"WORKING PAPER"

THE USES OF A BUSINESS TRANSFER TAX

December 20, 1985

TAX FOUNDATION, INCORPORATED
ONE THOMAS CIRCLE, N.W., #500
WASHINGTON, DC 20005

THE USES OF A BUSINESS TRANSFER TAX

Sometimes an issue seemingly buried underground by other events will surface suddenly and grab attention. So it is with the business transfer tax (BTT) now making waves in the Senate and elsewhere. Nobody was talking about this a year ago when Treasury I seemed to consign such a tax system at the Federal level to the bottom rung of priorities. Lo and behold, it's alive and kicking again. A business transfer tax could serve several purposes, including a whole new look of tax reform, relief from income taxation, help with the trade deficit, reduction of the budget deficit and as an alternative to the minimum tax--which is exactly why it is getting attention. These purposes, however, may not be all consistent.

Senator William Roth (R-Del.) a senior member of the Senate Finance Committee, has proposed two versions of the business transfer tax. Both would levy a Federal tax on net receipts of domestic business. The cost of raw materials and capital expenditures would be subtracted from gross receipts to obtain this base. Such a tax would be, in fact, a "consumption-based" value-added tax. Because of political misfortune associated with the value-added tax name, it isn't being called that. It's doubtful that many are being fooled, however.

Like all value-added taxes, the BTT would be considered an indirect tax for purposes of international trade. Under the GATT rules, indirect taxes can be imposed on imports and rebated on exports, while direct taxes, such as income taxes, cannot. Hence, the trade angle.

To reduce administrative costs and to distance the proposal further from the value-added tax stigma, the method of collection would be the so-called subtraction method whereby taxpayers self-assess their liability as under the income tax. The invoice/credit method of collection, used for value-added taxes in the EEC, would make the tax rebate process easier for export sales, but probably would require a thicker layer of administration. This invoice method also makes the tax more visible to the consumers--which is a virtue or defect depending on your strategic view. Whatever the method of collection, a Federal-level value-added tax most assuredly would involve some significant cost to both tax collector and taxpayer. It would not be just a simple excise tax as some have suggested.

The first version of BTT (S. 1102) would have allowed a dollar-for-dollar offset of tax liability against the employer's share of payroll taxes. Under this arrangement, it was estimated that about 85 percent of the tax would fall on importers, which would make most domestic producers happy but would not raise much net revenue and would be of doubtful GATT legality. Senator Roth went back to the drawing board and came back with BTT-II which, as of this writing, still has not been formally introduced in legislative form.

BTT-II is bigger and broader. It drops the FICA offset and offers instead only a deduction for BTT liability against Federal income taxes. This and a suggested tax rate of between 7 and 10 percent would spread the impact over both domestic producers of goods and services and imports, and raise an estimated $85 to $105 billion net at 1986 income levels.

Substitute For Ways and Means Style Reform.

Senator Roth did not propose BTT as a deficit reduction measure but as a means to redirect the whole thrust of income tax reform. BTT-II would "finance" substantially greater rate reduction for both individuals and corporations than under either the Administration program or the House tax bill without the very hard hit on capital recovery provisions. Senator Roth also would include in the package a slimmed down version of the Super Savings Act (SUSA) provision in the Roth-Moore bill (S. 243) which would greatly expand IRA treatment without additional tax penalties on early withdrawals. It is claimed that with BTT-II there still would be some revenue leeway to eliminate or soften some other base-broadening provisions in the reform proposals.

The result, of course, would be a very different horse from what the House Ways and Means Committee put on the track. Reportedly, there is considerable sentiment within the Senate Finance Committee itself and also within the Senate as a whole to look seriously at BTT or a "consumption-based" tax. But different people attach different priorities to such a program, and there the plot thickens.

<u>Capital Formation.</u>

Value-Added Taxation as a <u>substitute</u> for income tax long has been considered a potential aid to capital formation. In the present situation it also is being proposed as a means of <u>preserving</u> tax policy features deemed helpful for capital formation, such as accelerated depreciation. It's important to recognize certain assumptions here which can distort the perception of a value-added tax and what it can and can't do.

In the first place, a value-added tax by itself is not helpful to capital formation. It is not even really a tax on consumption. What we call "consumption-based" value-added tax is one which excludes capital expenditures from the tax base as they do in the EEC. That still doesn't make it a tax on consumption although most <u>assume</u> the incidence or ultimate burden of the tax will be borne mainly by consumers.

