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Report to Congressional Requesters

February 1989

TAX POLICY

Economic, Administrative, and Taxpayer Compliance Aspects of a Gross Income Tax

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GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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February 16, 1989

The Honorable Charles E. Grassley
United States Senate

The Honorable Bill Archer
House of Representatives

At your request, we reviewed a specific alternative tax system based on gross income. This system was proposed by the Government Research and Development Foundation[1] as a way to simplify the tax system and reduce compliance and administration costs.

A gross income tax, as opposed to a net income tax, would tax (1) the total receipts of a firm with few or no deductions for the costs of doing business; and (2) the total income of an individual with no deductions of any kind, such as the standard or itemized deductions. Under the proposal we reviewed, firms would be allowed to deduct from gross receipts the costs of goods purchased for resale. Goods purchased for resale include raw materials and any other inputs that become a physical part of the product sold.

Results in Brief

The proposed gross income tax would be a type of cascading transactions tax; that is, the same business inputs would be taxed more than once. We concur with Department of the Treasury and Congressional Research Service (CRS) reports that such a tax has three major economic limitations.

- It would arbitrarily tax some firms at higher rates than others. Firms that earned little net income or even suffered a loss for the year would still have to pay the gross income tax. This would provide an incentive for firms to merge with suppliers to reduce their taxes and thereby reduce competition.
- It would be a disincentive to investment because it would increase the effective marginal tax rates on capital.
- It would shift the distribution of the tax burden toward low-income people because it is a proportional tax.

Proponents believe a gross income tax would reduce administrative and taxpayer compliance costs if it replaced corporate and personal income taxes. However, Internal Revenue Service (IRS) officials believe that a

[1] Gross Income Tax (GIT) Legislation, June 1986.

gross income tax would not necessarily simplify the tax system and would not reduce IRS administrative costs. The officials also believe that the transition to a gross income tax would place an overwhelming burden on IRS.

Because of its potential for greater economic distortion, we believe a gross income tax would not be preferable to the current tax system even if complying with and administering it were shown to be less costly. The net income tax system, however, with its many exemptions and exclusions, is not an economically neutral tax either. But, as we pointed out in a previous letter,[2] movement toward a comprehensive net income tax, which is essentially neutral, is a better alternative than substituting for the present system a gross income tax, which is inherently not neutral. This movement would involve continued broadening of the base and closing of "loopholes" to include more income in the tax base, as was done in the Tax Reform Act of 1986. Our more detailed analysis is presented in appendix I.

Objectives, Scope, and Methodology

Our objectives were to

- identify the general economic effects of the proposed gross income tax and
- compare certain administrative and taxpayer compliance aspects of the tax with the current tax system.

To identify the general economic effects of the gross income tax, we reviewed tax policy literature, including two government studies—one by CRS and one by the Department of the Treasury. (See bib.)

To compare various administrative and compliance aspects of a gross income tax with the current tax system, we reviewed the CRS and Treasury studies' analyses of these aspects and discussed the issues with IRS officials. The two studies discussed compliance and administration from a qualitative, not a quantitative, perspective. The IRS officials responded to our questions on the basis of their knowledge of how IRS functions, not on the basis of a formal analysis or study.

We made our review in accordance with generally accepted government auditing standards. We did our work in Washington, D.C., between July and October 1988.

[2]Letter to Mr. Jim Bayless, Senator John Tower's office (GG9-116, May 2, 1979).

Agency Comments

In commenting on our draft report, IRS said that the report correctly reflected the IRS position that the proposed gross income tax would reduce neither IRS' administrative costs nor the paperwork or record-keeping burdens for most taxpayers. IRS also pointed out that it was in the advance planning stages of redesigning its tax processing system and that any major legislative proposals that would substantially change the current tax system by enacting new types of taxes should take this into account. (See app. II.)

As arranged with your offices, we are sending copies of this report to the Joint Committee on Taxation and, upon request, to other interested parties. The major contributors to this report are listed in appendix III.

