Pondering Federal Tax Reform — An Interview With Robert P. Strauss

by Frank Shafroth

The President's Advisory Panel on Federal Tax Reform held a hearing April 18 to discuss the interaction of federal, state, and local taxes. It wasn't a session that appears likely to shape the tax world, much less to fully understand the implications of a federal flat tax on states and local governments in a global economy. This was the seventh meeting of the panel; it was the only hearing to specifically address the relationship of the federal tax code with state and local tax policies. The panel's final report to the Treasury secretary is due July 31.

The panel was appointed in January and has been asked to submit a report presenting revenue-neutral options for reforming the U.S. Internal Revenue Code to reduce the costs and administrative burdens of compliance; maintain a progressive tax structure while recognizing the importance of home ownership and charity in American society; promote long-run economic growth and job creation; and encourage work effort, saving, and investment. There was no request to adhere to the president's draft principles on federalism, much less to address the potential effects on state and local taxpayers of any recommendations made by the commission.

I hold in my hand 1,379 pages of tax simplification.[1]

The president's advisory panel is chaired by two former members of the U.S. Senate, Connie Mack and John Breaux. It includes no representative from a state or local government. The federal world seems exceptionally flat.

The president's tax reform panel includes no representative from a state or local government. The federal world seems flat indeed.

In the wake of Congress's and the administration's abrupt intervention to seek to overturn state judicial authority in the Terry Schiavo case last month, a colleague from *Business Week*, stunned by the absolute disregard of the federalism principles on which the U.S. Constitution was established, called to ask if there was any other federal action with comparable disregard for the principles of federalism. I responded by asking him to name a single representative of the state and local sector appointed to the tax reform panel. The response was silence.

So, when the Tax Doctor detected no sound, he decided to consult a veteran in tax reformacology, Robert P. Strauss, a professor of economics and public policy at the H. John Heinz School of Public Policy and Management at the Carnegie-Mellon University in Pittsburgh. Strauss is a veteran of the U.S. Treasury and the Joint Committee on Taxation's staff; he also was responsible for ending West Virginia's onerous business and occupation tax 20 years ago and prepared contingency plans for the state of Washington should the fiscal death star of *Tyler Pipe*[2] descend on Olympia. A longtime proponent of giving states the option of letting the federal government collect their individual income taxes, Strauss is one of the few specialists who has considered the state and local administrative and revenue implications of federal consumption tax alternatives.[3]

Tax Doctor: Professor, rumor has it that you briefed the professional staff of the president's bipartisan tax reform panel on April 14.

Strauss: Briefed is probably a misnomer. Evidently sometime in the first week of April, I was suggested as a possible witness for the panel's April 18 hearing, but time and other limitations, which I never was quite able to figure out, precluded that from happening.

As you know, Congress affords any citizen this opportunity to express his or her written views in conjunction with the congressional hearing process. I was told that the commission was not doing this, but the staff would be interested in reading anything I might have written that pertained to the mission of the commission. So I promised and then e-mailed

[1] U.S. Rep. Delbert L. Latta, on tax reform, quoted in *U.S. News & World Report*, Dec. 23, 1985.

[2] For the uninitiated, *Tyler Pipe* threatened a mere 60 percent of Washington's budget and caused even opponents of income taxation to contemplate the unthinkable (adopting a state income tax) if Washington's cascading gross receipts system was struck down by the U.S. Supreme Court.

[3] Note, viz., "Administrative and Revenue Implications of Alternative Federal Consumption Taxes for the State and Local Sector," a study for the American Tax Policy Institute, *The American Journal of Tax Policy*, Vol. 14, No. 2 (Fall, 1997), pp. 361-452.

Robert P. Strauss

them an article on the topic that I did for the American Tax Policy Institute (ATPI) conference in January 1997.[4]

I had a far-reaching one-and-a-half-hour breakfast conversation on April 14 with two members of the reform commission staff. As it was approaching final exam time, I promised I would send them a 10-question exam that one might think of as "Ten Things Anyone Interested in Fundamental Federal Tax Reform Should Know About Its Effects on the State and Local Sector." I've included the exam as an appendix to this interview. In the meantime, perhaps Tax Analysts reporters can ask commission members to take the exam now to see how their learning process is going. It's an open-book exam, and collaboration is encouraged. Grades should be high, and I hope the exam will raise the level of discourse on the tax reform panel.

