



De-radicalizing Tax Reform

Tax Notes

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Summary

Ernest S. Christian explains how two popular tax reform proposals, the USA Tax and the flat tax, could be made to seem much less radical by being expressed in terms of amendments to the current Internal Revenue Code.

The author asserts that the proponents of fundamental tax reform have made it seem far more radical than is actually the case. Tax reform has its origins in first-year expensing, IRAs (Roth and otherwise), the DISC/FISC saga on exports, corporate-shareholder integration, and the kind of rate reduction and base broadening that occurred in 1986. In the on-going evolution of the tax code, argues Christian, the Roth IRA has brought both the USA Tax and flat tax into the mainstream. He explains that it adopted their core principle that income should be taxed only once; a result that can be achieved either by exempting the earnings on after-tax savings or by deferring tax on income until it is consumed.

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I. INTRODUCTION

[[[]]] Restructuring the American tax system is a much-needed fiscal reform that, while by no means easy or free of political tumult, is made to seem even more difficult by the high degree of radical rhetoric and confusing jargon with which it is currently afflicted. The facts are that the economic substance can be accomplished by a handful of familiar amendments to the Internal Revenue Code of 1986; not an especially surprising conclusion, but one that has not been much talked about.

[[[]]] Each of the current-code amendments into which tax reform can be translated has a history of its own, arising out of past "nonradical" attempts to achieve one or more of the same goals as tax reform. A low-rate tax with few or no itemized deductions is reminiscent of the "base broadening" in the Tax Reform Act of 1986. Taxing dividends solely at the business level is analogous to some basic forms of corporate-shareholder integration that have been talked about for years. The export exclusion calls to mind the historic DISC saga in the 1970s. The tax system has been moving toward expensing of business capital equipment since 1962. The onset of 401(k) and SEP plans in combination with IRAs and Roth IRAs has laid the groundwork for a more universal and unrestricted deduction for personal saving or, in the alternative, an exemption for the earnings on after-tax savings.

[[[]]] Restating tax reform in the more familiar terminology of the current code does not change its substance, but it does help many people understand the substance better. All members of Congress and their staffs are far more familiar with the structure and terminology of the current income tax than they are with something they often hear referred to by generic names such as a consumed income tax or a consumption tax (or by brand names such as USA Tax or flat tax). In some cases, terminology may also make the substance more palatable. For example, some members of Congress are ready and anxious to vote for a "consumption tax," but others are not. Instead of voting to tax consumption, they would rather vote to not tax savings (or, at least, not to tax it more than once). Others are even more timid and sensitive to terminological differences. Instead of voting to allow a deduction for saving, they would rather vote to allow a deduction for a contribution to an IRA.

[[[]]] Despite the ease with which the leading replacements for the current code can be expressed in familiar language, fundamental tax reform will not easily escape its radical reputation. Nearly all economists are habituated to using a different and politically awkward vocabulary when they talk about fundamental tax reform. They are not likely to change. Neither are those analysts and commentators who are totally caught up in the "VAT syndrome," unable to see that the existence of a value added base does not a multistage sales tax make. The fact remains, however, that neither the USA Tax nor the flat tax are radical futuristic tax designs. ⁽¹⁾ They are part of a long process of evolutionary change in the tax code that has been going on for many decades. To say so does not diminish them.

II. THE DIRECT ROUTE TO A NEUTRAL TAX SYSTEM

[[[]]] The common goal of all the leading tax reform proposals is to be "neutral." A neutral system taxes labor income and capital income the same. It does not bias the choice between

consumption and saving. It is evenhanded internationally. Once achieved, tax neutrality permits the economy to grow at a more rapid rate. A neutral tax is also simpler.

[][]] While they eventually do get there, some tax reform proposals employ confusing new terminologies and take needlessly unfamiliar, often jarring, routes to tax neutrality; thereby making tax reform seem a much harder task than in reality is the case. The more direct route to tax neutrality is to enact into law a dozen or so basic amendments to the current code, most of which are already well understood and already enjoy substantial support in the Congress and elsewhere.

[][]] The following amendments would accomplish the economic substance of even the most expansive of the reform proposals.

(1) To remove the bias against saving and investment:

(a) Allow all individuals a deduction for the entire amount of income they save for future use or, in the manner of the Roth IRA, allow no deduction but exempt the earnings on after-tax saving. ⁽²⁾

(b) Allow all taxpayers a full capital gains rollover so that they are not taxed when they move their savings from one investment to another.

(c) Allow all businesses full first-year expensing of capital investment so that income from capital, not capital itself, is taxed.

(2) To be neutral as between all forms of income:

(a) Tax all businesses (corporate and noncorporate) the same.

(b) Tax labor income and capital income the same.

(c) On a net basis, impose only one kind of tax on labor by allowing a full income tax credit for both the employee half (7.65 percent) and the employer half (7.65 percent) of the OASDHI payroll tax on wage income.

(3) To be neutral internationally: ⁽³⁾

(a) Enact a simple "territorial rule" that excludes from U.S. tax a U.S. company's foreign-source income when it both produces abroad and sells abroad into a foreign market.

