



Tax Reform Doesn't Have To Be Radical To Be Effective

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President Bush's effort to fix the tax code would be much easier if all aspiring tax reformers would drop the academic argot about "consumption taxes" and other cant that serves only to confuse and mislead.

Everyone should also get over the false idea that "fundamental" tax reform must consist of either a national retail sales tax or a flat tax that allows no deductions for home mortgage interest, charitable giving or anything else. They should also get over the corollary notion that measures the quality of tax reform by the amount of trauma caused. The truth is otherwise.

Take, for example, the president's goal of simplifying the tax code. Without doubt, repealing the mortgage interest and charitable deductions would cause much traumatic disruption. But the simplification value of doing so would be essentially nil. These traditional deductions are not complicated. In addition, President Bush has pledged to preserve them.

Now, consider the goal of boosting economic growth by removing double taxes on saving, investment and export trade. This could be accomplished - as some suggest - by replacing the entire federal income tax with a 35% national retail sales tax - but why go to such an extreme?

Double taxation of investment can be eliminated much more simply and directly under the current code - in the case of business investment, by replacing depreciation with first-year expensing and, in the case of personal saving, by using the Roth IRA technique to exempt the yield on all aftertax savings.

There are several ways of eliminating the double taxation of export income under either the current corporate income tax or something quite similar. And just last year, in Resolution 705, the House of Representatives voted 423-1 in support of doing so.

Using a vocabulary borrowed from academic economists, tax reformers have created the widespread impression that fixing the tax code is a radical experiment that starts by replacing the "income tax" with something called a "consumption tax."

Defining The Term

Before jumping to conclusions, however, it helps to understand the lingo. And guess what! In the academic argot adopted by tax reformers, the "consumption tax" appellation means good things.

For one thing, it means a tax that allows businesses to expense the cost of capital equipment. It also means a tax that defers tax on the amount of income that a person puts away in savings or a tax that does not defer tax but, instead, exempts the yield (e.g., interest) on previously taxed savings.

By this surprise definition, the Roth IRA is a "consumption tax" to the extent that it exempts from further taxation the yield on a limited amount of previously taxed income contributed to the retirement account. And if tax reform were to exclude from further taxation the yield on all previously taxed savings (not just previously taxed retirement savings), then, poof, the existing federal "income tax" would all of a sudden become a "consumption tax."

"OK," most Americans would say, "I'm against double-taxing saved income the same way I'm against double-taxing consumed income. But why didn't you say what you meant to start with? When you said 'consumption tax,' I thought you were talking about some kind of retail sales tax."

Confusion - in this case, deliberate - has also obscured the true nature of the much talked about "value-added tax."

In reality, a tax on value added is a fairly ordinary business tax similar to our current corporate income tax combined with a payroll tax imposed at the same rate.

In popular mythology, however, everyone thinks that a VAT is automatically included in the price of consumer products - despite demand elasticities and other factors that greatly limit the ability of a business to stick customers with its own tax costs.

The myth about the VAT always being passed on in the price of products was created in the 1960s. The French had replaced their old business gross receipts taxes with a new tax based on a quantity (similar to net income) that was called "value added."

In an effort to gain a trade advantage, the French wanted to subsidize exports by rebating the tax to each business in proportion to its exports, but the tax treaty (now WTO) prohibited rebates except in the case of a tax on the exported product itself (the classic example being a tax on an exported barrel of whiskey).

To get around this treaty prohibition, the French asked the U.S. trade negotiators to join them in pretending that a tax based on value added, unlike a tax based on net income, always becomes part of the price of products and, therefore, that a proportionate part of a business's value added tax payments can be rebated to it when it makes an export sale.

To help the struggling French economy of the 1960s, and with the hope of gaining other concessions they wanted (but didn't get), U.S. negotiators agreed to the fiction.

The "VAT," as it came to be called, quickly spread around the world. So did the myth which, by now, has been repeated so often that most people actually believe it.

Myth Conceptions

Even though they know better, many scholars have perpetuated the myth in order to preserve the special status of exports under the VAT. Other academics have added to the confusion by referring to the VAT as a "consumption tax," not because they think it is a tax on consumers but, instead, because it allows businesses to expense capital equipment.

Even some members of the U.S. Congress have joined the conspiracy about the VAT, in the hope that the U.S. will sooner or later convert the existing U.S. corporate tax on net income into a tax on business value added, and thereby gain the ability to exclude U.S. exports from tax in the same way that our trade negotiators allowed other countries to do nearly 40 years ago.

The current corporate income tax is already quite similar to a business value added tax. The VAT allows a deduction for first-year expensing of business capital equipment and, if tax reform succeeds, so will the corporate income tax.

The two forms of tax are also the same in not allowing a deduction for dividends paid to shareholders. They do, however, differ in the treatment of interest. The corporate income tax allows a deduction for interest paid, but the VAT does not: Both interest and dividends are nondeductible. (Nondeductible dividend and interest payments are, however, supposed to be excluded from the income of shareholders and creditors as illustrated in a 1992 Treasury study.)

A U.S. business VAT would probably have a rate of only 8% to 10% compared to the current corporate income tax rate of 35%. On the other hand, unlike the current corporate income tax, a VAT-like corporate tax would allow no deduction for wages paid to employees and, absent some adjustment, would make labor more expensive for companies to hire. The most obvious way to compensate companies for not being able to deduct wages is to allow them a tax credit for the current 7.65% employerpaid OASDHI payroll tax on wages.

The federal income tax may or may not be replaced by a "consumption tax" and the base of the corporate tax may or may not be changed to "value added." But before any decisions are made, it is important fully to understand the choices in plain English.

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