CHAPTER VI. TAXING CONSUMPTION INSTEAD OF INCOME

Instead of encouraging private saving by selectively reducing or eliminating taxes on certain forms of saving, or by introducing the complexities of tax-base indexing for capital income, the Congress could do so in a comprehensive and uniform way by exempting all saving from taxation. Because disposable income must necessarily be put to one of two uses--either spending or saving--an income tax with a deduction for saving is a tax on consumption.[1] In fact, because much saving is currently exempt from tax, the current tax is not a pure tax on income but rather a hybrid tax, with some characteristics of an income tax and some of a consumption tax.[2]

This chapter describes briefly how a consumption tax would work, the arguments made for and against it, some of the problems in moving from an income to a consumption tax, and the possible effects of a consumption tax on the distribution of tax burdens.[3]

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1 Under this dichotomy, taxes and gifts must be categorized as either consumption or saving.

2 As explained below, under a pure consumption tax, tax would be due on borrowed amounts (and interest and principal payments would be deductible). The current tax differs from a consumption tax in this important respect. Some say that the steps that have already been taken in moving toward a consumption tax are the politically easier steps of exempting much saving from tax, while it may be much more difficult to obtain the political support needed to tax borrowing. For a technical analysis characterizing the current tax as a hybrid tax and describing problems with this halfway house approach, see David Bradford, "The Economics of Tax Policy Toward Savings," in George von Furstenberg, ed., The Goverment and Capital Formation (1980), pp. 38-50.

3 For more in-depth analysis of consumption taxation, see Department of the Treasury, Blueprints for Basic Tax Reform (January 17, 1977); Joseph Pechman, ed., What Should be Taxed: Income or Expenditure? (The Brookings Institution, 1980); Institute for Fiscal Studies, The Structure and Reform of Direct Taxation (1978) (called British Meade Committee Report); William Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 Harvard Law Review (April 1974),

History of Interest in a Consumption Tax. John Stuart Mill, Thomas Hobbes, Alfred Marshall, and Irving Fisher, among others, advocated taxing consumption rather than income.[4] Irving Fisher, for instance, felt that saving should not be taxed because it is only a means to achieve the ultimate objective of delayed consumption. By this reasoning, an income tax is unfair because it taxes saving twice. More recently, Nicholas Kaldor argued for a supplementary consumption tax in order to tax the excessive spending of the wealthy.[5] In the late 1970s, the governments of Great Britain and Sweden, and the Department of the Treasury in the United States all published comprehensive studies exploring the desirability and feasibility of a consumption tax.[6]

In spite of much academic interest, however, only two countries, India and Sri Lanka, have enacted consumption taxes.[7] In both cases, the taxes supplemented income taxes and were repealed shortly after enact-

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pp. 1113-1188; Alan Gunn, "The Case for an Income Tax," University of Chicago Law Review (Winter 1979), pp. 370-400; Statement of David F. Bradford before the Subcommittee on Monetary and Fiscal Policy of the Joint Economic Committee (August 19, 1982); David Bradford, "The Economics of Tax Policy Toward Savings," pp. 11-71; Committee on Simplification, Section of Taxation, American Bar Association, "Complexity and the Personal Consumption Tax," Tax Lawyer (Winter 1982), pp. 415-442.

4 John Stuart Mill, Principles of Political Economy (Clifton, New Jersey: Augustus M. Kelley reprint, 1973), Book V., Chapter II, Section 4; Thomas Hobbes, Leviathan (London, England: J.M. Dent & Sons reprint, 1934), p. 184; Alfred Marshall, "The Equitable Distribution of Taxation," in A. Pigou, ed., Memorials of Alfred Marshall (1925), pp. 347, 350-351; Irving Fisher and Herbert Fisher, Constructive Income Taxation: A Proposal for Reform (New York: Harper, 1942).

5 Nicholas Kaldor, An Expenditure Tax (Westport, Conn.: Greenwood Press, 1977).

6 Institute for Fiscal Studies, The Structure and Reform of Direct Taxation; Sven-Olof Lodin, Progressive Expenditure Tax: An Alternative?, A Report of the 1972 Government Commission on Taxation (Stockholm: Liber Forlag, 1978); Department of the Treasury, Blueprints for Basic Tax Reform.

7 See Richard Goode, "The Superiority of the Income Tax," in Joseph Pechman, ed., What Should Be Taxed: Income or Expenditure?, pp. 50 and 71.

ment. Consumption taxation has recently attracted attention in the United States following press reports that Martin Feldstein, Chairman of the Council of Economic Advisors, favors this kind of tax.[8]

MECHANICS OF A CONSUMPTION TAX

Cash-Flow Approach

A consumption tax which uses a cash-flow approach to taxation would be collected in much the same way as the current individual income tax. Each taxpayer would report all spendable cash received during the year, including wages and salaries, gross business receipts, dividends, interest, rents, borrowed money, and proceeds from sales of assets. He would then subtract amounts saved, including money deposited into savings accounts, purchases of stocks, bonds and income-producing assets, repayments of debt, and so forth, from these receipts. He would be taxed on the remainder, which is his consumption. This system is similar in broad outline to the way in which deposits to Individual Retirement Accounts (IRAs) are now treated--contributions are deductible when deposited but contributions and accumulated earnings are taxed upon withdrawal.

