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CHAIRMAN PACKWOOD'S PROPOSED EXCISE TAX AND TARIFF CHANGES

SUMMARY

Senate Finance Committee Chairman Packwood's proposed excise tax and tariff changes would intensify the seriously adverse economic effects of these taxes. These changes would impair productivity, cost jobs and income, and waste our economic resources.

Selective excises not only burden purchasers of the taxed products and services, even more seriously they distort the use of production resources, resulting in less productive use of labor and capital. Those supplying these production resources sustain losses in income and wind up in production activities in which they are less well rewarded in real terms. The entire economy suffers from the dislocations resulting from selective excises.

If implemented, Senator Packwood's proposal to tax alcohol, tobacco, and motor fuels on the basis of their prices rather than, as at present, on the basis of physical quantities would result in increases in these taxes as their prices rise. Under present law, the adverse effects of these taxes declines as the prices of the taxed items increase. This erosion of the economic disadvantages of selective taxes would be lost as a result of the proposed change.

By denying the deductibility of Federal excise taxes in computing a business's taxable income, the true rate of these excise taxes would be increased, thereby intensifying their adverse effects on the economy. At the same time, nondeductibility of these taxes would increase the income tax rate on the true net income of the affected businesses. Instead of contributing to attainment of a level playing field, ostensibly a major objective of the current tax reform effort, this change would riddle the playing field with tax differential potholes.

Even worse, the Packwood proposal would attribute taxable income at least equal to their excise tax liabilities to businesses even if they had no taxable income, indeed, even if they sustained substantial losses. Taxing phantom income would be the ultimate in an Orwellian 1984 tax policy.

The proposed excise changes would raise an estimated $77 billion in tax revenues over the first five years, offsetting a significant part of the revenue losses from tax rate reductions, increases in the personal exemptions, and other revenue-losing income tax changes. The proposed excise tax changes would be a major element in a tax redistribution program, with those supplying the labor and capital services used in producing excise-taxed items bearing additional taxes to provide lower taxes for others.

The proposed excise tax changes would be a large step backwards in tax policy. They should be deleted from the tax reform package.

Introduction

In the summary of his tax reform proposals presented on March 13, 1986, Senate Finance Committee Chairman Robert Packwood recommended a number of major and drastic changes in the present income tax treatment of excises. Chairman Packwood proposed to disallow the deductibility of all excises and tariffs by business income taxpayers; he also proposed to impose the excise taxes on alcohol, tobacco, and motor fuels on the value of these products, i.e., on an ad valorem basis, rather than, as at present, on the basis of some physical volume measure of them, i.e., on an ad rem basis, and to raise the rate of the excise on wine to make it equivalent to that now imposed on beer.

These measures would increase the revenues from excise taxes and tariffs by an estimated $77 billion over the first five years in which these changes would be effective. Roughly $62 billion would come from the excise taxes and about $15 billion from the nondeductibility of tariffs. These revenue additions would be among the largest of those proposed in the Chairman's tax reform package. Because that package is alleged to be revenue neutral over the five-year revenue projection period, these additional revenues presumably are to be used to help offset the revenue losses estimated to result from the proposed reductions in individual and corporate income tax rates, the increases in the personal exemptions and standard deductions for individual taxpayers, and from a number of other proposed income tax revisions. As a result, these additional excise tax and tariff revenues would be one of the major elements in effecting a substantial redistribution of tax liabilities throughout the U.S. economy.

Just as significant, this huge increase in excise and tariff revenues over the amounts that would be realized under present law during the revenue projection period would be a sharp reversal of the trend of recent years. For many years, Federal budget receipts from excise taxes and tariffs have accounted for a decreasing fraction of total Federal budget receipts. In fiscal year 1940, excise tax and tariff receipts were 32 percent of all Federal budget receipts. Excise tax revenues increased in absolute amount during World War II, both because many additional excise taxes were levied and because the aggregate volume of economic activity expanded rapidly under the wartime forced draft economic conditions. Excise taxes and tariffs contributed a sharply declining share of total Federal tax revenues, however, because the sharp increase in income tax liabilities very greatly exceeded the growth in excise tax revenues. Between fiscal years 1950 and 1985, Federal excise tax and tariff revenues have fallen from 19.4 percent of total Federal budget receipts to 6.6 percent. In the absence of the changes proposed by Chairman Packwood, the relative contribution of these revenue services, it is estimated, would fall to 4.4 percent in fiscal 1990. Chairman Packwood's proposed excise tax and tariff changes would bring this wholesome trend to an abrupt halt. Over the five-year projection period, his proposed changes would boost the share of total tax revenues accounted for by excise taxes and tariffs from about 5.0 percent to about 6.6 percent.

