



Flat Tax? Sales Tax? Value-Added Tax?

by Richard W. Rahn

THE GASOLINE TAX, CHARGING THE USER AS FAR AS HE GOES, MAY BE THE PERFECT TAX

What type of tax reform do you want? Simplification of the existing progressive income tax system? A flat tax? A sales tax? A value-added tax?

Tax professionals, economists, elected officials and others heatedly debate the pros and cons of each. However, it is unlikely that real tax reform will occur until the financial crisis gets so bad that most people will agree to radical change.

Most tax reform discussions and debates lead with the premise that any new tax system has to raise roughly as much revenue as the present system. Why should that be? Currently, the federal government spends about 23 percent of gross domestic product, and state and local governments spend approximately another 15 percent net of federal transfers. In 1948, federal and state governments spent roughly half as much of GDP as they do today. A hundred years ago, total government spending was less than 9 percent of GDP, and most was at the local level.

Evidence indicates that total government spending is at least twice as high as it should be to maximize job creation, economic growth and the general welfare.

Assume the United States has accumulated so much debt that bond buyers will no longer buy U.S. government bonds. Also assume that the present income tax structure has collapsed because of its size and complexity or that the Supreme Court returns to first principles and limits the federal government to doing only what is in the Constitution, leaving the rest to the states or the people (as specified by the 10th Amendment). Either way, the federal government might be forced to cut its real spending in half or more from today's 23 percent of GDP to the 1948 level of 12 percent. Under such conditions, what type of tax system should be set up?

The Founding Fathers explicitly stated that the purpose of government was to protect person and property and ensure liberty. It was understood that government should do only those things the people could not do for themselves. In other words, the federal government provides for the common defense, the federal court system and not much else. One reason there is so much waste in government spending is because there is little relation between how the money is spent and how it is raised.

The gasoline tax is an ideal tax. There is almost a perfect correlation between the amount of road use and the tax. Bigger and more road-damaging vehicles and those who drive more miles use more gasoline — almost the perfect user fee. Rather than using revenues from an income tax (economically destructive, costly to administer and liberty-destroying) to support government, why not use more excise taxes and user fees?

If politicians had to propose a specific tax or fee to support each government program they wanted, and if the tax had to directly relate to the spending, government budgeting would be sounder and less economically damaging. Most government programs could be financed by user fees or excise taxes on the programs' beneficiaries. Challenge yourself by looking at each government program and try to figure out how it could be funded without access to "general revenues," i.e. the income tax.

The biggest federal government spending programs (accounting for about half the budget) are Social Security, Medicare, Medicaid and other government retirement and health programs. These programs could be turned into sound insurance programs, using dedicated payroll taxes — unlike the Social Security tax, which is spent on other programs. Chile pioneered a privatized and extremely successful social security program, which has been adopted in part or whole by 30-plus countries. Likewise, medical entitlements could be turned into true insurance programs — with higher deductibles and co-payments for most people — and limited subsidies only for the truly needy.

Defense and the court system are the only truly significant "common goods" mandated by the Constitution. Many expenses of the court system could be funded by "user fees." Defense spending is to protect liberty, person and property (like fire and auto insurance). The "protection of liberty and person" portion could be financed by a low-rate sales tax, which all people pay in proportion to their spending, and the "protection of property portion" could be paid for by a surtax on state and local real estate and business property taxes.

The bottom line is if federal government spending were for only those things mandated by the Constitution and for things that people could truly not do for themselves, there would be no need for the highly destructive federal individual or corporate income tax. Without the liberty-diminishing income tax, a huge, deadweight loss would be removed from the economy, enabling it to grow far faster, thus reducing the demand for many income transfer and welfare programs. If states and localities wished to spend money on noncore, government functions, that would be their choice.

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