

**KICK-OFF FOR TAX REFORM:
TACKLING THE TAX CODE**

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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AUGUST 3, 2006
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Printed for the use of the Committee on Finance

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U.S. GOVERNMENT PRINTING OFFICE

38-164—PDF

WASHINGTON : 2006

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United States Senate Committee on Finance
3 August 2006

Hearing on

"Kick-Off for Tax Reform: Tackling the Tax Code"

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Introduction

Chairman Grassley, Ranking Democratic Member Baucus, and other Distinguished Committee Members:

Thank you for the opportunity to share my views with you. My name is Martin B. Tittle. I am an attorney with a practice centered on international aspects of U.S. taxation. This statement is submitted on my own behalf and not on behalf of any government or private entity.

A Federal VAT Could Be Harmful for America's Senior Citizens

At today's hearing, Prof. Elizabeth Garrett suggested that "a Value Added Tax, along the lines of the VATs used by the vast majority of our major international competitors, should remain on the table but as part of the reform of Social Security and Medicare. Replacing the payroll tax with a VAT would provide a more stable source of revenue for these important programs. It would appropriately expand the base of those paying for the programs past today's workers to all citizens."

Prof. Garrett is correct that a VAT would impose costs on all citizens, but she did not explain why today's senior citizens should be taxed twice for Social Security and Medicare on the same earnings: once while they were working, through payment of payroll taxes that limited their ability to accumulate after-tax savings, and again, after enactment of the VAT, through purchases when those after-tax savings need to be spent.

Younger citizens with decades to go before they retire would have time to adjust to the new VAT system and make the trade-offs between consumption and saving that could allow a comfortable retirement.

For retired senior citizens and those very near retirement, however, there would be no opportunity to adjust and little to no benefit from elimination of payroll taxes. The purchasing power of their existing after-tax savings would be permanently diminished by the VAT, and the potentially offsetting effect of any income-related benefits beyond payroll tax elimination could be limited or nil, depending on individual levels of taxable income.

Witness Jane G. Gravelle confirmed the likelihood of this effect on America's seniors when she noted that "[c]onsumption taxes, such as the GIT [the Growth and Investment Tax Plan proposed by the President's Advisory Panel on Federal Tax Reform], inevitably shift the burden of the tax towards the current older generation and away from young and future generations. Essentially, those with assets who expect to consume out of these assets are subject to a substantially higher tax. This shifting across the generations is relieved to some extent by the transition rules that allow some recovery of depreciation, but this offset is quite limited. That shift means that older people pay a higher lifetime tax than younger or unborn generations."

A transition regime could help avoid this result. Such a regime might include a system of capital reporting that establishes the level of after-tax, pre-VAT capital for each taxpayer and then allows refunds for payments of VAT that are properly allocated to that pre-enactment capital. It is true that implementation of this or any transition system would necessarily make the tax system more complex.¹ It is also true that, without a budget surplus, a transition system involving refunds would require a higher VAT rate.² However, without some form of transition relief, the negative impact of a federal VAT on the buying power of retirees' after-tax savings would be both too high a price to pay for the VAT's advantages, and a price unfairly imposed on those least able to cope with it.

I urge the Committee to address this issue in future staff reports and Committee hearings that include consideration of a federal VAT.

¹ A VAT refund system could be viewed as presenting problems similar to those involved in the cash grant program that the President's Advisory Panel on Federal Tax Reform examined in connection with its decision to reject both a National Sales Tax and a full replacement VAT. See "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, Report of the President's Advisory Panel on Federal Tax Reform" 208, 211-12, 214, 255-56 (November 2005).

² Witness James Poterba mentioned this aspect of targeted transitional relief in his testimony to the Committee, but he suggested that "[t]he equity benefits of transition relief must ultimately be balanced against the efficiency cost of such relief and its associated distortions." I, for one, would find such a comparison a bit one-sided in the case of America's seniors. I doubt I could ever conclude, in the name of efficiency, that they should suffer diminished purchasing power due to a federal VAT when they finally need to spend their after-tax savings.