Jennie S. Stathis

Jennie S. Stathis
Director
Tax Policy and
Administration Issues

Contents

Abbreviations

CRS	Congressional Research Service
GAO	General Accounting Office
GNP	Gross National Product
IRS	Internal Revenue Service

Economic, Administrative, and Taxpayer Compliance Aspects of a Gross Income Tax

Background

The appeal of a gross income tax stems from its great revenue generating capacity with very low tax rates and the claim by its proponents that it is fairer and simpler and has lower administrative and compliance costs than the current tax system. Proponents have estimated that a gross income tax with a tax rate of 5 percent or less would generate revenue equal to that of the net income tax system.

We examined the June 1986 gross income tax proposal set forth by the Government Research and Development Foundation, a nonprofit organization devoted to public policy research.

Under the proposed tax, the tax liability of all taxpayers, both businesses and individuals, would be based on their gross income using a single tax rate. "Gross income" is defined for individuals as total income from all sources and for businesses as total receipts from all sources less the cost of goods purchased for resale. Goods purchased for resale include raw materials and any other inputs that become a physical part of the product sold. No other deductions from total receipts would be allowed. In other words, durable capital goods could not be depreciated, nor could the costs of other goods and services, such as electricity and accounting, be deducted, because they are not physically a part of the product.

Wage earners would not be required to file a gross income tax return if their sole source of income were wages. Firms would remit to the Internal Revenue Service (IRS) an amount equal to 5 percent of each employee's wages. IRS would be responsible for crediting the accounts of all wage earners for taxes paid and for sending them a statement at the year's end. Wage earners with income from other sources, such as interest income or transfer payments from the government, would be required to file a gross income tax return.

Taxpayers, however, would be allowed certain tax grants or credits, up to a maximum of 20 percent of their tax liability, as an incentive to pursue certain public goals. These tax grants would be paid by the government. Tax grants for wage earners would include donations to charities and churches, child care costs, mortgage interest costs, and replacement costs for catastrophic losses. Tax grants for businesses would include mortgage interest costs, research activities, clinical testing expenses, energy production, and catastrophic losses.

To not discourage business formation, the gross income tax for new firms would be phased in over 5 years. For its first year of operation, a new business would claim a tax credit equal to 100 percent of its tax liability. For the next 4 years, the tax credit would be reduced by 25 percentage points a year; in the fifth year, the business would be subject to the full tax.

Economic Analysis of a Gross Income Tax

Our review of the tax policy literature and studies by the Congressional Research Service (CRS) and the Department of the Treasury[1] shows that the proposed gross income tax is a cascading tax that would

- arbitrarily tax some industries at higher rates than others,
- tax firms that earned little net income or suffered a loss,
- raise effective tax rates on capital, and
- increase the tax burden on lower income people.

The general consensus of the literature is that the proposed tax is less equitable and less efficient than a net income tax.

The proposed tax is a cascading tax; that is, many business inputs would be taxed more than once because not all inputs would be deductible. If inputs were physically included in the product a firm sells, they would be deductible. Those not physically included, such as the services of capital goods, transportation, communications, the accounting department, and other overhead, would not be deductible.

The Gross Income Tax Is a Cascading Tax

To illustrate this process, suppose it takes two stages of production to make a product that sells for $1,000 to the consumer. The first-stage firm sells its intermediate products to the second-stage firm for $500, which physically includes $100 of its inputs. The second-stage firm sells the product to the consumer for $1,000. Of the $500 of purchases from the first- stage firm, only $200 are physically included in the final product; the other $300 are capital goods. Gross income for the first-stage firm is $400, and for the final-stage firm, $800. Total gross income is $1,200. If gross income were taxed at 5 percent, the tax collected would be $60.