Tax Doctor: Professor, once again the ship of state appears set to embark on the storm-tossed seas of fundamental tax reform — once again without meaningful consideration of its implications for the state and local sectors. How realistic do you think a national sales tax or value added tax system is?

Trying to get the states to move toward more taxation of consumption rather than income would be akin to trying to herd cats.

Strauss: I, like most academic economists, am concerned about the low level of the savings rate in the U.S. economy and support the general proposition that improving our aggregate savings rate is a national priority. Unfortunately, the framers of the U.S. Constitution could not agree on a centralized or unitary form of government, and instead agreed in Philadelphia a long time ago that fiscal concurrency was the only solution to the problems facing us in the late 18th century. This constitutional situation makes using federal tax policy for macroeconomic objectives a somewhat blunt policy instrument since revising the federal tax system to achieve this savings rate objective is not only technically difficult in terms of devising transition rules for a huge list of things, it does not guarantee that the states will move to reinforce this policy direction.

Trying to get the states to move toward more taxation of consumption rather than income would, I'm afraid, be akin to trying to herd cats. If the tax committees of Congress were to eliminate the Internal Revenue Code by Labor Day 2005, I think the governors and state legislators would gaze in silence for a couple of years to see if whatever got enacted to replace the old system worked much at all. My best guess is that, unable to go to the bond market to finance very large financial miscalculations to balance their budgets, the governors and state legislatures would take the cautious course and simply do what they have been doing in terms of tax policy.

Elimination of federal income taxes, both personal and corporate, would wreak havoc with what we know about the aggregate economy.

As the readers of *State Tax Notes* are quite aware, sales, excise, and gross receipts taxes are very important state and local revenue sources, on the order of one-fourth to one-third [of state revenue], but have been since the early 20th century rather unimportant federal revenue sources. In 2002 federal excise taxes totaled about $67 billion, while in 2001 state and local sales taxes were about $336 billion.[5]

We can also learn from federal tax history about whether or not we can move federal tax policy toward consumption taxation. When the president and Congress have contemplated imposing a significant excise tax, as they did in 1931-32 when the budget shortfall was about 55 percent, they found that fashioning a substantial excise tax was controversial and ultimately could not be passed by the full House.[6] Not only were the state and local sectors concerned about federal intrusion into what had typically been viewed as their tax domain — consumption taxation — but the Ways and Means Committee floundered in defining what should and should not be taxable. To any state legislator who deals with sales and use taxation, the debate was quite ordinary, but it was sufficiently frustrating for the committee members that they wrote in the committee report that accompanied the bill:

> A general sales tax may, unless every precaution is taken, involve so many administrative problems impossible of solution that it will fall of its own weight.

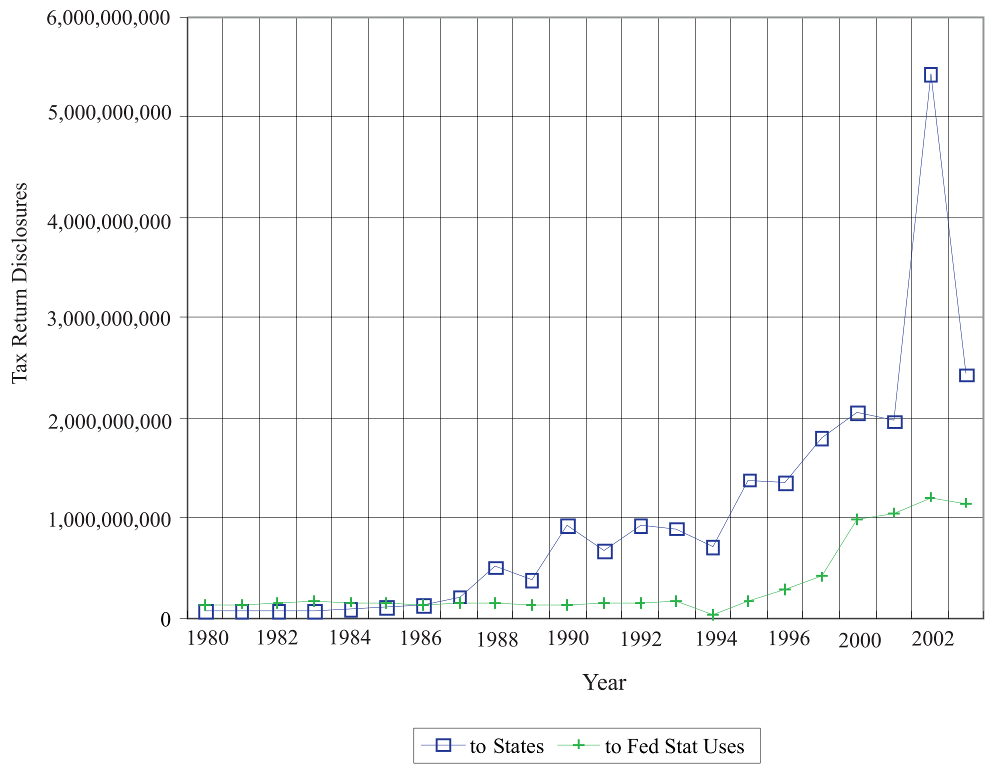
They sent to the floor, not a national sales tax, but rather a broad-based manufacturer's tax at a rate of 2.25 percent. It floundered on the floor of the House and never made it to the Senate. Congress noted that depreciation deductions exceeded net corporate income in the aggregate and set about to remedy that by defining depreciation in a more meaningful way, and also integrated the corporate and individual income taxes for a period of time.