A value-added tax is precisely a proportional tax on the factors of production--capital and labor. Depending on the market conditions facing the firm or industry, the tax would be passed on in part, and in some cases, in whole, to consumers in the form of higher product or service prices--just as with other forms of tax or costs of production. Even if wholly passed on to consumers, a value-added tax does not automatically encourage capital formation and investment.

The substitution of a value-added tax for current taxes on net income from production, or for measures that would increase the bite of net income taxes, would have direct implications for capital formation. Because of the double taxation of corporate earnings and individual savings under the present income tax system, effectively reducing reliance on such taxes would tend to increase funds available for investment. But it's not guaranteed. A rust bowl company with weak product demand and with little or no income tax liability would not be helped by income tax reductions. And its investment or modernization program could be hurt by increased cost of production under a value-added tax that could not be passed on to consumers.

For a reasonably healthy overall economy, a significant value-added tax substitution for income taxes, such as under BTT-II, probably would have some capital formation benefit. A limited, low-rate value-added tax, such as the 0.8 percent tax proposed to help finance the superfund, wouldn't make much difference for capital formation even if the alternative is increased income taxes to raise the same revenue.

Trade Angle.

It is often claimed that a value-added tax would help improve our dismal trade performance. And it could. But again, depending on what else is done. The fact that a value-added tax can be imposed on imports and rebated on exports by itself lends no advantage to domestic producers. With a credit against FICA taxes as under BTT-I, there is an obvious plus for any labor-intensive U.S. producers--some would say subsidy. Under BTT-II with a more uniform, supposedly GATT-legal value-added tax, U.S. exporters and domestic producers would benefit and be more competitive to the extent that their income tax liabilities were reduced by the BTT package. And again, for this to have any significant effect on our trade balance, a rather hefty replacement of income taxes would be required.

Alternative to the Alternative Minimum Tax.

The House tax reform bill contains a much stiffer alternative minimum tax on both individuals and corporations. This was inserted in response to the "fairness" issue--allegations that many upper-income individuals and corporations with economic income were paying little or no income tax--and also to raise some revenue, approximately $25 billion over five years according to the Joint Committee on Taxation figures. The corporate sector minimum tax proposal is estimated to raise about $6 billion over the same period, but private sector sources suggest that figure is way understated.

There are considerable objections to the minimum tax approach. It is inherently messy both for policy directions and tax administration. It diminishes the value of existing tax provisions, without any policy direction to do so. The House bill would set up a system of alternative income taxation that many taxpayers would have to compute for minimum tax liability whether or not it was actually incurred. Based on past experience, the minimum tax can have unintended economic impacts and involve substantial new complexities in tax planning. All these problems would be made more evident by expanding the minimum tax base--adding new preference items to it--and by narrowing the differential between the minimum tax rate and the regular tax rate, as was done in the House bill. In fact, some individual and corporate taxpayers could end up paying the higher alternative minimum tax even when they would have had significant regular tax liability.

A business transfer tax could replace the policy rationale at least for the corporate sector minimum tax. It would avoid many of the complications of dealing with dual income tax structures. Firms with very low or negative rates of income tax would "pay" a BTT (regardless of the ultimate burden) perhaps defusing the fairness issue.

One problem, however, is that firms would be "paying" the BTT whether or not they had economic income. Those with large net operating losses would be sharing the BTT burden along with profitable firms. And that may be extending the fairness doctrine further than advocated by minimum tax proponents.

Reducing the Deficit.

Finally, of course, the revenue raising potential of even a fairly low rate, broad-based BTT is quite awesome. In today's economy each percentage point of tax could raise approximately $10 billion net after deduction of BTT liability against income taxes. This has not escaped the attention of those who feel that we are going to have to raise taxes to solve the deficit problem. The Gramm-Rudman-Hollings deficit reduction measure probably will sharpen the focus on ways to pluck the goose further. That a BTT would fill this role so efficiently is still a big worry to those still concerned with the size of government.

In Summary

A business transfer tax could serve multiple rules. It would not necessarily serve them all well. For instance, a BTT designed mainly to reduce the deficit and not replace income taxes is not likely to do any good for capital formation if the real alternative to the BTT were reduced government spending. Nor in such circumstances would it be likely to improve the trade balance. For these reasons among others it would be important to spell out precisely what such a tax is expected to do should we cozy up more closely to the concept.

U.S. tax policy has flirted with value-added tax taxation on several occasions in the past and each time broken off before serious involvement. Each time the issue arose it ran into strong political objections as a "regressive" and "inflationary" tax. Neither charge is necessarily true, but the political stigma remains. That may well be its fate in the U.S. Senate. If not, it will make for a very interesting conference with the House of Representatives later this year.

Tax Foundation, Incorporated

December 20, 1985