The New Republic

GUIDE to the ISSUES

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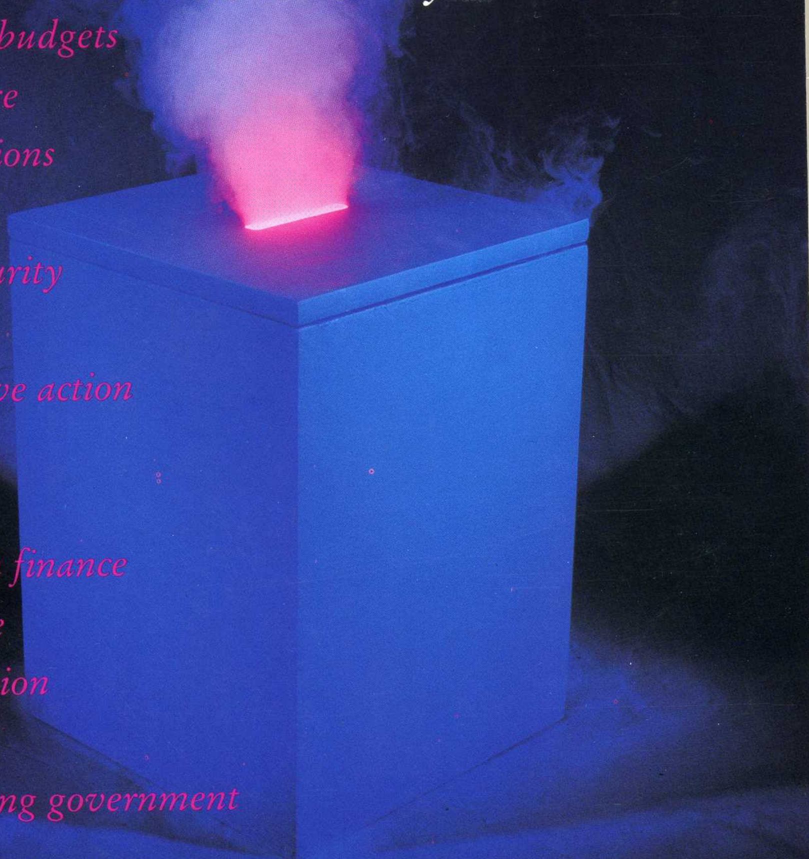
Introduction by Michael Lind



the '96 campaign

The New Republic Guide to the Issues

THE '96 CAMPAIGN

INTRODUCTION BY
MICHAEL LIND

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TAXES

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capital gains were indexed for inflation, and capi-
ble without limit, "gains and losses would balance,
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Flatliners

SHELDON D. POLLACK

SEPTEMBER 18 & 25, 1995

Ever since the Republicans embarked upon their radical, Contract with America-inspired agenda last fall, pundits have predicted that they would overreach themselves, creating a political fiasco and backlash. So far, on welfare, abortion, Medicare and the budget, Gingrich and company have proven the doomsayers wrong. But those battles pale before the one emerging over the future of the federal income tax. Right now, replacing the current revenue system with a flat tax is the GOP's hottest—and riskiest—idea.

The opening shots in this battle were fired even before the November elections. In the summer of 1994 Republican Representative Richard Armey of Texas introduced a bill (grandiosely titled "The Freedom and Fairness Restoration Act of 1994") calling for a "flat tax" imposed at a uniform 17-percent rate. Armey's proposal, modeled on the flat tax first advanced by Hoover Institution economist Robert E. Hall and political scientist Alvin Rabushka, didn't get much attention at the time. But that was before the November 1994 elections and before Armey became House majority leader. The once eccentric-sounding Hall-Rabushka flat tax has since emerged as a serious legislative proposal.

Of course, fringe "tax protesters" have long questioned the legitimacy of the federal income tax—notwithstanding the fact that the Sixteenth Amendment and the Supreme Court settled questions over its constitutionality more than eight decades ago. But lately Armey and his fellow Texan Bill Archer have brought the anti-income tax movement into the mainstream. From his pulpit as chairman of the powerful Ways and Means Committee, where all revenue bills originate, Archer has said that he wants to "rip the income tax out by the roots and throw it overboard."

On July 19, Armey (along with Richard Shelby of Alabama in the Senate) introduced a slightly modified rendition of the Freedom and Fairness Restoration Act in the 104th Congress. This latest version would phase in (over three years) a 17-percent flat tax on the wages and pensions of individuals earning more than $10,700 and of families earning more than $21,400. It would allow none of the traditional deductions or credits of the current income tax system except the one for dependents, and under the revised Armey plan the flat tax would be withheld from the wages and pensions of each individual taxpayer.