[4] In 1996 ATPI asked me to prepare and deliver a conference paper on the likely administrative and revenue implications of fundamental tax reform for state and local tax systems. They had earlier commissioned and received another academic's effort, but evidently were dissatisfied with the result. After I presented my paper at the conference, it was published in ATPI's tax law journal, *The American Journal of Tax Policy*. I have also written about the subject in "The Effects of a Flat Federal Consumption Tax on the States," *State Tax Notes*, Feb. 26, 1996, p. 649, *96 STN 39-51*, or *Doc 96-5457* and "Further Implications of a Federal Consumption Tax for State and Local Tax Administration," *State Tax Notes*, Oct. 14, 1996, p. 1085, *96 STN 201-46*, or *Doc 96-17655*.

[5] *See* Statistical Abstract of the United States: 2002, Table 408 and Table 414.

[6] *See* Strauss, op. cit, section 5.1.

Figure 1
Federal Tax Return Disclosures: 1980-2003
States and Federal Statistical Uses



A little over 10 years ago, I worked through the administrative and revenue problems that a national sales tax to replace all federal income and payroll taxes could create for the state and local sector and concluded that, for a host of reasons, it would not be a sensible thing to try to do. Besides the obvious issues of state sovereignty and the evolving benefits of state-federal cooperation in the administration of income taxes that would be sacrificed, elimination of federal income taxes, both personal and corporate, would wreak havoc with what we know about the aggregate economy.

Figure 1, compiled from the annual reports of the IRS to the Joint Tax Committee, shows just how widespread federal-to-state sharing of federal income tax return information has become and how important income tax return information is to the federal statistical agencies:

The states receive on the order of 2 billion disclosures per year, while federal statistical agencies, primarily the Census Bureau and the Bureau of Economic Analysis (BEA) of the Commerce Department, receive on the order of 1 billion disclosures per year. In the former case, these involve individual and corporate tax returns, underlying 1099s and W-2s, and so forth, that are then matched by the states for tax administration purposes. Census uses individual income tax return information for its estimates of population and income between decennial censuses, and the BEA uses tax return information in the construction of the GNP accounts.

If one thinks about a national sales tax as an adjunct or addition to our income tax system, and one that might be enacted to coordinate the various state sales taxes in an Internet world, then I think the national sales tax might make greater sense. With proper funding and focus for the IRS, Congress could devise a workable national sales tax at a modest rate whose revenues would seem to be welcome and its economic effect desirable. In this setting, IRS administration could materially help the states that are moving toward a streamlined system of sales and use taxes.[7] Obviously, the definition of the federal sales tax base would have to be carefully negotiated and cleared with the states, but in the context of a new, federal consumption tax I think it could be worked out politically. Whether or not the non-sales-tax states would then adopt the federal consumption tax base is hard to predict. However, with a cleanly developed retail sales tax base in the Internal Revenue Code, the states would generally be pressured over time to harmonize.