Despite the basic similarity to the current system of Individual Retirement Accounts, a true consumption tax would differ significantly, both in terms of the savings that would be deductible for tax purposes and the receipts that would be taxable. All forms of saving would be deductible, without limit. While the actual definition of saving would be an issue (particularly as to the inclusion or exclusion of collectibles such as antiques and jewelry), it would certainly include purchases of stocks and bonds, investments in businesses, and repayments of prior debt. There would be none of the current restrictions governing IRAs, such as ceilings on annual contributions or requirements that assets be held until retirement. Withdrawals could be made in any amount at any time and for any purpose, at which time they would be taxed unless reinvested.

On the other side of the coin, the definition of taxable receipts would be correspondingly broadened. All receipts of spendable cash would be taxed (unless they were saved). This would include the entire proceeds of sales of capital assets, instead of only the capital gains. Further, since borrowed amounts are available for spending, they would have to be included in the tax base, or else consumption would be understated. If an investor borrowed a sum of money and saved it, the deduction for saving

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8 "Why Washington Likes Consumption Taxes," Business Week (June 13, 1983), p. 80.

would offset the inclusion of the borrowing in the tax base, so there would be no net tax consequences. If the borrowed amount was not saved, it would have been spent and hence properly taxable. Unless borrowing was included in taxable receipts, taxpayers could omit the borrowing from their receipts and then take the deduction for saving the borrowed money, thereby obtaining potentially unlimited tax deductions for simply borrowing and lending.

As an example to compare a simple income tax with a simple consumption tax, suppose a taxpayer received in cash $20,000 in wages, $500 in interest, and $500 in dividends, for a total income of $21,000 in one year, and then invested $1,500 in bonds. Under a simple income tax with no exclusions and a flat-tax rate of 20 percent, the taxpayer would owe tax of 20 percent on the full $21,000 of income, for a total tax of $4,200. Under a similarly simple consumption tax, tax would be due on $19,500, which is the $21,000 of income, less the $1,500 saved. A 20 percent tax would yield consumption tax revenue of $3,900, for a federal revenue loss of $300. A 21.5 percent tax on $19,500 would be necessary to raise tax revenue of $4,200, the same amount as raised by the 20 percent income tax on $21,000. This consumption tax, then, would leave $15,300 available for actual consumption ($21,000 -$1,500 - $4,200 = $15,300).

Optional Prepayment Approach

The staff of the Treasury Department suggested in 1977 an optional tax accounting treatment to the so-called cash-flow approach just described.[9] Instead of allowing tax deductions for additions to saving and taxing in full withdrawals from saving, the alternate "prepayment" approach would ignore both ends of the transactions. No deduction would be allowed for new savings, and no tax would be due when savings and interest were withdrawn and consumed. (In effect, the tax due had been prepaid--hence the name of this approach.)

Under some circumstances, described below, the tax due on investment income would be the same under the two approaches, and giving taxpayers their choice of method would have some advantages. Tax accounting is clearly simplified if all transactions are ignored; taxpayers have the privacy of not having to divulge their holdings; and under a

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9 For complete discussions of the pros and cons of this optional treatment, see Department of the Treasury, Blueprints for Basic Tax Reform, pp. 122-131; and Michael Graetz, "Expenditure Tax Design," in Joseph Pechman, ed., What Should Be Taxed: Income or Expenditure?, pp. 167-182.

progressive rate structure taxpayers can essentially average their own taxes by judiciously selecting the type of treatment for different assets.

On the other hand, the optional treatment has come under attack because it shifts the perspective of the tax to one of opportunities rather than outcomes. Under the prepayment approach, tax would be effectively paid at the time of investment, since no deduction is allowed for the investment. If the discounted stream of returned equalled the price paid for the asset, this prepaid tax would equal the tax that would have been paid under the cash-flow approach. If an investor turned out to be lucky or had some reason to know that an investment would be extraordinarily good, the tax he would pay under the prepayment approach would turn out to be less than he would have paid under the cash-flow approach, which assesses tax on the basis of the actual after-the-fact yield of an investment. Thus, those who believe that tax should be assessed on the basis of outcomes rather than opportunities generally reject full optional prepayment treatment.[10] As explained below, however, they sometimes recommend prescribed prepayment treatment for the taxation of consumer durables, because returns from consumer durables (except housing) are quite predictable and small.

Tax Exemption of the Return to Saving

The return to most saving would not be taxed under a consumption tax. Investment returns would clearly be exempt from tax under the prepayment approach. Although no deduction would be allowed for the original investment, no tax would be due on either the yield or the original investment amount when withdrawn. Under the conditions for which the cash-flow and prepayment approaches are equivalent (see preceding paragraph), therefore, the return to saving would not be taxed under the cash-flow approach, either.

