TAX FOUNDATION

SPECIAL REPORT

March 1996
Number 57

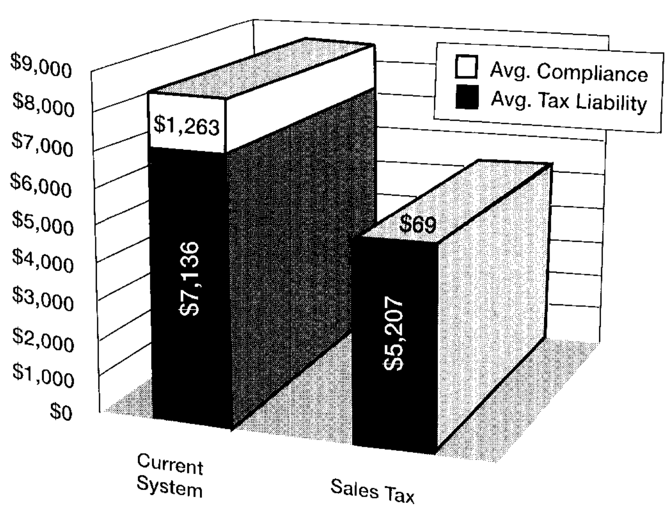
Analysis and Summary of the National Retail Sales Tax Act of 1996

By Arthur P. Hall, Ph.D.
Senior Economist
Tax Foundation

The National Retail Sales Tax Act, introduced by Reps. Dan Schaefer (R-CO) and Billy Tauzin (R-LA), proposes to replace the federal income tax system, the estate and gift tax, and all non-trust fund federal excise taxes with a sales tax on all goods and services. In an effort to offset the tax burden on low-income taxpayers, the Act proposes a refund mechanism (administered through the payroll tax system) based on officially designated poverty levels for families of different sizes. The tax rate is set at 15 percent.

As *Figure 1* shows, if the Schaefer-Tauzin sales tax plan were the law in 1997, it could reduce the tax-related burden for the average taxpayer by an estimated 37 percent (from $8,399 to $5,276). The reduction results from both a lower tax bill and the taxpayer savings that would result from reducing the high paperwork cost associated with the income tax. The lower tax bill results from the fact that government expenditures would be subject to the sales tax under the Schaefer-Tauzin plan.

Figure 1
Total Individual Tax Burden under Current Tax System and Proposed National Sales Tax System



* Includes individual and corporate income taxes, estate and gift tax, and non-trust fund excise taxes.
Source: Tax Foundation.

The Tax Foundation estimates that complying with the federal income tax system will cost individuals and businesses about $157 billion in 1997. This high cost is tantamount to a tax surcharge on all taxpayers. A major element of the tax reform debate in general, and the Schaefer-Tauzin sales tax plan in particular, is the desire for a more simple, less IRS-intrusive tax system, and the reduced compliance costs that would accompany such a system. The Schaefer-Tauzin sales tax plan could reduce the $157 billion income tax surcharge by about 95 percent to $8.5 billion, and, as currently written, would reimburse businesses for about 56 percent of their estimated compliance costs (see *Table 1*).

The Tax Rate and Tax Base

The National Sales Tax Act states: "There is hereby imposed a tax of 15 percent on the gross payments for the use, consumption or enjoyment in the United States of any taxable property or service, whether produced or rendered within or without the United States. . . .[T]he term 'taxable property or service' means — (A) any property (including leaseholds of any term or rents with respect to such property) other than intangible property, and (B) any service (including any financial intermediation services). . . .For purposes of the preceding sentence, services shall not include wages paid by an employer engaged in an active trade or business. . . .Services shall include wages paid by an employer not engaged in an active trade or business" unless those wages are paid by a qualified not-for-profit organization or government entity.

The practical distinction between the two types of employers named in the legislation — those engaged in and those not engaged in an active trade or business — primarily involves whether or not a fee-for-product or fee-for-service relationship with customers exists. Only products and services generated by firms engaged in an active trade or business will create a product or service subject to the sales tax. This implies that the market value of the product (and therefore the return on an employee's labor) will be less by all or some portion of the tax rate. To assure that the sales tax does not favor certain types of employment over others, the legislation places an excise tax equal to the sales tax rate on the wages of employees that do not produce taxable products or services.