Periodically there has been a lot of enthusiasm for imposing a federal VAT, either as a replacement tax or a new tax. But again, getting one to work is not as simple as what I put up on the blackboard each fall in my classes on taxation or what one

[7] Several years ago, I worked through ways the Internal Revenue Code might be amended to allow the IRS to help the states enforce a remote duty to collect that would not require overturning either *National Bella Hess* or *Quill* and would cause no constitutional difficulties. *See*: "Federal Tax Mechanisms to Enable State Taxation of Final Consumption," testimony before the Subcommittee on Oversight House Committee on Ways and Means, U.S. Congress, May 16, 2000, Room 1100 Longworth House Office Building (reprinted in *State Tax Notes*, June 5, 2000, p. 1977, at *2000 STT 97-66*, and at *Doc 2000-13934*). Online at: http://www.andrew.cmu.edu/user/rs9f/wm00b.pdf.

sees on Robert Hall and Alvin Rabushka's postcard tax return. To begin with, financial accounting records do not distinguish between internal and external costs, which are at the heart of any operational definition of value added. Net income is the difference between receipts and all costs. Implementation of a VAT would entail careful statutory definition and new accounting software. This would hardly be simplification in the short run, and if we look carefully at the travails of efforts to harmonize the VAT in the European Union, we will see ongoing administrative problems and a lot of complexity. At the state level, geographic attribution conflicts, which are at the heart of both entity and apportionment issues, would remain under a VAT.

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Some embrace the notion of going to a subtraction method VAT; however, that would be the worst of all possible worlds in my view. At least the credit-invoice method of administration has a self-enforcing mechanism. The subtraction value added method really offers few opportunities for tax collector oversight and checking and creates opportunities for very aggressive tax avoidance.

Tax Doctor: There has been considerable discussion and enthusiasm in some quarters for simply eliminating the federal income tax. What happens to state income taxes if no there is no federal income tax? What would happen to states that are heavily dependent on sales taxes? What options or courses would be available to states?

Strauss: If the federal government eliminated its individual and corporate income taxes, then the states would over time find taxation of income, especially income from capital — dividends, interest, rents, royalties, and capital gains — difficult to accomplish. Even state wage withholding systems could be put in jeopardy if federal wage withholding were eliminated. Much would depend on what the federal replacement system would be. If a federal VAT were imposed with no household component, there would continue to be information about gross receipts collected by various forms of business. Business revenues are compared by states when administering their sales and gross receipts taxes as a kind of economic reality check, and that could continue.

Under the existing federal-state exchange agreement, the states match all sorts of information by Employer Information Number, or EIN. Hopefully, a new system of federal taxation would continue to require such information and numeric identification so that states could continue to match documents. But in tax reform's most extreme form — elimination of the Internal Revenue Code and the IRS — one can imagine the development of a real vacuum that over time would lead to lower compliance levels in each of the states. Without a federal income tax code that serves as an anchor or reference point for the states, they would begin to drift away from uniformity. Overall, the federal-state tax system would become more heterogeneous and opaque and thereby more complex as well.

For those who view a federal consumption tax to be a simplification of our tax system, I think it's equally likely that over time there would be substantial centripetal forces that would make the combined federal-state tax system more complex than it currently is.

[With a federal consumption tax] it's equally likely that [instead of simplification] over time there would be substantial centripetal forces that would make the combined federal-state tax system more complex.

Tax Doctor: What do you think of this reform effort?

Strauss: The reform effort is ambitious in terms of scope and equally ambitious in terms of timetable. They have about six months to come up with their recommendations, and I'm not sure they have yet defined the origins of complexity in the Internal Revenue Code that they are expected to address and solve. When something like 89 percent of individual income taxpayers now use tax return preparation software and about half are filing electronically, the calls for getting rid of the income tax because it is too complicated seem somewhat antiquated. Where there is disagreement or conflict between the taxpayer and the taxing authority, as evidenced by litigation, and problems of compliance, as evidenced by repetition of audit problems, then there are grounds for review and reform. But I have not heard or read such claims about where the complexity in our federal tax system really lies.

One commission news release I saw a few weeks ago claimed that the compliance cost of our federal tax system was on the order of $150 billion, or more than the federal corporate income tax brings in after the foreign tax credit. Clearly, corporations maintain financial accounting and reporting systems for their internal management purposes as well as to comply with federal securities law. Attributing these administrative costs to be the costs of federal corporate income tax compliance is really improper. With electronic financial records, businesses can readily compute federal taxable income. I really don't think that it costs $150 billion to do so.

Tax Doctor: In recent years there has been a considerable decline in the availability of federal tax statistics. This would be far more pronounced if the federal income tax were dropped. What would the implications be for state and local governments and their revenue systems?