Against all significant criteria of good tax policy, the proposed excise tax and tariff changes would be a major step backward. The excise taxes and tariffs in the Federal revenue system are selective taxes; they are imposed at differing rates on selected products and services, rather than being levied at the same rate on all of the products and services produced and sold in the economy. As selective taxes, they have seriously adverse effects on the economy. The changes proposed by Chairman Packwood would intensify these adverse economic effects, impair the economy's growth, interfere further with the most productive use of our production capability, and result in less real wages and less of all other income throughout the economy, compared with the levels that would prevail if these excise tax changes were not enacted. The redistribution of tax burdens that would result from these tax changes would be substantial; there is no reason to believe that these shifts in tax burdens would conform with any acceptable standards of either economic efficiency or tax fairness. If the current tax reform effort is to extend its reach beyond the income tax, it should seek to reduce, if not completely eliminate, selective taxes, not to increase their weight in the Federal tax system.

The Basic Economics of Excise Taxation

Selective excise taxes are guilty of a number of serious fiscal and economic crimes. The outstanding attribute of a selective excise tax is that it raises the cost of the product, service, or activity on which it is levied relative to the costs of products, services, and activities not subject to such taxes. The consequence is that relative costs and prices differ from those that would be determined in the market place by the conditions of supply and demand. Selective excise taxes, in other words, distort the relationships among the market's valuations of goods and services.

These changes in relative market prices, in turn, lead to changes in the composition of output and of purchases. If one may appropriately assume that free markets provide price and cost information that leads to the most effective use of production capability and a composition of output that best and most economically satisfies our demands, then the price-and-cost-distorting effects of selective excises must result in a less effective use of our production capability and a less satisfying market basket of goods and services.

These relative cost and price distortions result because selective excises drive a wedge between the price a buyer must pay for a product or service subject to the tax and the price that the seller of the taxed product or service receives. An excise tax imposed on a product or service raises the cost of producing and selling any given amount of it. If the producer tries to raise the price of the product or service to cover this additional cost, purchasers will buy less of it. With a smaller volume of sales, clearly, total production of the taxed product or service must sooner or later decline. A smaller volume of output, of course, means that less production inputs are used by producers of the taxed products or services. As a consequence, total payments for production inputs decrease. Ultimately, the selective excise shows up in the form of higher market prices for the taxed product or service, a smaller volume of purchases of these products or services, hence a smaller volume of their output, less production inputs dedicated to their output, and reduced incomes to those supplying these production inputs.

A simple example may be helpful in understanding the incidence of selective excises. Suppose a widget manufacturer can produce 100 widgets at a cost of $10 per widget and requires a markup of $1 per widget to earn a profit sufficient to attract and maintain the capital resources needed for the most efficient, least costly production of 100 widgets. Suppose, also, that he can sell 100 widgets at a price of $11 per widget. If an excise of $1 per widget is levied on the manufacturer, raising his total production costs to $11, he would have to raise his price to $12.00 or reduce his markup. To the extent he raises his selling price, inclusive of the excise tax, above $11, he must be prepared to suffer a reduction in sales volume. Very likely, as he reduces his sales volume, his unit production costs will decline. At some lower volume, presumably, he will be able to sell that volume of widgets at a price sufficient to cover his production costs, his required markup, and the selective excise. Suppose that price is, say, $11.50, leaving him $10.50 after the selective excise is remitted to the government with which to pay for the labor and capital services, energy supplies, raw materials, etc., needed to produce, say, 90 widgets that people are willing to buy at a price of $11.50. The end result is that widget buyers now spend $1,035 on widgets instead of $1,100. Widget producers, however receive only $945 of the $1,035, the remaining $90 going to the government. There is now $55 less income --- wages, salaries, dividends, etc. --- available to those who participate in widget production.

