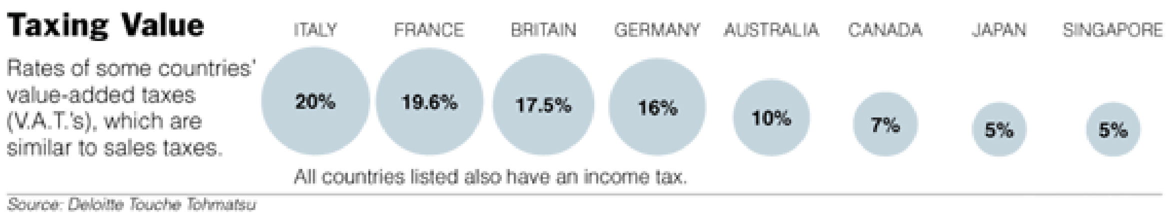
ECONOMIC VIEW

What if a Sales Tax Were the Only Tax?



The New York Times

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Published: October 17, 2004

REPRESENTATIVE JOHN LINDER, Republican of Georgia, is a man on a mission. He wants to replace the current tax system - or at least personal income and payroll taxes - with a national sales tax. When he brought this idea to the floor of the House of Representatives a couple of weeks ago, Democrats chided it as a pipe dream.

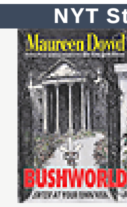
But in August, President Bush called it "the kind of interesting idea that we ought to explore seriously." From a taxpayer's perspective, it may indeed sound like a great idea: no more long instruction booklet to read, no more endless hours calculating the figures for every box on the form; you just pay at the cash register. Yet when it comes to designing such a new system, it's not quite as simple as it sounds.

Begin by assuming that the government needs just as much tax revenue, regardless of the system in place. Last year, the Internal Revenue Service collected about $1.7 trillion worth of individual income and payroll taxes.

Some of that money was returned as refunds. So, say that the government depended on those taxes to raise $1.5 trillion.

If every bit of spending in the economy were taxed - in other words, every one of the 12.2 trillion dollars paid by American consumers, businesses and the government for domestically produced goods and services - the rate would have to be about 12 percent. But hold on a second. Would the government really want to tax everything? Probably not.

For starters, having the government pay the tax on its own purchases wouldn't actually raise any money. Take out the government's spending, and the rate would have to rise to 15 percent.



In most states with sales taxes, food and clothing are exempt. The reason is to protect the poor. If a national sales tax lacked that exemption, poor people who pay no income tax (many actually receive a credit) would see their tax burdens grow substantially. In addition, the tax would be regressive. Because low-earning people spend a bigger share of their income than high-earning people, the low earners' taxes would be relatively higher.

So, say Congress made food and clothing exempt. That would carve an additional $1.4 trillion out of the tax base, and the rate would have to rise to 18 percent. Remember that food and clothing just became exempt for everyone, poor or not.

To take some of that money back, the government could try to give the exemption only to low-earners. But how would they be identified? Would they have to file - gasp! - a tax return reporting the previous year's income? Would the government distribute "I'm a low-earner" identity cards, to be shown sheepishly to cashiers? And how would the government prevent card holders from buying things for other people?

Putting those little problems aside, there are two other issues from the current tax system: housing and medical care.

At the moment, homeowners can deduct interest they pay on their mortgages from their income taxes. Without an income tax, this subsidy, long seen as part of what made the American dream come true, would disappear. Bringing it back, perhaps through direct grants, would require raising the national sales tax rate to 21 percent.

In addition, the current tax system subsidizes medical spending by allowing businesses to buy insurance for their employees out of pretax dollars. Many medical expenses paid out of pocket are also deductible from personal income tax. Would we want to eliminate these subsidies? Quite a few health economists would say yes, because it would discourage people from demanding care they didn't need. To keep the subsidies, the sales tax rate might have to climb to 25 percent.

THERE'S still one thing to account for, though: How would the new tax system affect behavior? Slapping a 25 percent tax on all the remaining purchases in the economy, by consumers and companies alike, might well affect spending. When the sales tax burden rises, prices at the checkout counter climb, but typically not by the complete amount of the tax; buyers and sellers share the burden.

For example, a 25 percent tax might lead to prices that are about 15 percent higher. That means a product that sold for $100 would sell for $115, including the tax. The flip side, of course, is that businesses would receive less revenue. Instead of getting $100 for that sale, a business would collect $115 minus 25 percent, or $86. Yet its costs would be the same, and it would still be paying the same corporate income tax.

That business might react by recognizing that its employees had just received a big increase in their take-home pay, from the abolition of the income tax. The business could actually cut salaries and still leave its employees with part of that raise from Uncle Sam. In fact, doing so might be the only way to make ends meet.

High-wage workers might find that any increase in the take-home price of goods and services would still be offset by their bigger take-home pay. But low-earners, who paid no income tax to start with, would find their budgets squeezed. So spending might actually fall, necessitating an even higher tax rate to support the federal government.

The national sales tax might have the upper hand in one area, however.

As part of its drive to create an "ownership society," the White House is chipping away at taxes on financial income and wealth. The estate tax is scheduled to vanish, taxes on dividends and capital gains have fallen, corporate income tax loopholes have grown, and proposals for enormous tax-free saving accounts would allow the sheltering of most portfolios.

All of these efforts point to a system that taxes only labor income like wages and salaries. Under this system, high-earning people might be able to shift their income into primarily nontaxed sources - for example, by taking their pay only in stocks, bonds and derivatives like options. With a national sales tax, at least, the top earners in the nation would have a much harder time avoiding taxes altogether.

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