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SAMUEL D. CHILCOTE, JR.
President

April 7, 1986

FEDERAL EXPRESS

MEMORANDUM

TO: Members of the Executive Committee

FROM: Samuel D. Chilcote, Jr.

The enclosed study, prepared by deSeve Associates, was commissioned by the Tobacco Institute when Senator Packwood's tax reform proposals were made public. deSeve Associates participated in the formulation of the Administration's original tax reform package by the Treasury Department.

This study will be released by the Coalition Against Regressive Taxation at a press conference in Washington on the morning of April 8.

SDC:dl

Enclosure

deSeve Economics

AN ANALYSIS OF THE FEDERAL EXCISE TAX AND TARIFF PROPOSALS IN THE SENATE FINANCE COMMITTEE MARKUP

A Report Submitted to:

The Coalition Against Regressive Taxation

April, 1986

EXECUTIVE SUMMARY

The tax reform plan currently under consideration by the Senate Finance Committee would have the effect of increasing excise taxes and tariffs substantially by 1) eliminating the business deduction currently allowed for Federal excise taxes and tariffs; 2) indexing the tax rates for alcohol, tobacco, and motor fuel to price changes; and 3) increasing the excise tax on wine.

This report concludes that, under widely accepted income tax accounting concepts, Federal excise taxes and tariffs are an "ordinary and necessary" expense for businesses on which they are imposed and that such expenses should therefore be deductible as a cost of goods sold. The elimination of this deduction is just an indirect way of increasing excise taxes and tariffs by 54 percent.

The report shows that the excise tax increases in the plan before the Senate Finance Committee would be borne disproportionately by low income taxpayers. Households with incomes of less than $10,000, for example, pay 8 percent of the excise and tariff increases, but account for only 3 percent of all income. Similarly, households with incomes of less than $20,000 would pay 23 percent of the excise tax and tariff increases but account for only 12 percent of all income. At the other end of the scale, households with incomes above $100,000--the recipients of nearly 14 percent of all incomes--would pay only 5 percent of the tax increases.

For individual taxpayers in the aggregate, the excise tax and tariff provisions would wipe out almost half of the income tax reduction promised by this plan. The effect by income class would be very uneven. Those in the highest bracket would lose in this way only 6 percent of their income tax reduction whereas those in the lowest bracket would lose more than 60 percent of theirs.

The 77 percent income tax reduction granted to those in the lowest bracket would shrink to a 13 percent reduction in tax liability when the excise tax and tariff increases are taken into account. The effect of the excise tax and tariff provisions on the income tax reductions by income class is shown below.

Tax Reductions by Income Class Under Finance Committee Staff Proposal

Income Class ($1,000's of 1986 Dollars)	Tax Reductions As Percent of Tax Liability: 1988	
	Income Tax Only	Combined Effect of Income, Excise & Tariff Changes
0 - 10	-77.2%	-12.9%
10 - 20	-23.0	-11.1
20 - 30	-9.7	-4.3
30 - 50	-8.1	-2.8
50 - 100	-6.7	-2.3
100 - 200	-4.2	-2.8
> 200	-5.9	-5.5
Average	-8.4%	-4.2%

In summary, the report demonstrates that there is no valid conceptual basis for the proposed elimination of the deduction of excise taxes and the proposed increase in excise taxes would be borne disproportionately by low income households.

deSeve Economics

Figure 1. Reduction for Lowest Income Class ($0-$10,000)