If the product, however, were produced in three stages of production and sold for the same price to the consumer, the total tax revenue would be higher. Suppose a new first-stage firm is added to the production process with a gross income of $200, while the gross income of the other

[1] See bibliography.

two stages remains at $1,200. Total gross income would now be $1,400, and tax revenue would equal $70, an increase of 16.7 percent. By adding the third stage of production, the tax base increases $200. The tax collected is higher because some of the nondeductible inputs are subject to the tax at an increased number of stages. It is this cascading process that gives a gross income tax its enormous revenue-raising power by increasing the size of the tax base.

Because of the cascading process, the tax base of a gross income tax would be equal to or a multiple of gross national product (GNP). A gross income tax that allowed deductions for all costs of doing business except depreciation would have a tax base equal to GNP. A gross income tax that allowed no deductions, known as a turnover or transactions tax, would have a tax base equal to total business transactions. Such a tax base would be a multiple of GNP and is the largest possible.[2]

The base of the gross income tax considered here would therefore be less than that of a turnover tax but more than that of a tax on GNP. This is because it would allow some deductions that a turnover tax does not but would allow fewer deductions than a tax on GNP, which allows everything but depreciation. The base would also be different from that of a value-added tax because it includes most or all of the value of a firm's inputs, not just the value a firm adds to the inputs purchased from other firms.

Effective Tax Rates on Industries Would Vary

As a result of the cascading process, different effective tax rates would be imposed on consumer goods and services depending on the number of independent production stages required to produce them and the amount of inputs that would not be deductible at each stage. To reduce or avoid the tax, firms would have an incentive to merge with their suppliers. For instance, in the second example, if the first- and second-stage firms merged, the tax on gross income would be reduced from $70 to $60 because gross income would decline from $1,400 to $1,200. To the extent that merging or vertical integration occurred, competition would be reduced.

According to the Treasury report, industries that would be taxed at higher effective tax rates because of their many production and distribution stages, would seek, through the political process, to have the

[2]Richard A. and Peggy B. Musgrave, Public Finance in Theory and Practice, 4th ed. (New York: McGraw-Hill Book Company, 1984), pp. 434-436.

nominal or stated tax rate lowered for their products. This would result in a highly differentiated rate structure as various industries claimed, on equity grounds, that the effective tax rates they paid were too high. The report said that Hawaii, Washington, and West Virginia had experienced the cascading effects of gross income taxes and the resulting differentiation of rate structures. The report also pointed out that many European countries, because of the economic distortions created, repealed their turnover or gross receipts taxes for economically neutral consumption-type, value-added taxes in the late 1960s.

A Gross Income Tax Could Increase Tax Rates on Capital

Because it is a cascading tax, a gross income tax could increase marginal tax rates on capital. It could do so because capital goods, which are not physically included in the final product, would be taxed many times as their value passed through the successive production stages. The Treasury study showed that substituting a gross income tax with a 6 percent tax rate for the corporate income tax (1985 tax law) would raise the effective marginal tax rate on capital by about 33 percent. Including a 6 percent gross income tax on personal income would lower the marginal tax rate on capital somewhat, but it would still be 22 percent greater. Comparing the net income tax with a gross income tax, the study concluded that a gross income tax would be a greater disincentive to investment because it would not allow the deduction of depreciation.

A Gross Income Tax Would Increase Tax Burden on Lower Income People

A single-rate gross income tax allowing no personal exemptions or deductions would shift the individual income tax burden toward low-income people. The reason for this is that a proportional gross income tax would replace a progressive net income tax. The Treasury study estimated that individual taxpayers with an economic income below $50,000 would pay 57 percent more in taxes, while those with an economic income above $50,000 would pay 30 percent less. At the extremes of the income scale, those earning under $10,000 would pay 700 percent more in taxes, while those earning more than $200,000 would pay 60 percent less.

