has substantial upfront capital expenditures but little initial revenue. In the early years, the firm has negative cash flow, but it expects to be profitable in the future. If the tax system does not refund losses until a firm is profitable, there is a delay in the receipt of the tax benefits associated with expensing its capital investments. The tax system would discourage firms from undertaking projects expected to have many years of negative cash flows. If there was some chance that the firm might go bankrupt before

receiving the benefit of its start-up losses, this would raise the effective tax burden on new investment.

Under the Growth and Investment Tax Plan, losses would not be refundable. To mitigate the impact that denying loss refundability would have on the effective tax rate on marginal investments, the Panel recommends providing interest on loss carryforwards. If the current interest rate is 10 percent, and a firm incurs a \$1 million loss this year, it may claim a \$1.1 million loss offset next year (adding 10 percent of \$1 million), or a \$1.21 million loss in two years (adding 10 percent of \$1.1 million). Losses would be carried forward indefinitely. By providing interest on the amount of tax later refunded, the tax system would achieve nearly the same effect as having full loss refunds for firms that eventually earn positive cash flows, provided that the interest rate paid on loss carryforwards is equal to the firm's borrowing rate. Allowing interest on losses carried forward alleviates the problem of firms losing the time value of money on carryforwards, but does not eliminate the risk of losing carryforwards entirely if a firm goes out of business.

Another strategy for allowing firms to capture the full value of the tax benefits associated with negative cash flow is to allow losses to be traded from one firm to another. If trading is not costly to firms, then allowing such trading may be equivalent to allowing full and immediate loss refundability. The Panel decided that losses should not be tradable under the Growth and Investment Tax Plan. Allowing tradable or refundable losses may encourage tax avoidance schemes in which the taxpayers make investments that would not have been worth undertaking in a no-tax setting. The value of tax losses created by such an investment may be a key component of its appeal. In addition, allowing loss trading could make it much more important to police so-called "hobby losses" and losses generated by various forms of disguised consumption, rather than investment, because those losses could generate tax savings even when the person incurring them would never realize offsetting positive cash flow.

Under current law, several provisions prevent the transfer of losses to taxpayers with positive income and the transfer of income to taxpayers with losses. One set of rules generally limits the ability to apply the losses of one corporation against income from another when the corporations are combined. Similar rules would be adopted under the Growth and Investment Tax Plan to limit the transferability of negative and positive cash flow.

“Destination-Basis” Taxation of Cross-Border Transactions

International transactions, including both imports and exports of goods and services, as well as financial transactions such as the repatriation of earnings by corporate subsidiaries, pose important challenges for all tax systems. The Growth and Investment Tax Plan is no exception. The tax could be implemented on either a “destination-basis” or an “origin-basis” to address international transactions. The former treats all domestic consumption equally, while the latter treats all domestic production equally. The Panel recommends using the destination-basis to implement the Growth and Investment Tax Plan.

A destination-basis consumption tax levies the same tax on consumption that occurs in the United States, regardless of where the good was produced. Under this system, sales to customers in other nations (exports) are excluded from the tax base while purchases from abroad (imports) are included. Thus, if a domestic manufacturer produces a product in the United States at a cost of \$90 that it sells abroad for \$100, the manufacturer is not taxed on the \$100. The manufacturer receives a rebate of the tax on the \$90 of production costs. This has the effect of eliminating the tax burden on goods that are sold abroad. The tax rebate that the manufacturer receives at the point of export is commonly known as a border tax adjustment. Purchases from abroad are taxed by either making them nondeductible to the importing business or by imposing an import tax.

The alternative “origin-basis” system taxes goods based on where they were produced – their origin. The tax base is domestic production, which equals domestic consumption plus net exports. Exports are included in the tax base because they are part of domestic production and imports are excluded because they are not. If a manufacturer produces a product in the United States at a cost of \$90 that it sells abroad for \$100, it is taxed on the sale. This means that identical items produced for domestic and for foreign consumption are taxed in the United States in exactly the same way. Purchases from abroad are either deducted by the importing business or not taxed at the point of entry into the United States.

Border Tax Adjustments and International Trade

The VATs imposed by our major trading partners are implemented on a destination-basis. They include border tax adjustments. While these taxes are often viewed as subsidizing exports because they exempt exports and tax imports, economic analysis indicates that destination-based taxes do not affect the balance of trade. To illustrate this proposition, suppose that the United States was trading with a foreign country in a completely tax-free environment. Trade would be conducted at a level at which each country enjoyed comparative advantage – selling to others the products and services that nation produces best. Now suppose that the United States imposed a destination-basis consumption tax. A domestic exporter would still sell its product in the foreign country at the same price as without the tax.

Similarly, a good sold in the United States by a foreign producer would be subject to the U.S. consumption tax. As a result, the foreign importer would compete in the United States on the same basis as local sellers. Consumers in the United States would make the same choices regarding imports and domestically-produced goods as they had made before the tax was imposed, since both are subject to the same tax. Economic theory suggests, therefore, that imposing a destination-basis tax does not affect a country's trade position.

The preceding discussion might suggest, in contrast, that an origin-basis tax could disadvantage domestic producers relative to foreign producers in the worldwide market. However, border tax adjustments are not the only mechanism working to maintain neutrality. Adjustments that take place through the market, such as changes

in exchange rates or in other economic variables, including wages and the prices of other inputs, should wholly offset any potentially detrimental trade effects on the value of exported goods under an origin-basis tax.

Returning to the previous example, assume instead that the United States imposes an origin-basis tax. Before the tax is imposed, the United States is trading in a completely tax-free environment. Recall that under an origin-basis system, exports are taxed and imports are exempt. If markets are competitive, the exporter will not be able to reduce his price and remain in business after the tax on exports is imposed. However, the U.S. currency may depreciate so that although the nominal price increases by the amount of the tax, the price paid for the export by foreign consumers in their currency is unchanged from its before-tax level. Therefore, trade will not be affected. As explained above, however, if exchange rates did not fully adjust, the price adjustment could occur through adjustments in domestic prices and wages.

The observation that a neither a destination-basis nor an origin-basis tax distorts the pattern of trade that would exist in the absence of any taxes does not imply that moving from the current income tax structure to a consumption tax would not affect trade. The current tax system places heavier burdens on some industries than on others. Replacing the current tax system with a system that is equivalent to a system with no taxes at all could raise exports in the industries that are currently taxed heavily.

Administration

The Panel recommends imposing the Growth and Investment Tax Plan on a destination-basis because such a tax will be easier to administer than a comparable tax on an origin-basis. An origin-basis system will engender serious disputes as a result of “transfer pricing.” The term transfer pricing refers to amounts charged (or not charged) for sales and transfers between related entities, often controlled by a single corporate parent. Because the different entities are related, they do not really care what price they charge each other. If they are located in different taxing jurisdictions they may have an incentive to set prices to minimize overall taxes rather than to reflect the actual value of the goods and services they are providing one another. Current tax rules use the internationally accepted standard for setting transfers prices; these prices must be set at the level that would have prevailed if the parties had been dealing at “arm’s length.” The application of this standard raises difficult compliance and administrative problems.

Under a destination-basis tax, transfer prices do not affect the computation of tax liabilities. Border adjustments make the tax base domestic consumption, which at the business level equals domestic sales minus domestic purchases. As a result, the prices established for cross-border transactions are irrelevant, and there are no opportunities to use transfer prices to minimize tax liabilities.

The same is not true under an origin-basis tax. Transfer pricing would continue to be a problem since export sales would be taxable and imports would be deductible. There is an incentive, as in the current system, to overcharge for imports and undercharge

for exports to shift income out of the United States. Related but more complex tax avoidance schemes are more difficult to accomplish under a destination-basis system for similar reasons (see Box 7.4 for an example).

Box 7.4. An Example of a Tax Avoidance Scheme under an Origin-Basis System

A foreign company purchases a \$100 product from a U.S. business by promising to pay \$110 in one year (a purchase on credit). The transaction is documented as the purchase of a \$90 good with \$20 of interest. By overstating interest on the sale, the business reduces its taxable receipts under an origin-basis tax while not changing its cash flows. The foreign company is indifferent to how the transaction is structured. Under a destination-basis system, the transaction with the foreigner is not subject to tax since it is an export and, as a result, there is no incentive to engage in this tax avoidance scheme in the course of cross-border transactions.