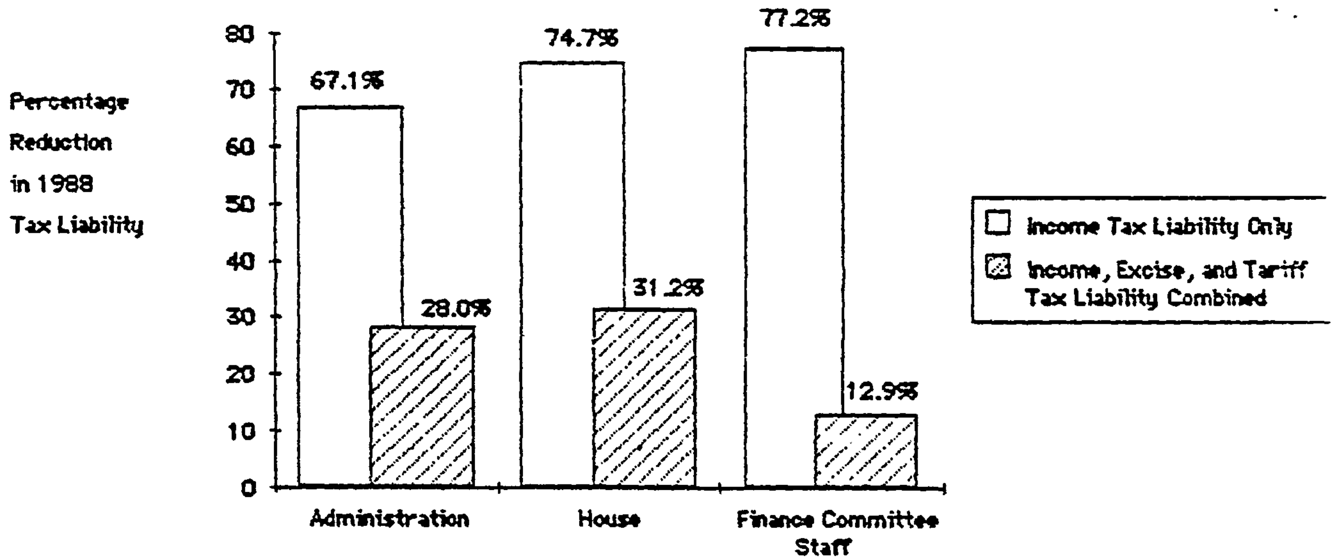
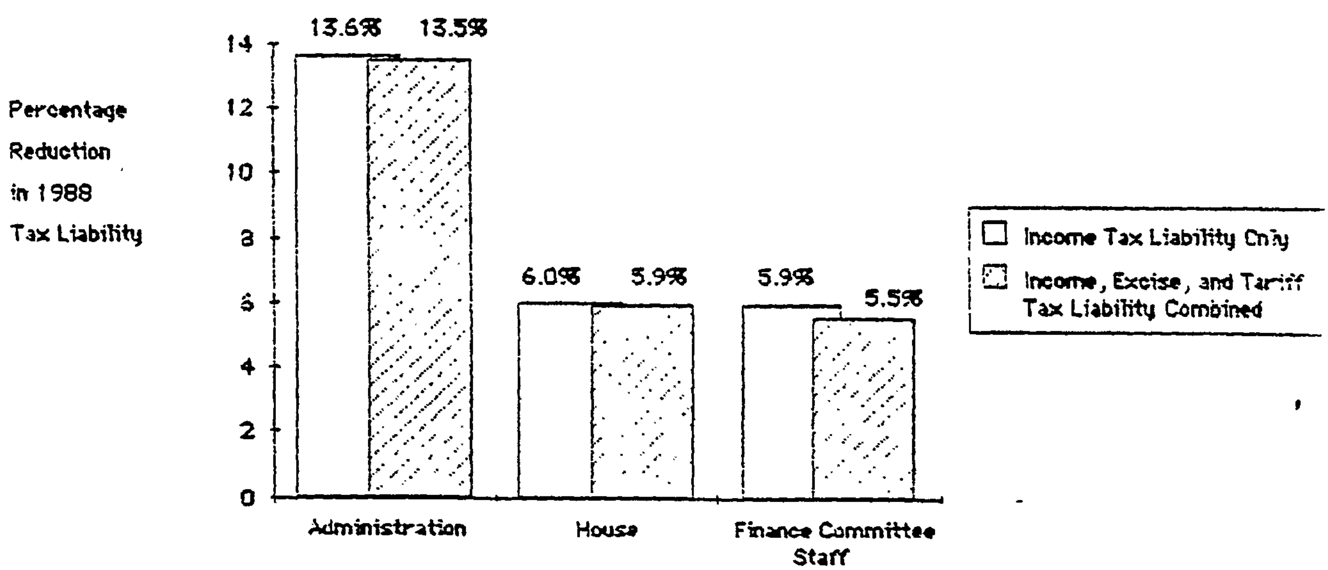


