Remarks of Senator Dave Durenberger
September 3, 1986

THE CONSUMPTION TAX ALTERNATIVE

I am pleased that Charlie invited me to participate in this conference. I want to apologize for my late arrival. The speakers who preceded me were kind enough to have provided me with their papers last week and I want to commend each of them for their thoughtful and provocative insights into the economic implications of the pending tax bill, as well as the potential impact of a consumption tax.

Although John Makin suggests that advocating a consumption tax "is about as popular as promoting daily floggings for retirees who have lost the use of one or more limbs," I think conferences like this will dispell some of the myths surrounding consumption taxes and will help advocates of a consumption tax, such as myself, avoid the VAT albatross that frightens so many politicians. However, if John's right, I may be looking for a new job in two years.

I have many questions about the overall impact that the tax reform bill crafted in the House-Senate conference will have on the economy. I'm sure many in this audience have already held a wake for the investment tax credit and fear that its loss will continue the erosion of America's industrial competitiveness.

There seems little doubt that repeal of the credit will increase the cost of capital to American companies, especially the hard-hit industrial sector of the economy. But when we consider the pros and cons of the tax bill, its important to remember that tax policy is but one factor to weigh in comparing costs of capital.

I think John Shoven's paper makes it eminently clear that two other factors--interest rates and inflation--play a much larger role in determining costs of capital than tax policy. Indeed, I am reminded of a study done by Arthur Andersen last year which showed that if tax policy is used as the sole measure of the cost of capital, Japan would have the highest cost of capital and Luxembourg and Belgium would have the lowest capital costs.

Thus in the debate over our nation's competitiveness in the international marketplace, too often we in the Finance Committee focus too much of our attention on such matters as the investment tax credit and accelerated depreciation, and too little on monetary policy and exchange rates.

I would suggest to you that the greatest danger to our industrial competitiveness comes from the ballooning federal deficit and the concommitant impact it has on interest rates, exchange rates and inflation--all of which have a substantial bearing on the cost of capital in the United States.

Furthermore, it should not go unnoticed that the precipitous decline in our industrial competitiveness vis-a-vis the Japanese, the Koreans and the Taiwanese, occurred in the 1980s at the same time that subsidies such as the investment tax credit were in place and the federal deficit began to hemmorhage.

I think 1986 will be remembered as a seminal turning point in the federal government's philosophy of taxation and the role it plays in directing the resources and priorities of the nation's economy, and inevitably the world economy. It's my view that the lower rates and base broadening encompassed in the bill reflects a renewed confidence in the decision making power of our citizens and a diminished reliance on a government which substitutes its priorities for those of the governed.

Yet reform of the income tax has done nothing to alleviate the budget monster that endangers the economic wealth and security of our nation both in today's economy as well as in the future. Although it is difficult to predict how the economy will respond over the long-term to the tax reform bill, I hope Joel Prakken is wrong in predicting that by 1995 GNP growth will be reduced by 3.1 percent, unemployment will rise 2.6 percent and the budget deficit will increase by $208 billion. If he's right, the 97 Senators who voted for the bill have made a devastating mistake.

I think we have leared some important lessons this year in trying to achieve the twin goals of cutting the deficit and reforming the income tax. I think 1986 will prove to be the last year that we can find enough "fat" to cut in federal spending in order to achieve deficit reduction. We're about at that point where what's left in spending is nearly all muscle.

And in the process of overhauling the income tax, from Treasury I all the way through to the House-Senate conference, I think we've found out just how far we can broaden the income tax base without incurring the unforgiveable wrath of our individual and corporate constitutents. There are certain "untouchables" outside the base--home mortgage interest, inside buildup on life insurance, tax-free health insurance, state and local income and property taxes, and incentives for oil and gas investment.

We've broadened the base about as far as politically possible, and I think it would be unwise for Congress to begin another round of income tax "reform" in the next few years. After a while, I think the public will become even more cynical (if that's possible) about what we in Washington do when we promise to reform the tax system every two years.

Moreover, I believe business could not stand the shock of another round of tax reform, unless we promised to keep rates low and reinstitute the investment tax credit. Of course, everyone in this room knows that under the current income tax system, that's just not affordable--you can't have a top rate of 34 percent on business and still retain the investment tax credit.

Thus we face a quandary in the next few years. If we can't squeeze much more into the income tax base, and we can't find much more to cut in the budget, how are we going to meet our Gramm-Rudman targets. We could put a surtax on the income tax. We did it to finance the Vietnam War and it might be possible to justify as a necessary measure to fight the budget war.