(b) Enact an exclusion of a company's gross export income when, instead of producing abroad, it produces in the United States and sells by exporting into a foreign market or by licensing into a foreign market in exchange for a royalty. ⁽⁴⁾

(c) Enact a simple import tax (with the same tax rate as the U.S. business tax rate) payable when a U.S. company (or a foreign company) produces abroad and sells back into the United States.

[][]] With the broad and neutral tax base brought about by these amendments to the current code, a low corporate tax rate and quite reasonable personal tax rate or rates could raise the same amount of tax revenue as the current personal and corporate income taxes combined.

III. TAX REFORM: A HANDFUL OF CODE AMENDMENTS

[][]] The flat tax ⁽⁵⁾ and the USA Tax ⁽⁶⁾ are variations on the same theme and their similarities are far greater than their differences. Because each has essentially the same tax base (rearranged differently in each case), either one can readily be converted into the other, just as either one (or both) can readily be translated into a handful of amendments to the current code.

A. Translating the Flat Tax

[][]] The flat tax is as depicted in Figure 1 [figure omitted].

[][]] The flat tax is a two-tier bifurcated tax structure that, in the parlance of tax reform, can be described as follows: returns to capital (but not capital itself) are taxed solely at the business level at a single flat rate (usually about 20 percent) and returns to labor are taxed solely at the personal level at the same flat rate. The foregoing is an accurate description of the flat tax that would replace the voluminous 1986 code in all its unsurpassed complexity. This simple statement of a simple tax does not, however, communicate to the reader the critical differences between the proposed new tax code and the current code. Translated, "[taxing] returns to capital (but not capital itself) solely at the business level" means (1) that all proprietorships, partnerships, and other businesses would be taxed as corporations, (2) that all corporations, regardless of size, would be taxed at the same rate on all their income, (3) that interest on business debt would no longer be deductible, and (4) that full first-year expensing would be substituted for depreciation in the case of newly acquired assets.

[][]] When the labor income side of the flat tax is also translated from tax reform parlance to the more familiar terminology of the code, "[taxing] returns to labor solely at the personal level" means that people who earn wages and salaries must file tax returns, but people who derive their income solely from capital do not. Interest, dividends, and capital gains are exempt from tax at the personal level. This exemption is justified because, at the business level, corporations are not allowed to deduct interest and dividends paid and, therefore, have already paid the tax on that income before it is distributed to shareholders and bondholders.

[][]] The basic components of the flat tax in comparison to the current code are summarized in Table 1a (Business Tax Characteristics) and Table 1b (Individual Tax Characteristics).

TABLE 1a BUSINESS TAX CHARACTERISTICS

Item	Business Taxation	Flat Tax	IRC of 1986
1	Corporations Taxed Separately from Individuals	Yes	Yes
2	All Business Entities Taxed as Corporations	Yes	No

3	Deduction for Dividends Paid	No	No
4	Deduction for Interest Paid	No	Yes
5	Deduction for Compensation Paid to Employees	Yes	Yes
6	Credit for Employer-Paid FICA Payroll Tax	No	No
7	Requires Depreciation of Capital Investment	No	Yes
8	Allows Expensing of Capital Investment	Yes	No
9	Deduction for Contributions to Qualified Employee Plans	No	Yes
10	Taxes Foreign-Source Income on a Worldwide Basis	No	Yes
11	Applies Territorial Rule to Exclude Foreign-Source Income Derived From Operations Abroad	Yes	No
12	Taxes Export Sales of American-Made Products and Services	Yes	Yes
13	Taxes Imports of Foreign-Made Products and Services	No	No

TABLE 1b INDIVIDUAL TAX CHARACTERISTICS

Item	Individual Taxation	Flat Tax	IRC of 1986
1	Wages and Salaries Taxed	Yes	Yes
2	Interest & Dividends Taxed	No	Yes
3	Capital Gains Taxed	No	Yes
4	Tax-Free Rollover of Capital Gains	N/A	No
5	Deduction for Saving	No	No (with small exceptions)
6	Itemized Deductions for:		
7	(a) home mortgage interest	No	Yes
8	(b) state taxes	No	Yes
9	(c) charitable contributions	No	Yes
10	Taxes Foreign-Source Income on a Worldwide Basis	No	Yes
11	Credit for Employee-Paid FICA Payroll Tax	No	No
12	Graduated by Means of Personal and Family Exemptions	Yes	Yes
13	Progressive by Means of Multiple Rates	No	Yes
14	Highly Complex With Numerous Special Rules (exceptions, exclusions, credits, etc.)	No	Yes
15	Requires Annual Tax Return	Yes	Yes
16	(a) simple return	Yes	No
17	(b) complex return	No	Yes

]]]] Judged against the political experience of most of us, some elements of the flat tax are downright shocking: e.g., a single flat rate for all wages and salaries; a zero rate for dividends, interest, and capital gains at the personal level. On the other hand, controversial though it may be, it is obvious that the flat tax is nothing more than a few fairly simple and readily understandable amendments to the current code. Economists and other tax policy experts may characterize the flat tax as a "consumption tax," and may point out the similarity to a VAT and a retail sales tax, but almost everyone else thinks of the flat tax as an amended version of the current income tax. Throughout the first session of the 105th Congress, in commenting on the need for a continuing debate about fundamental tax reform, the Speaker of the House of Representatives frequently referred to the choice between Congressman Armey's flat-rate "income tax" on the one hand and Congressman Archer's "consumption tax" on the other.