The Proposed Tax Would Not Be Efficient or Equitable

Because the proposed gross income tax, like all gross income taxes, is a cascading tax, it would be less equitable and efficient than the current tax system. A tax is considered efficient when it affects the economic allocation of resources as little as possible. On this basis, a gross income tax would be less efficient than a net income tax because it would discriminate more against saving and investment by increasing the marginal tax rate on capital. A tax is considered equitable if people with the same ability to pay are taxed the same, with "ability to pay" based on net income, which measures taxpayer contributions to the flow of income in society. Because firms with the same gross income would not necessarily earn the same net income, a tax on gross income would be less equitable than a tax on net income. Even firms that suffered a loss would still have to pay the tax on their gross income.

The lower efficiency and equity of the proposed gross income tax could potentially cause greater economic distortion than the current tax system. We therefore believe a gross income tax is not preferable to the current tax system even if complying with and administering it were shown to be less costly. The current tax system, however, with its exemptions and exclusions, is not perfectly efficient or equitable either. But, as we pointed out in a previous letter,[3] movement toward a comprehensive net income tax, which is basically efficient and equitable, would be a better alternative than substituting a gross income tax for the present system. Such a movement would involve continued broadening of the base and closing of loopholes to include more of net income in the tax base, as was done in the Tax Reform Act of 1986.

Administrative and Taxpayer Compliance Aspects

Proponents of the gross income tax system claim that administrative and compliance costs for individual wage earners would be reduced by 95 percent, for businesses by 90 percent, and for IRS by 70 percent. They also believe that the massive tax recordkeeping requirements would be reduced by 90 percent and the complexity of the tax system significantly reduced. Thus, they contend, resources used to meet the current tax system's requirements would be freed for production of more-needed goods and services.

To address these issues, we analyzed the studies done by CRS and the Department of the Treasury and discussed the issues with IRS officials. The CRS study, which reviewed an earlier version of the proposal we reviewed, said that complying with and administering the proposed gross income tax would probably be simpler and less costly. On the other hand, the Treasury study and IRS officials believed that the tax would not reduce the tax system's complexity or administration and compliance costs.

[3]Letter to Mr. Jim Bayless, Senator John Tower's office (GG9-116, May 2, 1979).

CRS based its analysis of the earlier proposal on the fact that several of its features resembled other taxes that are simpler to administer. Its study was issued before any analytical work on the structure and administration of the proposed tax had been done. The Treasury study, however, specifically looked at the structure and administration of gross income taxes, including the proposed tax.

Congressional Research Service Study

According to the CRS study, the earlier gross income tax proposal would reduce considerably the number of tax returns and taxpayers compared with the present tax system to the extent it was simply a multistage sales or turnover tax. However, CRS recognized that individuals who received income in addition to their wages or salaries would have to file a tax return. Because most individuals receive income other than wages, we believe the number of tax returns and taxpayers would not decrease by much, if at all.

According to CRS, calculating the tax would be simpler, particularly for service businesses whose gross income would be almost the same as their gross receipts because they would have few or no deductible expenses. A gross income tax would also eliminate many of the net income tax system's laws, regulations, and rulings, which mostly involve the determination of net income. And IRS collection and enforcement procedures were also thought to be simpler under a gross income tax. However, CRS pointed out that this type of tax usually involves more frequent audits because a great deal of tax is generated in even modest-sized businesses and because the temptation to cheat would be great. CRS, however, did not estimate the extent to which the proposed gross income tax would be simpler and less costly than the current tax system.

On the minus side, in addition to the tax's potential for economic distortion, CRS pointed out that a gross income tax would offer few advantages in the international area. It would be difficult to coordinate such a tax system with other countries, and all existing tax treaties would need renegotiation. Multinational corporations might be subject to double taxation or to some very complex rules for determining which transactions were taxed where.

Department of the Treasury Study

Because the Treasury study looked at all forms of gross income taxation, some of its findings and conclusions may not be fully applicable to the gross income tax proposal we reviewed. However, some of its observations on the administrative and compliance aspects of gross income taxes apply. For instance, it showed that several types of businesses would have difficulties in measuring gross income or gross receipts. These problems include how to treat interest for financial intermediaries, production for home use in agriculture, and imputed rental value of owner-occupied housing. The study concluded that because of these and other problems of definition and measurement, substituting a gross income tax for the current tax system would not reduce the administrative problems of income measurement.