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10 Full optional treatment is also open to some tax manipulation, which would have to be carefully policed (just as some income is now reviewed for tax manipulation). Moreover, the equivalence between the two approaches breaks down when the Congress changes tax rates over the course of time or if bequests are not taxed as consumption of the deceased. The self-employed would have to be required to use the cash-flow approach; otherwise, they could elect prepayment treatment and avoid tax on their labor income by paying themselves minimal wages and having prepaid tax on unusually high profits.

Similarity to a Wage Tax

Since the return to most saving would essentially be tax free under a consumption tax, a consumption tax is sometimes likened to a tax on wages. Only under a restrictive set of conditions, however, is a consumption tax equivalent to a wage tax.[11] Unless the return to wealth held on the enactment date was exempted from tax, the base of a consumption tax would exceed the base of a wage tax. Moreover, an individual's annual tax payments would be the same under the two taxes only if by coincidence his income from capital equalled his net saving in that year. (Under certain circumstances, however, the present value of the stream of his lifetime tax payments would be the same under the two taxes.)

Similarity to a Sales Tax

When most people first learn about a consumption tax and how it would work, they think of it as a sales tax. In the above example, for instance, a 27.5 percent sales tax on final consumption goods and services would yield the same revenue and influence behavior in the same way as the consumption tax, with less administrative burden.[12] A sales tax could thus readily be substituted for a flat-rate consumption tax, but it would be far easier to structure a consumption tax to make it progressive and to grant low-income relief, to allow for differences in family size and circumstances, and to allow for tax averaging and special subsidies now delivered through the tax system.

FAIRNESS AND ECONOMIC EFFICIENCY

Whether income or consumption is a fairer base for taxation is widely debated. Some analysts feel that income is a better indicator of ability to pay tax, because all income represents power to consume or save. According to this school of thought, whether income is in fact saved or spent is immaterial; all of income could potentially be consumed, and it is

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11 The conditions necessary for equivalence are enumerated in Graetz, "Expenditure Tax Design," pp. 172-173.

12 In the above example, the $4,200 tax is 27.5 percent of actual consumption ($15,300). The two consumption tax rates are equivalent but expressed differently. The 21.5 percent rate is calculated on a base that includes both consumption and taxes. This is called the gross or inclusive tax rate and corresponds to the familiar concept of income tax rates. The 27.5 percent rate is calculated on after-tax consumption and is called the net or tax-exclusive rate.

the power to consume, not the consumption itself, that is the appropriate basis for taxation.

Others think that lifetime income is the appropriate base for taxation, measuring as it does the total capacity to consume. This group holds that annual consumption is a better proxy for average lifetime income than is annual income. According to this view, although incomes rise and fall, individuals try to smooth out their consumption over their lifetimes, borrowing in youth, saving in mid-life and drawing from their savings in retirement. Taxing these relatively smooth consumption streams would approximate taxing individuals' expected lifetime incomes.

Yet other analysts feel that it is fairer to tax consumption than income. They base their reasoning on several considerations: individuals should be taxed on what they withdraw from the common pool, not what they contribute; consumption is a better measure of ability to pay tax; or it is unfair to tax saving twice--once when earned initially and again when savings have earned interest.

Since consumption is usually greatest relative to income during youth and retirement, most people would pay more tax during those years and less during middle age under a consumption tax than under an income tax. Essentially a consumption tax is geared to a longer-run perspective of economic well-being.[13] Students with low incomes attending professional schools, for instance, who borrow for present consumption in anticipation of high future earnings, would be taxed at a higher rate during their youth under a consumption tax than under an income tax. Since people like these students are arguably better off than people of the same current income with no prospect of higher future incomes, some feel that the students should pay the higher tax that they would owe under a consumption tax.

Under a proportional consumption tax, the same amount of tax is collected from individuals with equal initial wealth and lifetime incomes, regardless of when they spend their money.[14] An income tax, by contrast,

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13 Income averaging can reduce the heavy taxation that otherwise occurs under a progressive income tax for people whose year-to-year incomes fluctuate widely. Averaging of an individual's income over many years is probably not feasible, however, for it would entail excessive recordkeeping. The choice is, therefore, between short-term income averaging and consumption as an imperfect measure of long-term income.

14 This holds true only if they earn the same return on their savings and give the same gifts and inheritances (or if gifts and inheritances are

even if proportional, taxes more heavily the person who saves to consume later in life than the person who spends early in life.

On economic efficiency grounds, arguments can be made for and against a consumption tax. Because a consumption tax does not tax saving, it does not distort the tradeoff between present and future consumption--that is, the after-tax rate of return to saving is the same as the before-tax rate of return. For example, suppose that the market interest rate is 10 percent and an individual has income of $100, which he can save or consume. If there were no taxes at all, his choice would be between $100 of consumption this year and $110 next year. Under a consumption tax of 50 percent (gross rate), he could consume $50 ($100 x .50) in the first year (and save nothing), or he could consume nothing in the first year, save $100 and consume $55 ($110 x .50) in the second year. The relative tradeoff between present and future consumption--a dollar of consumption in the first year versus $1.10 in the second--would thus be preserved under a consumption tax ($50 x 1.10 = $55). By contrast, under an income tax a dollar of consumption forgone in the first year would provide less than $1.10 consumption in the second year.[15] A consumption tax would thus lead to a gain in economic efficiency, because saving would not be discouraged as it is under an income tax. Most likely this would lead to a higher saving rate.[16]

Under current law, some kinds of investment and saving receive preferential tax treatment, so that tax rates on capital income vary widely. The economic distortions that result would not exist under a pure consumption tax, since the tax rate on all saving would be zero. This is a major advantage of a pure consumption tax.

