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BEFORE THE COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

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RE: S. 722, THE USA TAX ACT OF 1995

Introduction to USA Tax

Over the last 25 years I have on many occasions appeared before this Committee but never with as much enthusiasm and conviction as today. The USA Tax proposal by Senators Domenici and Nunn is a landmark achievement in the on-going development of tax policy and design. It shows how you can accomplish revolutionary change in the American tax system. You can allow a full deduction for personal savings. You can allow wage earners a full tax credit for the FICA payroll tax on their wages. You can allow full expensing of business capital investment. You can exclude exports from tax while taxing imports. You can simplify the tax law, thereby making it less wasteful and less intrusive. You can do all this and more within the framework of a tax on income -- in this case, *consumed* income. You can do it without either raising taxes or increasing the deficit and without diminishing progressivity unless you choose to do so.

The USA Tax does not stop at the theoretical stage. S. 722 confronts the hard questions of reality and contains a fully articulated, fully functional new American tax system that would actually work in our complex economy and society. Yet, it is a true and successful exercise in minimalism.

> *The art of using the fewest and simplest elements to achieve the greatest effect.*

Its hallmark is neutrality, not regulation. The USA Tax is expressly designed not to interfere in the economic lives of Americans to any material extent beyond the amount of tax they pay. It concentrates on removing barriers to individual choice and barriers to economic growth. These are the keys to greater personal independence and responsibility. These are the keys to a higher standard of living which is the true measure of fairness.

The USA Tax is a completely new replacement tax. It is built from the ground up around a set of principles derived solely from the way income is actually created, received and used. Every dollar of income is created *at* the business level *by* the people who do the work and the people who provide the capital out of their savings.

When a dollar of income is created through the production of goods and services, the first part of the total USA Tax is collected from the business -- unless that income is reinvested to produce additional goods, services and income for us all. In that case, the business tax is deferred and is collected later when reinvestment ends. At that point, assuming a successful reinvestment, additional dollars of income will have been created and a greater amount of tax will be collected.

When the same dollars of income, net of the tax paid at the business level, flow out to and

are received by individuals as compensation for work or as compensation for the use of capital, the second part of the USA Tax is collected from them -- unless they choose to put the income back into the national savings pool where it will again be reinvested to produce additional goods, services and income for us all. In that case, the individual tax is deferred and is collected later when income is withdrawn from savings and spent. Only at that point have people actually "received" income for their own use and enjoyment and only at that point is the individual part of the USA Tax collected.

Although the USA Tax collects tax at points, it also splits the tax rate into two parts. The total tax is the same as if (i) individuals were allowed a tax credit for the business tax or (ii) there were no business tax and all tax was paid by individuals. This is illustrated below where in all three cases the desire is to collect $28 of tax on $100 of income created.

> USA Tax Split Rate: $100 of income × 11% business tax rate = $11 tax; $89 income received by individual × 19% individual tax rate = $17 tax. Total tax of $28 collected.
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> Credit For Business Tax: $100 income × 11% business tax rate = $11 tax; $100 "grossed up" income received by individual × 28% individual tax rate = $28 gross tax less $11 credit = $17 tax. Total tax of $28 collected.
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> Individual-Only Tax: $100 income received by individual × 28% individual tax rate = $28 total tax collected.

The USA Tax Removes the Tax Bias against Saving and Allows All Americans a Fair Choice. For individuals, the USA Tax is a simple tax on income minus the amount saved -- like a fully deductible IRA but without special governmental restrictions or accounts. For example, the Jones Family earns a combined salary of $48,000 and saves $5,000 which they use to start their own small business. They deduct $5,000 and pay tax only on the amount by which $43,000 exceeds their other deductions and exemptions. Having deferred tax on $5,000 of salary, if the Joneses later withdraw $5,000 from the business (and from the national savings pool), they will pay tax on the $5,000 of deferred salary at that time -- unless they roll it over into a stock, bond, a CD or any one of the many other choices people can make both when they initially save and when they move savings from one investment to another. So long as earnings are deferred and remain in the national savings pool, the tax continues to be deferred. Not only is the USA Tax neutral in an economic sense -- in the choice to save -- it also gives people full control over their savings. The USA Tax also does not tell people how much or how little they can save or for what purpose. Saving is not limited in amount or restricted to retirement uses.