]]]] Once one assumes, at least for the sake of illustration, a single rate and the total elimination of the array of personal deductions and credits that have been engrafted onto the current code, the Flat Tax is the equivalent of a broad-based, fully "integrated" income tax.⁽⁷⁾ If, instead of taxing dividends solely at the corporate level, the flat tax imposed the same rate of tax on dividends at both the business level and the personal level, and then credited the business tax against the personal tax, aficionados of the current code would more readily see the flat tax as an integrated system rather than as some radical new departure. It would then resemble the familiar shareholder-credit (or credit-imputation) method of integration that has been talked about in tax policy circles for years.

]]]] Both proponents and opponents of the flat tax put great emphasis on the flat rate of tax at the personal level, but what's the big deal? The personal rates under the current code have been flattening out for many years as the top rate has come down from the 90 percent range to the 40 percent range while the bottom rate has remained pretty much in the 10 to 15 percent range. Moreover, the flat tax is not a proportionate tax. Insofar as wage income is concerned, the large personal exemptions allowed by all current versions of the flat tax introduce a degree of graduation that is very significant and likely to become even greater.⁽⁸⁾

B. Translating the USA Tax

]]]] The S. 722 version of the USA Tax is as depicted in Figure 2 [figure omitted].

]]]] The USA acronym stands for "Unlimited Savings Allowance," which is what its authors chose to call the deduction for personal saving that is the most prominent and distinguishing characteristic of this tax reform proposal. Like the flat tax, the USA Tax is a two-tier system that has both a business tax and a personal tax. Unlike the flat tax, however, the USA Tax includes and taxes labor income and capital income at both the business level and the personal level. In this respect, it resembles the split-rate method of corporate-shareholder integration where a partial tax is collected at the business level when income is distributed and the remainder of the tax is collected at the individual level when the income is received.⁽⁹⁾

]]]] The explanation accompanying the most familiar version of the USA Tax, the one in S. 722 with progressive personal tax rates, highlights that USA has included all in one package the entire "wish list" of amendments needed to make the tax system truly neutral without greatly disturbing the powerful "distributional" politics of the current code.⁽¹⁰⁾ (In the aggregate, the distribution of the total tax burden among the established five income classes, lowest to highest, is about the same as under current law and the relative shares of the total tax burden borne by corporations as a group and by individuals as a group are about the same as under current law.) There is, however, also a flat-rate version of the USA Tax that is in most respects the same as in Figure 2 and in S. 722 except that it has only a single rate at the personal level.⁽¹¹⁾ Thus, despite the importance often attached to the "progressive" distributional result achieved in S. 722, multiple tax rates are not the defining characteristic of the basic USA construct.

]]]] The operational components of the USA Tax, in comparison to the current code, are in Table 2a (Business Tax Characteristics) and Table 2b (Individual Tax Characteristics).

]]]] As illustrated, the 1986 code already has 13 out of 30 characteristics that are the same as the USA Tax. Starting from that base, only three core amendments to the 1986 code are necessary to start a domino-like process that would make it almost identical to the USA Tax. In summary form, the three core amendments and the principal ancillary amendments that each core amendment would entail are in Table 3.

]]]] Core amendments are not necessarily of greater significance than ancillary amendments. Rather, the distinction is between cause and effect, with ancillary amendments being the logical (in some cases, inevitable) consequence of a core amendment. This cause-and-effect relationship is obvious and easily illustrated in the case of first-year expensing of business capital equipment. For example, the desire to tax returns to capital (instead of both returns of capital and returns to capital) would be the rationale for allowing first-year expensing of business plant and equipment as in the first core amendment in Table 3. Having decided to tax only returns to capital, logic says that all returns to capital should be taxed and taxed alike. Therefore, ancillary to the core amendment allowing expensing, it is logical to expect an amendment disallowing the current deduction for interest paid. With that ancillary amendment, neither interest nor dividends would be deductible and all returns to capital (both debt and equity) would be taxed at the corporate level. Having done that, the next logical step is an amendment to tax all forms of businesses as corporations. Otherwise, all returns to all forms of capital would not be taxed alike. There is certainly nothing radical about either of these ancillary amendments. The Treasury Department has been talking for years about various ways to eliminate the distinction between corporations and partnerships. Numerous proposals have been made over the years to treat debt and equity the same. Many scholars have waxed eloquent about the economic costs of maintaining the tax bias against equity capital.⁽¹²⁾

]]]] In the category of individual taxation, there is also an easy illustration of how one amendment logically follows another. The second core amendment in Table 3, allowing a deduction for personal saving, inevitably leads to capital gains rollover. The ability to sell stock A for a gain and reinvest the proceeds in stock B without having immediately to pay tax

on the gain is implicit in allowing a deduction for personal saving. For example, if the owner of stock A sold it for a gain of \$5,000 and bought stock B for \$5,000, he would have income and a deduction in the same amount (i.e., \$5,000 of income from stock A offset by a \$5,000 saving deduction for the purchase of stock B). Thus, not only does a deduction for saving allow people to accumulate savings in the first place, it allows them to move it from one savings vehicle to another without tax penalty.