Besides reducing incentives for tax-minimizing transfer pricing, a destination-basis tax is easier to apply to royalty income from abroad. Royalties received from abroad represent payments for exports of intangible assets, and so would be exempt from taxation under the Growth and Investment Tax Plan. The owner of the intangible would be taxed when he uses the proceeds to consume. Royalties paid for foreign-created intangible assets would not be deductible since they are payments for imports. Transfer pricing problems may be particularly severe in the case of royalties, because it is difficult to establish arm's length prices for intangible assets. The destination-basis tax closes down opportunities to inappropriately set transfer prices since the prices established for cross-border royalty transactions would be out of the tax base.

Choosing the destination-basis for the treatment of cross-border transactions under the Growth and Investment Tax Plan "closes" the tax system. This means that businesses are only able to claim deductions from the tax base that are offset by corresponding inclusions in the tax base. Closing the system through border adjustments precludes tax avoidance opportunities that involve structuring cross-border transactions to generate tax deductions for payments to foreigners who are outside the system.

While closure is attractive on balance, it has some drawbacks. Deductions should only be allowed for purchases from domestic suppliers and sales should be exempted only if they are truly to foreigners. This makes it essential to monitor deductions and exemptions. Moreover, citizens of the United States can avoid import taxes by consuming foreign-produced goods purchased outside of the United States. This creates an incentive for citizens to buy goods abroad.

Location Incentives

The presence of expensing for new investment under the Growth and Investment Tax Plan would make the United States an attractive place to invest foreign capital. The investment incentives discussed above would apply to all firms operating in the United States, not just to firms headquartered in the United States. At the same

time, the tax code would no longer give U.S. multinational corporations an incentive to move production overseas because the tax burden would be based on *sales* within the U.S., regardless of where the goods are produced. As explained in detail earlier in this chapter, the Growth and Investment Tax Plan also would eliminate many of the complex cross-border tax planning activities that reduce the revenue collected under current corporate income taxes. Reducing the incentive for such tax planning would be an important step toward simplifying the tax system.

Refunds for Exports

The border tax adjustment described above would provide tax refunds to exporting firms. The amount of the refund would be determined by the costs incurred in producing an export, including the firm's labor costs. For firms that sell primarily in the export market, their border tax adjustment rebate could exceed any tax liability that they face on their domestic sales. Exporting firms whose border tax adjustments exceed their taxes on domestic cash flow would be provided a refund for their excess border tax adjustment. In addition, until exchange rates or domestic prices adjust after the imposition of the tax on imports, businesses that import significant amounts of goods could operate at a loss after taxes, because they would receive no deduction from income for the costs of their imports. They could thus be paying taxes greater than their net pretax cash income.

Although the excess deductions generated by an export business and those generated by a domestic business suffering losses are conceptually similar, they would be treated differently under the Growth and Investment Tax Plan. Domestic firms suffering losses would most likely prefer an immediate rebate of taxes if given a choice, notwithstanding that their loss carryforwards would be increased by an interest factor under the plan. Thus, special rules may be needed to police the allocation of expenses between domestic businesses generating losses and export businesses when both are operated within the same firm or through affiliates.

Border Tax Adjustments and the World Trade Organization

Multilateral trade rules originally developed as part of the General Agreement on Tariffs and Trade (GATT), and now incorporated into the rules of the World Trade Organization (WTO), affect the use of border adjustments. GATT/WTO rules treat border tax adjusting "direct taxes" as a prohibited export subsidy. In contrast, "indirect taxes" on exports may be border adjusted so long as the amount remitted does not exceed the amount of indirect tax "levied in respect of the production and distribution of like products when sold for domestic consumption."

Many developed countries with border-adjustable VATs couple those VATs with a single-rate tax on capital income at the individual level. Some of these countries also have wage subsidies, progressive taxation of wages, or both. The Growth and Investment Tax Plan is equivalent to a credit-method VAT at a 30 percent rate, coupled with a progressive system of wage subsidies and a separate single-rate tax on capital income. The Panel therefore believes that the Growth and Investment Tax Plan should be border adjustable.

However, given the uncertainty over whether border adjustments would be allowable under current trade rules, and the possibility of challenge from our trading partners, the Panel chose not to include any revenue that would be raised through border adjustments in making the Growth and Investment Tax Plan revenue neutral. If border adjustments are allowed, then the plan would generate about \$775 billion more revenue over the ten-year budget window than is currently estimated in the scoring of this plan.

Other Issues Associated with the Implementation of the Growth and Investment Tax Plan

The Growth and Investment Tax Plan, like any other tax system, will rely on rules and definitions that must be broadly applied to a wide variety of taxpayers and activities. Taxpayers inevitably respond to taxes by altering their behavior to minimize or avoid taxes. In addition, complexity is added as rules are crafted to prevent tax avoidance or abuses. For example, current law distinguishes between interest and dividend payments by corporations. This creates opportunities for tax planning and avoidance that, over the years, have spawned countless complex rules to clarify definitions and deny favorable treatment in specific circumstances.

In designing the Growth and Investment Tax Plan, the Panel attempted to avoid distinctions between types of taxpayers, transactions, or activities that would create distortions and complexity. However, there would still be a need for some rules to delineate when specific transactions or activities are subject to tax. For example, rules to distinguish between financial and non-financial transactions, and rules regarding the treatment of transactions between businesses and taxpayers not subject to the cash flow tax (such as individuals and non-profits), are likely to be particularly important to the implementation of the tax. These issues, and others, are examined in more detail in the Appendix.

Transition

Replacing the current income tax with the Growth and Investment Tax Plan would affect the value of many assets. The Panel recognizes that transition issues are central to the analysis of fundamental tax reform, and therefore recommends providing some transition relief.

The basic issues associated with transition relief can be illustrated by considering an owner of business assets that were recently purchased for \$100 and that could be depreciated under the current income tax system over ten years. This business owner would not be able to recover this tax basis in an immediate and transition-free switch to a cash flow tax. Returns on the asset – either on the sale of the asset or through cash generated by deploying the asset – would be taxed, but pre-enactment basis could not be used to offset this income. For example, if the business owner sold the asset for \$100 soon after the new tax system with a 30 percent tax rate was in effect, all \$100 of the sales proceeds would be taxable and \$30 of tax would be due – even though the owner's economic position had not changed. On the other hand, investors who purchased new, but otherwise identical, physical assets after the Growth and Investment Tax Plan took effect would be able to expense their purchases, effectively receiving \$30 of tax benefits for purchasing \$100 of new equipment. This transitional

loss would be offset by future gains that the business owner would receive under the Growth and Investment Tax Plan, as returns from new investments would be taxed at a lower rate.

The Growth and Investment Tax Plan also would affect the tax treatment of existing financial assets, such as bonds and mortgages. For borrowers, eliminating interest deductions will increase future tax liabilities. For lenders, these effects will vary greatly. Individuals would pay a lower 15 percent tax on interest income, providing a windfall to these debt holders. Similarly, non-financial businesses will no longer pay tax on interest income and the value of their loans would increase.

The Panel recognizes that adoption of the Growth and Investment Tax Plan might have a negative impact on a number of households and on some business taxpayers. The Panel therefore recommends several types of transition relief. First, there should be transition relief on existing depreciation allowances. Depreciation allowances on assets put in place prior to the effective date for the Growth and Investment Tax Plan should be phased out evenly over a five-year period. In the year when the Growth and Investment Tax Plan is enacted, taxpayers with depreciable assets would be able to claim a deduction for 80 percent of the depreciation they would have been eligible to receive under the old system. In the second year this percentage will drop to 60 percent, the third year it would be 40 percent, the fourth year it would be 20 percent, and it would be zero after five years.

Second, for businesses with outstanding debt, the Panel recommends the same five-year phase-out structure, followed by deductions of 60, 40, and 20 percent. Eighty percent of an interest deduction that would have been allowed under the old law would be permitted in the first year after the effective date of the Growth and Investment Tax Plan. A similar set of rules would apply to interest income that would have been taxed under the old tax regime. Eighty percent of such interest would be included in cash flow in year one, followed by inclusion shares of 60, 40, and 20 percent. Any modifications to existing contracts would be treated as new contracts, and would terminate the transition relief for these contracts. Sales of physical assets would similarly terminate the benefits of pre-enactment depreciation allowances. As described in Chapter Five, transition relief would also apply to the deductibility of interest on home mortgages that were outstanding on the effective date of the Growth and Investment Tax Plan.

