

Inching Away From Income Tax

'Value-Added' Levy Would Turn System Upside Down

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In the heart of the Treasury Department, their work deeply under wraps, tax-policy experts are hatching policy options for what could be the Bush economic team's first big idea: shifting the U.S. tax system away from taxing income, toward taxing consumption.

But taking what has long been an academic ideal and translating it into real-world tax policy would take a dramatic commitment of presidential leadership, a long education and political campaign, and a bipartisan convergence of political interests, tax-policy experts say. Few of them are holding their breath.

"It's true that you can write down a simpler tax system on paper than the one we have," said William G. Gale, a tax expert at the Brookings Institution and a critic of consumption-tax proposals. "But it's not necessarily true that you could get that tax system through the legislative system, or ensure it would stay that way once you did."

Officially, a year-long tax policy project at Treasury will merely present President Bush with tax-reform options, probably early next year. But economists and tax lobbyists close to the effort believe that Treasury Secretary Paul H. O'Neill is serious about elevating tax reform on Washington's agenda. If Congress is not prepared to act yet, at least the issue could underpin Bush's reelection campaign, they say.

Pamela F. Olson, the deputy Treasury secretary for tax policy, would only hint at where the project is heading when she said: "It is inherently difficult to measure income and becoming more so. There are just too many ways to minimize it."

On the corporate side, she said, a tax system that was formed 40 years ago, before the proliferation of international investment and multinational corporations, is ill equipped to track income in today's global economy.

The Treasury is looking at long-term proposals to scrap the corporate income tax and replace it with a value-added tax, which would work like a national sales tax on consumer and corporate purchases.

But, Olson said, policymakers realize that tax reform cannot simply be aimed at corporate taxation. Individuals must be included.

"You can't do one without the other," she said.

Taken to their logical conclusions, Olson's concerns indicate that the administration wants profound changes in a government revenue system that for a century has sought to measure the income of its citizens and corporations — from wages, sales, savings and investment — and tax them at prescribed rates.

“I think they're very serious,” said Sen. Charles E. Grassley (R-Iowa), the ranking Republican on the Senate Finance Committee.

Not everyone is convinced that the income tax system is growing untenable.

“There's no question that measuring income and taxing on the basis of income is becoming increasingly more difficult,” said Joel B. Slemrod, a tax economist at the University of Michigan. “What's not clear is the effort this administration is making to pursue income.”

The alternatives to an income-based tax system have been fought over in academic circles for years. Among Republicans, two camps emerged in the 1990s: those advocating a single flat tax rate on wages but no taxation on investment and savings, and those advocating a national sales tax to replace the tax on wages, investment and savings completely.

Both proposals would in effect shift the U.S. tax system toward one that taxes its citizens on money they spend, since the fruits of savings — interest, dividends from stocks and the gain in value of investments — would not be taxed. The United States is the only developed Western nation without a value-added tax. European nations have been able to lower income tax rates — but not abolish income taxes — with a system of value-added taxes that have steadily risen since World War II.

In theory, by radically simplifying the tax code and encouraging savings and investment, either tax system would significantly boost economic growth. Corporate resources now devoted to accounting and tax avoidance could go to more useful pursuits. The cost of investment capital would decline as increased savings expanded the pot of money available for lending.

That conclusion, though widely held by economists of all political stripes, is debatable. Slemrod studied the economic growth effects of the 1986 tax reform law, the last serious attempt to simplify the tax system, and found them to be marginal. In an economy so dependent on consumer spending, some economists fear that a shift toward penalizing spending could have horrendous consequences for short-run economic growth.

But the sanguine view was endorsed by key administration members, including O'Neill, White House economic adviser Lawrence B. Lindsey and Council of Economic Advisers Chairman R. Glenn Hubbard, long before they joined the administration.

“Knowing what goes on in the minds of the leaders at Treasury and the CEA, these people really understand the value of consumption taxes,” said Kevin A. Hassett, a conservative tax economist with close ties to the administration.

But both a flat tax and a national sales tax present profound policy and political challenges. A flat tax rate of 21 percent would be necessary to bring in the revenue now collected in income taxes, Gale said.

That would mean the tax rate for the most affluent taxpayers would fall from 38.6 percent, while the rate for millions of middle-income taxpayers would increase from 15 percent. If investment income were no longer taxed, the truly rich — who live largely on savings, investments and trust funds — could virtually avoid taxation, while the middle class would end up paying more. The notion of a progressive tax system, in which the rich pay a larger share of income than the poor, could be turned on its head.

For those in the 15 percent tax bracket, the effect probably would be a lot worse than a jump to 21 percent. Politically, it would probably be impossible to deny corporations tax deductions that they already can claim, particularly on research and development and on equipment investment. To grandfather those in, while collecting the same amount of revenue, the flat tax rate would have to be 23 percent .

Homeowners would clamor to maintain their mortgage interest deductions. Nonprofit organizations would insist on saving the deduction for charitable contributions, and businesses would insist that losing their deduction for health insurance costs would vastly increase the ranks of the uninsured. Saving those deductions would push the flat tax rate to 27 percent.

Suddenly, the flat tax would not be so flat or so politically attractive. Even that rate assumes Bush and congressional Republicans would sacrifice their hard-won tax deductions for having children, adopting children and supplying employer-sponsored child care.

“The problem is that the Republican attitude toward tax reform has fundamentally changed since they took control,” said Bruce R. Bartlett, a conservative economist at the National Center for Policy Analysis. “They are in the deduction game too.”

Similar arguments of tax fairness and burdensome rates would also dog a national sales tax. To produce enough revenue, the sales tax rate would have to be at least 25 percent. Without a federal income tax, states would probably have to drop their income taxes and add to their sales taxes, pushing the rate beyond 30 percent, Slemrod said. That would create huge incentives for retailers and consumers to push sales off the books and onto a black market. Again, poor and middle-income workers, who spend virtually all they earn, would be disproportionately saddled with the sales tax, since they would not have the luxury to avoid it by shifting their income into savings and investment.

Hassett suggested that the administration ultimately will embrace changes that would move the country toward a consumption-based tax system without actually declaring one. For instance, he said, Bush could propose allowing businesses to claim a one-time tax deduction for investments, rather than writing off the costs of investments over several years.

For individuals, Bush could propose unlimited, tax-deferred contributions to individual retirement accounts or 401(k) plans. Under that plan, individuals would be able to deduct from taxable income any wages, interest, dividends or pensions they saved or invested for retirement.

“If they just did those two things,” Hassett said, “it would be huge.”

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