TABLE 2a BUSINESS TAX CHARACTERISTICS

Item	Business Taxation	USA Tax	IRC of 1986
1	Corporations Taxed Separately	Yes	Yes
2	All Business Entities Taxed as Corporations	Yes	No
3	Deduction for Dividends Paid	No	No
4	Deduction for Interest Paid	No	Yes
5	Deduction for Compensation Paid to Employees	No	Yes
6	Credit for Employer-Paid FICA Payroll Tax	Yes	No
7	Requires Depreciation of Capital Investment	No	Yes
8	Allows Expensing of Capital Investment	Yes	No
9	Deduction for Contributions to Qualified Employee Plans	No	Yes
10	Taxes Foreign-Source Income on a Worldwide Basis	No	Yes
11	Applies Territorial Rule to Exclude Foreign-Source Income Derived From Operations Abroad	Yes	No
12	Taxes Export Sales of American-Made Products and Services	No	Yes
13	Taxes Imports of Foreign-Made Products and Services	Yes	No

[[[]]] Allowing a deduction for saving also eliminates two related concepts that dominate the current code: the accretion-to- wealth concept of income and the related idea of "constructive" receipt. Under the current code, income is taxed when it is earned and available to be spent even though it may, in fact, be deferred. For example, except in the case of certain qualified retirement plans, an employee who has earned a salary cannot defer tax on that salary even though it is not paid to him in cash, but is, instead, deposited by the employer in a five-year bank certificate of deposit payable to the employee. Moreover, under the current code, the interest earned on the bank deposit would be taxed to the employee as it accrues inside the bank account even though not withdrawn. In both cases, the employee has experienced an increase in wealth and is treated as having "constructively" received cash or the equivalent, in exactly the same way as if (i) the employee had received a salary check from the employer and then deposited it in the bank and as if (ii) the bank had paid out the accrued interest on the certificate of deposit and the employee had redeposited it in his savings account. So says the current code. But, if personal saving is made deductible, the picture changes dramatically. By applying the same "as if" steps as before, we see that even if the employee is deemed to have constructively received the salary and then deposited it in the bank and even if the employee is deemed to have received the accrued interest and

redeposited it in the bank, it makes no difference so long as the deposit of salary and the redeposit of the interest both give rise to a deduction for saving.

TABLE 2b INDIVIDUAL TAX CHARACTERISTICS

Item	Individual Taxation	USA Tax	IRC of 1986
1	Wages & Salaries Taxed	Yes	Yes
2	Interest & Dividends Taxed	Yes	Yes
3	Capital Gains Taxed	Yes	Yes
4	Tax-Free Rollover of Capital Gains	Yes	No
5	Deduction for Saving (with small exceptions)	Yes	No (with small exceptions)
6	Itemized Deductions for:		
7	(a) home mortgage interest	Yes	Yes
8	(b) state taxes	No	Yes
9	(c) charitable contributions	Yes	Yes
10	Taxes Foreign-Source Income on a Worldwide Basis	Yes	Yes
11	Credit for Employee-Paid FICA Payroll Tax	Yes	No
12	Graduated by Means of Personal and Family Exemptions	Yes	Yes
13	Progressive by Means of Multiple Rates	Yes	Yes
14	Highly Complex With Numerous Special Rules (exceptions, exclusions, credits, etc.)	No	Yes
15	Requires Annual Tax Return	Yes	Yes
16	(a) simple return	Yes	No
17	(b) complex return	No	Yes

[[[]]] The result of allowing a deduction is the same as if (a) the employee were treated as not having received the salary until he cashed in the certificate of deposit and spent the money and as if (b) the employee were allowed the same tax-deferred "inside build-up" of interest on his bank account as if already allowed under the current code in the case of certain insurance contracts, qualified IRAs and various qualified employee (and self-employed) retirement plans. It is also a fundamental principle of the current code that shareholders may experience an increase in wealth "inside" their corporations without realizing personal income. So long as accumulated earnings remain in "corporate solution" shareholders are shielded from personal tax. Only when they realize income by receipt of a distribution out of corporate solution (or by a sale of stock) are they taxed.

[[[]]] Allowing people an unlimited deduction for saving may strike some members of Congress as radical, but allowing people to move their savings from one asset to another is hard to

argue with. So is the proposition that wage earners and other ordinary folk ought to be able to defer tax under the same "realization principle" of the current code that already applies to corporate shareholders.

[][]] Moving on to the third core amendment in Table 3, and keeping in mind that payments of dividends, interest and wages are all proposed to be made nondeductible at the business level, it is easy to see why allowing no deduction for wages inevitably leads to allowing a credit for the existing 7.65 percent OASDHI payroll tax paid by employers. Without that credit, returns to labor (wages) would be taxed more heavily than returns to capital (interest and dividends). For example, if the corporate tax were 10 percent, \$100 used to pay dividends would bear a \$10 tax and \$100 used to pay interest would bear a \$10 tax, but \$100 used to pay wages subject to payroll taxes would bear a tax of \$17.65.