The USA Tax is also even-handed in its definition of income. Interest, dividends and gains are treated the same as wages and salaries. All are included in income -- less the amount saved -- and are taxed under the same rate schedule.

The USA Tax Simplifies the Tax Law, Thereby Reducing the Presently High Cost of Compliance and Administration. The proposed new income tax code in S. 722 is much smaller in size than the present monstrosity and will be much easier to apply. It consists primarily of straightforward, understandable rules of universal application with few exceptions. For a tax statute, and given the complexities of the economy in which it must operate, the USA Tax is written in plain English.

The USA Tax retains deductions for charitable contributions and home mortgage interest, and allows a new deduction for education costs but these are not the source of any significant amount of complexity. For example, the home mortgage interest deduction involves no more than transferring onto a tax return a single number furnished annually to the homeowner by the mortgage lender. The USA Tax uses progressive tax rates in a three-bracket system, but the use of one, two or three rates has no material effect on complexity one way or the other.

Under the USA Tax, people will still have to file tax returns. In that respect, paying taxes will still involve some paperwork and computation, although much less than today. We might all wish to be totally relieved of that burden, just as we all might wish to be excused from paying taxes altogether. On balance, however, the annual process of Americans filing simple tax returns is a net positive. It reinforces in our minds an acute awareness of how much tax we pay for what government spends.

The USA Tax Allows Wage Earners a Full Tax Credit for the Employee-Paid 7.65% FICA Payroll Tax, Thereby Assuring That the Real Marginal Rate on Wage Income Is No Longer Higher Than on Dividends, Interest and Other Financial Income. Because of this credit, the nominal rates under the USA Tax are *inclusive* of the payroll tax and are, therefore, the real marginal rates on both wage income and financial income. In contrast, the rates under present law are in *addition* to the payroll tax. For example, a middle bracket rate of 31% under present law is 31% on dividends, but the real marginal rate in the same bracket is 38.65% on wage income up to the OASDI wage base.

Another Way of Looking at the Payroll Tax Credit Is to Say That the Stated Rates under the USA Tax Are Lower Than They Appear To Be. In the first year, on a joint return, the USA Tax rates in S. 722 are 19%, 27% and 40%, and after a transition period are 8%, 19% and 40%. From the perspective of most wage income, another way of looking at the rates under the USA Tax is to reduce each bracket rate by 7.65 percentage points. Viewed that way, the rates under the USA Tax on wage income up to the OASDI wage base are as follows.

	First Year (Joint Return)	**Fifth Year (Joint Return)**
	11.35%	1%
	19.35%	11.35%
	32.35%	32.35%

The USA Tax Removes the Bias against Business Capital Investment and Levels the International Playing Field. In the business area, the USA Tax also concentrates on eliminating arbitrary distinctions and removing barriers to productivity and growth. All businesses are taxed alike without regard to size, corporate or noncorporate form of organization, or whether financed by debt or equity capital. The business tax rate is a uniform 11%. Because the USA Tax allows all businesses a full credit for the employer-paid 7.65% FICA payroll tax, the uniform 11% rate is *inclusive* of the payroll tax. This 11% inclusive rate compares to a 35% present law corporate tax rate in addition to a 7.65% employer-paid payroll tax rate.

All businesses are allowed to expense the cost of plant and equipment, inventory and supplies. Having recovered these costs out of sales, the remaining "gross profit" is taxed at 11% before paying employees their share and before paying shareholders and debtholders their share. The result is a uniform 11% tax at the business level on returns to labor and returns to capital. Both are treated the same, just as they are under the individual tax.

The USA Tax achieves parity in the international arena, thereby giving American workers and companies a fair chance to compete and win in global markets. The USA Tax excludes export sales from the 11% business gross profit tax. It taxes imports at 11%. Thus, the more a U.S. company increases its exports to foreign markets, the less tax it will pay in proportion to total revenues and total gross profit. Conversely, the more foreign-based companies manufacture abroad and compete in the U.S. market, the more import tax they will pay. All businesses that compete in our markets will pay their proportionate share of the cost of government in this country.

