ECONOMICS

The End of Income Taxes

by David A. Hartman

The tax cuts proposed by President George W. Bush take significant steps toward the reform of a federal tax code that retards growth of the capital stock, productivity, and incomes of all Americans. His plan to eliminate the death tax, increase expensing of investment for small businesses, end double taxation of dividend income, expand "returns exempt" taxation of IRA savings, and lower progressive rates on individual incomes are all welcome contributions toward a more efficient tax code. Yet even if it is enacted, the President's proposal will likely add more obstacles to comprehensive reform of the tax code because, once again, tax reform has been launched in a manner that defies economic and political priorities and realities.

The ultimate priority of federal tax reform is to increase savings for investment. To do so, however, by increasing the magnitude of our sizable federal deficit while failing to reduce spending would largely offset the net benefits of such a plan. It is far more effective to change *how* we tax—that is, to replace lost revenues with better-designed taxation. Tax neutrality is particularly important since the United States is engaged in a war with as-yet-unknown financial demands. And the incipient burden of the baby boomers' retirement requires greater national *savings for investment*, not increased federal *indebtedness*.

Since the private economy is mired in a protracted recession, the current priority should be to address tax reform to those areas where taxation is the chief problem. Remediation of the depression in formation of capital stock, depressed corporate income, the massive trade deficit of our uncompetitive manufacturing sector, and the flight of corporate headquarters overseas—which shrinks the compensatory trade surplus in corporate services—should be the targets of the President's reform efforts, yet his reform proposals only marginally address them.

The principal enemy of tax reform continues to be the spurious claim that tax cuts only benefit the rich. It does not seem to matter that the Kennedy and Reagan tax cuts showed definitively that reducing high marginal individual rates and lowering effective corporate rates stimulates growth of investment, output, and incomes for *all* Americans.

Though our liberal demagogues have failed to understand this, our OECD competitors have taken the message seriously and have relentlessly cut effective taxation on corporations and investment capital. At one time, the United States had the competitive advantage of the lowest corporate taxation in the world. Now, effective corporate taxation in the United States is close to the world's highest, and the ballooning trade deficit in manufacturing and the flight of U.S. corporations abroad are the direct consequences.

Tax-reform measures must address the political appearances of equity. All principal alternatives seek to alter the tax on either consumed income or consumption, excepting only the "necessities" as the basis for optimum equity, efficiency, and growth. In effect, any of these alternatives tax *investment savings only once*.

By comparison, the current tax code taxes a dollar when earned and saved or consumed; then, it taxes the returns to a corporate dollar invested (even before profits return the invested dollar); then, it taxes a previously taxed dollar of corporate profit received as a dividend or capital gain; and, finally, it taxes up to 55 percent of the remaining savings upon death. The ultimate goal of such a tax code is to discourage capital formation and productive incentives in favor of equality of incomes and wealth—which only occurs in a primitive society.

There are four principal candidates for tax reform. The first is the consumed-income tax, which taxes all income at the individual level only but defers taxation on savings for investment until consumed. The retail-sales tax taxes only consumption (including residential housing), thereby exempting savings for investment until consumed as well. The value-added tax, which proposes a levy on the difference between revenues and expenditures for goods and services, including capital investment (thereby exempting savings for investment until consumed), amounts to a consumption tax. Finally, the "flat tax" is a consumed income tax that amounts to a value-added tax at the corporate level and a "returns exempt" income tax for individuals, which exempts returns to capital (dividends, interest, and capital gains) in order to avoid double taxation.

The devil, however, is in the details. The consumed-income tax is paid (ideally, at a flat, instead of a progressive, rate) on all individual income, but savings for investment is tax-deferred until consumed. The retail-sales tax is assessed at the point of sale levied on retailers. The value-added tax is assessed upon all commercial and governmental entities. But the "flat tax" is assessed as a value-added tax on commerce, and the same flat rate on individual income taxes wages and salaries but *does not tax dividends, interest, and capital gains*. This is, in fact, tax symmetrical, but it is far too easy to call it an "unfair exemption of the rich."

In the early stages of the tax-reform movement, the "flat tax" designed by Professors Hall and Rabushka was favored by conservative and libertarian economists, probably because it was adopted by Republican House Majority Leader Dick Armey. The "Armey flat tax," however, never gained momentum. Under the direction of Grover Norquist, Americans for Tax Reform has enlisted five "caucuses" in the House of Representatives to promote "zero capital gains tax"; "end the death tax"; "abolish the alternative minimum tax"; "expense capital investment"; and "unlimited IRAs," as steps toward the flat tax. Curiously enough, a caucus to "end double taxation of dividends," the largest of the presently proposed tax cuts, was not created, nor was an "exempt interest" caucus.

The problem with the Armey flat tax, (as Steve Forbes' abortive run for the Republican presidential nomination in 1996 demonstrated) is that a code that proposes to tax Joe Lunchbucket's wages and Sally Steno's salary but not dividends, interest, and capital gains is a sitting duck for class warfare, whether or not it is a well-designed, efficient, and equitable substitute for the present inefficient and inequitable tax code. Both the flat tax and expansion of Roth IRAs (returns-exempt savings) pose the same problem.