Figure 2. Reduction for Highest Income Class (> $200,000)



AN ANALYSIS OF THE FEDERAL EXCISE TAX AND TARIFF PROPOSALS IN THE SENATE FINANCE COMMITTEE MARKUP

Introduction

The tax reform plan developed to serve as the markup document for the Senate Finance Committee includes three major changes to excise taxes. These changes, are:

-- Eliminate the business deduction currently allowed for Federal excise taxes and tariffs.

-- Index the alcohol, tobacco, and motor fuel excise taxes to price changes.

-- Increase the tax on wine to the alcohol equivalent level of the tax now on beer. On average, this amounts to about a 300 percent increase in the tax on wine.

Part I of this paper analyzes from two perspectives the proposed elimination of the deductibility of Federal excise taxes and tariffs. First, the proposal is evaluated in terms of its consistency with the basic concept of income taxation. Second, the proposal is evaluated in terms of its ultimate incidence on businesses and consumers.

Part II of this paper analyzes the distributional consequences of the tax proposal. Estimates are provided on the same basis as the preliminary Joint Committee on Taxation estimates of the individual income tax provisions of the plan submitted to the Senate Finance Committee, so that the distributional impact of the excise tax and tariff provisions can be readily contrasted with the corresponding impact of the income tax provisions.

I. The Conceptual Basis For Deductibility of Excise Taxes

The corporate income tax is, as its name implies, a tax on income. Income subject to tax is essentially gross income less the costs incurred by the business in producing that income. As stated in Section 162 of the Internal Revenue Code, "There shall be allowed as a deduction all the ordinary and necessary (emphasis added) expenses paid or incurred during the taxable year in carrying on any trade or business..." Indeed, if the deduction for such costs and expenses incurred were not allowed, the tax would be the economic equivalent of a form of sales tax rather than an income tax.

Deductions allowed under the Federal corporate income tax structure include virtually all costs associated with the conduct of the business, including compensation of employees, depreciation expenses to cover plant and equipment used in the business, purchase of inputs from other businesses, and taxes other than Federal income taxes incurred as a result of business operations.

Under the income tax concept, Federal excise taxes and tariffs are clearly deductible as a cost of goods sold or an "ordinary and necessary" expense for businesses that manufacture or import taxed products. Indeed, in contrast to certain other expenses over which businesses have some control, such as the employee wage bill, businesses have no control over the excise tax or tariff cost imposed on them. The manufacture of cigarettes, for example, must, without exception, incur a Federal excise tax cost of 16 cents for each pack of cigarettes produced and sold domestically. The manufacturer may attempt to streamline business operations to reduce other costs of business, so that the product can be sold at the lowest possible price consistent with making a reasonable return on investment, but there is no way in which the 16 cent excise tax cost can be reduced or avoided. A similar argument can be made in the case of the 12 percent excise tax imposed on truck dealers.

The tax expenditure analyses developed annually by the Treasury Department provide an alternative assessment of the excise tax deductibility issue. These analyses measure the "major departures from what is commonly understood to be the base of a truly comprehensive income tax." These detailed analyses show estimates for approximately 70 corporate income tax provisions that have been identified by Treasury to be deviations from a "normal" tax structure. The deductibility of excise taxes is not among these 70 provisions, clearly indicating that Treasury recognizes this deductibility to be inherent in a business income tax system.

Succinctly stated, the excise tax is an ordinary and necessary cost of doing business for firms manufacturing or importing taxed products.

The Incidence of Eliminating Excise Tax Deductibility

The incidence of taxes is an area within the economics profession in which there is considerable difference of opinion. The general consensus is that consumption taxes are borne by consumers, payroll taxes are borne by wage earners, and income taxes are borne by the factors that produce that income. In the case of the corporate income tax, the tax is generally regarded as a tax on capital.