On the other hand, much of the potential gain in economic efficiency from an idealized consumption tax would be lost if the Congress enacted

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taxed as consumption of the donor). It is not true of a progressive consumption tax (with graduated rates or low-income relief or both).

15 Under a 50 percent income tax, the tradeoff is between $50 ($100 x .50) in the first year and $52.50 ($50 x (1 + (.1)(.50))) in the second year.

16 As explained in Chapter IV, in theory an increase in the after-tax rate of return to saving may lead either to more or less saving. Although it would probably lead to more saving, no one is quite sure how much more, and additional domestic saving may flow abroad and therefore not result in additional domestic investment in plant and equipment and increased domestic productivity.

additional savings incentives or special tax breaks for investments in certain activities, or exempted from tax certain kinds of consumption, such as housing or political contributions. In addition, because the base of a comprehensive consumption tax would be smaller than the base of a comprehensive income tax, the average rate of a consumption tax would have to exceed somewhat that of a comparable income tax in order to raise equal revenue.[17] A consumption tax, therefore, would increase the rate of tax on wages and salaries spent on current consumption and impose greater distortions than an income tax on the choice between leisure and working to purchase current consumption goods and between untaxed fringe benefits and taxable consumption.[18]

Several new studies suggest that economic welfare would increase overall as a result of a change from income to consumption taxation.[19]

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17 The rate of a proportional (flat-rate with no exemptions) consumption tax, for instance, would probably have to be between 5 and 10 percent higher than the rate of a proportional income tax, since about 5 to 10 percent of total personal income is saved. According to the Treasury Department, a 14 percent proportional consumption tax with no exemptions or deductions would raise the same amount of revenue as the current individual and corporate income taxes combined. It estimates that the same revenue would be raised from a 13 percent proportional uniform income tax which integrated a comprehensive individual income tax and the corporate income tax with no exemptions or deductions. (John Chapoton, Assistant Secretary of the Treasury for Tax Policy, Testimony before the Senate Finance Committee (September 28, 1982), p. 4.)

18 The rate of tax on wages and salaries put into saving would drop to zero under a consumption tax.

19 Alan Auerbach, Laurence Kotlikoff, and Jonathan Skinner, "The Efficiency Gains from Dynamic Tax Reform," Harvard Institute of Economic Research Discussion Paper No. 870 (December 1981); Don Fullerton, John Shoven, and John Whalley, "Replacing the U.S. Income Tax with a Progressive Consumption Tax: A Sequenced General Equilibrium Approach," National Bureau of Economic Research Working Paper No. 892 (May 1982). Fullerton, Shoven, and Whalley calculate the welfare effects of moving from the current income tax, which they characterize as a hybrid consumption/income tax since about half of saving is currently exempt from tax, to eight alternate tax systems. They range from a pure income tax with integration of the corporate and individual taxes, to a pure income tax without integration, to income taxes with varying percentages of saving

Another study came up with roughly the same result for a model of the United States in isolation, but when the model was adapted to allow foreigners to invest in the United States and Americans to invest abroad, a move to a consumption tax was found to decrease American welfare overall.[20]

OTHER ADVANTAGES AND DISADVANTAGES OF A CONSUMPTION TAX

A consumption tax would solve some of the most difficult problems with the current income tax, neither help nor hinder others, and create some new problems of its own.

Integration of Corporate and Individual Taxes

A true consumption tax would in and of itself resolve the issue of integration of the individual and corporate taxes by eliminating the corporate tax. Individuals would deduct investments in corporate stock and be taxed on all earnings from the stock. Distributed dividends would be

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exempt from tax, to consumption taxes with and without integration, and with and without subsidies for housing. Moving from the present system further toward a consumption tax (by exempting more and more saving from tax) improves welfare, with the greatest improvement coming from the pure consumption tax coupled with repeal of the corporate tax (equivalent to a one-time cash grant to the country of about $1.3 trillion, or 2.7 percent of the discounted present value of all future national income). Although welfare drops in the first years following enactment of a consumption tax, welfare increases enough in later years to more than make up for the drops in the first years, so that from a long-term perspective the welfare (in discounted present value terms) of households in all income groups increases.

20 Saving by Americans would increase upon enactment of a consumption tax, driving down the before-tax rate of return to investment in the United States and as a result reducing investment in the United States by foreigners. Some of the increased saving by Americans would be invested abroad. (Lawrence Goulder, John Shoven, and John Whalley, "Domestic Tax Policy and the Foreign Sector: The Importance of Alternative Foreign Sector Formulations to Results from a General Equilibrium Tax Analysis Model," paper presented at the National Bureau of Economic Research Tax Simulation Conference (January 1981).)

taxed unless reinvested by stockholders, and retained earnings would be reflected in higher stock prices and hence taxed in full upon sale of the stock for consumption. Abolition of the corporate tax would eliminate the double tax on dividends and thus end both the present tax discrimination against incorporated businesses and the current bias favoring debt rather than equity financing. Corporate income would be taxed only once and at the rate applying to the stockholder who was the ultimate beneficiary of the income, rather than to the corporation.