The proposed gross income tax is a "pure" tax in that it is designed with no exceptions, exclusions, or special treatment of income from any source. However, the history of the net income tax is one of exceptions, exclusions, and special treatment. The Treasury study therefore pointed out that policymakers might wish to exclude some goods and services or economic sectors from a gross income tax or to tax them at different rates, as was done in Hawaii, Washington, and West Virginia. The reasons for doing so would be to reduce the regressivity of a gross income tax; free exports from the tax; or reduce, on equity grounds, the higher effective tax rates on industries with many production and distribution stages. These actions would add to the complexity of a gross income tax and increase its administration and compliance costs.

Discussion With IRS Officials

The views of IRS officials were based on their knowledge of how IRS functions rather than a formal analysis or study. They thought that the proposed gross income tax would not reduce the complexity of the tax system by much, if at all. Furthermore, the administrative and compliance costs of the tax system, in their opinion, would probably not be reduced at all.

Administrative Aspects

According to IRS officials, substituting a gross income tax for the net income tax would not reduce IRS costs. IRS would still need to maintain its return processing, examination, collection, taxpayer service, and other functions. Service centers would have to process even more returns and claims for tax grants than they do now, and the examination program would have to deal with new issues. In addition, claims for tax grants by individuals and businesses would frequently be subject to examination, and IRS would have to deal with the transition to a gross income tax system.

IRS officials questioned whether the number of individuals filing returns would decline; this would depend on the reduced number of returns from individuals with income only from wages who would not seek a tax grant compared with the number of returns from low-income people reporting income from other sources or income in kind. And firms, including exempt organizations, would still have to file returns. According to the officials, just including a return in the system imposes substantial costs on IRS in terms of processing, examination, and collection.

The proposed gross income tax would put all firms on a cash basis for tax accounting purposes. IRS officials do not envision that the examination or auditing function, a large category of IRS costs, would be reduced much under a cash basis gross income tax. Although one set of complexities would be eliminated from audits of large corporations—accruals and depreciation—other complex issues, such as timing and inventory, would remain.

In addition, under the gross income tax proposal, IRS would have new tasks. First, it would have to send all wage earners an annual statement of taxes received on their behalf, identifying employers, the amount and date of payments, and the employers' tax identification numbers. At the same time, IRS would have to send wage earners a list of all tax grants or credits for which they may be eligible and may submit a claim. IRS would have 6 weeks to process and pay such claims. If it chose not to audit the claims and paid the refund, it would be precluded from examining the claims after the 6-week period, even in the case of fraud. Thus, IRS would have to choose between establishing a significant audit program involving prerefund claims or tolerating a sizable area of potential or even probable noncompliance if it did not audit the claims.

According to IRS officials, the proposal would result in millions of claims for tax grants. In reality, processing these claims would take longer than under the current system. There would be about a 1-year lag before taxpayers received their IRS statement of wages and other income, along with the list of tax grants for which they could file a claim for refund. This is because IRS would have to process the information returns reporting wages and other income through a document-matching program. The computer file for document matching would not be completed until the end of the year following the tax year. Taxpayers would then file their claims for refunds, and IRS would begin processing them. Assuming that IRS elected to have a compliance program for these claims, many claims would be audited during the next year. Thus, claims would not be paid for well over a year from the end of the tax year, and audited claims would not be paid for at least 2 years. This means that for any given year, IRS would be processing two forms from taxpayers:

tax returns for the preceding year and claims for tax grants of 2 years ago. This scenario would be even more complicated during the transition period, when IRS would also be processing net income tax returns.