Third, the Panel proposes special transition relief for firms that might be affected by border tax adjustments. If exchange rates do not adjust as rapidly as economic theory predicts they should, then border tax adjustments would place an undue burden on imports and importers. The Panel therefore recommends a four-year phase-in period for border tax adjustments. The phase-in rules would be administered on a firm-by-firm basis, and they would be limited to a base amount, calculated as the average value of import purchases, or export sales, in the two years before the Growth and Investment Tax Plan took effect. In the first year, an importer would be able to deduct 90 percent of import purchases up to their import base. Imports that exceeded that base would not be deductible. Exporters would pay tax on 90 percent of exports up to the base amount. Exports that exceeded the base would not be taxed. In the second year, 60 percent of imports up to the firm's base amount would be deductible and 60 percent of exports would be taxed. The percentage would be reduced to 30 percent

in the third year. In the fourth year, the border adjustment would be fully phased in: Cash flow taxes on exports would be rebated at the border and imports would not be deductible from cash flow.

Finally, the Panel recommends specialized transition rules for financial institutions. If the Panel's recommended approach to the taxation of financial institutions is adopted, special transition rules would be needed to determine the status of outstanding loans made by these companies. Because financial firms never received a deduction against cash flow when raising the capital for outstanding loans, it would be unfair to levy tax on returns of capital when the lending firm receives them. Interest on loans extended prior to the effective date of the Growth and Investment Tax Plan, however, would be taxed as a component of individual cash flow. As with debt contracts for homeowners and non-financial businesses, any modifications to existing contracts would be treated as new contracts and not entitled to transition relief.

The Panel recognizes that there are other potentially important transitional issues, such as the tax treatment of existing tax loss carryforwards and tax credits and the treatment of inventory holdings when the Growth and Investment Tax Plan is implemented. In addition, the transition to the Growth and Investment Tax Plan would have a substantial impact on the financial statements of many large companies as the expected change in future tax liabilities – after considering transition relief – must be recorded for financial accounting purposes. The Panel does not specifically address these transition issues, but it recognizes that they are important concerns that would need to be addressed.

There is a fundamental tradeoff between the amount of transition relief provided when a consumption tax is adopted and the growth and efficiency gains from the tax reform. Providing generous transition relief to households and firms that lose tax benefits that are available under an income tax, but not a consumption tax, reduces the efficiency gains of reform. This occurs because financing such transition relief requires raising tax rates in the consumption tax regime, which increases tax-induced distortions in labor supply and other aspects of household behavior. If transition relief is financed with a temporary increase in tax rates for some period after tax reform is enacted, then the efficiency costs will be concentrated in this period, and the net growth impact of adopting a consumption tax may be much smaller than the long-run analysis suggests. Once the transition period ends, however, the economy will ultimately achieve the long-run gains associated with the consumption tax. If tax rates are raised permanently to finance transition relief, then there will be some reduction in long-run economic growth relative to the benchmark case of no transition relief.

The revenue costs of the foregoing recommendations regarding transition relief are incorporated in the Panel's calculations of the Growth and Investment Tax Plan's ten-year revenue cost. More generous transition relief would require higher tax rates on businesses and individuals, or tighter limits on mortgage interest deductions, the exempt amount of employer-provided health insurance, or other tax subsidies. More limited transition relief, by comparison, could be paired with even more significant tax rate reductions.

The Panel views transition relief as a critical and very difficult issue in moving from the current hybrid income tax to a consumption-based tax system. Ultimately, the

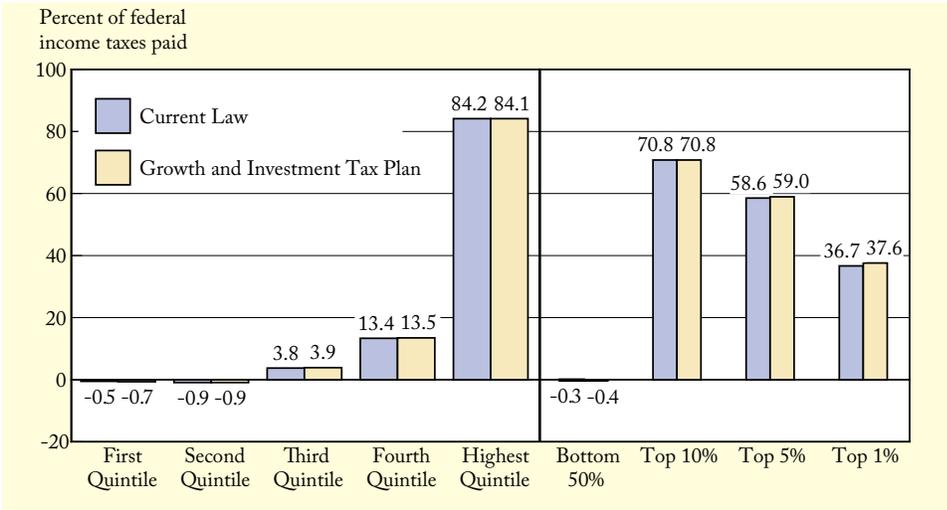
political process must determine the appropriate level of transition relief. The Panel urges those who consider transition issues to recognize that the costs of transition relief are measured not just in the additional revenue needed to fund transition provisions, but also in the reduced efficiency gains that flow from higher marginal tax rates.

A Progressive Tax System

The Growth and Investment Tax Plan removes impediments to saving and investment, and promotes long-term productivity growth, while largely preserving the current distribution of the federal income tax burden across income classes. While there are some variations in the income classes shown below, the overall distribution closely tracks current law.

The Treasury Department provided distribution tables for the Growth and Investment Tax Plan. Estimates for 2006 are shown in Figures 7.4 and 7.5. Similar to what was presented for the Simplified Income Tax Plan, Figure 7.4 breaks the population into fifths – or quintiles – and also shows the bottom 50 percent of the population (ranked by income), along with the top 10, 5, and 1 percent of the population. Figure 7.5 groups taxpayers by using income levels ranging from zero to \$15,000 of income to more than \$200,000 of income.

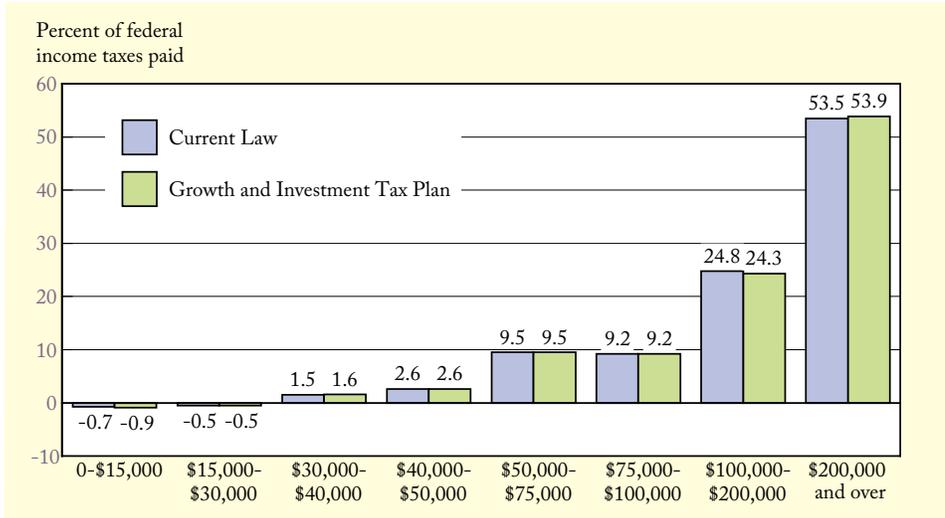
Figure 7.4. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.5. Distribution of Federal Income Tax Burden Under Current Law and the Growth Investment Tax Plan by Income Level (2006 Law)