Notice what the imposition of the selective excise has done. It has led widget buyers to cut their purchases and to reduce their total outlays for widgets, presumably allocating more of their incomes to the purchase of other products and services. It has also led widget producers to cut back on their output, hence on their purchases of the production inputs that go into manufacturing widgets; total payments by widget producers for these production inputs are also reduced. To be sure, the price of widgets has gone up by some fraction of the selective excise tax imposed on them, and widget buyers have been induced thereby to shift to some other market basket of products and services than the one they found most satisfying before the excise tax was imposed; for widget buyers, one must presume, the new market basket is somewhat less satisfying than the original one. But the major initial burden of the selective excise tax on widgets clearly has been borne by those supplying the production inputs to widget manufacturers.

In fact, the story about the incidence of the selective excise doesn't end here. Many of the production inputs used in manufacturing widgets may be more or less specialized in widget production, at least for some period of time. To the extent that the amount of these production inputs used in widget manufacturing is reduced as a result of the levying of the excise tax, they are likely to remain idle until they can be adapted to other production uses. The widget employees who are let go when widget output is reduced in response to the imposition of the excise may be out of work for some time until they acquire new skills or locate other jobs in which they can use their existing skills, albeit less productively than in widget manufacturing. In time, presumably, the production inputs released from widget manufacturing will be used in other lines of production. In some cases, this will occur only if the rates of payment for these inputs and for all of the inputs in these other production lines are less they otherwise would be.

As widget purchasers change the composition of their purchases, buying fewer widgets and a larger volume of other products and services, prices and volumes of output of these other products and services are likely to increase, requiring larger amounts of the production inputs used in their production. Of course, reallocating production inputs from one use to another is not costless. The costs of changing the use of production inputs should be included among the burdens of selective excises. Sooner or later, then, the selective excise on widgets also shows up in distortions of outputs and inputs and in incomes elsewhere in the economy.

Customs duties create similar distortions. These taxes make imported raw materials, imported manufactured inputs, imported consumer goods, etc., appear artificially expensive. Assuming that foreign suppliers are unwilling to absorb all of the tax themselves, the tariffs handicap American buyers -- producers and consumers -- by arbitrarily raising the costs of imports, denying Americans some of the advantages of foreign trade. American consumers are hurt when they buy imported products bearing tariffs because the tariffs tend to increase the prices of those products. Consumers will also be hurt when they buy American products that contain some imported inputs because the tariffs raise production costs; some part of this cost increase ultimately shows up in product prices.

The distortions of output and of input uses and the losses in consumer satisfactions that are imposed by the imposition of selective excises are serious and substantial economic burdens. Because of the use of selective excises in the nation's tax system, the economy's production capability is less productively used than it otherwise would be. Selective excises, in other words, are fiscal engines of waste. Wasteful uses of production inputs reduce the capacity of the economy to grow over time. In terms of the economic efficiency and growth goals of tax policy, therefore, selective excises should not be included in the nation's tax system except for the few cases in which they might conceivably offset structural deficiencies in the market system. Because those deficiencies are extremely difficult to identify and to measure, it is highly unlikely that selective excises appropriate for their correction could be designed with reasonable accuracy. There are, therefore, virtually no appropriate uses for selective excise taxes.

Selective excises taxes also rank very low in terms of the fiscal criteria of "good" taxes. For the most part, these levies escape the painful awareness by those who must ultimately bear their burden. But hidden taxes are, for the very fact of their obscurity, bad taxes. If taxes and tax burdens are to enter into democratically determined decisions about how much of the economy's production capability is to be made available to government, people must be aware of these taxes and painfully conscious of their burden.

Assessment of the Proposed Changes in Excise Taxes and Tariffs

Chairman Packwood's proposed revisions of excise taxes and tariffs should be evaluated in the light of the basic attributes of these levies and their assessment in terms of fundamental tax criteria. On these grounds, the proposals score very poorly, indeed.