TABLE 3

Core Amendments	Ancillaries
1. Expense Business Capital Investments	
a.....	disallow deduction for interest paid
b.....	tax partnership like corporaiton
2. Deduct Personal Savings	
a.....	capital gains rollover
b.....	deferral of tax on inside build-up
3. Disallow Deduction for Compensation Paid	
a.....	allow credit for existing OASDHI taxes
b.....	exclude exports from tax
c.....	tax imports
d.....	apply corporate tax on territorial basis

[][]] Similarly, under a tax system which taxes wages at the individual level, it is necessary to allow a credit for the employee- paid 7.65 percent OASDHI payroll tax in order not to tax returns to labor at a higher rate than is imposed on returns to capital. For example, if there were no credit for payroll tax, and if the generally applicable income tax rate were 19 percent, \$100 of wages would bear a tax of \$26.65 (19 + 7.65), whereas \$100 of interest or dividends would bear a tax of only \$19.

[][]] Many critics of the search for tax neutrality are anxious to point out that allowing no deduction for wages is a characteristic of a value added base; thereby reinforcing the false idea that allowing no deduction for wages paid is an exotic new departure outside the tradition of tax experience in America. (The base of the USA business tax is equal to value added and, when the business and individual components of the flat tax are taken together, its base is also equal to value added. No question about that.) On the other hand, it is wrong to assume that the basic idea of no deduction for wages is foreign to the 1986 code and its predecessor, the long-standing and historic 1954 code. In fact, this ingredient of a value added base has existed within the overall framework of the code ever since the employer payroll tax was enacted. This can readily be seen in the current code when the corporate income tax and the employer payroll tax are viewed together. The easiest illustration is first to assume that there is a 7.65 percent OASDHI tax on all wages (instead of a 1.45 percent HI tax on all wages and a 6.20 percent OASDI tax on only the first \$68,400 in 1998) and, second, to assume that the corporate tax rate is a flat 7.65 percent (instead of escalating up from 15 to 35 percent). Illustration: When the corporation pays \$100 of wages, the current corporate income tax would allow \$100 of wages to be deducted and, therefore, the assumed 7.65 percent corporate income tax rate would not apply to an amount of income equal to \$100 of wages, but the 7.65 percent payroll tax would apply to the \$100 of wages and the corporation would pay a tax of \$7.65. Hence, even though wages are ostensibly deductible, the business pays a \$7.65 tax, which is exactly the same tax as it would pay if the corporate tax did not allow wages to be deducted and (a) the payroll tax were repealed or (b) an income tax credit were allowed for the amount of the payroll tax. Current law differs from this hypothetical only in a matter of degree. Because the current 35 percent corporate tax rate for large corporations is much greater than the payroll tax rate and because only wages up to \$68,400 are subject to the existing OASDI tax, the existing payroll tax is, in most cases, an effective disallowance of only a fraction of the total deduction for wages.

[][]] In the case of small businesses, however, the payroll tax can be the equivalent of a total disallowance of any deduction for wages paid -- a curious, but nevertheless true, phenomenon under the current code. Take, for example, the case of a corporation that is subject to the current 15 percent "small business" income tax rate and deducts against that 15 percent rate the \$50,000 salary paid to the two owner-employees (a married couple). It must, however, pay a 7.65 percent payroll tax on that salary and the owner-employees must pay a 7.65 percent employee payroll tax on that salary. The total tax is 15.30 percent.

[][]] Leaving aside whether the deduction for wages is, in effect, fully or partially disallowed by the existing payroll tax, and looking at the principle involved, only one other thing keeps us from having all the elements of a value added base under current law: Corporations are allowed to deduct interest, despite urgings from the Treasury Department and others to make interest nondeductible the same as dividends are already nondeductible. One of the Treasury's more recent such proposals included the outline of a reformed and integrated business tax that would have (a) treated all forms of business as corporations, (b) lowered the business tax rate, and (c) made interest payments nondeductible the same as dividends.⁽¹³⁾ Had this comprehensive business income tax proposal been enacted, the combination of it and the existing employer payroll tax would have created a value added

component within the base of the current code. It is very doubtful that the existence of this component within the tax system would have been thought of as some radical new departure from the American tradition of taxing income.

[[[]]] When the value added base arises from having expressly denied deductions for returns to labor (wages) and returns to capital (interest and dividends) as suggested in Table 3, the next logical step is to take advantage of the benefits associated with the existence of a value added base. Specifically, it would appear almost inevitable (as indicated in Table 3) that an import tax would be imposed on goods and services produced abroad by foreign labor and capital; just the same as the reformed income tax would impose a uniform domestic tax on the returns to labor and capital in the United States. It would also seem logical that export sales revenues would be excluded from the reformed income tax, consistent with international practices. International treaties permit the import and export adjustments -- in the manner of a VAT -- even though the Congress did not undertake to enact a VAT, even though the reformed income tax is structured quite differently from a VAT, and even though the existence of a value added base is a byproduct of rearranging the basic components of the current code into a neutral pattern.⁽¹⁴⁾ The point being, of course, that a value added base and the two international attributes typically associated with something called a "VAT" are not such radical leaps from current law after all.⁽¹⁵⁾