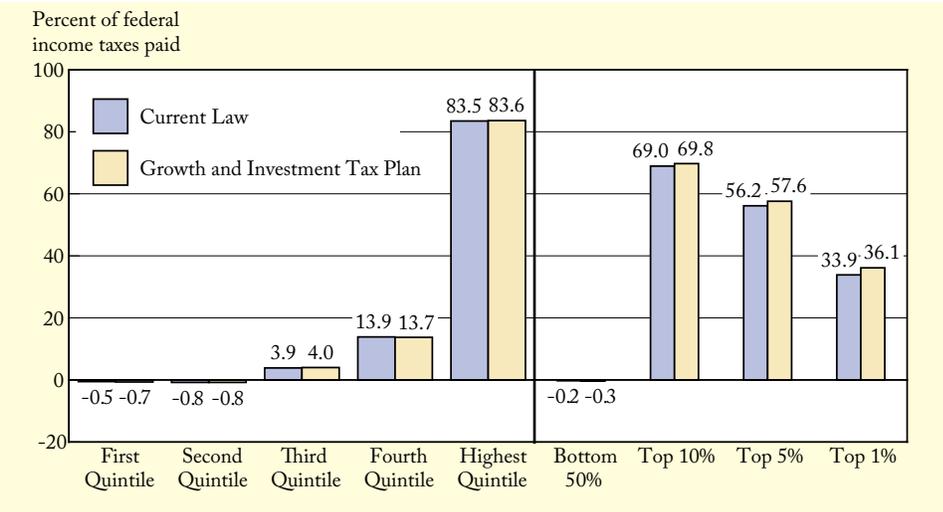


Note: Estimates of 2006 law at 2006 cash income levels.
 Source: Department of the Treasury, Office of Tax Analysis.

To provide additional information about the effect of the Growth and Investment Tax Plan on the distribution of the tax burden, the Panel asked the Treasury Department to provide a distribution of the plan for the tax law that would be in place in 2015, the last year of the budget window, while holding income constant at 2006 levels. This distribution would account for provisions that change over time, such as transition relief for business and individuals and the rapid growth of the AMT under current law.

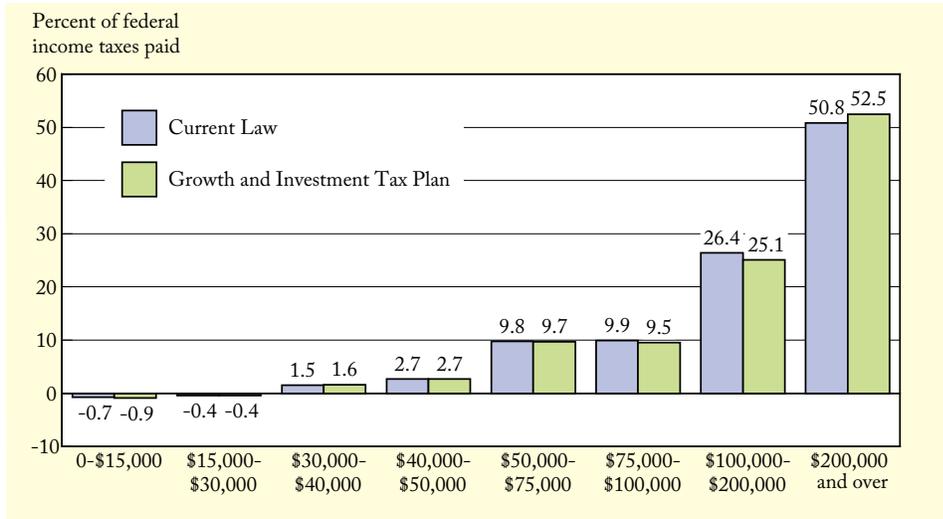
One of the most expensive items in the Panel's proposed reforms is the repeal of the AMT. Covering the \$1.2 trillion cost of this repeal over the ten-year budget window requires changes in other components of the tax code. While taxpayers are aware of the cost of tax changes that may limit some itemized deductions, many taxpayers who are likely to pay the AMT in future years, but who have not yet paid this tax, may not recognize the benefits associated with AMT repeal. Figures 7.6 and 7.7 demonstrate how the distribution of the tax burden under the current income tax system, with the AMT, will evolve over the next ten years, as well as how the Growth and Investment Tax Plan will affect that distribution in 2015.

Figure 7.6. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.
 Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.7. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Level (2015 Law)



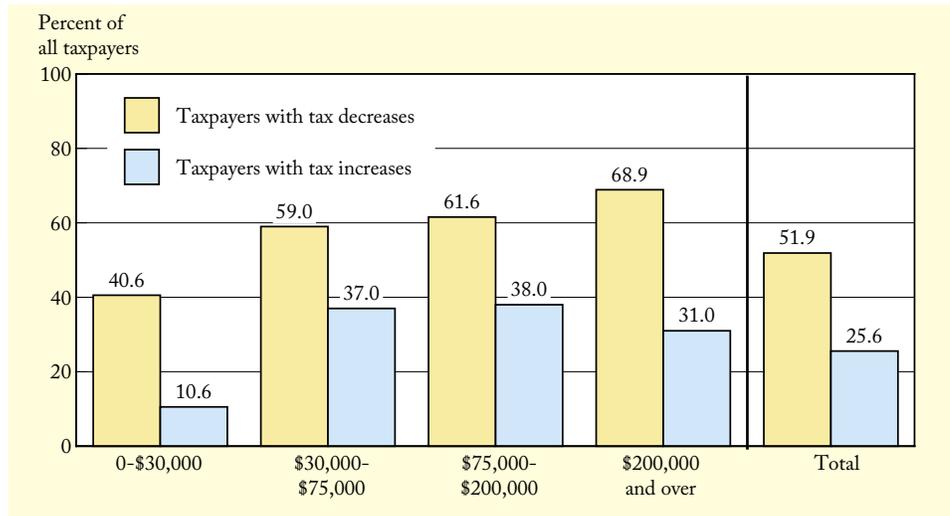
Note: Estimates of 2015 law at 2006 cash income levels.
 Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department also provided two additional sets of distribution tables that are explained and presented in the Appendix. One table demonstrates the tax burden under the Growth and Investment Tax Plan for the entire ten-year budget period. The other shows the tax burden if the corporate income tax is distributed 50 percent to owners of capital and 50 percent to labor, rather than solely to owners of capital income.

Another way to evaluate the distributional effects of a tax reform proposal is to consider the number of taxpayers who would face higher or lower taxes under the proposal. The constraint of revenue neutrality implies that any tax relief provided to one taxpayer must be financed with higher taxes on somebody else. Looked at solely from the perspective of one's tax bill, any revenue neutral tax reform is certain to generate both "winners" and "losers." The Panel recognizes that this comparison is inevitable, but at the same time urges taxpayers to recognize other benefits of tax reform. Greater simplicity in the tax system would allow taxpayers to save time and money, and would inspire confidence that the tax system is straightforward and fair, and not providing hidden loopholes to others. Greater economic growth, which is projected to occur under the Growth and Investment Tax Plan, would also generally benefit all Americans by increasing their incomes.

Figures 7.8 and 7.9 demonstrate that at each income level in both 2006 and 2015, there would be many more taxpayers who would pay less in taxes than those who would pay more in taxes. In total, under the Growth and Investment Tax Plan, there would be more than twice as many taxpayers who would receive a tax cut.

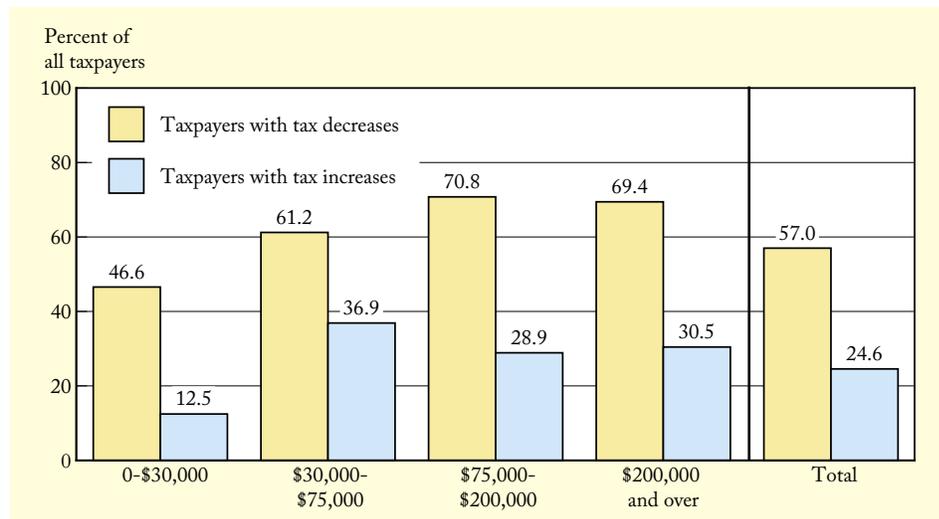
Figure 7.8. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Growth and Investment Tax Plan (2006 Income Levels)



Note: Estimates of 2006 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.9. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Growth and Investment Tax Plan (2015 Income Levels)



Note: Estimates of 2015 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.