Although little reliance need be or should be placed on the estimates of the revenue consequences of particular tax revisions, the magnitude of the estimated revenue gains from Chairman Packwood's excise and tariff revisions are surely strongly indicative of the severity of these proposed changes. Virtually on the grounds of these revenue estimates alone, one might well conclude that the proposed changes would significantly aggravate the economic disabilities of the present selective excise tax and tariff system. If the revenue gain of $77 billion over the five-year projection period is deemed to be a reasonable estimate, these proposed revisions would increase revenues from these sources by about 32 percent over the amounts projected for the period under present law. Increasing the average weight of these taxes by close to one-third is moving in the wrong direction in the light of any appropriate objective of tax reform.

Apart from this consideration, the particulars of the proposed revisions are themselves highly objectionable. Arguments may be advanced in the abstract for preferring either an ad valorem or ad rem assessment of selective excises. As a practical matter in today's fiscal and economic environment, the proposal to shift from an ad rem to an ad valorem basis for the excises imposed an alcoholic beverages, tobacco, and motor fuels should be seen as a means for obtaining higher tax yields from these products over time, insofar as their prices rise, without having to rely on explicit legislative enactment of higher tax rates.

When imposed on an ad rem basis, selective excises' effective rates decline, in real terms, as the market prices of the taxed products and services increase. This erosion of the real effective rates of selective excises serves to moderate their adverse economic consequences. By converting these taxes to ad valorem imposts, this reduction in their real effective tax rates is averted, and their adverse economic consequences are maintained. Considerations of tax requirements for economic growth and efficiency militate strongly against switching these taxes to an ad valorem basis.

As objectionable, indeed if not much more so, is the proposed repeal of the deductibility of selective excises and tariffs from gross income in determining the taxable income of business income taxpayers. Denying deductibility of these levies would increase their weight and their adverse economic effects

Excise taxes and tariffs, no less than wages, energy supply costs, capital costs, raw material costs, etc., must be taken into account as costs associated with the production and sale of the taxed products or services. No less than any other production and sales cost, excise taxes enter into a business' decisions about how much of what to produce and to sell at what prices.

The income tax imposed on business net income has always provided for the deduction of all costs incurred in the processes of production and sale, although, to be sure, the manner in which these deductions have been allowed has at times been changed and often has not accorded with the requirements of neutral tax treatment. But to deny the deductibility of excise taxes and tariffs would be to distort the measurement of the net income produced by a business just as much as would denying the deductibility of payrolls, raw materials, etc.

Present law quite correctly includes Federal employment taxes as part of employees' compensation and as payroll costs, fully deductible by the employer business in determining taxable income under the income tax. These employment taxes are, in economic terms, selective excises, virtually identical in their basic economic attributes to any other excise tax imposed by the Federal government. If there were any economic or fiscal justification for repealing the deductibility by a business of, say, the gasoline excise tax, there would be no less justification for repealing the deductibility by business of employment taxes. Repeal of employment tax deductibility would, obviously, have an enormously adverse effect on employment costs, on employment, and on labor income, as well as imposing wrenching distortions of the composition of economic activity. Repealing the deductibility of the Federal selective excise taxes would have very much the same sort of devastating economic effects, even if somewhat less severe in magnitude.

Because the excise taxes in the Federal revenue system are not applied uniformly to all production and sales of all products and services, but are, on the contrary, highly selective, denying the deductibility of these taxes would result in grossly differing effects among businesses. Businesses involved heavily in producing and selling products and services subject to selective excises, obviously, would find the net-of-tax costs of their operations increased relative to those of other businesses. The prices of their outputs would have to go up and the volume of their output would have to contract relative to that of other businesses, as would their employment of labor and capital services and other production inputs. Repealing the deductibility of excise taxes and tariffs in measuring taxable income for income tax purposes would intensify the distorting effects of these levies.