[[[]]] If border tax adjustments were adopted as an ancillary amendment, their existence should then lead to another important international amendment: application of the business tax system on a territorial basis instead of on a worldwide basis as under the current code. Under a territorial system, U.S. companies would be permitted to invest and compete directly in foreign markets solely under the tax system of the host country, thereby being on a level tax playing field with the companies of the host country. The principal political barrier to enactment of a territorial rule has always been the "runaway plant" syndrome, i.e., the fear that if a territorial rule were adopted and U.S. companies were not taxed on their operations abroad, U.S. manufacturers would be encouraged to move their plants abroad and sell their products back into the U.S. market. Proponents of territoriality tend to dismiss the idea of "runaways" that serve the U.S. market and focus, instead, on the merits of U.S. companies competing in foreign markets where they sell abroad, not back into the U.S. Border tax adjustments reconcile the two conflicting views of territoriality. Because of the import tax, there is no U.S. tax advantage in a U.S. company locating a plant abroad in order to sell back into the U.S. market. The U.S. tax is the same whether the company produces and sells in the United States or produces abroad and sells in the United States. Because of the export exclusion, there is also no U.S. tax incentive for a company to manufacture abroad for the purpose of selling abroad. The U.S. tax rate on exports is zero and the U.S. tax rate on producing abroad and selling abroad is zero. Insofar as serving foreign markets is concerned -- which is what global competitiveness is actually all about -- U.S. companies would have an even choice: stay here and export or "compete on the ground" in the foreign country, whichever is the more competitive and efficient in the circumstances.

C. Hypothetical Composite

[[[]]] One way to see how closely related radical tax reform is to a reasonably noncontroversial

rearrangement of the basic ingredients of the current code is to imagine a mark-up in the Ways and Means Committee under the following ground rules: Members are to vote for or against each of a series of amendments put forward, one- by-one, by the chairman; and members are to vote for or against each amendment as a matter of principle, with revenue and other considerations put aside. With these ground rules, it is highly improbable that a majority of the committee in the 105th Congress would vote against the principle of allowing people an unlimited IRA- type deduction for savings or against the principle of allowing a business first-year expensing for the amount of its capital investment. Moreover, if the chairman of the committee went through the entire list of amendments in Table 3 to convert the current income tax into the USA Tax, it is not unreasonable to envision an unbroken series of "yes" votes, at which point, the chairman could turn over the last page of the listing and announce to the members of the committee that they had just adopted the substance of one of the "radical" tax reform proposals.

[[[]]] Assuming that the Congress would agree on the full complement of amendments in Table 3 as previously discussed, and the current code were revised accordingly, there would then be almost no difference between it and the USA Tax and not much difference between it and the flat tax. For illustration purposes, Tables 4a and 4b compare the USA Tax and a hypothetical "IRC of 1998," which is the current code altered by all the core and ancillary amendments in Table 3.

IV. EXPANDING THE IRA CONCEPT

[[[]]] The defining characteristic of both the USA Tax and the flat tax is the way they treat saving. Under both systems, income that is saved is taxed once, not twice as under the current code. It is here that we confront the "yield-exemption" of the flat tax, which excludes from further tax all financial returns on after-tax income, and the "deduction" approach of the USA Tax, which taxes income only when withdrawn from savings (or, in the favored parlance of economists, when "consumed"). It is also here that we most clearly and powerfully confront the central theme of fundamental tax reform restated in traditional terminology. At rock bottom, the flat tax is a stripped-down version of the current code with an improved "back- loaded" IRA, and the USA Tax is a stripped-down version of the current code with an improved "front-loaded" IRA.

TABLE 4a BUSINESS TAX CHARACTERISTICS

Item	Business Taxation	USA Tax	IRC of 1998
1	Corporations Taxed Separately	Yes	Yes
2	All Business Entities Taxed as Corporations	Yes	Yes
3	Deduction for Dividends Paid	No	No
4	Deduction for Interest Paid	No	No
5	Deduction for Compensation Paid to Employees	No	No
6	Credit for Employer-Paid FICA Payroll Tax	Yes	Yes
7	Requires Depreciation of Capital Investment	No	No

8	Allows Expensing of Capital Investment	Yes	Yes
9	Deduction for Contributions to Qualified Employee Plans	No	No
10	Taxes Foreign-Source Income on a Worldwide Basis	No	No
11	Applies Territorial Rule to Exclude Foreign-Source Income Derived From Operations Abroad	Yes	Yes
12	Taxes Export Sales of American-Made Products and Services	No	No
13	Taxes Imports of Foreign-Made Products and Services	Yes	Yes

TABLE 4b INDIVIDUAL TAX CHARACTERISTICS

Item	Business Taxation USA	USA Tax	IRC of 1998
1	Wages & Salaries Taxed	Yes	Yes
2	Interest & Dividends Taxed	Yes	Yes
3	Capital Gains Taxed	Yes	Yes
4	Tax-Free Rollover of Capital Gains	Yes	Yes
5	Deduction for Saving (with small exceptions)	Yes	Yes
6	Itemized Deductions for:		
7	(a) home mortgage interest	Yes	Yes
8	(b) state taxes	No	Yes
9	(c) charitable contributions	Yes	Yes
10	Taxes Foreign-Source Income on a Worldwide Basis	Yes	Yes
11	Credit for Employee-Paid FICA Payroll Tax	Yes	Yes
12	Graduated by Means of Personal and Family Exemptions	Yes	Yes
13	Progressive by Means of Multiple Rates	Yes	Yes
14	Highly Complex With Numerous Special Rules (exceptions, exclusions, credits, etc.)	No	No
15	Requires Annual Tax Return	Yes	Yes
16	(a) simple return	Yes	Yes
17	(b) complex return	No	No

[[[]]] If the current code were amended to expand the front- loaded deductible IRA that was broadly available to all savers between 1981 and 1986, the resulting universal and unlimited front- loaded IRA would accomplish the essence of the USA Tax. In both cases, a deduction would be allowed for all income that is saved. In both cases, the principal amount saved and all earnings on principal would be taxed when dissaved -- in the case of the IRA, when withdrawn from the IRA account; in the case of the USA Tax, when withdrawn from savings in general.

