

■ A CONSUMPTION TAX

More Injustice For the Poor

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If Michael Dukakis wins in November, and if he heeds the advice of many liberal economists, he will introduce a tax on consumption in 1989. Indeed, *Fortune* recently forecast that regardless of who is inaugurated in 1989, "consumption taxes are almost inevitable." It is an odd policy for liberals to favor, as it will tax the entire income of poor and near-poor workers (who consume all that they earn), most of the income of the working class (which saves very little), but only a fraction of the income of the rich (who save considerably). In short, it is a regressive tax. How could liberals favor a consumption tax?

While I have heard liberal economists argue for a consumption tax on several occasions at the Brookings Institution, its potential role in 1989 became clear to me during last April's bipartisan meeting on the American economy, chaired by former President Jimmy Carter and President Reagan's Secretary of Labor, Ann McLaughlin. Presidential candidates George Bush and Michael Dukakis have each agreed that, if elected, they would consider the group's recommendations. The meeting included a typical cross-section of economists, chief executive officers, intellectuals and community and labor leaders. During the financial panel discussions, conservative economists argued adamantly for reducing deficits by further cutting public expenditures after the elections, and they opposed raising taxes. Liberal economists accepted many of the Federal expenditure cuts suggested by conservatives but sought additional ways to reduce the deficits. They proposed additional taxes, including one on consumption.

Along with their urgent concern about reducing deficits, the economists favor a consumption tax because they are worried sick about the low level of American saving. Economists reason that if people are penalized (with taxes) for consuming, they will presumably save more. Indeed, one version of the consumption tax would not only require Americans to report their income each year but also their total assets as of January 1 and December 31. Whatever income had not been used to acquire more assets (whether property, stocks, bonds or gold) would be assumed to have been "eaten up," and people would be taxed accordingly.

Everyone who took Economics 101 knows that consumption taxes are regressive, because the poor consume a far larger proportion of their income than the rich. But now

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liberal economists who favor a consumption tax argue that its regressivity can be overcome. A closer look at what they suggest shows that their remedies tend to be based on highly unrealistic assumptions, or else they only make a consumption tax less regressive than it might be otherwise. Most important, this type of tax must be considered in the context of other recent changes in the tax system: It would add insult to injurious modifications made by the Reagan Administration.

Rebates to the poor are one means that economists have suggested to make a consumption tax less of a penalty on the underprivileged and less of a party for the rich. A typical rebate strategy calls for all individuals (or households) to file a tax return regardless of whether they had any earnings. The poor would then receive an annual refund of all or part of the consumption tax they had paid. This way, economists claim, the poor would not be short-changed. The problem with this approach is that it assumes the poor will bank their annual refund and then use it at a few dollars a day to make up for the higher cost of milk, bread, health services and so on. But there is strong evidence from sociological and psychological studies that such annual refunds would be used for consumption sprees (a party, a flashy motorcycle); in this scenario, the poor would be forced for the rest of the year to buy fewer necessities, at an increased cost due to the consumption tax. If sent weekly, the rebate might work, but this would amount to an administrative nightmare whose costs would significantly reduce the revenues collected.

Thomas Vasquez, president of the Policy Economics Group and a former staff member of the Treasury Department who is not opposed to a consumption tax, notes that rebates "do not address the cash flow problem facing the taxpayers. The tax benefits would accrue generally at the end of the year, while the consumption tax is being paid currently." He also points out that only those who file tax returns will benefit; and for the poor (or any of us), preparing a return is no small task. Many poor individuals, unwilling to take on a burden that they do not face now, might not file a return, and thus never get their rebate.

Exempting basic items (food, shelter, health care) from the consumption tax is another common suggestion. This idea also has its difficulties. Economists correctly report that such a selective consumption tax would distort the economy because people would buy more exempt items. Further, it would only mitigate the regressivity of the tax, not overcome it. Poor and working-class Americans would still pay a tax on nonbasic items—say, clothing—that consume a larger proportion of their budget than that of the rich.