Because the issue of excise tax deductibility is related to the corporate income tax, some people have confused its ultimate incidence with that of the corporate income tax and argued that elimination of excise tax deductibility would be progressive. In fact, this provision is nothing more than an indirect way of increasing excise taxes. In contrast to the corporate income tax, which affects all businesses, the elimination of deductibility affects only those businesses that manufacture or import taxed products, and the degree to which they are affected is directly proportional to the amount of excise tax they pay (which, as noted earlier, is outside of their control).

Under the rate structure proposed in the Senate Finance Committee markup document, with a top corporate rate of 35 percent, the elimination of deductibility of excise taxes would lead to a 54 percent increase in existing excises. To maintain current after-tax income levels, the affected firms would have to increase prices by more than the 35 percent corporate tax rate since they will retain only 65 percent (100 percent less 35 percent for taxes) of the income that results from the price increase[1]. As a result, direct increases in excise taxes, such as those proposed in the Senate Committee document, would effectively be 54 percent larger than the amount of the nominal direct increase. If corporate tax rates were ultimately reduced by less than proposed in the markup document, and elimination of excise tax deductibility were retained, the amount of the tax increase would be even larger. Under the current 46 percent maximum corporate rate, the elimination of deductibility would amount to an 85 percent excise tax increase.

II. The Distributional Impact of the Senate Plan

The summary of the Finance Committee staff plan, released last month, showed the reductions in 1988 tax liability by income class for 1) the Administration's proposal, 2) the House bill, and 3) the "Finance Committee Staff Option." This distributional analysis excluded the effects of the proposed increases in excise taxes and customs duties in the plan and thereby greatly overstated the magnitude of the proposed tax reductions, especially for low-income taxpayers.

Table 1 shows the percentage distribution of income, current law income taxes, and current law excise taxes and customs duties. The table highlights the fact that excise taxes are borne disproportionately by low-income taxpayers. Taxpayers with incomes of less than $10,000, for example, pay 8 percent of all excise taxes

1/ To maintain their current after-tax incomes if deductibility is eliminated, firms would have to raise prices by the following percentage: $(1/1-t) \times 100$ where t is the corporate tax rate. For example, if $t = .35$ the percentage is 53.85%; if $t = .46$, it is 85.19%.

Table 1

Percentage Distribution of Income, Income Taxes, and Excise Taxes/Customs Duties Under Current Law

(percent)

Income Class ($1,000's of 1986 Dollars)	Percentage Distribution of Revenue			Relative Tax Burden[1]	
	Income (1)	Income Taxes (2)	Excise Taxes/ Customs (3)	Income Taxes (4) = (Col. 2 / Col. 1)	Excise Taxes/ Customs (5) = (Col. 3 / Col. 1)
0 - 10	3.0%	0.6%	8.1%	0.2	2.7
10 - 20	9.1	6.3	14.7	0.7	1.6
20 - 30	13.6	13.6	17.2	1.0	1.3
30 - 50	29.6	23.3	30.3	0.8	1.0
50 - 100	31.1	22.5	23.9	0.7	0.8
100 - 200	7.7	11.8	3.9	1.5	0.5
> 200	5.9	21.9	2.0	3.7	0.3
Total or Average	100.0%	100.0%	100.0%	1.0	1.0

Note: Detail may not add to total due to rounding.

1/ Percentage of taxes paid for each income class divided by percentage of income received by each class. A ratio greater than 1.0 for a particular income class indicates that the class bears a higher than average tax burden for the given type of tax.

and customs duties, but have only 3 percent of all income. These same taxpayers pay less than 1 percent of all income taxes. For high-income taxpayers, the reverse is the case. Very little of their income is used to pay excise taxes and customs duties, but a very high percentage is used to pay income taxes.

In order to provide a more complete assessment of the distributional effects of the Finance Committee staff plan, this section presents estimates of the effects of including the proposed increases in excise taxes and customs duties in the distributional analysis.