Source: Department of the Treasury, Office of Tax Analysis.

The preceding figures describe the overall effects on groups of taxpayers. While this is informative, the Panel understands that many taxpayers would like to have a greater level of specificity, and would like to know what would happen to their own tax bill. In order to provide that type of information, the Panel has developed an array of hypothetical taxpayers and calculated their taxes under the Growth and Investment Tax Plan.

The Panel chose these hypothetical taxpayers using a methodology that has already been described in Chapter Six. In short, the Panel asked the IRS to construct a set of stylized taxpayers with different family structures, age, income, and deductions, using data from actual tax returns. These examples reinforce an essential point: looking at elements of the Growth and Investment Tax Plan alone can lead to very misleading conclusions. Just like the Simplified Income Tax Plan, the Growth and Investment Tax Plan has been carefully crafted to achieve substantial improvements in the tax system while minimizing the changes in total tax liabilities experienced by individual taxpayers and the overall distribution of the tax burden. While some elements of the plan, considered in isolation, may increase the taxes paid by some taxpayers, other elements will have offsetting effects. The focus should be on the aggregate changes in tax liability that would result from the Growth and Investment Tax Plan.

Table 7.3 shows how a set of hypothetical taxpayers would be affected in 2006. For example, a stylized married couple under age 65 earning about \$100,000 would expect to pay \$9,340 in taxes in 2006. Under the Growth and Investment Tax Plan, that couple would pay \$9,004, a decrease of 3.6 percent. A stylized married couple under age 65 at the median income level of \$66,200 would expect to pay \$3,307

under current law. Under the Growth and Investment Tax Plan, that couple would pay \$2,349 in taxes, a decrease of 29 percent.

Much like the Simplified Income Tax Plan, a single taxpayer under age 65 at the median income level of about \$24,000 would receive a tax cut of 4 percent. A head of household taxpayer at the median income of about \$23,000 would have his or her tax bill remain roughly the same. Single taxpayers and heads of households who are at the 95th percent of income would face a tax increase under the Growth and Investment Tax Plan.

The Panel also felt that it would be instructive to see how this plan affected taxpayers living in high-tax and low-tax states. Accordingly, the Panel asked the IRS to vary the amount of state and local taxes paid by each of the taxpayer groups under age 65. Using the methodology described in Chapter Six, the Treasury Department then calculated how tax liabilities would change for those taxpayers.

The examples in Table 7.4 show that because of the interaction between the alternative minimum tax and other provisions, there would be no difference in the treatment of the stylized married couple earning about \$100,000 or in the treatment of the married couple earning about \$207,000. In other words, regardless of whether those couples live in high-tax or low-tax states, they would still benefit from a reduced tax bill under the Growth and Investment Tax Plan. The stylized couple earning about \$66,000 living in a low-tax state would receive a tax cut of \$1,081 while the same couple living in a high-tax state would receive a tax cut of \$781. Under the Growth and Investment Tax Plan, these taxpayers would pay the *same* level of tax, regardless of where they live.

For single taxpayers and heads of household who itemize and are not subject to the AMT under current law, there would be a larger tax increase for those who are living in high tax states. This is due to the fact that taxpayers in high tax states currently pay less in tax than taxpayers in low tax states. Under the Growth and Investment Tax Plan, this would no longer be the case – taxpayers with similar income and characteristics would face the same tax bill.

Table 7.4. Examples of Taxpayers Under the Growth and Investment Tax Plan in 2006 (in dollars)

Model Taxpayer Percentile	Income	Salaries and Wages	Taxable Interest, Dividends, & Capital Gains	Itemized Deductions				Income Tax under 2006 Law at 2006 Levels		
				State and Local Taxes	Mortgage Interest	Charitable Contributions	Misc (before 2% floor)	Current Law	Growth and Investment Tax Plan	Percentage Change in Tax Liability

Single Taxpayers Younger Than 65

1	Bottom 25th	12,300	12,300				369		385	158	-59.0%
2	50th	24,300	24,300				729		2,003	1,922	-4.0%
3	Top 25th	41,000	40,700	300			1,230		4,758	4,447	-6.5%
4	Top 5th	82,800	80,500	2,300	4,000	6,400	2,000	2,200	13,541	14,523	7.3%

Heads of Household Younger Than 65

(bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)

5	Bottom 25th	14,000	14,000				420		-4,941	-5,488	-19.5%
6	50th	23,100	23,100				693		-4,225	-4,242	-2.4%
7	Top 25th	37,200	36,700	500			1,116		1,960	1,238	-9.5%
8	Top 5th	71,800	71,300	500	2,900	8,300	2,400	2,500	7,042	8,005	5.4%

Married Filing Jointly Younger Than 65

(all have two child dependents)

9	Bottom 25th	39,300	38,600	700			1,179		-282	-783	-178.2%
10	50th	66,200	65,300	900	2,300	8,200	2,400	2,100	3,307	2,349	-29.0%
11	Top 25th	99,600	97,800	1,800	4,100	9,400	2,700	2,200	9,340	9,004	-3.6%
12	Top 5th	207,300	196,200	11,100	10,000	14,400	5,400	2,800	40,417	37,959	-6.1%

Single Taxpayers (and Surviving Spouses) Age 65 and Over*

13	50th	24,800	0	4,900			555		1,919	2,338	21.8%
14	Top 25th	42,800	0	7,400			1,130		5,731	6,529	13.9%

Married Filing Jointly Age 65 and Over**

15	50th	51,000	0	4,800			1,125		2,772	2,723	-1.8%
16	Top 25th	77,500	0	10,000			2,230		9,635	9,750	1.2%

Note: * The 50th percentile taxpayer has gross social security benefits of \$6,300 and taxable pensions, annuities, and IRA distributions equal to \$13,600. The top 25th percentile taxpayer has gross Social Security benefits of \$12,000 and taxable pensions, annuities, and IRA distributions equal to \$23,400.

** The 50th percentile taxpayer has gross social security benefits of \$18,400 and taxable pensions, annuities, and IRA distributions equal to \$27,800. The top 25th percentile taxpayer has gross Social Security benefits of \$21,000 and taxable pensions, annuities, and IRA distributions equal to \$46,500. See text for further explanation of sample taxpayers.

Source: Department of the Treasury, Office of Tax Analysis

Table 7.5. Examples of Taxpayers with “High” and “Low” State and Local Tax Deductions under the Growth and Investment Tax Plan in 2006

Taxpayer Characteristics and Placement in Income Distribution	Adjusted Gross Income	State and Local Taxes Deduction	Income Tax under 2006 Law at 2006 Levels		
			Current Law	Progressive Consumption Tax Plan	Growth and Investment Tax Plan

Single Taxpayers Younger Than 65

Top 5% in “low-tax” state	82,800	3,500	13,666	16,244	14,523
Top 5% in “high-tax” state	82,800	6,400	12,941	16,244	14,523

Heads of Household Younger Than 65

(bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)

Top 5% in “low-tax” state	71,800	2,400	7,167	9,154	8,005
Top 5% in “high-tax” state	71,800	4,800	6,567	9,154	8,005

Married Filing Jointly Younger Than 65

(all have two child dependents)

50th in “low-tax” state	66,200	1,900	3,307	2,727	2,349
50th in “high-tax” state	66,200	3,900	3,307	2,727	2,349
Top 25th in “low-tax” state	99,600	3,600	9,340	9,599	9,004
Top 25th in “high-tax” state	99,600	6,900	9,340	9,599	9,004
Top 5% in “low-tax” state	207,300	8,300	40,417	42,868	37,959
Top 5% in “high-tax” state	207,300	16,300	40,417	42,868	37,959

Notes: Taxpayers have same characteristics as those in Table 7.4 with the exception of state and local taxes. See text for further explanation of sample taxpayers.