Although complete integration of corporate and individual taxes has long been considered desirable by many economists, it has never been implemented, partly because of the administrative difficulty of doing so within the framework of a graduated-rate income tax. On the other hand, some feel that a separate corporate income tax should be retained as a tax on the privilege of doing business as a corporation with limited liability or because the corporate tax makes the overall tax system more progressive.[21] Any degree of progressivity can be achieved instead through graduation of the rates of a consumption tax, however. If the corporate income tax was abolished, not only would the tax rates on consumption have to be high enough to generate the revenue of both the individual and corporate income taxes, but the top marginal rates would also have to be quite high to replicate the current degree of progressivity.

If the corporate tax was retained, it could be kept in its present form, but instead it would probably be fashioned after the consumption tax treatment of self-employed business income. Tax would be imposed on all cash received from the sale of goods and services, less the cost of all labor and other inputs purchased during the year. Expenditures on plant and equipment would be deducted (expensed) in full in the year of purchase, rather than depreciated, and the full proceeds of the sale of plant and equipment would be taxed. Similarly, the full cost of production inputs would be deducted in the year purchased, making it unnecessary to keep track of inventories of these items for tax purposes as is done now.

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21 Arguments for retaining a corporate income tax are presented in Richard Goode, "The Superiority of the Income Tax," pp. 66-67; The Institute for Fiscal Studies, The Structure and Reform of Direct Taxation, pp. 227-258; and Paul McDaniel's comments in What Should be Taxed: Income or Expenditure?, pp. 291-292. Repeal of the corporate income tax in this context is advocated by: Department of the Treasury, Blueprints for Basic Tax Reform, p. 133; Testimony of John Chapoton before the Senate Finance Committee (September 28, 1982), p. 19; and David Bradford, Statement before the Joint Economic Committee (August 19, 1982), pp. 15-16.

Resolution of Some Accounting Problems

If the corporate income tax was eliminated, there would be no need for corporate tax accounting. Moreover, the self-employed would deduct costs of goods, plant, and equipment in the year purchased, so the difficult problems of accounting for depreciation and inventories under an income tax would no longer exist.[22] Defining and measuring capital gains would no longer be a problem, since proceeds from the sale of all assets would properly be included in full in the tax base. Therefore, taxpayers would no longer have to keep records over many years of prices paid for assets. Moreover, it would be unnecessary to attempt or approximate accrual taxation of capital gains.

As discussed in Chapter III, pension income (and to a more limited extent life insurance earnings) is afforded favorable tax treatment under current law, partly because it is so difficult to determine the extent of an individual's claims prior to distribution. The appropriate treatment of life insurance and pension income under a consumption tax is easy to implement and no different from that of other investments: full deductibility of contributions and full taxability of withdrawals and distributions.[23]

Accounting for Inflation. As discussed in the last chapter, making the necessary accounting adjustments to index an income tax fully for inflation is extremely complicated. These inflation accounting problems would not be at issue under a consumption tax, because all tax accounting would be done on a current basis--that is, consumption would be measured in current dollars each year as the difference between cash inflow and cash devoted to saving.[24] Like investments in stocks and bonds, capital

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22 So as not to discriminate against investment in education, tuition, and other educational fees should also be immediately deductible under a consumption tax, just as they should be capitalized and deducted over a number of years under an income tax. In both cases, however, education expenses should in theory not be deductible if they are made solely for enjoyment rather than to increase a person's earning potential.

23 The appropriate consumption tax treatment of life insurance proceeds is part of the larger question of the taxation of gifts and bequests. This is as complicated an issue for a consumption tax as for an income tax. It is discussed thoroughly in Graetz, "Expenditure Tax Design," pp. 200-207.

24 To avoid bracket creep under a consumption tax, however, it would be necessary to take the relatively simple steps needed to index bracket

purchases would be deducted in the year made (expensed, rather than depreciated). Proceeds from sales of appreciated assets would be included in full in the tax base, with no adjustment for inflation-induced nominal gains, because their potential consumption value would be measured by the purchasing power of the dollar prevailing at the time of sale.[25]

Existing Problems Not Solved by a Consumption Tax

Certain problems with the income tax--such as the inherent difficulties of choosing the unit of taxation (family or individual), and of taxing fringe benefits and the consumption made possible through nonmarket work and poor tax compliance in certain areas--would remain under a consumption tax. In fact, compliance could worsen. Individuals would stand to gain more from some noncompliance, since if they did not report the sale of assets, they would avoid tax on the full proceeds, rather than on just the capital gains.

The tendency of the Congress to enact special tax incentives and preferences might not abate, and in addition there would be new pressure brought to bear to exclude certain kinds of consumption from taxation.[26]

Taxation of Consumer Durables. The theoretically correct tax treatment of consumer durables, most notably owner-occupied housing, would be somewhat easier to implement under a consumption tax than under an income tax. As explained in previous chapters, the current tax preferences for owner-occupied housing have caused overinvestment in housing. Taxing the consumption from housing would put investment in

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widths and personal exemption and standard deduction amounts.