In making this distributional assessment, the time period chosen for measuring the effects of indexing selected excise taxes is somewhat arbitrary, since the size of tax increases associated with this provision depends on the time period chosen. The further out in time one goes, the greater is the tax increase relative to current law. For the distributional analysis presented below, the estimates include two years of inflation adjustments, which, under the Congressional Budget Office (CBO) assumptions that underlie the congressional tax reform estimates, would be approximately 8 percent.[1] For wine taxes, these inflation adjustments are imposed on top of the proposed 300 percent increase. The further 54 percent increase in excise taxes that results from elimination of excise tax deductibility is estimated separately and is imposed on top of the increases described above.

1/The exact specification of the indexing mechanism has not yet been made public. The estimates presented in this report assume that excise tax increases are linked to overall prices as measured by the consumer price index for all urban consumers (CPI-U), which is the index used for indexing the individual income tax. If the excise tax indexing were to be linked to the prices of taxed products, and if the "base period" did not reflect the other excise tax increases that would be imposed under the plan (e.g. elimination of deductibility), the effects of indexing would be much larger than the percentage estimates presented above.

The distributional estimates are developed using the deSeve Economics proprietary data base, which includes both income and consumption data for a sample of approximately 140,000 taxpayers. The estimates are developed for each of several components of excise taxes and customs duties: alcohol, tobacco, gasoline, and import duties on clothing and footwear. All other excise taxes and customs duties are distributed by income class according to the distribution of overall consumption.

Table 2 presents the distributional effect of each of the three components of the excise tax increases: the direct increase in wine taxes; the effect of indexing; and the effect of elimination of deductibility. The results show that by far the largest component of the excise tax increase is the elimination of deductibility and that a disproportionate share of the excise tax increase is borne by low-income taxpayers. As shown in Table 1, almost 23 percent of the increased excise tax burden is borne by households in the lowest two income classes; in contrast, these same income classes account for only 12 percent of total income.

Table 3 shows the distributional impact of the excise tax increases relative to the income tax reductions in the Senate plan. It shows that the excise tax increases, in the aggregate, offset about 45 percent of the income tax reductions (column 2 divided by column 1). More importantly, the excise tax increases offset 62 percent of the income tax cut for the lowest income class, while offsetting 6 percent of the income tax cut for the highest income class. Clearly, the exise tax proposals have a very regressive distribution.

Table 4 presents estimates of the percentage change in tax liability under the Senate plan in two ways. The first set of figures shows the proposed income tax reductions as a percent of income tax liability. These are the figures originally presented

Table 2

Distributional Effect of Proposed Increases in Excise Taxes and Customs Duties Under the Staff Plan: 1988 1/

(in millions of dollars)

Income Class ($1,000's of 1986 Dollars)	Wine Tax Increase (1)	Indexing 2/ (2)	Elimination of Deductibility (3)	Total (4)	Percentage Distribution of Total Increase (5)
0 - 10	$46	$68	$1,153	$1,267	8.0%
10 - 20	75	143	2,112	2,330	14.7
20 - 30	91	176	2,470	2,737	17.2
30 - 50	211	299	4,304	4,814	30.3
50 - 100	197	211	3,390	3,798	23.9
100 - 200	24	26	571	621	3.9
> 200	7	9	301	317	2.0
Total	$651	$931	$14,300	$15,883	100.0%

1/The estimates incorporate the consumer behavioral response to the price increases (i.e., a reduction in quantity demanded) resulting from the excise tax and tariff changes.

2/The indexing of excise taxes is limited to taxes on alcohol, tobacco, and motor fuels. The estimates presented above assume two years of indexing adjustments based on increases ~~in~~ overall prices (the CPI-U). This represents an increase of about 8 percent. If the estimates were presented to show five years of indexing adjustments, the indexing increases would total 22 percent and the amounts in column 2 would be nearly three times as large. If indexing were linked to individual product prices instead of overall prices, the indexing adjustments could be even larger.