Source: Department of the Treasury, Office of Tax Analysis

Beyond the Growth and Investment Tax Plan: The Progressive Consumption Tax Plan

The foregoing discussion emphasizes that the Growth and Investment Tax Plan is not a true consumption tax because it imposes a 15 percent tax on the interest, dividends, and capital gains received by individuals. This feature affects the distribution of the tax burden by raising the tax burden on those with substantial income flowing from their financial assets. It also raises the tax on saving and capital investment. In addition, just like the Simplified Income Tax, this provision preserves important components of the income tax system, and thus retains some of its compliance and administrative costs. For example, individuals would be required to keep track of their tax basis in financial and real assets. Many of the complex rules in the current income tax system, such as those that govern wash sales, hedges, and straddles, would be required under the Growth and Investment Tax Plan. It would also require firms to track earnings and profits in a way that makes it possible to distinguish dividend payments from returns of capital.

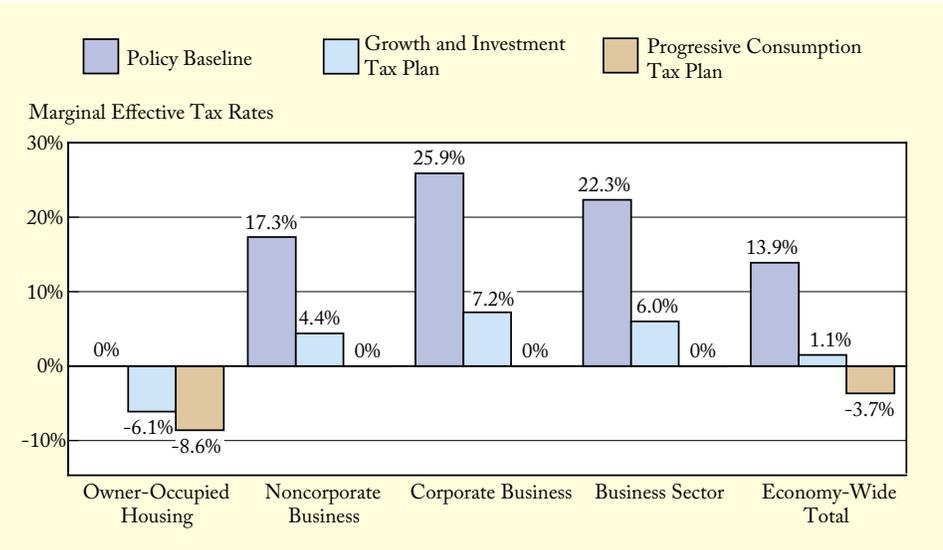
The Panel developed a consensus in support of the Growth and Investment Tax Plan, but many members supported an even more fundamental change in the tax structure, such as adopting the Progressive Consumption Tax Plan. Even some members who did not support the Progressive Consumption Tax Plan agreed that the structure described below is the most attractive way to implement consumption tax in the United States, should the political branches decide to pursue such a shift in the tax base. Such a tax would closely resemble the Growth and Investment Tax Plan, but there would be several important changes. First, there would be no taxation of capital income at the household level. Second, because there would be no taxation of capital, there would be no need for special saving accounts, like the Save for Retirement and Save for Family accounts, that would exempt certain savings from taxation. All saving would be tax-exempt. This would eliminate the complex record-keeping associated with various types of tax-preferred investment accounts. While record-keeping would be much less onerous under the Growth and Investment Tax Plan or the Simplified Income Tax Plan than under the current system, such record-keeping would be eliminated with the Progressive Consumption Tax Plan. Third, in order to achieve revenue neutrality, the deduction and exclusion for employee-provide health insurance coverage would be lowered by approximately 25 percent and both the top individual tax rate and the tax rate on business cash flow would rise to 35 percent. Table 7.6 summarizes the tax rate structure under the Progressive Consumption Tax Plan.

Table 7.6. Tax Rates under the Progressive Consumption Tax Plan (2006)

Tax Rate	Married	Unmarried
15%	Up to \$80,000	Up to \$40,000
25%	\$80,001 - \$115,000	\$40,001 - \$57,500
35%	\$115,001 or more	\$57,501 or more

The principal advantages of the Progressive Consumption Tax Plan relative to the Growth and Investment Tax Plan would be its more favorable treatment of saving and investment, and its greater simplicity and transparency. As summarized in Figure 7.10, the effective tax rate on new investment projects that are expected to just break even, the “marginal project” that economists consider in defining the investment incentives under different tax codes, would be zero under the Progressive Consumption Tax Plan. Moving from the low tax rate on capital under the Growth and Investment Tax Plan to the zero tax rate of the Progressive Consumption Tax Plan would provide additional stimulus to economic growth. The simplicity benefits of the Progressive Consumption Tax Plan would derive from eliminating the need for the record keeping and filing associated with capital income taxation of individuals.

Figure 7.10. Comparison of Marginal Effective Tax Rates on Different Types of Investments



Note: The tax rates for the policy baseline assume, among other things, that the 2001 and 2003 tax cuts would be permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a \$5,000 limit) would be enacted.
 Source: Department of the Treasury, Office of Tax Analysis.

Although the conceptual difference between the Progressive Consumption Tax Plan and the Growth and Investment Tax Plan is substantial, with the latter a hybrid tax system combining income tax and consumption tax elements, it is important to point out that for most households, the effect of the two taxes would be virtually identical. Because the Growth and Investment Tax Plan includes a variety of provisions to provide tax-exempt saving opportunities, most individuals would find that the bulk, if not all, of their returns to capital would not be taxed under either the Progressive Consumption Tax Plan or the Growth and Investment Tax Plan. Save for Family and Save for Retirement accounts, in particular, would mean that most individuals could earn the full before-tax return on their investments. Since business investment would be fully expensed under both plans, the only tax provisions that would discourage investment in new, marginal investment projects would be the 15 percent tax on dividends, interest, and capital gains under the Growth and Investment Tax Plan. The Growth and Investment Tax Plan would move our system a long way toward the Progressive Consumption Tax Plan, and would capture most of the associated efficiency benefits, while still preserving some elements of the progressive taxation of capital income.

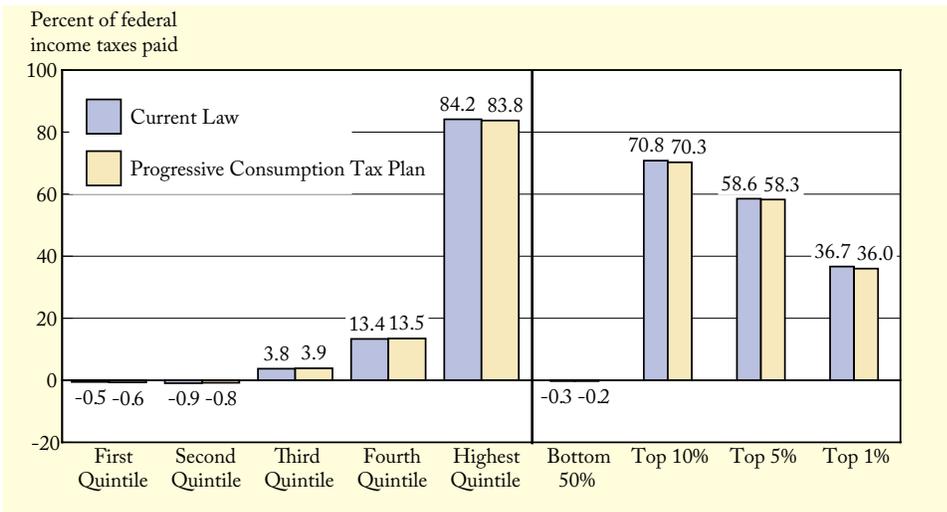
The principal objection to the Progressive Consumption Tax Plan was that it would result in a less progressive distribution of tax burdens. While there would certainly be households that would not need to write any checks for taxes under this tax system, it is important to point out that they would still pay taxes. The Progressive Consumption Tax Plan collects taxes from firms on supernormal returns to businesses investment, rather than from households. Thus, an individual who receives a dividend

payment receives the distribution after the firm has already paid taxes. This tax burden on the business reduces the amount that the firm is able to pay in dividends to shareholders, but the shareholder does not write a check to the government and so does not *appear* to make a tax payment. Distinguishing between the economic burden of taxes and the point of collection of taxes is essential in analyzing the differences between various tax structures.