25 If an individual wanted to maintain the real value of his capital, he would have to reinvest (and deduct) the portion of his nominal return that represented the inflation premium.

26 Since consumption is included in the base of an income tax, similar pressures are brought to bear to exclude certain kinds of consumption from income taxation. Under the current tax, for instance, large medical expenses, moving expenses, and political contributions are deductible or allowed tax credits. When India and Sri Lanka enacted consumption taxes, they allowed exemptions for many kinds of consumption, including political campaign, marriage, and funeral expenses. (Nicholas Kaldor's comments in What Should Be Taxed: Income or Expenditure?, p. 156.)

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housing on an equal footing with other types of investment and hence the allocation of economic resources. At the same time, of course, it would increase the taxes of homeowners. There might, therefore, be support for exempting housing expenses from a consumption tax.

Under a pure consumption tax, the purchase of a house would be treated just like any other investment. The price of the house would be deductible in the year of purchase, and the imputed or implicit rental value, net of expenses, included in receipts during each year of ownership, along with the full sale proceeds in the last year.[27] The amount of tax that would be collected under this cash flow approach could, however, be roughly approximated by ignoring the transaction altogether, as in the so-called prepayment approach described above. In this way, the practical and political problems of imputing rental values would be avoided.

Under the prepayment approach, the tax deduction for the initial house purchase would be denied and the imputed consumption and the sale proceeds would not be taxed.[28] So as not to impose an enormous tax liability on most homeowners in the year of home purchase, the prepayment approach would have to be carried through to the tax treatment of mortgages. Rather than including the entire mortgage in receipts in the year of purchase (and allowing deductions for mortgage interest and principal payments), the mortgage proceeds would not be taxed, but no deductions would be allowed for payments of mortgage interest and principal.

As an example of the prepayment approach, suppose that a couple bought a house for $80,000 with a 20 percent downpayment of $16,000 and a 30-year, 15 percent mortgage for the remaining $64,000. Because under this approach the loan amount would not be included in receipts and the house purchase price would not be deductible, in the first year the couple would be taxed on the $16,000 downpayment, which is the cash spent but

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27 The deduction for the price of a house in the year of purchase would often be offset partly by inclusion of the full amount of the mortgage in the tax base in that year. Nevertheless, some taxpayers would have such a large net deduction in that year that their taxable consumption would be reduced below zero. The Congress could permit taxpayers to carry forward unused deductions to future years.

28 The prepayment approach departs significantly from the cash-flow approach if a homeowner's tax rate changes greatly during his ownership tenure--either because of a progressive rate schedule or because of legislated rate changes--or if housing prices rise or fall substantially counter to general expectations.

not allowed to be deducted. In future years, the $9,766 annual payment of mortgage interest and principal would similarly be taxed as cash spent but not allowed to be deducted. The sale proceeds would not be included in receipts, and no deduction would be allowed for retiring the outstanding mortgage. If the house was sold five years later for $90,000, for instance, the $27,117 received in cash after paying off the remaining mortgage would all be available for consumption without any tax due on it at that time. (In effect, the tax due had been prepaid.)[29]

IMPLEMENTATION PROBLEMS

The most difficult problems in implementing a consumption tax would stem from the transition from an income to a consumption tax, the international complications of changing the U.S. tax system, and the potential for greater concentration of wealth.

Problems of Transition

One serious question in moving to a consumption tax from the current income tax is how to treat consumption from wealth existing on the date of enactment, when that wealth had been accumulated from income that might have been fully taxed, partially taxed, or not taxed at all under the income tax. Wealth accumulated out of pretax dollars, such as that in individual retirement accounts, poses no problem, since it would be treated in basically the same way under a consumption tax as under the current income tax: it would be taxed in full upon withdrawal for consumption.

There are two basic approaches to dealing with wealth accumulated out of income that had been taxed under the income tax.[30] Under the first approach, called the "prepaid" approach, consumption from wealth held on the date of enactment of the new tax would go untaxed. Since much

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29 Some advocate taxing the real gain on housing in this context, as an ad hoc correction for the prepayment approach's intrinsic failure to measure properly consumption during periods of unexpected relative price changes. In this example, assuming there had been no inflation, this would entail taxing the $10,000 difference between sale and purchase price.