Businesses would be subject to the same 17-percent flat rate. Direct mailings by the business lobbying group Citizens for a Sound Economy proclaim the simplicity and "fairness" of the Armey-Shelby flat tax and boast that it would "reduce the individual income taxes of virtually all Americans." This is true, but mostly because the plan comes up around $200 billion short of revenue annually, compared to the current income tax system. Treasury calculates that a 25.8-percent flat tax would be needed to maintain current levels of revenue. Of course, at such a rate the flat tax would be a lot less attractive politically.

Though Armey's is the main flat tax proposal now before Congress, there is no lack of competitors. These days it seems that any congressional leader or would-be presidential contender needs only a few hours and some energetic staff members to draft an entirely "new" tax system. For example, last January House Minority Leader Richard A. Gephardt came out in support of a flat (or flatter) income tax, to be imposed at a 10- to 11-percent rate on all but the wealthiest 20 percent of American taxpayers.

Then, under pressure from leftist Democrats, Gephardt did an about-face and proposed five tax brackets with a progressive rate structure ranging from 10 to 34 percent. According to Gephardt's July 6 speech to the Center for National Policy, the revenue lost under his plan through the lowering of the top rate to 34 percent from the current 39.6 percent would be funded by drastically reducing "corporate welfare." This is familiar rhetoric. When pressed for details by reporters at his press conference for the proposed tax, Gephardt could only make vague references to going after corporations that avoid paying U.S. income tax by shifting income to foreign jurisdictions with lower income taxes. Lots of luck. Candidate Bill Clinton tried out such rhetoric. But as president he quickly learned that it's not so easy. Treasury has been investigating this complex issue for decades and still cannot come up with a scheme that works.

Presidential hopeful Arlen Specter, the moderate Republican senator from Pennsylvania, also jumped on the flat-tax bandwagon in what seemed

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an overnight conversion. The long-shot presidential candidate introduced a flat-tax proposal that lamely copies Armey's bill. The only feature of Specter's proposal that distinguishes it from Armey's is its retaining of limited deductions for charitable contributions and interest on a home mortgage.

The most radical and least understood aspect of all the flat-tax proposals is that they are really consumption taxes in disguise. The tax base of a "pure" consumption tax (the goal of the Armey plan) is an individual's annual income, less savings for the year. This is in contrast to an income tax that (to the dismay of most economists who want to promote savings) taxes annual income plus the return on capital (savings, for example). When you cut through the technical language, the end result is to tax an individual's net consumption for the year and exempt the return on capital investment (dividends and interest).

That might sound reasonable enough to economists, who bemoan the disincentives and inefficiencies that result from taxing the return on capital, but the effects of such a shift would be drastic. Savings—income not consumed—would no longer be taxed. Certain taxpayers, therefore, would benefit greatly. For example, wealthy individuals with high annual income but low consumption patterns (a rich miser such as the late Sam Walton of Wal-Mart or, perhaps, Bill Gates of Microsoft) would likely pay less tax under a consumption tax than under the current system—although their businesses would likely pay more.

Perhaps for this reason, a bill introduced by Senators Sam Nunn and Pete Domenici, as well as Senator Specter's bill, makes all kinds of exceptions to consumption tax principles so it doesn't look like their bills are taking from the middle class and giving to the wealthy. Most flat-tax proposals retain at least some of the most politically appealing features of the income tax—some progressivity, the deductions for home mortgage interest and charitable contributions, and the Earned Income Tax Credit. Still, a flat tax on the order of 17 to 20 percent will inevitably reduce the tax burden on the rich while increasing that of the middle class.

Most polls show widespread backing for a flat tax, but beneath this veneer of support lie powerful political constituencies who will fight it tooth and nail. Whole sectors of the national economy have grown up around, and depend upon, the kind of tax preferences that the flat tax would eliminate. Universities, museums and city orchestras all rely upon the incentives to charitable giving created by high marginal tax rates and deductions for contributions (for this reason, most flat-tax proposals have already caved on the issue and kept some limited deductions for charitable donations).

Then there's the housing industry, which won't be likely to sit still and bear the kind of blow that repeal of the deduction would inflict. Hall and Rabushka argue that the loss of the deduction will be offset by the lower costs of borrowing which should result from exempting interest payments from taxation. Of course, if interest rates really plunge, after-tax rates of return on investment will too, thus defeating one of the main justifications for adopting the flat consumption tax in the first place—creating added incentives for savings and investment.