The USA Tax Neither Increases Nor Decreases Total Revenues and Does Not Materially Alter the Distribution of the Total Tax Burden Either Between Businesses and Individuals or Among High, Middle and Low Income Groups. The USA Tax concentrates on restructuring the fundamental components of the tax system. Separating the *way* we tax ourselves from the *amount* we tax ourselves serves several purposes. First, it permits full and objective concentration on arriving at the best fundamental tax structure for the long-term best interests of America, unimpeded by other considerations that will vary over time as revenue needs change and as attitudes about progressive versus proportional taxation change. Second, it serves to demonstrate that such a tax structure can be created and that the fundamental goals of tax restructuring can be achieved even within the constraints of revenue and distributional neutrality. For example, within these constraints, the USA Tax still allows a full deduction for personal savings, expenses business capital investment, excludes exports from tax, and greatly simplifies

the tax law.

If the constraints of revenue and distributional neutrality were to be relaxed, the rates of tax could be lowered and compressed -- even into a single rate, if the Congress desired. Similarly, the Congress could decide not to allow personal deductions for charitable contributions or home mortgage interest. The structure of the USA Tax would, however, remain the same and all the goals related to savings, business investment, exports and simplification would still be achieved. Rates of tax, the total revenues raised, etc. are important policy decisions, but they are extraneous to the highly salutary basic structure of the USA Tax which is designed to produce fundamentally correct and consistent results in all events.

It should be kept in mind that by historical standards, the USA Tax rates are already fairly "flat." There are only three bracket rates, the brackets are not very wide, and the top rate is only twice the bottom rate. The credit for employee-paid FICA tax, allowed by the USA Tax but not allowed by present law, plays a major role in maintaining distributional neutrality relative to present law.

USA Tax for Individuals -- Rates, Exemptions, Deductions and Basic Computations

The USA Tax has three brackets and three rates that increase as income increases. For illustration, the rate schedule for married persons filing jointly is set forth below.

Taxable Income Above	1996	1997	1998	1999	2000
$ 0	19.00%	15.00%	13.00%	10.00%	8.00%
5,400	27.00%	26.00%	25.00%	20.00%	19.00%
24,000	40.00%	40.00%	40.00%	40.00%	40.00%

Taxable Income equals Gross Income minus Exemptions and Deductions.

	Gross Income =	Wages and salaries plus financial income such as interest, dividends and amounts received from the sale of assets.
	Exemptions =	A Family Allowance: ....$4,400 Single .... $7,400 Married/Joint .... $3,700 Married/Separate .... $5,400 Head-of-Household
		Personal and Dependents: $2,550 each for taxpayer, spouse and all dependents.
	Deductions =	The Unlimited Savings Allowance -- Everyone is allowed a full deduction for the amount of income they save. E.g., deposits in a savings account, purchase of a stock or bond, start-up capital contributed to one's own small business.

		Higher Education Deduction -- The USA Tax allows a deduction for tuition paid for higher education. The deduction is limited to $2,000 per person for the taxpayer, a spouse and up to two dependents. The total deduction in a year is limited to $8,000. Higher education generally includes college and similar vocational education. The deduction is also allowed for remedial education of students under 18 years of age.
		Home Mortgage Interest Deduction -- generally same as under present law.
		Charitable Contribution Deduction -- generally same as under present law.
		Alimony Paid Deduction -- same as under present law.

Tax Due equals (Taxable Income × Tax Rate) minus Credits.

	Credits =	A refundable credit for the employee-paid portion of the FICA payroll tax. A refundable credit for the amount of withholding tax paid in advance. A refundable credit for the amount of estimated tax paid in advance. S. 722 also allows a refundable Earned Income Tax Credit, although the status of the EITC in general may be uncertain under House and Senate budget resolutions.