30 For discussions of the problems of a transition to a consumption tax and the two approaches discussed here, see Department of the Treasury, Blueprints for Basic Tax Reform, pp. 204-212; and Graetz, "Expenditure Tax Design," pp. 261-275.

consumption would be tax exempt under this approach, tax rates on the remaining consumption would have to be commensurately higher. Moreover, many wealthy people would be able to support themselves indefinitely from their stock of existing wealth and hence pay no consumption tax, perhaps for their entire lifetimes. Under the income tax, tax would have been due on the income earned on existing wealth. Upon enactment of a consumption tax under the prepayment approach, the after-tax yield on assets would increase immediately, conferring windfall gains on asset owners because additional wealth could accumulate much faster than under the income tax. Those holding wealth on the date of enactment would thus suddenly find themselves in a much better financial position compared to those whose earnings come only from wages and salaries and who consume all or most of their income each year.[31]

Under the second approach, all existing wealth would be included in receipts in the first year of the consumption tax, so consumption from that wealth would be fully taxed. This approach would require taxpayers to divulge their net worth on the transition date. Taxpayers would have an incentive to conceal their wealth in order to finance tax-free consumption in later years, and even if they did report all of their wealth, doing so would impose a large one-time administrative cost on the taxpayers themselves, financial institutions, and the IRS. In addition, it might be considered unfair to tax consumption from wealth that had been saved from previously taxed income. The total federal tax burden of people now retired and those about to retire, for instance, would exceed what they had expected, and they would have little opportunity to compensate through added work or saving.[32] The added tax due under this approach in the early years following enactment, however, would be gradually offset (and eventually more than offset) by the tax exemption of the return to saving that is inherent in consumption taxation. Sixteen years after enactment of a consumption tax, for instance, a 50 percent bracket taxpayer who had earned a 10 percent return on his savings would be able to finance more consumption after-tax under the consumption tax (even though his wealth had been taxed as an initial receipt in the year of enactment) than under

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31 Eventually, the flow of additional dollars into saving would reduce yields on savings, and the concomitant additional investment would increase workers' productivity and hence wages, possibly leading to somewhat higher after-tax wages than under the income tax.

32 On the other hand, current retirees are, as a group, receiving a very good return on their contributions to the Social Security system, and savings accumulated in pension programs, IRAs, and Keogh Accounts have not yet been taxed.

the income tax.[33] Those not needing to tap their savings for a long time, therefore, would not be adversely affected by this kind of transition rule. To ease the transition for the elderly who would be hard hit by this approach, large personal exemptions for the elderly could be enacted for a temporary phase-in period.

Although each of these approaches to the transition has serious problems, other alternatives would probably be too complex to be practical. One such complicated alternative was suggested by Treasury Department staff in 1977.[34] They proposed taking the prepaid approach but requiring taxpayers to calculate their tax under both the consumption and income taxes and pay the higher amount each year during a ten-year transitional period before the income tax was eliminated entirely.

Just as with imposition of a comprehensive income tax, imposition of a consumption tax would reduce the wealth of those owning assets that currently receive preferential income tax treatment. Also as with a comprehensive income tax, policymakers would have to decide whether and how to tax income that had accrued but not been taxed under the income tax. For instance, capital gains that had accrued but not been realized and hence not taxed should, in theory, be taxed on the enactment date of a consumption tax. To do so would be extremely difficult administratively, however.

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33 At the end of 15 years, \$100 invested in a 10 percent account would have grown to \$208 if the return was taxed annually under an income tax at a 50 percent rate (\$100 x $(1.05)^{15}$ = \$208). If the \$100 were treated as an initial receipt under the consumption tax, and then reinvested, it would grow to \$418 at the end of the fifteenth year (\$100 x $(1.10)^{15}$ = \$418), and after payment of a 50 percent consumption tax, \$209 would be left for consumption. After 15 years, the potential consumption out of accumulated wealth would be greater under the consumption tax than under the income tax. If the market interest rate was 4 percent instead of 10 percent, it would take a much longer time--36 years--for the accumulated earnings under the consumption tax to exceed those under the income tax. Moreover, those at or close to retirement on the enactment date would probably not live long enough to recoup the loss. (Example modeled after example in Blueprints for Basic Tax Reform, p. 207.)

34 Department of the Treasury, Blueprints for Basic Tax Reform, pp. 209-210.

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International Problems

Some international problems would arise because no other country taxes individuals exclusively on the basis of their consumption.[35] It would be difficult, for instance, to prevent people from earning income in the United States and retiring elsewhere to consume it.[36] Likewise, it would seem unfair to require resident foreigners who had earned their income in a country that taxed income to pay tax on their consumption here. In addition, it would be extremely difficult to renegotiate the many tax treaties with other countries.

Wealth Accumulation and Concentration

Under a consumption tax, people who could and did save large portions of their incomes would pay less tax than under an income tax. Therefore, they would find it easier to amass sizeable holdings. Further, those who had already accumulated wealth could reinvest their investment earnings without having to pay tax. Although enactment of a consumption tax might cause all taxpayers to increase their savings and wealth, many tax analysts believe that the distribution of wealth would change, and that wealth would become more concentrated. To offset any growing concentration, the consumption tax could be supplemented by a substantial tax on gifts and estates. Some supporters of a consumption tax argue, however, that estate and gift taxes run counter to the rationale for a consumption tax.

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35 Some countries, do, however, rely heavily on value-added taxes. The effective tax rate on income from capital now varies widely from country to country. In the United Kingdom, it is only about 4 percent, for instance, compared to about 36 percent in Sweden, 37 percent in the United States and 48 percent in Germany. (Mervyn King and Don Fullerton, eds., "Comparisons of Effective Tax Rates," in The Taxation of Income from Capital: A Comparative Study of the U.S., U.K., Sweden and West Germany, Discussion Paper 38 (Princeton University, Woodrow Wilson School of Public and International Affairs, December 1982), Table 17.1.) For a complete discussion of international problems and possible solutions, see Graetz, "Expenditure Tax Design," pp. 248-255.