Moreover, there is no apparent strategy to implement a stepwise reform of taxation that is tax neutral and, thus, able to avoid the increased deficits that will be produced by the Bush tax cuts. Thus, the new tax-reform movement is heading down a dead-end road. There is little evidence that the public will endorse a revolutionary all-or-nothing reform of federal taxation, financed by escalated deficits.

Our tax-reform gurus are trying to feed the wrong end of the horse. The corporate income tax is double taxation on corporate income. Consequently, the best way to accomplish reform is to *replace* the corporate income tax with a consumption tax, and the best candidate is a subtraction-method value-added tax. The value-added tax has the broadest tax base, resulting in the lowest rate for a given yield. Since it is territorial (it does not tax foreign income), it would make the United States the preferred location for international headquarters. By exempting exports and including imports, it would help close the trade deficit, since all other OECD competitors have value-added taxes. And by exempting capital investment, it exempts savings for investment, directly promoting the necessary growth of investment for increased productivity and incomes in general, and at the corporate level in particular. Best yet, replacing the corporate income tax with a value-added tax can accomplish this on a tax-neutral basis, without large deficits.

Many conservative and libertarian economists oppose a value-added tax on the grounds that, in Europe, it led to a runaway expansion of government. However, that was the result of imposing the value-added tax in addition to the corporate income tax instead of *replacing* the corporate income tax. Those who favor a consumption tax such as the VAT claim that the retail-sales tax is preferable, because it is visible. But the VAT can be legislated to be visible and results in lower rates than a retail-sales tax because of its broader base, since the value-added tax will include taxation of government, whereas a retail-sales tax will not.

A ten-percent value-added tax in the form of a business transfer tax that credits payroll taxes (replacing the 35-percent corporate income tax) would provide a sufficient surplus of revenues to convert the personal income tax to a 15-percent single rate. It could further provide the surplus necessary to eliminate all of the principal discriminatory features of the tax code as well—the "death tax," the alternative minimum tax, phaseouts of exemptions and deductions, the marriage and married parenthood penalties, and customs duties. The surplus could also be augmented by converting the earned-income credit to healthcare vouchers, providing relief for Medicaid spending. It could further convert the 15-percent single-rate tax to a consumed-income tax, allowing unlimited deferral of income tax on saving for investment until consumed. And all of this can be accomplished on a tax-neutral basis without added deficits.

Over the course of a decade, the increased growth of investment, output, and incomes plus broader definition of the consumed-income tax base could allow a ten-percent business-transfer tax and a ten-percent single-rate consumed-income tax. A 20-percent business-transfer tax, however, would achieve the same tax-neutral results. Who would not prefer to see an end to the IRS snooping into his income and assets as a result of ending the corporate and individual income taxes?

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WAR

Illusions of a Tidy War

by Andrew J. Bacevich

In the final days and hours preceding the current Persian Gulf war, reports extolling the dazzling information-age capabilities that American troops would take into battle against Saddam Hussein became a media staple. Newspapers, newsweeklies, and television vied with one another in enthusing about the latest in satellite-guided bombs, unmanned aircraft, and state-of-the-art digital gadgetry. The media coverage of the war's first hours and the spectacular air campaign that ensued reinforced these impressions.

The schematic versions of "today's battlefield" used to juice up these stories—elaborate graphics for print, animation on television, and, finally, video clips of the real thing—offered Americans a bowdlerized version of the "Revolution in Military Affairs." For the last decade and more, this RMA has been the subject of intense interest among defense experts. According to its advocates, the RMA is transforming the way that the Pentagon fights. In sharp contrast to the uncertainty, error, waste, and carnage that characterized combat in the industrial age, U.S. forces today wage war with economy and precision. For the United States, military power, once a blunt instrument, has become a scalpel. At least so the average citizen perusing the latest issue of *Time* or taking his cues from FOX News might reasonably conclude.

Whether intended or not, one effect of such reporting has been to reinforce popular expectations that war against Iraq would be brief, antiseptic, and decisive, producing clear-cut results at an affordable cost. To what degree did such expectations account for popular acquiescence in the plans to topple Saddam Hussein and, by extension, to implement a doctrine of preemptive war? It is difficult to answer that question with certainty. The effect was not trivial, however. We are a people of vivid imaginations and short memories. Among Americans willing to give the Bush administration a free hand, images of precision war are at least as important as their recollections of September 11.

Unfortunately, the expectations stoked by these images are illusory. The prospects of a tidy war producing a neat, tidy result are slight. Technology changes the way that soldiers fight, but it does not change the nature of war. That nature remains stubbornly rooted in politics, which is seldom given to tidy outcomes. The ongoing war in Iraq is unlikely to prove an exception.

Indeed, the experience of the 1990's—a decade in which U.S. forces time and again demonstrated their technological edge over all comers—warns against any such expectation.

For evidence, we need look no further than the previous Gulf War, touted at the time as a turning point in military history. A victory of seemingly unprecedented proportions guaranteed peace in the region and held out the promise of reducing America's own burdens as guarantor of the region's stability. At least so the elder George Bush promised.

In fact, Operation Desert Storm yielded few of its expected benefits. Instead, in its aftermath, the United States found herself drawn further into the morass of