

Bush Launches Stealth Attack on Income Tax Administration's Proposal Would Poison Roots of Tax

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Former congressional tax committee chairman Bill Archer liked to say that he wanted to "pull the income tax out by its roots" and replace it with a consumption tax or a flat tax, which is a consumption tax in disguise. He wasn't successful because the flat tax is patently unfair. It would slash taxes on the wealthy and create a shortfall that would necessitate sharply higher taxes on middle- and lower-income families.

President Bush is pursuing a different strategy: He wants to poison the roots of the income tax so it will collapse under its own weight. Then we'll have a consumption tax by default. It's a terrible way to make policy, but so far it's working.

Part of the poison is the growing complexity of the income tax. Read the Treasury Department's 12-page description of the proposal to eliminate dividend taxes for a taste.

But the killer toxin comes in the form of tax-free "savings accounts" and expansions of tax loopholes that are dissolving the income tax piece by piece. The president's new budget will feature two blockbuster items. It will create new "lifetime savings accounts," which will allow anyone to save up to \$7,500 per year tax-free for any purpose.

And it will more than double the contribution limit for tax-free Roth IRAs (now renamed "retirement savings accounts" or RSAs), from \$3,000 to \$7,500, and remove the income limits that had previously confined these accounts to middle-income families. Altogether, a couple could set aside up to \$30,000 per year in these tax-free accounts—\$3 million to \$4 million including interest over a working life.

Add these double-strength tax loopholes to the provisions already enacted or proposed—\$5,000 medical savings accounts, \$2,000 education savings accounts, college savings plans (so-called 529 plans) that allow hundreds of thousands of dollars of tax-free savings for education, and traditional pensions and 401(k) retirement accounts that were vastly expanded in 2001—and it's hard to imagine why anyone would pay tax on any savings.

Why is this poison for the income tax? Savings account for more than 40 percent of income for people with incomes over \$1 million. Many high-income taxpayers earn all their income from savings. Those coupon clippers would now pay no tax whatsoever if savings are exempt. Simple arithmetic suggests that tax burdens on the middle class will have to increase a lot if high-income taxpayers get 40 percent off their tax bills.

What's more, the latest proposals would be "paid for" by means of costly budget gimmicks. The plan would raise tax revenues in the near term by providing an incentive for taxpayers to convert traditional IRAs into the new RSAs. That scheme would increase tax payments now, but at the cost of much more lost revenue in the future. That is, we would be borrowing from our children and grandchildren on very unfavorable terms to them solely to mask the impact of these new policies on the deficit.

Some economists think a comprehensive consumption tax would boost economic growth, but the backdoor consumption tax that would result from the president's policies would surely stifle it. Leaving interest expense deductible while the returns to saving are tax-exempt is a classic recipe for tax shelters—purely tax-motivated investments that would never be undertaken absent tax incentives. Conservatives who think that the invisible hand maximizes economic well-being should hate this sort of sabotage.

In short, the president's strategy would produce a tax system that combines the inefficiency and complexity of a loophole-ridden income tax with the unfairness of the flat tax. At that point, the president might happily propose to reform the system by doing away with the last remnants of the income tax. That would be an improvement over the sabotaged system that is evolving. But it would still shift the tax burden away from those most able to pay it.

The income tax and the estate tax are the two most progressive elements of the federal tax system. Although Bush is trying mightily to eliminate the estate tax, at least that battle is happening out in the open. In contrast, the progressive income tax is being quietly poisoned in the bowels of the White House.

The antidote is fewer loopholes and less complexity—not more of the same.

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