Because the deduction for income that is saved defers tax only for so long as that income is left in the national savings pool, taxable income for a year may include withdrawals from savings of income that had been deducted and deferred in a prior year. Further, in the year that prior-year savings is withdrawn, the same person may also have deposited some current-year income in savings. Thus, depending on whether the amount withdrawn exceeds the amount deposited or vice versa, the person may have "net withdrawal income" or a net savings deduction. For example, in 1996 (prior year), the Smith Family deferred tax on $1,000 of salary income by putting it in Savings Account A. In 1998 (current-year), the Smith Family deposits $500 of 1998 salary in Savings Account B, but withdraws $1,000 from Savings Account A. In 1998, the Smith Family has net withdrawal income of $500 ($1,000 withdrawn from Savings Account A less $500 deposited in Savings Account B). On the other hand, had the Smiths in 1998 deposited $1,000 in Savings Account B and withdrawn only $500 from Savings Account A, they would in 1998 have a net savings deduction of $500 ($1,000 deposited in Savings Account B minus $500 withdrawn from Savings Account A).

Because the USA Tax only taxes income (current-year plus prior-year income on which tax has been deferred), retirees and others will not have additional taxable income when they withdraw "old savings" that has already been taxed under present law. For example, before they retired in 1996 (first year of USA Tax), Mr. and Mrs. Brown had saved $100,000 out of after-tax income. Because they had been allowed no deduction (and had prepaid tax instead of being allowed to defer tax), they can during retirement withdraw the $100,000 without having to again

pay tax on it. The USA Tax only taxes income *once,* not twice.

Also, because the USA Tax taxes income (not expenditures), borrowing does not result in tax even though the amount borrowed is "consumed." For example, James Jones borrows $7,000 to live on while in his last year of college. James will not pay tax because he has no 'income." However, when he graduates, gets a job and earns a salary, he will repay the loan out of income and get no deduction for the repayment. Thus, when James does have income, he will pay tax on the income that he had "consumed in advance" while in school.

It is under the USA Tax conceptually and in every other way correct not to include in income either borrowing or withdrawals of "old saving" that has already been taxed. It is, however, necessary to take these events into account in another way in a some circumstances. For example, in 1998 Mr. Executive earns $200,000, consumes $200,000, borrows $200,000, and buys Stock A for $200,000. The USA Tax would not allow him to claim a $200,000 savings deduction and pay zero tax on his $200,000 of earnings. *Reason*: Net of borrowing, Mr. Executive did not save anything. He did not add to the national savings pool. He only borrowed someone else's existing savings and shifted it into Stock A. Similarly, Mr. Executive could not withdraw $200,000 of his own "old savings" *and* at the same time, claim a deduction for $200,000 Stock A purportedly bought with his $200,000 current-year earnings. Again, he did not add anything to the national savings pool. He only shifted his savings to another investment.

This special netting rule for borrowing and old savings involves some amount of computation and complexity. Borrowing must be accounted for and old saving must be distinguished from new saving that has been deducted. In order to relieve nearly all taxpayers from the special netting rule, the USA Tax contains two simplifying rules. First, all home mortgage debt plus ordinary consumer debt up to $35,000 is excluded. Second, people with less than $50,000 of previously-taxed "old savings" can elect to deduct it over three years. Thus, nearly all taxpayers will be excluded from the special netting rule and will never be involved with it.

The three-year amortization deduction for $50,000 of old savings also provides an additional and substantial monetary benefit to retirees and others. The amortization deduction, in effect, gives back to them the present law tax that they prepaid on savings up to $50,000.