According to one calculation, the tax burden on those with income below \$10,000 a year would almost double if a \$50 billion consumption tax was introduced—an increase from the 0.57 percent of the total revenue these taxpayers now contribute to 1.02 percent. If basic necessities are excluded, the burden increases by "only" 63 percent, from 0.57 percent to 0.93 percent. Either way, the proportion of the tax carried by those who make \$50,000 per year or more decreases, with the greatest benefits going to those with an income of \$200,000 or more. This latter group currently pays 12.28 percent of all taxes; if a consumption tax is introduced,

it will pay only 11.7 percent (or 11.74 percent if basic necessities are exempt). Only a tax on jewels, yachts, stretch limousines and other such items referred to as luxury goods would reverse the pattern, but no one has suggested such a tax, either because of the relatively small revenue such a selective, narrowly based tax would generate or because it is far more risky, politically, to add tax burdens to the rich than to the poor. (Jesse Jackson's proposals for raising wealthy people's taxes were rejected out of hand by the Democratic Party, yet many of its economists favor a consumption tax.)

Still other economists suggest alleviating the regressivity by establishing varied tax levels on different items. Several European countries use this method: In Holland, for example, the tax is 4 percent on food, public transportation and medical services, and 18 percent on everything else. Italy has nine different rates. Aside from creating new administrative complexities and increasing the temptation to manipulate the system, these effects generally do make a consumption tax somewhat less regressive, although determining to what degree would require more information on the effects of the differential tax rates than we now have. For instance, how strong is the incentive for the affluent to circumvent such a tax when it reaches 38 percent on items dear to them, as in Italy?

A final suggestion has been to change the *name* of the tax, to call it a "business transfer tax," making it sound as if it taxes businesses rather than consumers. But merely hiding a regressive tax is unlikely to work; to paraphrase the old saying, you cannot fool all of the people for long periods of time.

In sum, a 1989 consumption tax seems unavoidably regressive and patently unfair. It would be bad enough anyway, but seen in the light of changes that have come

about during the Reagan era, it seems downright cruel. Few Americans realize how much more regressive the tax system has become over the past eight years — it has gone largely unnoticed beside the general awareness that tax rates have been reduced across the board. Many know that one low-income group has been exempt since 1986, which added a touch of progressivity, as did the closing of some loopholes. True also, corporate taxes, which were cut in 1981, were raised somewhat in 1986. But the Reagan Administration's significant increase in the level of payroll taxes (Social Security) and the proportion of total revenues that are derived from this source has greatly added to the unfairness of the tax system. Social Security taxes have always been very regressive because there are no exceptions: A poor family that earns only \$6,000 a year must pay the tax from the first dollar on up. Further, while the tax base has been widened somewhat, those with an income above \$45,000 do not pay Social Security tax on any earnings *above* that mark. If a person's income is \$50,000, \$100,000, \$1 million or \$20 million, that person will pay the same amount to Social Security as a person with an income of \$45,000. Thus, the *rate* is much lower for the rich.

Reagan, by cutting all other taxes but increasing the Social Security tax, has shifted us away from the relatively progressive income tax. The numbers tell the story: While Social Security provided only 5 percent of total Federal revenues in 1950, it now accounts for 27 percent.

Most recently, in July, Reagan extended Medicare benefits to cover catastrophic health care. The additional costs are financed by a supplemental premium, a 15 percent surcharge on income tax that will rise to 28 percent by 1993. This sounds like a progressive change until one realizes that the tax is capped at \$800 for now, increasing to \$1,050 by 1993. This means that while Americans earning below \$7,000 a year will pay their full share of the tax, those with an income of \$7,000 or higher will pay a smaller proportion — and the higher the income, the lower that proportion becomes. For example, for someone who earns \$70,000, it will be 1.5 percent, while the one who earns \$7,000 will pay 15 percent.

In short, given the way the total tax system has been tilted over the past several years, any person with even modest concern for the poor and for lower-income families must conclude that a broad-base consumption tax (one that covers more than luxuries) adds to the heap of injustices of the Reagan era instead of helping to correct some of the system's built-in regressiveness. □