[[[]]] The addition of the Roth IRA in the 1997 legislation is a good example of how the

continuing evolution of the current code de-radicalizes tax reform. The Roth IRA affirms in statutory form the principle that underlies all fundamental tax reform proposals: Do not tax both the amount that is saved and the earnings on after-tax savings. Under the Roth IRA, no deduction is allowed, but people over 59 years of age can, as a general rule, withdraw otherwise taxable earnings from the Roth IRA totally tax-free. For example, if a person has put \$100 of principal into the Roth IRA and earned \$50 of interest inside the Roth IRA, he can withdraw the entire \$150 tax-free. If nothing more were done to the current code other than to expand the current Roth IRA by making everyone eligible and by removing the dollar limit on contributions and the restrictions on use, the resulting universal and unlimited Roth IRA would accomplish the economic essence of the flat tax. (In neither case would a deduction be allowed for savings and, therefore, income would be taxed when earned, but in neither case would the earnings on principal be taxed when withdrawn from saving.)

[[[]]] The architects of both the flat tax and the USA Tax ought to pay particular attention. The Roth IRA uses the yield-exemption approach in a way that avoids the false impression, manifest in the flat tax, that only wages are being taxed. The Roth IRA also applies only to future savings, not to existing savings as in the case of the flat tax.

[[[]]] The USA Tax, which already is directed solely toward future saving, would be vastly simplified if its architects replaced the full up-front deduction for saving with an unlimited and universal Roth IRA that is not restricted to retirement savings.

V. CONCLUSION

[[[]]] To the extent that being "radical" implies that something is untested and experimental, the mainstream tax reform proposals of the 1990s do not qualify. The Taxpayer Relief Act of 1997 probably contains more ad hoc unvetted provisions than does either the USA Tax or the flat tax. The massive Tax Reform Act of 1986 made many momentous changes in the tax laws of the United States without nearly the same degree of thoughtful analysis and deliberation that has already gone into the USA Tax and the flat tax.

FOOTNOTES

1. The unique characteristic of the retail sales tax -- total elimination of personal tax returns -- cannot be achieved by familiar amendments to the current code. Therefore, this report concentrates on the flat tax and the USA Tax.
2. There are two ways to remove the bias against saving. One is to allow a deduction for the principal amount saved, which has the effect of deferring tax until income is consumed. The other method allows no deduction, and therefore, no deferral of tax. Instead, it exempts the earnings on after-tax savings.
3. As the term is used in this report, the tax system is "neutral internationally" if it treats all like events alike without regard to form, and if it treats all taxpayers alike, in the same circumstances, without regard to citizenship or organization. For example, in the suggested prototype, all foreign-source income is excluded from U.S. tax without regard to whether the

taxpayer is U.S. or foreign and without regard to whether such foreign-source income is derived directly from operations abroad or indirectly by means of export or licensing from the United States.

4. When royalties arise from the sale of intangible properties under a patent, know-how agreement, or some similar arrangement and when the purchaser is located abroad, it is obvious that royalties should be excluded from gross income in the same way and for the same reasons as other export sales. A "territorial" rule could also exclude foreign-source royalties from gross income. Royalties are usually subject to foreign withholding taxes in much the same way as dividends to which they are often similar in other respects as well.

5. The Freedom and Fairness Restoration Act of 1997, 105th Cong., 1st sess., H.R. 1040, Congressional Record 143, no. 31, daily ed. (12 March 1997): H948. Freedom and Fairness Restoration Act of 1995, 104th Cong., 1st sess., H.R. 2060, Congressional Record 141, no. 67, daily ed. (19 July 1995): H7256. In a legislative context, the flat tax is primarily associated with House Majority Leader Richard K. Armey, R-Texas, and Sen. Richard Shelby, R-Ala., but more broadly, it is identified with two academics, Robert E. Hall and Alvin C. Rabushka, and is often referred to as the Hall-Rabushka flat tax. Robert E. Hall and Alvin C. Rabushka, *The Flat Tax* (Stanford: Hoover Institution Press, 1985), and Robert E. Hall and Alvin C. Rabushka, *The Flat Tax*, 2d ed. (Stanford: Hoover Institution Press, 1995). In both its legislative form and its academic origins, the flat tax is distinguished by its low single rate of tax and the absence of any personal deductions except for large personal exemptions necessary to mitigate the effect of the flat rate.

6. The USA Tax Act of 1995, 104th Cong., 1st sess., S. 722, Congressional Record 141, no. 67, daily ed. (25 April 1995): S5664- 74. The USA Tax is primarily identified with its two leading sponsors, Sen. Pete V. Domenici, R-N.M., and former Sen. Sam Nunn, D- Ga. Often referred to as "Nunn-Domenici," the USA Tax is distinguished both by its bipartisan support and by its attempt to deal with a broad range of issues, including the payroll tax, cross-border adjustments for exports and imports, and a deduction for saving, all within the familiar structure of a progressive-rate income tax.