Distribution of the Progressive Consumption Tax Plan

The Treasury Department computed the distribution of tax burdens under the Progressive Consumption Tax Plan, as under the Growth and Investment Tax Plan, and compared those burdens with the distribution under the current tax system. Figures 7.11 and 7.12 show the estimates for 2006.

Figure 7.11. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentiles (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.

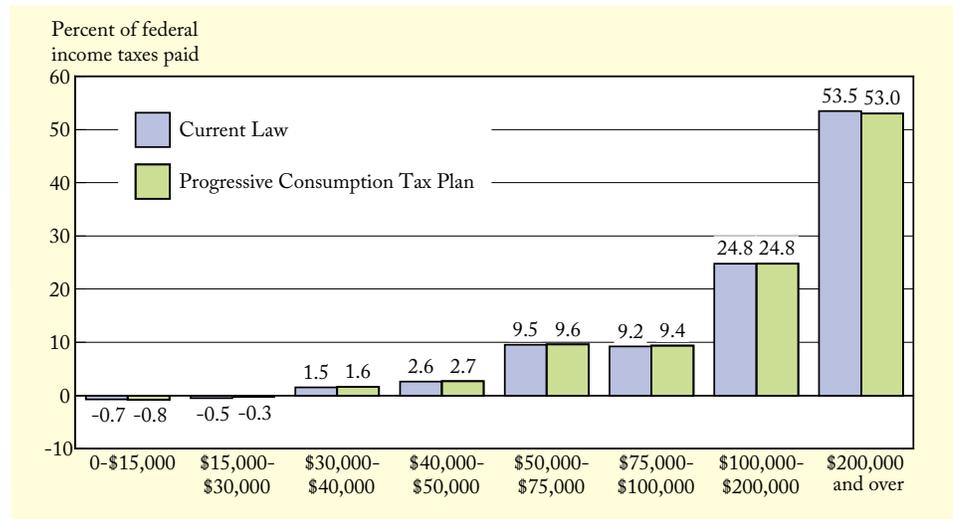
Source: Department of the Treasury, Office of Tax Analysis.

Just like for the Simplified Income Tax Plan and the Growth and Investment Tax Plan, the Treasury Department also produced an analysis of the Progressive Consumption Tax Plan for 2015, using 2006 income levels. Figures 7.13 and 7.14 show those estimates.

As shown in the above figures, a combination of tax credits for low- and middle-income households combined with the broadening of the tax base and the progressive tax rate schedule makes it possible to generate very similar distribution of the tax burden under the Progressive Consumption Tax Plan and the current system. This finding is important: Many previous analysts have dismissed structures like the Progressive Consumption Tax Plan as inevitably shifting the burden of taxes toward

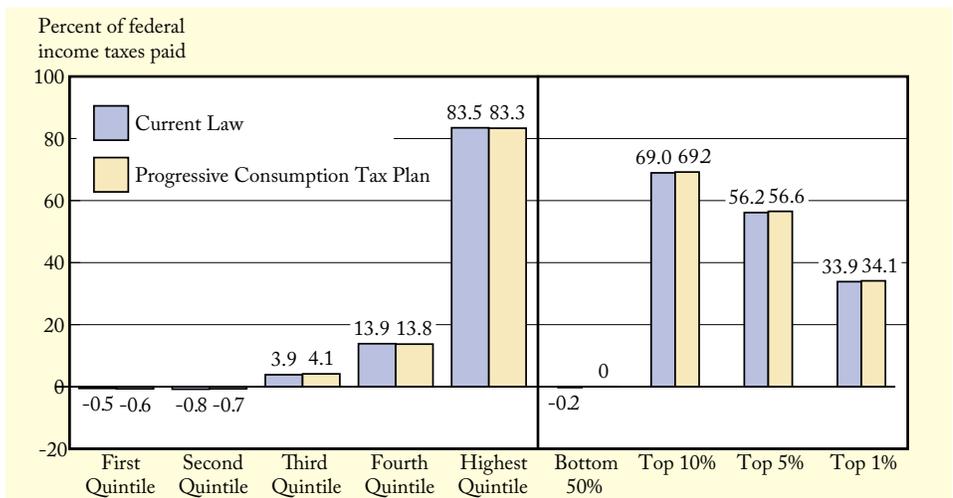
lower-income households, on the grounds that such households spend a greater share of their income than their higher-income counterparts. Figures 7.11 through 7.14 suggest it is possible to implement a consumption tax without this distributional effect.

Figure 7.12. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
 Source: Department of the Treasury, Office of Tax Analysis.

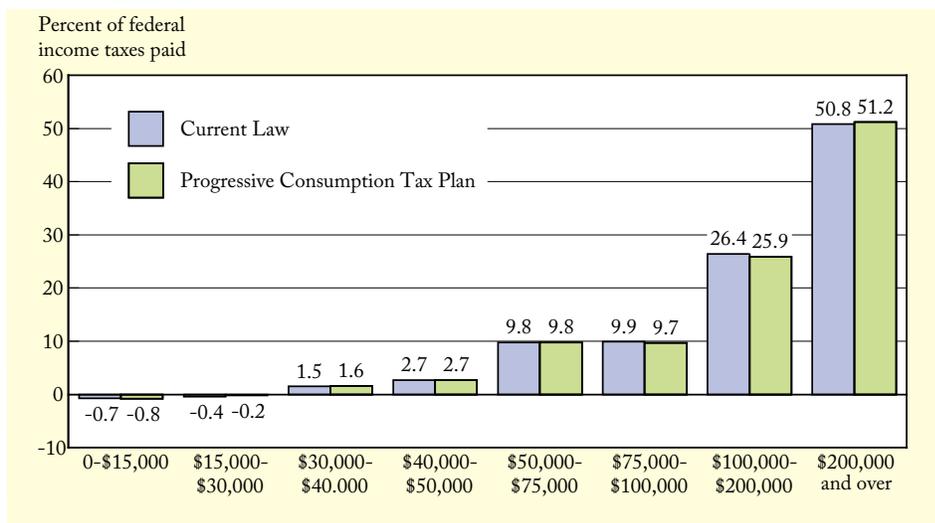
Figure 7.13. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second \$12,910; Third \$27,461; Fourth \$45,345; Highest \$84,124; Top 10% \$123,076; Top 5% \$169,521; Top 1% \$407,907; Bottom 50% below \$36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.14. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Level (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury.

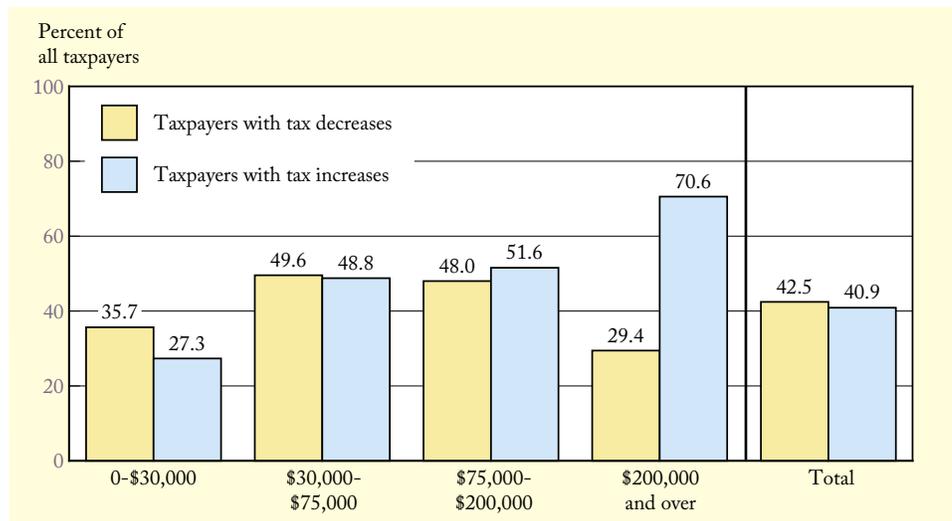
Furthermore, the Treasury Department calculated the number of taxpayers who have tax decreases and tax increases under the Progressive Consumption Tax Plan. Figures 7.15 and 7.16 show those estimates for 2006 and 2015. In both years, there are more taxpayers who have a tax decrease than who have a tax increase. However, there are more taxpayers with incomes of more than \$200,000 who would have a tax increase. It is unclear why this occurs, but it is likely that the benefit of removing the tax on capital income was not enough to offset the effect of higher tax rates, which were increased to make this plan revenue neutral.