Strauss: I'm not sure I agree with you that there has been a decline in the availability of federal tax statistics. The IRS Statistics of Income Division is putting more and more tables and analysis of federal tax return information on the Web. Obviously, without a federal income tax, there would no longer be administrative household and business income records to tabulate, and that would create serious information shortfalls for the state and local governments and federal statistical agencies as well. It would be increasingly difficult to devise federal grant-in-aid formulas and give out federal aid if there were no income data for the Census Bureau and the BEA to analyze.

Tax Doctor: To what extent, in our global economy, have you seen evidence of change in coordination of tax administration and how important might that be in a credible tax reform bill?

Strauss: Our bilateral federal tax treaties have increasingly focused on information sharing and the enabling of remote audit authority in the business tax area, especially in the area of tax shelters. If we ceased taxing corporation income at the federal level, there would be no information to share or audit.

I might also add that one needs to think very carefully about the incidence of a federal consumption versus our current federal income taxes. Presumably our geographic reach with respect to a federal consumption tax involves consumption within the United States (and its territories); however, our income tax reaches beyond the water's edge when domestic corporations elect to repatriate subsidiary earnings, and immediately in the case of divisions' earnings. Similarly, we are able to tax foreign corporations here in the United States. As such, we extend our reach overseas with an income tax. Just what the comparative incidence arithmetic would be is an interesting question that few are asking. Through the centuries, countries have always sought to finance the costs of domestic government on others. My sense is that a consumption tax would have a shorter reach than our current income tax.

When about half [of returns are filed] electronically, the calls for getting rid of the income tax because it is too complicated seem antiquated.

Tax Doctor: In March, George Will wrote, "The power to tax involves, as Chief Justice John Marshall said, the power to destroy. So does the power of tax reform, which is one reason why Rep. John Linder, a Georgia Republican, has a 133-page bill to replace 55,000 pages of tax rules. His bill would abolish the Internal Revenue Service and the many billions of tax forms it sends out and receives. He would erase the federal income tax system — personal and corporate income taxes, the regressive payroll tax and self-employment tax, capital gains, gift and estate taxes, the alternative minimum tax, and the earned income tax credit — and replace all that with a 23 percent national sales tax on personal consumption."[8] Will conveniently omitted mention of the more than 7,500 existing sales tax systems in the United States, and he failed to mention that the Linder bill would impose the national sales tax directly on the goods and services of state and local governments — in effect mandating a tax on police, fire, school, emergency response, and other state and local services.

Do you have any thoughts on the potential effect of such a proposal on state and local tax systems and revenues? On state and local economies?

Strauss: I view the "Linder tax" as an important exercise, and one that would likely receive a lot of careful scrutiny by the tax committees of Congress before they enacted it. Working through an actual draft bill and introducing it are useful exercises, because in the legislative drafting process you have to face up to important details. Getting cosponsors helps the author understand whether or not there is broad support for the proposal.

My primary concern with the proposal is that a 23 percent rate would not likely bring in the same amount of money as do the taxes and administrative mechanisms that Linder proposes eliminating. If he misses the mark, and the federal deficit substantially widened, it's imaginable that international bond markets would notice this, with adverse effects on interest rates. This could happen even before final passage.

There are times in our history when congressional actions that have unintended effects get memorialized to the detriment of the advocates. For example, think about the legacy of the Smoot-Hawley Tariff Act of June 1932. Probably every American high school student has been taught for the better part of a half-century that the tariffs due to Smoot and Hawley dramatically deepened the Great Depression and caused long-term economic havoc. That's quite an economic legacy for them and their descendents. There's merit in remembering President Lyndon Johnson's quip: "To do what's right is easy; to know what's right to do is another matter."

Tax Doctor: Under the Linder bill, Will says, all goods — imported and domestic — would be treated equally at the checkout counter, and all taxpayers — including more than 50 million foreign visitors annually — would pay "as much as they choose, when they choose, by how they choose to spend." And his bill untaxes the poor by including an advance monthly rebate for every household equal to the sales tax on consumption of essential goods and services, as calculated by the government, up to the annually adjusted poverty level. Presumably that would mean elderly persons could choose not to purchase prescriptions, medical services, access to the Internet, or other public and nonprofit services. What do you think the effect of a mandatory national tax on state and local services would be for businesses and citizens? Or a tax on the Internet?

State and local public investment should not be taxed by a federal consumption tax.