The USA Business Tax -- Rates, Deductions and Basic Calculation

Every business that is producing and selling goods and services, and, therefore, creating income, must file an annual business tax return and pay the 11% tax on its annual "gross profit" which is a defined term under the USA business tax. In calculating its gross profit tax base to which the 11% tax is applied, the business adds the amount it received from sales of goods and services and subtracts the amount it paid to other businesses for the goods and services it had to buy from them (plant, equipment, inventory, supplies, rent, utilities, telephones, fuel, legal and accounting fees, etc.). Excluded from the gross profit calculation are financial receipts and payments. For example, the business neither includes interest and dividends received nor deducts interest and dividends paid. Compensation payments to employees are not deductible. Amounts received from export sales of goods or services to a purchaser outside the United States are excluded from the calculation of gross profit. Correspondingly, an 11% import tax is imposed on the sale of goods and services into the United States from abroad. E.g., a foreign business that manufactures outside the United States but sells its products in the U.S. market will pay the import tax. A tax credit is allowed for the 7.65% employer FICA payroll tax that businesses must pay on wages paid to employees. The USA business tax is territorial. Businesses will not include in gross profit the proceeds from sales made or services provided outside the United States and they will not subtract amounts paid for the purchase of goods or the provision of services outside the United States. Businesses will not be taxed on dividends paid by foreign subsidiaries. Foreign businesses will include in gross profit amounts received for goods sold or services provided in the United States and will subtract amounts paid for goods acquired and services provided in the United States.

Resisting Analogies -- The USA Tax Is *Sui Generis*

The USA Tax combines some elements that may also be found, variously, to some extent, and in different forms, in taxes said to be based on net cash flow, net income, consumed income or true business valued added, but because the USA Tax is a hybrid, none of those analogies is altogether accurate or especially illuminating.

Interesting and fairly accurate analogies could also be made to an amended, much improved and simplified version of present law. For example, the USA Tax on businesses has been analogized to a combination of the existing employer payroll tax and a low-rate version of the existing corporate income tax amended to provide for expensing of capital investment and amended to treat debt and equity the same. The USA Tax on individuals has also been analogized to a simple version of the existing individual income tax amended to allow an unlimited, unrestricted IRA deduction for income that is saved and that is taxed only when withdrawn from the IRA. But, here again, the attempt to translate the USA Tax into something else tends to obscure its own merits.

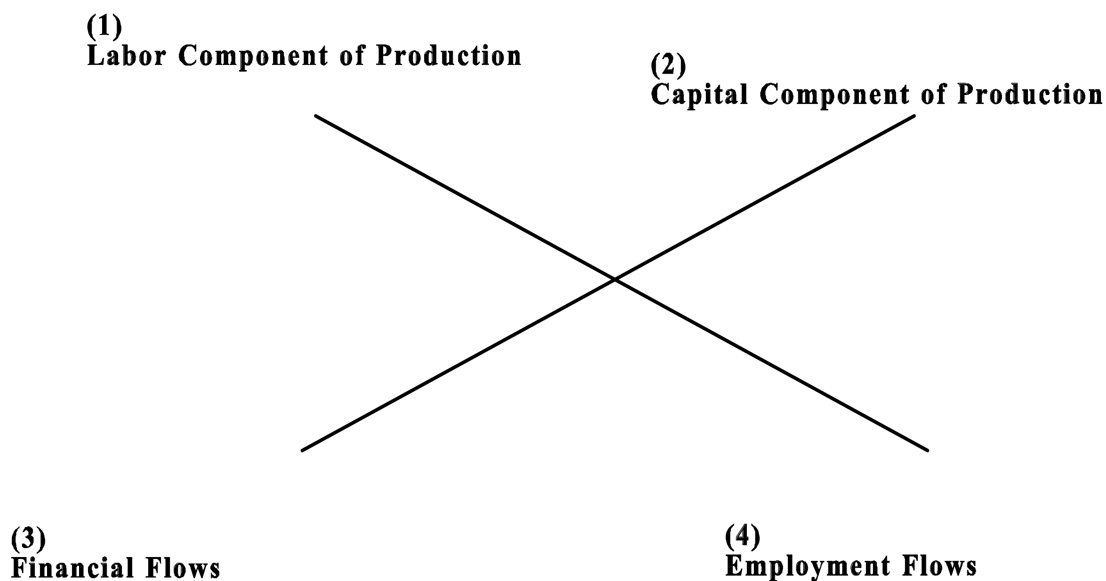
The USA Tax is best understood in terms of its own actual substance and its own consistently applied concepts -- not in terms of the tax system of the past that is being repealed and not in terms of some tax system that exists somewhere else or that is only generally described in academic literature.