Table 3

Distributional Impact of Income Tax Reductions and Excise/Customs Tax Increases Under the Staff Tax Plan: 1988

(in billions of dollars)

Income Classes ($1,000's of 1986 Dollars)	Income Tax Reductions (1)	Excise/Customs Tax Increases (2)	Net Tax Reduction (3)
0 - 10	-2.1	+1.3	-0.8
10 - 20	-6.0	+2.3	-3.7
20 - 30	-5.0	+2.7	-2.8
30 - 50	-7.9	+4.8	-3.1
50 - 100	-6.3	+3.8	-2.5
100 - 200	-2.1	+0.6	-1.5
> 200	-5.4	+0.3	-5.1
Total	-35.2	+15.9	-19.3

Note: Detail may not add to total due to rounding.

Table 4

Percentage Change in Tax By Income Class
Under Alternative Tax Reform Proposals: 1988

Income Class ($1,000's of 1986 Dollars)	President's Proposal (1)	House Bill (2)	Senate Finance Committee Markup (3)
I. Income Tax Reductions As Percent of Income Tax Liability			
0 - 10	-67.1%	-74.7%	-77.2%
10 - 20	-16.3	-22.8	-23.0
20 - 30	-8.1	-9.7	-9.7
30 - 50	-6.2	-8.7	-8.1
50 - 100	-7.4	-7.3	-6.7
100 - 200	-10.1	-7.5	-4.2
> 200	-13.6	-6.0	-5.9
Average, All Classes	-9.8%	-9.1%	-8.4%
II. Income Tax Reductions and Excise/Customs Increases As Percent of Income and Excise/Customs Liability 1			
0 - 10	-28.0%	-31.2%	-12.9%
10 - 20	-12.9	-18.0	-11.1
20 - 30	-7.1	-8.5	-4.3
30 - 50	-5.4	-7.6	-2.8
50 - 100	-6.6	-6.5	-2.3
100 - 200	-9.7	-7.2	-2.8
> 200	-13.5	-5.9	-5.5
Average, All Classes	-8.8%	-8.2%	-4.2%

1/The percentage reductions under the President's proposal and the House bill are revised to show the income tax cuts as a percent of income taxes and excise taxes and customs duties.

with the Staff plan and showed very large tax cuts for low-income taxpayers. The second set of figures shows the corresponding percentage reductions in tax liability when the excise tax and customs duties increases are included in the analysis. These figures show the net reduction in these taxes as a percent of current law income taxes, excise taxes and customs duties combined.

The effect of including excise taxes in the analysis dramatically changes the results. When only income taxes are included in the distributional analysis, the Staff plan appears to reduce taxes of low-income taxpayers by somewhat larger amounts than either the President's plan or the House bill. In contrast, when the increases in excise taxes and customs duties are factored into the analysis, the tax reductions for low-income taxpayers are dramatically less than under the President's plan or the House bill. For households at every income level the plan before the Senate Finance Committee provides less generous tax reduction than does the President's proposal or the House bill.

Table 5 reproduces two columns from Table 4 in order to highlight the impact of the excise tax and tariff provisions on the total tax reductions. For households with incomes below $10,000, the 77 percent reduction in income tax liability becomes only a 13 percent reduction in total tax liability when income tax changes are combined with changes in excises and tariffs. At the other extreme, households with income above $200,000 suffer a very modest percentage offset in their income tax reduction from 5.9 percent to 5.5 percent.

Table 5

Tax Reductions by Income Class Under
Finance Committee Staff Proposal

Income Class ($1,000's of 1986 Dollars)	Tax Reductions As Percent of Tax Liability: 1988	
	Income Tax Only	Combined Effect of Income, Excise & Tariff Changes
0 - 10	-77.2%	-12.9%
10 - 20	-23.0	-11.1
20 - 30	-9.7	-4.3
30 - 50	-8.1	-2.8
50 - 100	-6.7	-2.3
100 - 200	-4.2	-2.8
> 200	-5.9	-5.5
Average, All Classes	-8.4%	-4.2%