Because most government services do not result in taxable transactions, the Schaefer-Tauzin plan places an excise tax of 15 percent on the wage compensation of federal, state and local government employees. For the same economic reason, the excise should also apply to the wage compensation of the employees of nonprofit organizations, but the plan does not provide for such taxation. However, the plan does substantially narrow the current definition of nonprofit organizations.

Table 1 summarizes the derivation of the Schaefer-Tauzin plan's tax base and the revenue produced by different tax rates. Personal consumption expenditures mark the starting point. The expected level of individual income tax liabilities is added to consumption expenditures, because the elimination of the federal income tax would increase the amount of people's disposable income exposed to the sales tax. It seems likely, however, that some portion of the extra disposable income would be saved. To account for this outcome, and to make a conservative estimate of the required sales tax rate, the expected 1997 corporate income tax liability of $181.6 billion is omitted from the estimated sales tax base. Government expenditures would be taxed under the Schaefer-Tauzin plan, so they are also added to personal consumption expenditures.

The only item that is subtracted from personal consumption expenditures is the value of housing services. Housing was omitted for two reasons. First, this item includes the imputed value of owner-occupied homes. This component of the government's personal consumption expenditure figure is not the result of a market transaction. It is a measure that attempts to value what homeowners would pay in rent if they rented their homes instead of owning them. Because of the added complexity, the Schaefer-Tauzin plan would not require homeowners to calculate their implied rent for the purposes of taxation. Second, the Schaefer-Tauzin plan would not define mortgage interest payments as consumption. Therefore, subtracting the value of housing services offers a conservative estimation method for dealing with this reduction in the sales tax base.

As *Table 1* shows, the estimated 1997 sales tax base amounts to $6.4 trillion. With this tax base, assuming no refund mechanism associated with the sales tax system, a 13.82 percent sales tax rate could replace the revenue generated by the individual and corporate income tax, the estate and gift tax, and all non-trust fund excise taxes. However, the Schaefer-Tauzin bill includes a refund mechanism. At the time the legislation was drafted, a rate of approximately 15.7 percent would have provided revenue neutrality. Reps. Schaefer and Tauzin chose to round the rate down to 15 percent. (The legislation was proposed prior to the release of the President's fiscal 1997 budget, which substantially increased the projected levels of income tax revenue. These revised revenue projections have the effect of raising the revenue neutral rate to 16.42 percent.)

Table 1
Estimated 1997 Sales Tax Base and Revenue Neutral Sales Tax Rate ($Billions)

Personal Consumption Expenditures	$5,522.9
Individual Federal Income Tax Liability	+ 642.5
Government Consumption Expenditures	+ 1,086.4
Housing Services	- 832.4
Estimated Sales Tax Base	$6,419.4
1997 Revenue Target*	$ 886.8
Revenue-Neutral Tax Rate with No Refund	13.8%
Revenue-Neutral Tax Rate with Refund	16.4%
Estimated Revenue with 15% Rate and Refund	$ 810.0
0.5% Compliance Cost Reimbursment to Retailers	- 4.8
1% Administrative Cost Reimbursment to States**	- 9.6
Net Revenue to the Federal Government	$ 795.6

* Includes revenue from individual and corporate income taxes, estate and gift tax, and non-trust fund excise taxes. The income tax accounts for 95 percent of the total.
** Assumes each state participates and, as a prerequisit, conforms its sales tax base (if any) to the federal sales tax base.
Source: Tax Foundation estimates using data from Office of Management and Budget and 1996 Economic Report of the President.