However, I think a surtax would be unwise because it would, in many ways, negate the encouragement to saving and capital formation which result from the lower tax rates included in this year's bill. And it would add to the public's cynism about the promise of tax reform.

It would thus appear to me that the only viable option we have to solve the budget deficit mess is to phase in a consumption tax, either in the form of a value-added tax or a business transfer tax as proposed by Bill Roth. As you know, there is great reluctance on Capitol Hill to go down the consumption tax route.

We all remember what happened to Al Ullman when he first raised the idea of a VAT. And the President and many of my colleagues oppose the idea because they fear that it's revenue potential is so large that it will reduce our budget cutting discipline and become an easy vehicle to finance new social spending programs.

I share the President's and my colleague's concerns that a VAT or BTT would undiscipline Congress. And I would note that many of the European countries that have adopted VATs spend a larger percentage of their budgets on social expenditures. Yet, I believe the consumption tax alternative is inevitable and that we can protect against any attempts to inch up the VAT rate a point or two to pay for questionable spending programs.

A consumption tax cannot be tried as an experiment with a low rate of 1 or 2 percent to either pay for the budget deficit or, as some in this room would suggest, pay for restoration of an investment tax credit. Two years ago Treasury estimated that if a VAT were adopted, IRS would have to hire 20,000 additional employees and that the cost to the Treasury would be $700 million a year. And that doesn't include the additional hundreds of millions or billions in compliance costs for business!

So I suggest to you that if we are serious about adopting some form of consumption tax, the public and the business community will have to be thoroughly convinced that the benefits of the VAT outweigh its costs.

Some estimates, based on political realities as to the consumption tax base, suggest that such a tax could raise $25 billion for each percentage point of tax. Thus if we adopt a 7 percent VAT, in theory we could raise $175 billion a year. Depending on how Congress chooses to "spend" that money will determine whether the VAT or any other type of consumption tax can pass political muster with the public.

In my view, at least $75 billion of that money must be earmarked by Congress to reducing the deficit. That would send a clear and unmistakable signal to the business community and our trading partners that the United States is committed to ending its federal deficit. With that commitment, I believe the course of the economy would be headed in one direction--upwards; and the direction of interest rates would head in the other direction.

Of the remaining $100 billion, $60 billion could be used to entirely eliminate the 2.9 percent Hospital Insurance (medicare) portion of FICA. We're headed for a crisis in financing medicare in the next four years. Unless we begin to consider alternatives to medicare financing, such as a consumption tax, we are faced with inevitably raising the most regressive and unfair tax--the payroll tax.

* And the remaining $40 billion could be used to eliminate all federal excise taxes. By eliminating federal excise taxes, state governments would no longer have have to compete for excise tax revenues with the federal government. The Federal government has been increasingly imposing mandates on state governments, while concurrently cutting federal aid to the states. The House-Senate tax bill will make it extremely difficult for states to issue tax-exempt bonds to finance badly needed infrastructure improvements. Under these circumstances, it would be a welcome relief to the states to be able to make greater use of excise taxes.

These are just a few of the ways that a consumption tax could be used to alleviate the stresses on the payroll tax and state governments. The list of alternative uses of consumption tax revenue is endless. We could lower income tax rates further; eliminate the corporate tax entirely; end the taxation of savings; restore business incentives. But the key point is that a major portion of the revenues must be used for deficit reduction.

Nearly 20 percent of the fiscal 1987 trillion dollar budget is dedicated to paying interest on the debt. 55 percent of the income tax is needed to pay the national debt. The deficit was responsible for the soaring dollar that destroyed many of our export markets and is a prime factor in the trade deficit that appears to get worse each month.

I think the public recognizes the inevitability of some new taxes to close the deficit. There is a growing awareness that the debt we are accumulating today is going to cause a shock to the living standards of our children and our children's children. It is not unlike the situation we see in Latin America where poorly managed governments, having piled up extraordinary debts in the 1970s, are now paying for such excesses with lower living standards and unreal inflation. That is the legacy we will leave to our children, if we don't address the deficit soon.

It is clear to me that there is a price the economy will pay in adopting a consumption tax. Joel Prakken suggests that our GNP would be reduced and civilian unemployment would rise in the first 10 years. I would hope that an accomdative monetary policy would ease the burden that would be associated with introduction of a consumption tax. However, I think we face no choice. We either begin to pay now for our excessive consumption or face a future that promises less growth, higher unemployment and a lower standard of living for our children.