Strauss: A national consumption tax via a retail sales tax mechanism is a very blunt instrument to achieve distributional objectives. Either an expenditure tax or a saved income tax is a much better policy instrument than a retail sales tax in terms of achieving distributional objectives. When we look at state sales tax bases, we find various household "necessities" are exempted in the interests of achieving some form of vertical and horizontal equity. My calculations some years ago led me to the conclusion that if you exclude housing, food, clothing, and medicine, a revenue-neutral national retail sales tax would be on the order of 40 percent or 50 percent, which in turn would create enormous black market incentives and compliance problems.[9] Even Canada's experience with a 10 percent retail sales tax is not particularly encouraging.

Some argue that taxing state and local services is necessary to ensure neutrality between the public and private sectors, and evidently drafters of the Linder sales tax bill have been con-

[8] George F. Will, "The Tax Plan To Kill K Street," *The Washington Post*, Mar. 31, 2005.

[9] Strauss, op cit, section 7.

vinced that this is the correct answer. However, because the state and local sector is responsible for much physical and human capital infrastructure in the economy, this would mean that various forms of public investment would be taxed, and thereby discriminated against. It seems to me that not only should private investment be tax-favored, but so should public investment. This leads me to the conclusion that state and local public investment should not be taxed by a federal consumption tax. However, this would be difficult to administer. Just as it is difficult under an expenditure tax to differentiate between the consumption component and the investment component of consumer durables expenditures, there are issues in deciding whether or not, say, expenditures for public education are investment or consumption expenditures. The point of moving to a consumption measure of ability to pay is to encourage savings and investment.

Tax Doctor: Linder and Will write as if the move to a national consumption tax would be, administratively, an especially simple process — and that most of the tax collection would be done by the states (although it seems state taxpayers would have to pay the national sales tax for providing this service to the federal government). The idea that the tax would be simple to administer seems to contravene all the information gleaned from the years of work by the states as part of the Streamlined Sales Tax Project, which shows that establishing a uniform, nationwide sales tax system is exceptionally complex. What are the implications for tax administration?

Strauss: Asking the states to collect a federal tax is reminiscent of what the old Soviet style of tax collection was before the Berlin Wall fell. While I have a lot of respect and confidence in our state revenue agencies, I'm not sure that the system would be as well served with this sort of bottoms-up tax administrative process as with the cooperative process that we now have. Obviously, there is a federal interest in having revenue for the federal budget collected in an efficient and honorable manner. Without federal supervision and a conflict adjudication process that serves federal interests, it's hard to see how this plan could be made to work effectively. Federal piggybacking, which I helped devise in conjunction with the enactment of general revenue sharing more than 30 years ago, posited that adjudication of conflict had to be through the federal administrative and court process.

Asking the states to collect a federal tax is reminiscent of what the old Soviet style of tax collection was before the Berlin Wall fell.

State collection would seem to turn the federal Supremacy Clause upside down, and perhaps return us to the days of the Articles of Confederation, when apportionment and federal finance depended on figuring out what the states self-reported property was worth. As you may recall, that really didn't work very well. I doubt in the final analysis that this form of tax administration would be embraced.

Tax Doctor: As the federal government increasingly disinvests in the nation's public infrastructure of schools, universities, highways, ports, and water and sewer facilities, it imposes greater pressure on state and local capital finance. Local and state bond issuance has been at all-time highs over the past four years. As the need for building and repairing essential infrastructure becomes more important to local and state governments, how do you see the more than $2 trillion municipal bond market and government budgets reacting to the tax reform proposals? What would it mean to replace the federal income tax with a consumption tax that applied to the equipment and services provided by state and local governments to build, rehabilitate, and maintain infrastructure?

Strauss: It's well known that movement to a federal consumption tax would eliminate most of the incentives for tax arbitrage in the bond market. Not only would borrowing costs for state and local governments go up and converge with those for other debt instruments, holding risk considerations constant, they would also go up for nonprofits and even universities such as my own.[10]

Tax Doctor: In a report issued on February 5, "Corporate Tax Avoidance in the States Even Worse Than in the Federal," Citizens for Tax Justice said that if corporations were taxed on their profits at an average statutory state corporate tax rate of 6.8 percent in 2003, states would have collected more than $67 billion. Instead, states collected only $25.4 billion — a $41.7 billion difference. As tax reform is discussed in all corners of the government, how should the commission address the growing problem of corporations not paying their fair share of taxes? Is there an opportunity to address in a constructive way concerns about the business activity tax as part of this reform effort?