Nondeductibility of Excise Taxes: Effects on True Rates of Income Tax and Excise Taxes

	Present Law	Packwood Proposal: Income Tax Effect	Packwood Proposal: Excise Tax Effect
Gross Receipts	$100	$100	$100
Less: Cost of goods sold	55	55	55
Gross profit	45	45	45
Less: Other expenses	30	30	30
Excise tax:			
Actual	5	5	5
Equivalent	5	5	7.69
Deductible	5	-	7.69
Taxable income	10	15	7.31
Income tax @ 35 percent	3.50	5.25	2.56
Total taxes, actual	8.50	10.25	10.25
Income tax as percent of actual net income of 10	35	52.5	25.6
Excise tax as percent of:			
gross receipts	5	5	7.69
actual net income	50	50	76.9

Disallowing deductions for excise taxes and tariffs, moreover, would also increase the rate of income tax actually falling on business incomes correctly measured as net of all costs incurred in the production of that income. Equivalently, the repeal of excise tax deductibility would increase the effective rate of these excise taxes. These effects are highlighted in the hypothetical case summarized in the following table.

Repealing excise tax deductibility would raise the income tax liability in this case by 50 percent, from $3.50, under present law, to $5.25, or from 35 percent to 52.5 percent of the actual net income of $10. Total excise tax plus income tax liabilities would increase from $8.50 to $10.25. If deductibility of excise taxes were retained, the same increase in total tax liabilities would result if the excise tax were $7.69 instead of $5.00, or nearly 54 percent more.

The extent of these hidden income tax rate increases would depend, obviously, on the amount of Federal excise taxes and tariffs paid by a business in relation to its other costs of production and sales. In view of the very substantial differences in the extent to which differing businesses incur these imposts and in the weight of these taxes in their total costs, repeal of the deductibility of excises and tariffs would differentially increase from one business to another the actual income tax rates on correctly measured taxable income.

If the income tax is not to fall with differing weights on equally profitable business operations merely because of differences in the extent to which these businesses are exposed to selective excise taxes, taxable income must exclude these excise taxes (indeed, all taxes paid by businesses). Failure to exclude these selective excises from taxable income means that the income tax itself will intensify the distortions imposed by the selective excises.

Chairman Packwood's proposal to deny the income tax deductibility of excise taxes is confined to Federal excises. Excise taxes imposed by other governments in the United States presumably would continue to be deductible in computing business net income for Federal income tax purposes. Distinguishing between a selective excise imposed by a state government and an identical or similar excise imposed by the Federal government in terms of economic effects or the most rudimentary principles of tax fairness must boggle the mind. It is impossible to find any basis in reason for disallowing the deduction of excise taxes imposed by one level of government while continuing to allow the deduction of the same or similar taxes imposed by other governments. This is certainly not to suggest that the excise taxes imposed by other governments should be disallowed as well; even if reason, logic, and basic principles of taxation did not preclude this result, the new fiscal burdens that would be imposed on state and local governments by H.R. 3838 or Chairman Packwood's proposed modifications of that legislation should do so.

Much has been made during the current tax reform effort of the desirability of providing a level playing field in the tax treatment of businesses with differing kinds of operations, differing production inputs, differing time patterns in incurring costs and realizing incomes, etc. Many of the proposals that have been advanced with this purpose in mind would, to be sure, miss the mark; many, indeed, would tilt the playing field against saving and investment and riddle that playing field with the potholes of differing business tax burdens on the basis of the kinds of production facilities they use. But these misses, for the most part, are mischances, the results of failure to understand the effects of various tax provisions in present law and in the various reform proposals. The proposed disallowance of deductions for Federal excise taxes and tariffs can't be excused on these grounds.

By far the most radical, indeed, astonishing of the Chairman's excise tax proposals is the one requiring businesses to pay income tax at the top corporate rate on taxable income deemed to be at least equal to their excise tax liabilities, irrespective of the actual amounts of their net incomes. This presumably means that, merely by virtue of the fact that it is liable for payment of excise taxes, a company with a net operating loss, even one many times larger than its excise tax liability, would have to pretend that it had positive taxable income at least equal to the excise taxes it must pay and to pay income tax on this phantom taxable income. This imputation of taxable income and assessment of income tax liability where no taxable income exists is the Orwellian 1984 of tax policy. It could well serve as a disastrous precedent for more generally assessing tax liabilities without any reference to economic realities.

