



Tax Reform and the Politics of Stealth

by Richard E. Wagner

The Treasury Department is undertaking a thorough study of the Federal tax system. The point of this study is to consider whether the Bush Administration should propose to replace our income tax with a consumption tax. There is much to be said in favor of this shift, in the abstract. Once we consider the details of political practice, however, there is much to be said for keeping a familiar monster rather than adopting an unknown one. We should always remember that when it comes to tax reform, political realists invariably trump fiscal philosophers.

With respect to fiscal philosophy, the argument in favor of taxing consumption is simple and direct. An income tax discriminates against saving. It taxes saving twice while taxing consumption only once. Suppose someone earns \$50,000 and is taxed at 30 percent. That person pays \$15,000 in tax and has \$35,000 available for personal consumption. For someone who spends the entire \$35,000 on personal consumption, tax liability is capped at \$15,000.

Someone else sets aside \$10,000 for saving. In the next ten years that saving returns \$1,000 per year in interest and dividends. Each year an additional \$300 of tax is paid. What economists and accountants call the present value of those additional tax payments is \$3,000. The person who saves \$10,000 from net income will thus pay \$3,000 more in tax on the same income than the person who consumes the entire net income.

It is easy to see why most fiscal philosophers prefer consumption over income taxation. Between two people who earn the same amount, the person who chooses to save more will pay a higher tax. This is what is meant by the double taxation of saving. A shift to consumption taxation can eliminate this double taxation.

Taxation always discourages whatever is taxed. The double taxation of saving discourages saving. Yet saving is central for economic progress. It is saving that provides the capital that makes possible the creation of new enterprises. These new enterprises, moreover, are a particularly dynamic part of our economy. Most of the public's attention may be placed on large, established enterprises, but the most robust dynamism within our economy has always resided with the relatively new enterprises.

We all know, however, that the devil is in the details. There are numerous details that would have to be addressed in any major tax reform. Those details are the province of the political realists and not the fiscal philosophers. Any effort at tax reform will surely be much more a monument to political realism than it will be testimony to the musings of tax philosophers.

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Consider the simple matter of tax rates. A flat rate tax of about 20 percent would collect roughly the same revenue as the present income tax. This would be a tax that excluded saving, but otherwise exempted nothing. Many people would clamor for some deductions. Interest on home mortgages would surely be a popular candidate. So would deductions for charitable contributions. Indeed, there are many candidates. To accommodate these clamors, rates would have to rise, perhaps to 30 percent or so.

Another source of clamor concerns the progressive rate structure of our income tax. If we were to shift to a flat-rate tax on consumption, it is easy to envision claims surfacing that some modest income tax should be retained to supplement a consumption tax, mostly to create some modest progressivity.

We would thus have two taxes where now we have one. This is hardly reform. It is rather a stealthy form of increased taxation. It is no accident that European nations have higher taxes than we do. They use both income and value-added taxes. Two taxes will invariably collect more revenue than just one of those taxes alone.

This might not happen immediately. But within a few years, total taxes will surely be higher if we have two taxes. Taxes may start slow, but they move in only one direction. Just look at what has happened to the Alternative Minimum Tax. This was created in 1969, in response to a finding that 155 people who had income in excess of \$200,000 paid no income tax because of the sizes of their deductions. The AMT was created to cover these few instances. It is now estimated that 36 million taxpayers will be taxed under the AMT by 2010. The AMT now has nothing to do with its initial justification, and everything to do with the added revenue that it collects.

There is a strong philosophical case to be made for taxing consumption at a rate that is flat and low. The Treasury Department may well eventually report proposals that reflect this philosophy, though this is necessarily only speculation. What is not a matter of speculation, though, is that if such a tax were created without simultaneously abolishing all vestiges of our income tax, including its AMT branch, our total tax burden would rise significantly in the subsequent years.

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