Table 2
Comparison of Total and Average Tax Burdens Under Current Tax System versus Schaefer-Tauzin National Retail Sales Tax Plan

	Total Tax Burden		Average Tax Burden		Average Tax Rate	
Adjusted Gross Income	Current System* ($Million)	Sales Tax System** ($Million)	Current System	Sales Tax System	Current System	Sales Tax System
$1 under $25,000	$60,519	$61,422	$939	$953	6.7%	6.7%
$25,000 under $50,000	175,386	141,544	5,616	4,532	13.0	9.6
$50,000 under $75,000	162,092	129,475	10,445	8,343	14.2	10.3
$75,000 under $100,000	106,472	78,305	17,144	12,609	16.5	10.7
$100,000 under $200,000	131,636	94,290	29,513	21,140	18.3	11.4
$200,000 or more	242,046	143,099	174,440	103,130	27.5	12.9
All Taxpayers	$886,847	$647,054	$7,136	$5,207	15.9%	10.4%

* Includes income taxes, estate and gift tax, non-trust fund excise taxes. Capital/labor split distribution of business tax burden.
** Includes tax liability net of Family Consumption Refund. Government consumption expenditures account for $162,958 million in sales tax revenue.

How the "Family Consumption Refund" Works

In 1997, a 15 percent tax rate would generate a total refund for wage earners worth an estimated $153 billion. The rebate is calculated by multiplying the sales tax rate by the official poverty level (calculated by the Department of Health and Human Services) for families of different sizes. For example, the estimated 1997 poverty level for a family of four is $16,070. Such a family would therefore receive a refund equal to $2,410 (15% X $16,070). If a family's wages did not exceed the poverty level figure, the refund would equal the 15-percent sales tax rate multiplied by the family's wages.

The Family Consumption Refund would be administered by the Social Security Administration through the payroll tax system. Each family would have their payroll taxes reduced by the amount of their refund. For example, if the aforementioned family of four received a pay check twice monthly, those paychecks would have their payroll taxes reduced by $100.42 ($2,410 divided by 24 paychecks) each pay period. (Families with more than one wage earner would have the choice of splitting the refund between two paychecks.) Because the 15-percent sales tax rate is less than the total payroll tax rate of 15.3 percent, the refund of a family will never exceed the combined employer/employee payroll tax liability. (The Social Security and Medicare trust funds will be reimbursed from general revenues by the amount of the Family Consumption Refund.) In 1997, the average wage-earning taxpayer would receive an estimated refund of $1,231.

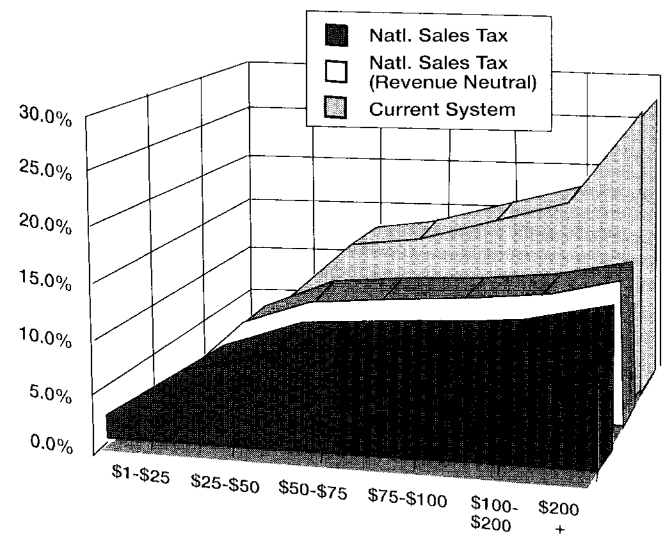
Tax-Related Burdens: The Sales Tax vs. The Current System

The intent of the Family Consumption Refund is to generate a progressive distribution of the sales tax burden. *Figure 2* demonstrates the result. The Schaefer-Tauzin sales tax plan has a progressive tax burden distribution, but it is far more proportional than the distribution of the current system, which primarily represents the income tax system.