It seems clear that these proposed excise tax changes were advanced not in the interests of improving these levies nor in the interests of true reform of the income tax. They appear to have been advanced merely as devices for raising some substantial part of the revenues needed to offset the very large revenue losses that other features of the tax reform program would entail.

These revenue raisers, moreover, are presumed to be relatively painless; because they would not fall directly on individual income taxpayers as such but on business income taxpayers, popular resistance to these tax increases is probably deemed to be slight. The notion appears to be that only directly affected businesses would be injured by denying deductibility of Federal excises for income tax purposes. Although this is clearly not the case, although the economy as a whole will sustain the losses imposed by aggravating the distortions imposed by selective excises, these losses are not readily apparent and measurable by the average individual. The fact that they escape our awareness in no way abates the harmful effects of Chairman Packwood's proposals.

Some may attempt to justify raising the excise tax cost of the production and consumption of tobacco products and alcoholic beverages on sumptuary or health grounds. If a good case could be made for transferring responsibility from the individual to the government for determining how much of what kind, if any, of these products to consume, that fundamental decision surely should not be made in the shadow of income tax reform. If the Congress wants to raise the real rates of all of the present customs duties, it should face the issue of intensified protectionism openly and squarely, not slip it under the tax reform rug. If a case could be made for gearing motor fuels excise taxes to the market value of motor fuels, that decision deserves to be made on its own merits and in the open, not hidden from view by the overshadowing arguments concerning income tax reform and the most effective and desirable ways of financing the revenue losers in the income tax reform package.

In this connection, the issue surely should be forcefully addressed whether producers and users of the products and services now subject to Federal excise taxation and tariffs should bear so large and disproportionate a share of the burden for financing the rate reductions and other revenue losers in the income tax reform effort. Enhancing the real burden of selective excises and tariffs certainly cannot be justified on its own merits. Asking some part of the population to pick up the chips for others in order to provide tax reductions and to do so through the proposed excise and tariff tax changes amounts to a kind of mindless redistributive tax policy. Why should people who work in truck manufacturing, telephone communications, airlines, tire manufacturing, tobacco, alcoholic beverage, and other excise-taxed industries pay for the tax reductions of those otherwise employed? If tax policy is to be applied to the questionable assignment of redistributing income and wealth among the population, at least it should be done with some clear notion of who are to be the income transferees and who are to be the transferors.

Apart from these issues, the likely economic effects of the proposed excise tax and tariff changes should be given substantial weight in the evaluation of these proposals. As already urged, the proposed revisions, by increasing the true rates of the excise taxes and tariffs, and differentially increasing income tax rates, would significantly enhance excise tax distortions of relative prices and costs, of the allocation of production inputs among their alternative uses, and of the composition of total output and consumption. These distortions, although difficult to perceive, to identify, and to measure are nonetheless real; the higher the true rate of the excise taxes and tariffs, the more severe these distortions become.

For this reason, Chairman Packwood's proposed excise tax and tariff revisions would, if enacted, seriously impair the efficiency with which the economy would operate. Production activity would be less productively undertaken. The loss in productivity would show up not merely in displacement of employees from their more productive to less productive jobs, but in loss in employment, at least during the transition period, and loss in real wages. Because some of the selective excises rest on products and services used throughout the business sector, moreover, the increase in their true rates resulting from the proposed changes would tend to raise production costs very widely throughout the economy. The adverse effects of these increases in costs, though not readily apparent, would nevertheless be real and would be in the form of less output, employment, and real income than would prevail if these changes were not made.

However useful the purposes to which the additional revenues to be derived from these excise tax changes might be deemed to be, they surely should not be undertaken without a thorough assessment of the costs they would inevitably impose. These costs are not readily measured, but they would be incurred as a result of the enactment of the proposed changes. Against any relevant economic and fiscal criteria of tax policy, these costs are excessive. The proposed changes in excise taxes and in their income tax treatment should be rejected.

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