7. The existence of both a business-level and an individual- level tax is not, in and of itself, the problem at which traditional proposals to integrate the separate corporate and personal taxes under the current code are aimed. Instead, they seek to eliminate the distortions that arise because, under the current code, the business- level tax applies only to some businesses (corporations) but not to others (partnerships) and because the corporate tax applies to returns to equity capital (dividends) but not to returns to debt capital (interest). An excellent discussion of these difficulties and various integration proposals to ameliorate them appears in American Law Institute, Federal Income Tax Project, Reporters Study of Corporate Tax Integration (Philadelphia: The American Law Institute: 1993). Some approaches would (like the flat tax) make interest nondeductible and, therefore, eliminate the bias in favor of debt. Others would (like the flat tax) tax partnerships as corporations. Most typically, however, traditional integration systems have attempted to treat dividends as if they were interest and corporations as if they were partnerships. The most well-known is the traditional shareholder-credit (or credit-imputation) system whereby shareholders who

receive a dividend are allowed a tax credit for their presumed allocable share of the corporate income tax. By collecting all of the tax on returns to capital at the corporate level (instead of partly at the corporate level and partly at the individual level), the flat tax makes the elaborate and often difficult shareholder-credit system unnecessary. In 1990, the present author suggested and broadly outlined an "integrated" system whereby a tax on both returns to labor and returns to capital would be precollected at the business level. That having been done, only shareholders and wage earners in tax brackets higher than the business tax rate would pay personal income tax. See Ernest S. Christian, "The Best of Both: Where the VAT and Corporate Integration Converge," *The Tax Executive* vol. 42, no. 1 (January-February 1990).

8. Ernest S. Christian, "The Tax Restructuring Phenomenon: Analytical Principles and Political Equation," *National Tax Journal*, Vol. XLVIII, no. 3 (September 1995). The table below is an excerpt from this article.

ILLUSTRATIVE EFFECTIVE TAX RATES

Nominal Marginal Rate	Exemption	Wage Income	Effective Rate
20%	\$26,200	\$26,200	0%
20%	\$26,200	\$35,000	5%
20%	\$26,200	\$52,400	10%
20%	\$26,200	\$61,500	11%
20%	\$26,200	\$78,600	13%
20%	\$26,200	\$131,000	16%
20%	\$26,200	\$262,000	18%
20%	\$26,200	\$524,000	19%

9. The split-rate approach is the third of three basic approaches to corporate-shareholder integration. If the total tax is to be 20 percent, the first option is to set the corporate rate at 20 percent and the shareholder rate at zero. The second approach is to tax returns to capital at 20 percent at the corporate level and at 20 percent at the shareholder level, but, then, to allow the shareholder a credit for the corporate tax. The third approach, used by the USA Tax, is to split the 20 percent rate between the corporation and the shareholder with no credit of one against the other. For example, a 10 percent rate for corporations and a 10 percent rate for shareholders.

10. Ernest S. Christian and George J. Schutzer, "USA Tax System -- Description and Explanation of the Unlimited Savings Allowance Income Tax System," *Tax Notes Special Supplement*, Vol. 66, no. 11, March 10, 1995.

11. No flat-rate version has been introduced in Congress as of early 1998, but it has been widely talked about and is an obvious approach as an alternative to the steeply progressive

rates of 19, 27, and 40 percent in S. 722. One analysis suggests that a flat rate of about 30 percent would produce a short-run revenue-neutral result. Once various transitions are completed the rate can drop. *Growth and Fairness: An Overview of the Unlimited Savings Allowance With Distribution Tables* (Washington, DC: The American Business Conference, 1997).

12. Attempts to treat equity and debt the same and efforts to eliminate distinctions based on form of organization have ebbed and flowed over the years as various generations of Treasury tax officials, under several presidents, have pushed forth their ideas about how to integrate the corporate tax. There was, for example, considerable interest in integration in the mid-to-late 1970s and in the early 1990s. An excellent discussion of the current code's bias against equity and the serious economic costs arising therefrom appears in Department of the Treasury, *Integration of the Individual and Corporate Tax Systems -- Tax Business Income Once* (Washington, DC: GPO, 1992). This 1992 Treasury report also contains an excellent bibliography of the many publications on the subject.

13. *Id.*

14. A business-level tax that includes both the labor factor and the capital factor would, in general, qualify under international agreements. See Gary C. Hufbauer and Carol Gabyzon, *Fundamental Tax Reform and Border Tax Adjustments* (Washington, DC: Institute for International Economics, 1996). The authors of this analysis specifically examined the question whether differences in terminology, statements and characterization in political debates, and other reflections of a particular country's traditions and culture would significantly alter the "GATT-ability" of a tax. They concluded not.

15. The flat tax actually has a base equal to value added when the capital-only base of the business tax is combined with the labor- only base of the individual tax, but because the base is split between two different types of taxpayers, most analysts greatly doubt that the flat tax could be border-adjusted under applicable international treaties. Thus, the flat tax presents the curious situation of a value added base without the benefits normally associated therewith.