36 A tax on emigration could be imposed if this were considered a serious problem. Moreover, most Americans would probably not consider leaving the country simply to save tax. In fact, currently Americans can avoid income tax more easily by simply moving their assets to tax havens (Ibid., p. 254).

DISTRIBUTION OF THE TAX BURDEN UNDER A CONSUMPTION TAX

A consumption tax could be designed to be as progressive as desired--progressive, that is, with respect to consumption, the base of the tax. If saving rates (as a fraction of income) by income class were known, a consumption tax could also be designed to be as progressive as desired with respect to income. Unfortunately, little reliable data exist on individuals' saving patterns, so any attempt to design a consumption tax with any given degree of progressivity relative to income would be only an approximation.[37]

Even with these limitations, when the Treasury Department outlined a proposed consumption tax in 1976, it used the data available to design a rate schedule that would maintain, as closely as possible, the amount and distribution of the liabilities of the then-current income tax.[38] The rate schedule designed consisted of three brackets with marginal rates of 10, 28, and 40 percent for joint returns. The base of this consumption tax, while of course smaller than the base of a comparably comprehensive income tax, was 23 percent larger than the combined bases of the corporate and individual income taxes at that time.[39] This was, therefore, a comprehensive consumption tax; many items (such as charitable contributions) would have been taxed even though they are not taxed under the current income tax.

To the extent that the Congress enacted special tax preferences under a consumption tax, rates would have to be that much higher to compensate. Even though a consumption tax can be designed to preserve roughly the overall distribution of the tax burden, many individuals would find themselves losers or gainers. In a given year, within any given income group, those who saved a large portion of their income would gain, and those who spent a large portion would lose. More generally, those who consumed early in life would lose, while those who saved and consumed late in life or left large estates would gain.

The Congressional Budget Office (CBO) made a rough attempt to update the Treasury work in this area. With the same basic goals in mind,

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37 This would not be a serious problem if consumption was chosen as the tax base precisely because it was thought to be the fairer base. In that case, the goal would be progression with respect to consumption rather than income.

38 Department of the Treasury, Blueprints for Basic Tax Reform.

39 Ibid., p. 169

but replicating the total revenue yield and income distribution of the current tax system in 1984 (including fully phased-in provisions of the Economic Recovery Tax Act), rate schedules for a broad-based consumption tax and a narrow-based consumption tax were devised. Under the broad-based tax, no itemized deductions would be allowed and nominal capital gains would be taxed in full. The rates on consumption under this tax would range from 10 to 35 percent, in five brackets, as shown in Table 17.[40] Table 16 also shows the rates that would be required if current tax law, with its narrow tax base, were maintained but all savings were deductible. In this case, rates would have to be higher, ranging from 10 to 60 percent.

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40 Like the Blueprints rates, these rates are "gross" or "tax inclusive" rates (see footnote 12 for a definition of gross tax rate).

TABLE 17. MARGINAL CONSUMPTION TAX RATES AND TAXES DUE BY INCOME (TAX RATES DESIGNED TO MATCH PROJECTED 1984 CURRENT LAW REVENUES AND DISTRIBUTION OF TAX BURDEN)

	Broad-Based Consumption Tax[a]		Narrow-Based Consumption Tax[b]	
Taxable Consumption (In dollars)	Marginal Tax Rate[c] (In percents)	Tax Due at Bracket Bottom (In dollars)	Marginal Tax Rate[c] (In percents)	Tax Due at Bracket Bottom (In dollars)
0- 2,100	10	0	10	0
2,100- 4,200	10	210	10	210
4,200- 8,500	10	420	10	420
8,500- 12,600	15	850	25	850
12,600- 16,800	25	1,465	30	1,875
16,800- 21,200	30	2,515	40	3,135
21,200- 26,500	30	3,835	40	4,895
26,500- 31,800	30	5,425	50	7,015
31,800- 42,400	30	7,015	50	9,665
42,400- 56,600	30	10,195	50	14,965
56,600- 82,200	35	14,455	50	22,065
82,200-106,000	35	23,415	50	34,865
106,000-159,000	35	31,745	55	46,765
159,000-212,000	35	50,295	60	75,915
212,000 +	35	68,845	60	107,715

SOURCE: Congressional Budget Office.

a. Taxable consumption equals adjusted gross income under current law less personal exemptions and zero bracket amount, less estimated net saving, plus excluded portion of nominal long-term capital gains. Estimated saving rates range from -217.0 percent of gross income for those below $2,000 of income to 31.8 percent for those above $50,000, with an average of 11.3 percent. (The average saving rate nationwide is lower than 11.3 percent because it is based on the saving of all Americans, including the many low-income people whose saving rates are very low and who do not file tax returns.)

b. Taxable consumption equals taxable income under current law, less zero bracket amount, less estimated net saving.

c. Gross or tax-inclusive rate.