The most striking aspect of *Figure 2*, however, is the reduction in the individual tax burden under the sales tax system. The key reason for this reduction is the fact that the tax on government expenditures accounts for almost 20 percent of the revenue generated by the sales tax plan. This result implies that the purchasing power of the government is reduced by 20 percent. If taxpayers became dissatisfied by the resulting reduction in government "services" and desired to hold government purchasing power at current levels, the result would be identical to exempting the government sector from taxation. Such an outcome would mean a 25 percent increase in the sales tax rate to 18.8 percent from the currently legislated 15 percent.

Table 2 provides a more complete picture of the distributional outcome that might result from adopting the National Retail Sales Tax Act. It reports by income group the estimated 1997 total

Figure 2
Average Tax Rate for Current Income Tax System, Sales Tax, and Revenue-Neutral Sales Tax, by Income Group



Source: Tax Foundation.

Table 3
Estimated Saving Rate by Income Group

Adjusted Gross Income	Estimated Saving Rate
$1 under $25,000	-6.40%
$25,000 under $50,000	3.38%
$50,000 under $75,000	5.15%
$75,000 under $100,000	5.91%
$100,000 under $200,000	6.53%
$200,000 or more	7.35%
All Taxpayers	3.66%

Source: Tax Foundation estimates based on: John Sabelhaus, "What is the Distributional Burden of Taxing Consumption?" *National Tax Journal*, vol. XLVI (Sept. 1993), pp. 331-344.

tax liabilities, average tax liabilities, and the average tax rates of the current system and the Schaefer-Tauzin sales tax plan. Total reported income is used to calculate the average tax rate under the current system. Under the sales tax system, the sum of total reported income and expected income tax liabilities is used.

The current system includes the burdens of the individual and corporate income taxes, estates and gift taxes, and non-trust fund excise taxes. The burden of corporate income taxes was assumed to fall equally on wage income and investment income. Consumption patterns reported by the 1994 consumer expenditure survey were used to make estimates of the excise tax burdens.

In order to make distributional comparisons between the income-tax-dominated current system and the sales tax, sales tax burden calculations started with taxpayers' income. Rather than estimating consumption expenditures directly, income that would be used for consumption was estimated. The tacit assumption underlying this estimation approach is that taxpayers will use all of their income for consumption once they have put some of their income into savings and made certain untaxed payments. The primary list of untaxed payments include: federal payroll taxes, state and local income taxes, state and local property taxes, mortgage interest payments, and charitable contributions. (Mortgage interest payments and charitable contributions are explicitly left untaxed by the Schaefer-Tauzin legislation. Home purchases are subject to the sales tax. However, the legislation specifies that the tax on home purchases may be amortized over a 30-year period.)

Saving behavior by income group is a largely unexplored area of economic research. *Table 3* presents the saving rates used in this report. The estimates used for this report derive from research done by John Sabelhaus while he worked for the Congressional Budget Office. (His estimates are used and described in the March 1994 CBO Memorandum titled "Estimates for a Prototype Saving-Exempt Income Tax".) The national average saving rate of 3.66 percent reported in *Table 3* indicates that the estimation procedure produces reasonable results on average. However, the accuracy of the estimates for any particular income group, particularly the top income group, are uncertain. Notice that the lowest income group shows a negative saving rate, indicating that taxpayers in this group are net borrowers (or major transfer payment recipients) and must pay sales tax on the expenditures made with borrowed or transfered funds. (For purposes of calculating income subject to the sales tax, the saving rates reported in *Table 3* were applied to taxpayers' total reported income plus the federal income taxes they would no longer pay under the sales tax regime.)

Data by income group for the untaxed payments is readily available from the Internal Revenue Service and the annual consumer expenditure survey. The data from the IRS has higher credibility, but is limited to taxpayers that itemize their deductions, primarily taxpayers with annual incomes above $50,000. In order to improve on the estimates for income groups below $50,000, consumer expenditure survey data was pooled with IRS data.

SPECIAL REPORT (ISSN 1068-0306) is published at least 10 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

4-12 pp.
Annual subscription: $25.00
Individual issues $5.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

Editor and Communications Director
Stephen Gold

Tax Foundation
1250 H Street, NW
Suite 750
Washington, DC 20005
(202) 783-2760