Strauss: I'm not sure that I really know what "fair-share" taxation is, but I do understand and believe that the state corporate income tax has become anemic as a state revenue source.

About a dozen years ago,[11] I did a back-of-the-envelope calculation that demonstrated that about one-third of the federal corporate profits base "disappeared" on the way to state capitals. That is not quite the same order of magnitude as the CTJ number or as one that I heard some years ago from a senior tax official of a major U.S. corporation. My view then and now is that this sort of tax gap reflects the high quality of training that corporate tax officials receive while in our business and law schools. Taxpayers are entitled to minimize their taxes, and under the threat of shareholder suits, they have to. Tax collec-

[10] I recall explaining the interest rate convergence phenomena over lunch some years ago to a Carnegie-Mellon trustee, a retired CEO of a well-known corporation, who supported replacement of our federal income tax system with a VAT, and who viewed debt finance as an important thing for the university to engage in. He was a little vague about whether the deductibility of interest did any good for a tax-exempt organization, since it certainly was beneficial for the corporation he led.

When I explained that under a consumption tax, the university could no longer borrow at exempt rates, invest at taxable rates, and pocket the difference until it caught the attention of the Internal Revenue Service, because the rates would essentially be the same, he became very uncomfortable. The university had become rather leveraged. But essentially he "got it." Some university financial officials were annoyed with subsequent orders to match borrowing and investing maturities to reduce risk. Unfortunately, I think we have backslid in other material ways that are best left to the reader's imagination.

[11] Robert P. Strauss, "Federal Collection of State Corporate Income Taxes," in Thomas F. Pogue (editor). *State Taxation of Business: Issues and Policy Options* (New York, Praeger Press, 1992), 69-88.

tors are in the business of maximizing revenue collections for their political officials.

If one wants to impose a state corporate income tax and make sure the tax base doesn't disappear, the solution lies in the states piggybacking on the bona fide federal corporate income tax return. However, I am mindful that this idea is still well ahead of its time and would be avidly resisted by the business community.

Tax Doctor: The director of the president's advisory panel says he has "heard repeatedly" that "the best solution would be a broad-based, low-rate tax system that will provide the greatest economic efficiency, simplicity, and ease of administration." Could you describe such a system — but describe a system consistent with our federal system?

Strauss: I think you forgot to mention that such a tax system should also be fair and equitable. Precisely what these phrases mean often is the stuff of political campaigns and obfuscation. In fact, vertical and horizontal equity can be well-defined and measured.

If the advisory panel really believes that a retail sales tax or VAT would be easier to write, enact, and administer, then I think it is engaging in wishful thinking.

These vertical and horizontal equity goals conflict with the goals of achieving economic efficiency and ease of administration. Moreover, any system that seeks to avoid being vertically regressive winds up becoming complicated. Complexity is not caused by having multiple tax rates, exemptions, or deductions — TurboTax can figure out tax liability in a system that has multiple tax rates, provides exemptions, and itemizes deductions. If we take complexity to be the opposite of simplicity, we can readily observe that it is due to such things as distinguishing between active and passive income, defining what dependency is in the determination of an allowable exemption on a personal return, or figuring out just what domestic production really is. Clarity achieved via reform of a tax code is overcome in a few years by tax planning that entitles taxpayers to pay less tax.

If the panel really believes that a retail sales tax or VAT would be easier to write, enact, and administer, then I think it is engaging in wishful thinking. Exempting certain commodities or taxing them at different tax rates inevitably spawns new products that seek to fall into the exempt or lower-rate classification. Litigation inevitably follows about the edge of the classification. Moral claims would undoubtedly arise about why certain commodities deserve to be taxed at the lower tax rate. Consumption taxation would transform K Street but certainly would not eliminate it. Legions of representatives and advocates would charge Capitol Hill with studies documenting the utility and value of clients' products. This is just a commonsense observation.

Tax Doctor: More than $100 billion of U.S. corporate debt matures this quarter — one of the greatest quarterly repayments in U.S. history. Fitch Ratings and Thomson Financial calculate $113.6 billion and $117.3 billion, respectively, will come due in the next three months.[12] That comes as the prospect of aggressive interest rate increases by the Federal Reserve weighed on Treasuries and sent yields to new highs. Moreover, for issuers looking to refinance maturing paper with longer-term debt, the yield curve has also steepened, raising rates on longer-dated bonds more sharply than on short-term debt, thus raising borrowing costs. Like municipal bonds issued by state and local governments, U.S. Treasury bills have tax advantages. What would happen to those advantages under a national sales or consumption tax system, and what are the implications for the massive debt the nation's taxpayers confront?