Likewise, state and municipal governments won't be thrilled to lose the special tax treatment now afforded to interest paid on their bonds. Since all interest will be exempt from taxation under the flat tax, tax-exempt state and municipal bonds will lose their preference. This could result in as much as a 30 percent drop in the value of portfolios of tax-exempt bonds. The economic upheaval that could ensue should give conservative Republicans pause.

House Republicans are presumptuous in thinking they can remake so much of federal fiscal policy all at once. In repealing the income tax, they will be moving into uncharted waters—no one really knows what the impact would be on much of the national economy. The political danger for the GOP goes well beyond the familiar charge that they are coddling the rich.

All these objections aside, how would we actually switch to a consumption tax? That simple question is one that proponents of the flat consumption tax cannot answer. Since all current national savings have already been taxed under the present income tax regime, it would be necessary to exempt these amounts from taxation under the new tax. Otherwise, the savings of all taxpayers (those of Mom and Pop, for instance, who have accumulated their lifetime savings to get them through their retirement years) would be taxed a second time—this is essentially a consumption tax, remember—as they spend their savings in retirement. But any set of rules that would allow taxpayers to identify their pre-"reform" savings for some grace period under the old income tax regime would be a nightmare of complexity. And exempting so much of the national wealth from the consumption tax would obviate the very benefits the new tax regime is supposed to bring.

Boston University economist Laurence Kotlikoff, an ardent and well-respected proponent of a flat consumption tax, offers another reason why there should be no rules to avoid double taxation. Kotlikoff suggests that the older generation of taxpayers, who enjoy benefits far in excess of their contributions, has already reaped an economic windfall from the Social Security system. He has a point. Still, many people could be devastated by a double tax on their savings—and all out of proportion to the "excess" benefits they received in Social Security. In any event, the mere specter of riled-up seniors mobilizing their powerful political associations should be enough to dissuade members of Congress from embracing Kotlikoff's rough economic justice.

Will the 104th Congress pass a flat consumption tax? So far, few Republicans have raised much objection to the heady idea of abandoning the income tax system wholesale. But, as the flat tax proposals move beyond rhetoric into the congressional labyrinth, they will confront political reality.

A key figure in that confrontation will be Oregon Senator Bob Packwood. Packwood chaired the Finance Committee during the great tax reform effort of 1986. But he also contributed mightily to the distortion of the tax laws through countless special interest provisions, particularly those designed to benefit Oregon's timber industry. In 1986 Packwood was one of those (along with his counterpart on Ways and Means, Dan Rostenkowski) who took control of the radical tax reform movement generated by tax professionals in Treasury and sculpted it into a more moderate and politically viable package. He may do so again.

This past April and May, even before the Finance Committee began consideration of the House tax-cut package H.R. 1215, Packwood held hearings on the flat tax, with both Armey and Specter testifying in support of their own proposals. Packwood needs to appear supportive of the flat tax now, since the scandal-plagued senator can hardly be seen as blocking his party's hottest idea. But Packwood, who understands the tax system as well as anyone in the Senate, can see the danger that a flat tax presents, and he may work quietly to gut it.

During Packwood's hearings, Finance Committee Democrats Bill Bradley and Carol Moseley-Braun made the traditional liberal case against the flat tax, calling it "regressive" and focusing mostly upon the perceived benefits to the "rich" of a tax rate that is a uniform 17 percent (or 20 percent under Specter's plan), as opposed to the present 39.6-percent maximum. Such familiar rhetoric from Democrats will not by itself sink the flat tax. Only when—and if—conservatives themselves grasp the enormity and risk of restructuring the entire fiscal organization of post–New Deal government will the flat-tax bandwagon lose momentum. If they do not, the flat tax could very well become the Republicans' public policy debacle—the fiscal equivalent of the Clinton administration's ill-fated health care initiative. As Robert Reischauer, former director of the Congressional Budget Office, puts it: "It [tax reform] may look great from a mile away, but up close, it's a political minefield."

Reaganomics, RIP

MICHAEL LIND

NOVEMBER 13, 1995

Return, for a moment, to December 18, 1980. On that evening, David Stockman, who had been recently nominated to be director of the Office of Management and Budget in the Reagan administration, dined at the Century Club in New York with leading supply-siders, including Jude Wanniski and Lew Lehrman. According to Stockman's 1986 memoir, *The Triumph of Politics,* Jude Wanniski harshly criticized him for his assurances to Wall Street that the enormous Reagan tax cuts would be paid for by equally substantial budget cuts. Wanniski denounced this approach as "root-canal" Republicanism, defined as "threatening to heave widows and orphans into the snow." The supply-siders believed that massive tax cuts would pay for themselves, so there was no need to cut the budget in order to balance the deficit.

They were wrong, of course. The architects of Reaganomics preserved