Using the same methodology as the other plans, the Treasury Department provided examples of hypothetical taxpayers for 2006. These examples are shown in Table 7.7. Examples of hypothetical taxpayers in high-tax and low-tax states are shown in Table 7.5.

Revenue Neutrality

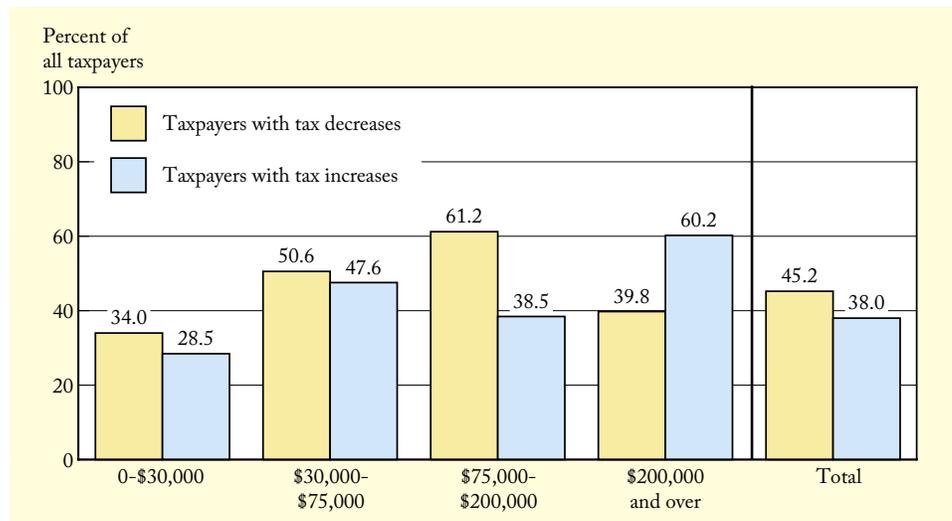
The Treasury Department estimated that both the Growth and Investment Tax Plan and the Progressive Consumption Tax Plan would be revenue neutral. It is worth noting that the plans are balanced without using any revenues from the shift to a destination based tax system through border adjustments. The amount of revenue gained from border adjustments during the budget window would be approximately \$775 billion under the Growth and Investment Tax Plan and approximately \$900

Figure 7.15. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Progressive Consumption Tax Plan (2006 Income Levels)



Note: Estimates of 2006 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
 Source: Department of the Treasury.

Figure 7.16. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Progressive Consumption Tax Plan (2015 Law)



Note: Estimates of 2015 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
 Source: Department of the Treasury.

billion under the Progressive Consumption Tax Plan. If policymakers were to propose either of these plans and decide to use the revenues from border adjustments, the additional revenue could be used to further reduce tax rates or make other adjustments to the plans. Both plans also provide transition relief, which has been

Table 7.7. Examples of Taxpayers Under the Progressive Consumption Tax in 2006 (in dollars)

Model Taxpayer Percentile	Income	Salaries and Wages	Taxable Interest, Dividends, & Capital Gains	Itemized Deductions				Income Tax under 2006 Law at 2006 Levels		
				State and Local Taxes	Mortgage Interest	Charitable Contributions	Misc (before 2% floor)	Current Law	Progressive Consumption Tax	Percentage Change in Tax Liability

Single Taxpayers Younger Than 65

1	Bottom 25th	12,300	12,300				369		385	270	-29.9%
2	50th	24,300	24,300				729		2,003	2,034	1.5%
3	Top 25th	41,000	40,700	300			1,230		4,758	4,590	-3.5%
4	Top 5th	82,800	80,500	2,300	4,000	6,400	2,000	2,200	13,541	16,244	20.0%

Heads of Household Younger Than 65

(bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)

5	Bottom 25th	14,000	14,000				420		-4,941	-5,600	-13.3%
6	50th	23,100	23,100				693		-4,225	-3,433	18.7%
7	Top 25th	37,200	36,700	500			1,116		1,960	1,177	-40.0%
8	Top 5th	71,800	71,300	500	2,900	8,300	2,400	2,500	7,042	9,154	30.0%

Married Filing Jointly Younger Than 65

(all have two child dependents)

9	Bottom 25th	39,300	38,600	700			1,179		-282	-94	66.6%
10	50th	66,200	65,300	900	2,300	8,200	2,400	2,100	3,307	2,727	-17.5%
11	Top 25th	99,600	97,800	1,800	4,100	9,400	2,700	2,200	9,340	9,599	2.8%
12	Top 5th	207,300	196,200	11,100	10,000	14,400	5,400	2,800	40,417	42,868	6.1%

Single Taxpayers (and Surviving Spouses) Age 65 and Over*

13	50th	24,800	0	4,900			555		1,919	1,673	-12.8%
14	Top 25th	42,800	0	7,400			1,130		5,731	5,287	-7.8%

Married Filing Jointly Age 65 and Over**

15	50th	51,000	0	4,800			1,125		2,772	1,853	-33.1%
16	Top 25th	77,500	0	10,000			2,230		9,635	7,973	-17.2%

Note: *The 50th percentile taxpayer has gross Social Security benefits of \$6,300 and taxable pensions, annuities, and IRA distributions equal to \$13,600. The top 25th percentile taxpayer has gross Social Security benefits of \$12,000 and taxable pensions, annuities, and IRA distributions equal to \$23,400.

**The 50th percentile taxpayer has gross Social Security benefits of \$18,400 and taxable pensions, annuities, and IRA distributions equal to \$27,800. The top 25th percentile taxpayer has gross Social Security benefits of \$21,000 and taxable pensions, annuities, and IRA distributions equal to \$46,500. See text for further explanation of sample taxpayers.

Source: Department of the Treasury, Office of Tax Analysis

described earlier in the chapter. The cost of transition relief in both plans is about \$400 billion.

Moreover, as noted in Chapter Six, some members of the Panel believe that it is likely that lawmakers will extend a current-law provision, referred to as the “patch,” to ease the effects of the AMT on millions of unsuspecting taxpayers. If the Panel did not need to account for the cost of the patch, estimated to be about \$866 billion, tax rates could be reduced further in both plans. For example, the tax rates in the Growth and Investment Tax Plan could be reduced across the board by 5.6 percent, so the

top rate could be lowered from 30 percent to 28.3 percent. Similarly, the rates in the Progressive Consumption Tax Plan could be reduced by 5.3 percent, so the top rate could be lowered from 35 percent to 33 percent.

Pro-Growth Tax Plans

The Growth and Investment Tax Plan retains a tax burden on capital income, while the Progressive Consumption Tax Plan eliminates this burden. Both plans would encourage economic growth, but the effects would be larger under the Progressive Consumption Tax Plan. The Treasury Department has evaluated the growth effects of both plans using a range of economic models.

The Treasury Department estimates that the Progressive Consumption Tax Plan could increase national income by up to 2.3 percent over the budget window, by up to 4.5 percent over 20 years, and by up to 6.0 percent over the long run. The Treasury Department models also suggest that the Plan could increase the capital stock (the economy's accumulation of wealth), with estimates ranging from 0.7 percent to 5.1 percent over the budget window, from 2.5 percent to 16.7 percent over 20 years, and from 8.0 percent to 27.9 percent over the long run.

For the Growth and Investment Tax Plan, Treasury estimates that the plan could increase output (national income) by up to 2.4 percent over the budget window, by up to 3.7 percent over 20 years, and by up to 4.8 percent over the long run. The Treasury Department models also suggest that the plan could increase the capital stock, with estimates ranging from 0.5 percent to 3.7 percent over the budget window, from 1.8 percent to 12.1 percent over 20 years, and from 5.6 percent to 20.4 percent over the long run.