Strauss: Interest on federal paper is constitutionally taxable by state and local governments as long as such taxation is part of a system of nondiscriminatory taxation of other types of public debt. Few states actually exercise this prerogative. In a world of federal consumption taxation, federal and private interest income could continue to be taxable by the states, but interest rates would converge due to the elimination of the federal tax exemption for state and local debt. State and local borrowing costs would rise, holding risk per se constant.

Tax Doctor: The panel announced a request for new proposals, which had to be received by April 29. If you were to describe the outlines of a new proposal, what would be the most important elements from a state and local perspective?

Strauss: The first purpose of federal taxation is to finance agreed-on federal public services. If the panel proposes a base and rate that cannot plausibly be expected to bring in the same amount of revenues that the discarded federal tax system brings in, then state and local budgets will suffer, and there will be a lot more fiscal uncertainty. That can be very bad from the state and local perspective.

The states rely very heavily on the IRS, and if the Service gets short shrift, the states have to go it alone.

From the point of view of the states, the second most important thing would involve whether or not the IRS would remain intact or be asked to do things it cannot reasonably be expected to do. The states rely very heavily on the existence and effects of the IRS, and if the Service gets short shrift, the states will be positioned to have to go it alone. In fact, over the last 10 years, tax administration has become more integrated, as Figure 1 above demonstrates. Information sharing is really essential to effective and economical state tax administration. Going it alone will mean that compliance will suffer, and so will confidence in our state and local tax systems.

[12] Jennifer Hughes in New York, *London Financial Times*, Apr. 6, 2005.

Appendix I

Open Book Exam

Fundamental Tax Reform And State and Local Tax Systems

Ten Things Anyone Interested in Fundamental Tax Reform Should Know About Its Effects on the State and Local Sector

Note: There are 10 questions of equal weight, for 100 points total.

Q1. A 1 percent increase in the real, after-tax rate of return on private savings raises the U.S. savings rate to:

A. -1.4
B. -0.5
C. -0.03
D. -0.001
E. Nobody knows for sure

Q2. A tax on business gross receipts at 20 percent will bring in less revenues than a 20 percent value added tax (choose one).

A. True
B. False

Q3. Name one state that does not incorporate the Internal Revenue Code into its state revenue code.

Q4. The percentage of states with personal income taxes that rely on either federal adjusted gross income or federal taxable income in the calculation of state taxable income is:

A. 0-20 percent of states
B. 21-40 percent of states
C. 41-60 percent of states
D. 61-80 percent of states
E. 81-100 percent of states

Q5. The percentage of states that are currently under federal-state cooperative agreements with the Internal Revenue Service is:

A. 0-20 percent of states
B. 21-40 percent of states
C. 41-60 percent of states
D. 61-80 percent of states
E. 81-100 percent of states

Q6. The 1932 manufacturer's wholesale excise tax, H.R. 10236, that was reported by the Ways and Means Committee of the U.S. Congress:

A. Never got to the House floor
B. Got to the House floor but was never voted on
C. Was passed by the House but never considered by the Senate;
D. Was defeated on the House floor
E. Was passed by the House and the Senate but died in Conference Committee
F. Was passed by the Congress but vetoed by President Roosevelt.

Q6. Name and briefly discuss three administrative mechanisms for administering a VAT.

Q7. The accounting records of domestic corporations, kept in accordance with financial reporting and accounting requirements of the Securities and Exchange Commission, readily support the administration of a credit-invoice VAT.

A. True
B. False

Q8. Were the Internal Revenue Code to eliminate taxation of income, the states would be able to easily obtain information on:

A. Dividends paid and dividends received (True or False)
B. Interest paid and interest received (True or False)
C. Capital gains realized (True or False)
D. Rent paid and rent received (True or False)
E. Royalties paid and royalties received (True or False)

Q9. The Internal Revenue Service could implement a national retail sales tax in 12 months.

A. True
B. False

Q10. A revenue-neutral ($1.3 trillion in revenues) VAT rate that excluded housing, medical care, food, and clothing would be:

A. 5-10 percent
B. 11-16 percent
C. 17-20 percent
D. 21-25 percent
E. 26-30 percent
F. 31-35 percent
G. 36 percent

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The Tax Doctor is a column by Frank Shafroth, former director of state-federal relations with the National Governors Association.