Fundamental Concepts -- Understanding the USA Tax as an Integrated Whole

The USA Tax is an integrated, internally consistent whole that collects a single amount of tax in two parts and at two points in the economy. The first part is collected at the business level where income first arises from the production of goods and services and the second part is collected when the income (net of the tax collected at the business level) is received by individuals either as wages and salaries or as interest, dividends, gains, etc.

Because the rate of tax is also split into two parts, with one part applying to income when created and another part applying to income when received, the total amount of tax and the total rate of tax on a dollar of income is the same as if the total amount of tax had been collected solely at the business level or, in the alternative, solely at the individual level.

The USA Tax derives from the way the economy actually works -- from the way real goods and services are actually produced, from the fact that this productive process is the source of all income, and from the way that individuals actually receive that income either as employment flows (wages and salaries as compensation for work) or as financial flows (interest and dividends, etc. as compensation for the use of their capital and, ultimately, a return of that capital). When a tax is injected into the economic process by which income is created, it must be collected either at the point of production (businesses) or the point of receipt (individuals). If the tax is collected at the point of production, it must be based either on the labor component of production or the capital component of production, or both. If the tax is collected at the point of receipt, it must be based either on the employment flows to individuals, or the financial flows to individuals, or both. Therefore, this basic structure and operation of the economy dictates the structure of almost any tax -- whether it is called the USA Tax or, generically, “X.”



A potential component of a tax base appears at each of the four endpoints marking the extremities of the two intersecting lines in the form of an "X," but there is, in a sense, some duplication. The Employments Flows (4) are a reappearance at the individual level of the Labor Component (1) at the business level, and (4) is equal in amount to (1) less any tax already collected out of (1) at the business level. Similarly, the Financial Flows (3) are a reappearance at the individual level of the Capital Component (2) at the business level, and (3) is equal in amount to (2) less any tax already collected out of (2) at the business level.

Within this rigid construct, there is flexibility in the design of a tax in choosing to impose tax at all or only on some of the four possible points, in choosing to impose tax at uniform or varied rates on one, more or all of the potential components of the tax base, and in choosing to specially define one, more or all of the potential components of the tax base. Even these choices are, however, not open-ended. Great care must be exercised in order to avoid inconsistent treatments of "likes" and similar anomalies that cause undesirable economic or political consequences. The administrative consequences of choices and combinations of choices must also be taken into account.

Setting aside matters such as the tax rates, and concentrating on fundamentals, there are four basic constructs that are highly pertinent to the origins and development of both the USA Tax as well as various alternatives.

> Basic Construct X-1. Collect all tax at the business level based on the Labor Component (1) of production and the Capital Component (2) of production.
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> Basic Construct X-2. Collect all tax, in the same total amount, at the individual level based on the Financial Flows (3) and the Employment Flows (4).
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> Basic Construct X-3. Collect the same total amount of tax, but collect it in part at the business level and in part at the individual level as follows. Tax the Capital Component (2) at the business level and tax the Employment Flows (4) at the individual level.
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> Basic Construct X-4. The same as X-3 except that a partial tax at the business level is collected from both the Labor Component (1) and the Capital Component (2), and, at the individual level, the remainder of the tax is collected from both the Employment Flows (4) and the Financial Flows (3).

Basic Construct X-4 represents the USA Tax. The essential ingredients of a modified business cash flow tax or true tax on business value added (as distinguished from the VAT form of retail sales tax) can be found in Basic Construct X-1. Basic Construct X-2 contains the basic building blocks of a household-only cash flow tax. Basic Construct X-3 represents the Flat Tax.

Although less clearly and completely, a sales tax can also to some extent be fitted into and understood within this framework. Like X-2, a sales tax is also a household-only tax. Unlike X-2, however, the sales tax is not based on any direct measurement of total Employment Flows (4) and Financial Flows (3), but is instead based solely on item-by-item purchases. Therefore, it involves no tax return by a household and because it does not, the sales tax cannot vary the rate

of tax by household income and cannot distinguish between purchases made with income, purchases made with previously taxed savings, or purchases made with borrowed funds.

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