The transition to the proposed gross income tax would also place an overwhelming burden on IRS, according to IRS officials. According to the proposal, the gross income tax rate would be 1 percent during the first year. Taxpayers would file two tax returns—a gross income tax return and a regular income tax return. If the tax on the gross income tax return were less than the tax on the regular tax return, the gross income tax liability would be applied as a direct credit against the regular tax liability. For each succeeding year, the gross income tax rate would be increased 1 percentage point and the same process would be in effect. This would go on until the amount of revenue raised under the gross income tax equaled the revenue raised under the current tax system. After that, only gross income tax returns would be filed. IRS officials said that, in effect, all taxpayers would be filing two tax returns during the transition period and IRS would have to process and audit both of them.

The officials said that IRS does not have the computer systems or capacity to run two tax systems in tandem for what could be a 4- to 6-year period or to meet the requirement for paying tax grants within 6 weeks after they are filed. They said they would need a minimum of 4 years to design the necessary systems and procure state-of-the-art computers to carry out the tasks.

Taxpayer Compliance Aspects

IRS officials thought that most individual taxpayers would have a somewhat easier time under the proposed tax system than under the present system. However, many low-income people, who do not now have to file a tax return, would have to file one under the gross income tax system. In addition, people who receive income in kind, such as low- or no-cost housing, would have to include such income, valued at market prices, in their gross income and might have to pay a tax. This would pose collection problems for IRS because low-income people with in-kind income would not necessarily have the cash to pay a tax on it.

Firms and corporations would have to switch to cash accounting for tax purposes under the proposed tax. IRS officials thought businesses would still need to retain tax accountants and lawyers for tax planning. Although businesses would no longer have to compute depreciation for tax purposes, they would still have to keep depreciation records for financial accounting and other purposes. Thus, the savings in compliance costs for firms might not be large.

Adding to compliance costs and problems with the proposal, according to IRS officials, is the fact that tax-exempt organizations, including churches, would have to file returns identifying all income sources. This requirement would cause a significant compliance problem for IRS. Enforcing reporting requirements and verifying income and expenses would require additional resources, even though these organizations would be entitled to a refund. Audits would still be made and could result in reduced or disallowed refunds.

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

DEC 16 1988

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to comment on the draft report, "TAX POLICY: Economic, Administrative, and Taxpayer Compliance Aspects of a Gross Income Tax". As proposed, the Gross Income Tax does not appear to reduce IRS' administrative costs, nor would it necessarily reduce the paperwork or recordkeeping burdens for most taxpayers.

Under the proposal 75-80 percent of all current individual taxpayers would still have to file a tax return because they report income other than wages. Moreover, many if not most of the remaining 20-25 percent of current individual taxpayers would file claims for refunds for the "tax grants" that are provided for by the proposal. This assumption is based on our experience with the deduction for charitable contributions for nonitemizers. In Tax Year 1986, the last year the deduction was available, almost 28 million nonitemizers claimed this deduction.

Furthermore, adding to the total number of returns and claims that would have to be prepared by taxpayers and processed by the IRS are the new filers under this proposal. First, as proposed, there is no provision permitting joint returns. As of the end of April this year, 43.8 million joint returns had been filed for Tax Year 1987. Under the GIT, joint filers who both had wages would have to file separate returns. Second, many low income individuals receiving transfer payments would be required to file a return as would tax exempt organizations, including churches.

In light of the increased volume of returns and claims that would be filed, the Gross Income Tax does not appear to simplify tax administration including returns processing, examination of returns and collection of delinquent taxes. With respect to examinations, it would be impossible for IRS to examine all claims for refund within the six-week time frame provided in the proposal. If not selected for audit during this period, the proposal would preclude raising or adjudicating any issues relating to the claim for a refund of tax grants. It would also be impossible, with our current resources, to operate both the current processing system and the new processing system as required during the transition from a net income tax to a gross income tax.

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Finally, we would point out that the IRS is already in the advance planning stages of redesigning its tax processing system. Any major legislative proposals that would substantially change our current tax system by enacting new types of taxes should take this effort into consideration.

With kind regards,

Sincerely,

Larry Gibbs

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